



## SMID Cap Growth Strategy



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### Key Takeaways

- ▶ SMID growth stocks rose in the fourth quarter, benefiting from a post-election rally and the market's rotation back to growth leadership in December.
- ▶ The Strategy outperformed its benchmark in the fourth quarter, as contributors in health care and materials overcame detractors in the consumer discretionary sector.
- ▶ Our investment approach focuses on companies that can compound high levels of growth without depending on macro tailwinds, provide durable returns and have access to capital to fund high-growth opportunities.

### Market Overview

A market broadening in the fourth quarter sparked by Donald Trump's election victory and a further interest rate cut from the Federal Reserve proved momentum-driven and short lived. While small cap, value and cyclical shares were bid up in the aftermath of Trump's win, large caps and growth stocks reasserted control by quarter's end. As a result, the Russell 2500 Index rose 0.62%, underperforming the 2.75% of the Russell 1000 Index but outperforming the 0.33% return of the Russell 2000 Index. Growth ultimately outperformed during the quarter with the benchmark Russell 2500 Growth Index returning 2.43%, nearly 270 basis points ahead of the Russell 2500 Value Index.

Within the Russell 2500 Growth Index, the rebound and rotation toward growth stocks helped propel the information technology sector (IT, +8.54%) to the best performance in the fourth quarter, followed closely by the communication services sector (+8.16%). The financials (+7.34%), industrials (+5.20%), consumer staples (+4.32%) and energy (+3.59%) sectors also outpaced the broader index. The consumer discretionary sector (+0.99%) generated positive returns but lagged overall performance. The more interest-rate-sensitive real estate (-7.88%) sector came under pressure due to the uncertainty over the trajectory of future interest rate cuts, making it the worst-performing sector in the benchmark, followed by the materials (-7.06%) sector, which continues to struggle with an uncertain outlook and repeated pushout of recovery expectations. The health care (-5.16%) and utilities (-2.41%) sectors also declined.

Although SMID growth stocks have continued to be challenged relative to their larger peers, a variety of factors, including the length of the underperformance, relative valuations, credit spreads and

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forward earnings growth, suggest that the temporary leadership rotation of the third quarter could prove more enduring in 2025. Moreover, after a two-year period dominated by a narrow handful of narrative themes and idiosyncratic challenges for many end markets (consumer, small-medium-businesses non-AI technology to name a few), we may see a broadening of performance.

### **Portfolio Performance**

The ClearBridge SMID Growth Strategy outperformed the benchmark in the fourth quarter, as our strong stock selection in the health care and materials sectors overcame detractors in our consumer discretionary holdings. The confluence of higher rates and the potentially disruptive nomination of RFK Jr. as Secretary of Health and Human Services weighed heavily on health care subsectors such as biotech, providers and health care services. As a result, the Strategy benefited from our underweight to biotechnology, as well as company-specific outperformance of some medical device holdings that drove strong relative performance.

Doximity, which offers a cloud-based collaboration platform for medical professionals that supports patient care and telehealth, was our top-performing holding in the sector. Shares rallied on a beat and raise quarter, with the company citing strong advertising revenue growth with impressive EBITDA flow through. Doximity has a history of consistent execution and, while it stumbled last year in effectively communicating realistic guidance and outlooks, it appears that management has regained investors' trust through several quarters of solid execution.

Our biggest detractor was previously strong year-to-date performer Wingstop, which franchises and operates restaurants offering classic wings, boneless wings and tenders. The company fell victim to a selloff as investors took profits amid high expectations during the fourth-quarter earnings season. While we had previously trimmed our position size in Wingstop due to what we perceive as elevated valuation levels, we believe that the company's long-term revenue and profit compounding potential remain attractive and we are maintaining our exposure.

### **Portfolio Positioning**

We added a new position in Radnet, in the health care sector, which owns and operates freestanding diagnostic imaging centers. The imaging market is seeing secular growth from a shift in the site of care from the more expensive inpatient setting to freestanding centers like RadNet, which has both an attractive organic share opportunity and new construction and acquisition-based geographic expansion potential. AI applications also offer RadNet both an additional revenue stream and cost savings potential.

Also within health care, we initiated a position in TG Therapeutics, a commercial stage biotechnology company focused on multiple sclerosis (MS), a significant chronic disease end market. We believe that the company's lead product, Briumvi, has the potential to grow its market share significantly within the largest drug class in the \$8 billion MS market and can create an attractive long-term growth runway.

We exited our position in ChampionX, within the energy sector, which provides chemistry solutions and engineered equipment and technologies to oil and gas companies. With the company set to be acquired by Schlumberger — the world's largest oil services company — in the fourth quarter, and not anticipating a better offer for the company, we exited the position in advance of the deal closing to redeploy assets into other compelling opportunities.

### Outlook

Our investment approach evaluates businesses without any macro tilt, focusing on companies that can compound high levels of growth in large markets without depending on macro tailwinds, provide durable returns and have ample access to capital to fund high-growth investment opportunities.

The last two years have been characterized by a hyperfocus on narratives (largely related to generative AI), as a multiyear, multisector generational product cycle has been compressed into a 12- to 18-month period. We believe that our patient fundamental derisking process has identified businesses with exposure to these trends, as well as sufficient enduring idiosyncratic opportunities to support attractive returns as this product cycle matures. Moreover, we continue to identify investments that can benefit from the eventual "application layer" of generative AI, in addition to businesses across the spectrum of growth with attractive long-term compounding potential.

### Portfolio Highlights

The ClearBridge SMID Cap Growth Strategy outperformed its Russell 2500 Growth Index benchmark during the fourth quarter. On an absolute basis, the Strategy had gains across seven of the 10 sectors in which it was invested (out of 11 sectors total). The leading contributors were the IT and industrials sectors, while the consumer discretionary and health care sectors detracted the most.

On a relative basis, overall sector allocation effects contributed to performance, highlighted by an overweight to the outperforming IT sector. Stock selection in the health care, materials and consumer staples sectors also benefited performance. Conversely, stock selection in the consumer discretionary and IT sectors weighed on performance.

On an individual stock basis, the biggest contributors to absolute returns during the quarter were Summit Materials, Wix.com, XPO, HubSpot and Rubrik. The largest detractors from absolute returns were Wingstop, ICON, Vaxcyte, Ultragenyx Pharmaceutical and Ashland.

In addition to the transactions mentioned above, we initiated new positions in Regal Rexnord, AAON and Comfort Systems USA in the industrials sector, Oscar Health in the financials sector, Natera in the health care sector as well as Texas Roadhouse and Churchill Downs in the consumer discretionary sector. We exited positions in Procore Technologies, Novanta and Smartsheet in the IT sector, Celsius in the consumer staples sector and Summit Materials in the materials sector.

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