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Small Cap Strategy

Key Takeaways

- ▶ The Strategy outperformed its benchmark as strong stock selection in health care and consumer discretionary sectors overcame detractors in financials.
- ▶ The first quarter's retreat in tech and the outbreak of trade wars weighed particularly hard on small caps, generally thought to be more fragile than their large cap peers.
- ▶ Small caps ended the first quarter in the bottom decile of valuation relative to large caps but, being more domestically focused than larger more tariff-vulnerable companies, they may turn out to be even more attractive at these valuations.

Market Overview

Despite an optimistic start to the year, the threat of tariffs and trade policy changes under the new Trump administration and a rotation out of AI-related tech stocks spurred volatility and uncertainty that sent equities lower for the first quarter. A risk-off mentality weighed particularly hard on small cap stocks, generally thought to be more fragile to their larger cap peers, resulting in the benchmark Russell 2000 Index declining 9.48%, nearly 500 basis points worse than the large cap Russell 1000 Index and over 500 basis points behind than the S&P 500 Index. Concerns over the economic ramifications of new tariffs, declining consumer sentiment and obfuscation of the trajectory of interest rates and earnings helped value stocks seize leadership from growth stocks with the Russell 2000 Value Index returning -7.74% compared to the -11.12% of the Russell 2000 Growth Index.

Portfolio Performance

Amid this turmoil, the ClearBridge Small Cap Strategy outperformed its benchmark in the first quarter as strong selection in the health care and consumer discretionary sectors helped overcome detractors among our industrial holdings.

Despite the prospect of higher rates and continued policy uncertainty from new and controversial leadership at the Department of Health and Human Services, the health care sector was the primary contributor to both absolute and relative returns and contained three of our top five individual contributors: Corcept Therapeutics, Intra-Cellular Therapies and Verona Pharma. Corcept, which manufactures drugs used to treat endocrinologic, neurologic disorders as well as cancer, saw its share price surge late in the quarter after it announced positive data from a Phase 3 trial for an ovarian cancer

Small caps are more domestically focused, meaning that in a prolonged trade war they may be even more attractive.

indication of its drug relacorilant. This represents a potentially significant market expansion opportunity, and further positive data may propel its drug to become a leading treatment for ovarian cancer. Intra-Cellular Therapies, a biopharmaceutical company that develops treatments for central nervous system disorders, also saw an increase after it announced its intention to be acquired by Johnson & Johnson for a more than 50% premium to its share price; we exited our shares following the announcement. Finally, Verona Pharma rose on strong earnings that showed an increase in fourth quarter and 2024 sales figures for its lung disease therapy, Ohtuvayre, which was launched in August, and which we believe can capture a significant proportion of the \$10 billion Chronic Obstructive Pulmonary Disease (COPD) market.

Stock selection within consumer discretionary also positively contributed to performance, led by online educational curriculum, software and solutions company Stride. In addition to posting positive fourth-quarter earnings, with both revenue and earnings above analyst expectations, the company continues to see solid enrollment growth, especially in its career learning offerings. We believe the company's solid execution on its post-COVID online education growth objectives has demonstrated its ability to win and maintain new enrollments and that the continued expansion of its career learning offerings — tailored to the unique career interest of its members — remains an attractive opportunity for future growth.

Stock selection in the industrials sector was the primary detractor during the quarter, mainly due to Allegiant Travel — an airline and hospitality company specifically catering to leisure travelers. Despite its airline revenue exceeding market expectations for the fourth quarter, the company's share price declined after announcing it was reducing the value of its Sunseeker Resort. Resignation of its Chief Operating Officer in early March and economic uncertainty may put additional pressure on consumer spending — particularly with regards to leisure and discretionary purchases. Primoris Services, which provides a range of construction, maintenance and infrastructure engineering services, also saw its share price decline after the announcement that President Trump would cease spending on the proposed \$300 billion in green infrastructure legislation enacted under the Biden administration, hampering the growth projections of the company's energy division.

Portfolio Positioning

We swapped our exposure in WaFd for Columbia Banking System, the holding company for Umpqua Bank, which provides banking, mortgage and other financial services. We believe Columbia has a number of advantages over WaFd: a more attractive valuation, more consolidated geographic footprint, more diversified and higher yielding loan book; better established lending base is and consistently higher net interest margin. Additionally, we believe that Columbia will

generate meaningful synergies and tangible book value recoveries from loans written down on its 2023 merger with Umpqua.

We also adjusted our positioning within health care by adding Privia and exiting Lantheus. Privia offers a unique health care platform (including technology infrastructure, centralized shared services, access to broader care) that reduces physicians' administrative work and improves clinical integration, resulting in better health care services and outcomes for patients. The company has successfully been able to scale its platform, avoiding the pitfalls of competitors, and thus has become a preferred partner for independent health care providers. Meanwhile Lantheus, which develops diagnostic and therapeutic products that assist clinicians in the diagnosis and treatment of heart, cancer and other diseases, faces increased concerns over changes in the Centers for Medicare and Medicaid Services reimbursement rates. Additionally, we believe that increased competition to the company's Pylarify diagnostic imaging agent could negatively impact margins.

Outlook

The outlook for small caps is muddled by uncertainty about the U.S. economy under new tariff rules, just as it is for large caps. The difference is that small caps have ended the first quarter in the bottom decile of relative valuation versus large caps after years of underperformance. Since tariffs were announced, that difference has only widened. While small cap businesses are thought to be generally more fragile than their larger-cap counterparts, they are also more domestically focused, meaning that in a prolonged trade war, they may turn out to be even more attractive at these valuations.

Portfolio Highlights

The ClearBridge Small Cap Strategy outperformed its Russell 2000 Index benchmark during the first quarter. On an absolute basis, the Strategy had losses in nine of the 11 sectors in which it was invested during the quarter. The leading contributor was the health care sector, while the industrials and information technology (IT) sectors were the main detractors.

On a relative basis, overall stock selection and sector allocation effects contributed to performance. Stock selection in the health care, consumer discretionary, materials and IT sectors, as well as an underweight to the IT sector benefited performance. Conversely, stock selection in the industrials and financials sectors weighed on performance.

On an individual stock basis, the biggest contributors to absolute returns in the quarter were Corcept Therapeutics, Intra-Cellular Therapies, MP Materials, Verona Pharma and Stride. The largest detractors were Allegiant Travel, PROG, Encore Capital, Scholar Rock and Arrowhead Pharmaceuticals.

In addition to the transactions listed above, we initiated new positions in ASGN, Zeta Global and TeraWulf in the IT sector, Arrowhead Pharmaceuticals and Beta Bionics in the health care sector and Green Plains in the energy sector. We exited positions in HF Sinclair in the energy sector, nLIGHT and indie Semiconductor in the IT sector and EnerSys in the industrials sector.

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