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Mid Cap Strategy

Key Takeaways

- ▶ Mid cap equities posted positive returns during the quarter, outperforming both large and small cap peers as market leadership broadened amid a highly volatile quarter.
- ▶ The Strategy underperformed its benchmark, as weakness in information technology, health care and consumer discretionary more than offset strength in industrials and consumer staples.
- ▶ We were active in the consumer discretionary sector, focusing on owning businesses that can perform across a range of scenarios, while remaining flexible as the environment evolves.

Market Overview

Mid cap equities delivered positive returns during the first quarter, with the Russell Midcap Index gaining 1.3% and outperforming both large cap and small cap peers. Large caps, as measured by the Russell 1000 Index, declined 4.2% during the period, while the smaller cap Russell 2000 Index posted a more modest gain of 0.9%, as signs of a broadening in market leadership continued to emerge. While mid caps were not immune to the broader market selloff, driven largely by investor concerns surrounding the ramifications of the conflict pitting the U.S. and Israel against Iran, performance was more closely tied to underlying business fundamentals and sector-level dynamics.

Investor attention remains split between the impact artificial intelligence (AI) will have in every facet of the economy, and the short- and long-term impact of the war in Iran. Early signs of stabilization that were emerging in parts of the industrial economy after four years of predominantly negative manufacturing activity could very well be snuffed out by higher energy costs and economic uncertainty. The pace and durability of any recovery remain unclear given mixed economic signals and a spike in oil prices driven by the closure of the Strait of Hormuz.

Meanwhile, the debate around AI has remained front and center across almost every sector of the market. Rapid advancements in large language models and growing enterprise adoption have led to intensifying debates around winners and losers, as well as second- and third-order impacts. Business models reliant on workflow, information aggregation or labor-intensive services are facing increased scrutiny as investors assess the potential for AI-enabled disruption. In contrast, companies tied to AI infrastructure, electrification and power demand have been viewed as AI beneficiaries, powering their stock prices higher. Meanwhile, more asset-heavy business models across materials, energy

and industrials have attracted renewed interest both due to limited obsolescence risk from AI and interest in cyclical recovery potential.

Portfolio Performance

The ClearBridge Mid Cap Strategy underperformed its Russell Midcap Index benchmark during the quarter, as pressure across information technology (IT), health care and consumer discretionary more than offset strength in industrials and consumer staples.

The pace and durability of any recovery remain unclear given mixed economic signals and an unexpected spike in oil prices

IT was the largest detractor during the period as software and platform companies — including holdings Tyler Technologies, which provides software solutions to public sector clients, and Rubrik, a data security and cloud management company — faced pressure as investors began to doubt their competitive positioning in an increasingly AI-driven landscape. AppLovin, a mobile advertising and app monetization platform, detracted modestly as the stock digested a strong move upward earlier in the year and the market wrestled with the near-term potential of its new e-commerce product. However, we believe AppLovin's position as an early adopter makes it a long-term beneficiary of AI, as greater gaming and application development should increase the need for discovery by advertisers.

Health care was an area of weakness during the quarter. Declines were particularly prevalent in contract research organization ICON and digital health platform Doximity, due to investor concerns over the possibility of AI disruption in drug development and advertising. We exited our ICON position during the quarter but continue to hold a small position in Doximity as we believe that it is competitively well positioned and, despite being caught up in near-term disruption concerns, will be a long-term beneficiary of AI.

Several of our consumer discretionary holdings faced both macro and company-specific challenges. Chewy, a leading online retailer of pet products, and Churchill Downs, an operator of gaming and entertainment assets — including the Kentucky Derby — were among the weaker performers during the quarter. Chewy's stock has drifted lower recently in response to its in-line results and continued investment in the business. In the case of Churchill Downs, regulatory developments related to potential competitive casino approvals, as well as the concern surrounding emerging online prediction markets, contributed weakness in the shares

These headwinds were partially offset by strength across a broad set of industrials, driven by high-quality compounders positioned to benefit from improving or stabilizing end markets, enthusiasm for cyclical recovery stories and AI infrastructure/power beneficiaries. For example, Regal Rexnord, a provider of engineered power transmission components, benefited from improving operational execution and exposure to electrification trends. XPO, a less-than-truckload transportation provider, is benefiting from implementing an array of strategies to improve service quality, mix and pricing. This is helping

profitability while positioning the company for a possible uptick in freight demand and activity. Finally, Vertiv, a manufacturer of power, cooling and infrastructure management systems primarily serving data centers, continued to benefit from the robust demand associated with data center construction.

Positive stock selection in consumer staples was led by Casey's General Stores, a defensive compounder whose value-focused business model continues to see resilient consumer demand, particularly amid an increasingly uncertain macro environment.

Portfolio Positioning

Portfolio activity during the quarter reflected our continued focus on positioning toward companies where we see attractive combinations of structural growth, improving fundamentals, strong balance sheets and compelling risk-reward. We were particularly active within the consumer discretionary sector, adding five new holdings and exiting one.

New addition Somnigroup International, a vertically integrated manufacturer and retailer of mattresses through brands like Tempur-Sealy and Mattress Firm, should benefit from meaningful synergy potential from the Mattress Firm acquisition, continued share gains in a fragmented market and upside to a recovery in housing-driven demand.

We also increased exposure to travel and consumer services through Viking Holdings, a premium cruise operator benefiting from strong forward bookings and an affluent customer base, and Hilton Worldwide, whose asset-light model, robust development pipeline and high-margin fee streams support consistent free cash flow and long-term growth. Meanwhile, we exited our position in Expedia following a period of strong share price appreciation, as valuation became more balanced and the escalation of the Iran conflict introduced greater uncertainty around the near-term travel demand outlook.

In more idiosyncratic recovery situations, Carvana, an online used vehicle retailer, has continued to gain market share in the used car market after years of heavy investment in the business, while Valvoline, the largest quick lube operator in North America, provides a differentiated consumer-facing business with defensive growth characteristics. Its demand profile is supported by stable miles driven, a consumer preference shift away from dealerships and a favorable mix shift toward higher-value synthetic oil changes.

Outlook

As we look ahead, the range of potential outcomes remains wide. The path of economic growth, the durability of a recovery across cyclical end markets and the ultimate impact of AI on business models are all still taking shape. Our focus remains on understanding businesses at a

fundamental level — how they generate returns, how durable those returns are and how they may evolve over time.

We are spending more time challenging long-held assumptions, particularly in areas where technological change could alter competitive dynamics. At the same time, we are mindful that periods of uncertainty often create opportunity, especially for companies with clear strategies, strong execution and the ability to adapt. We also believe that many mid cap companies are better positioned than commonly appreciated to incorporate generative AI into their operations as a potential source of efficiency and long-term value creation. Whether in logistics, industrial manufacturing or health care delivery, the ability to rethink cost structures and productivity could become an important differentiator over time.

Ultimately, our approach remains grounded in selectivity and discipline. We are focused on owning businesses that can perform across a range of scenarios, while remaining flexible as the environment evolves.

Portfolio Highlights

The ClearBridge Mid Cap Strategy underperformed its Russell Midcap Index during the first quarter. On an absolute basis, the Strategy had contributions from five of the 11 sectors in which it was invested during the quarter. The largest contributors were the industrials and energy sectors, while the health care and IT sectors were the chief detractors.

On a relative basis, overall stock selection detracted but was slightly offset by a positive contribution from sector allocation. Stock selection in the IT, health care, consumer discretionary, materials, energy, real estate and utilities sectors weighed on performance. Conversely, stock selection in the industrials, consumer staples, financials and communication services sectors, as well as underweights to the communication services and financials sectors, benefited performance.

On an individual stock basis, the largest detractors from relative returns were AppLovin, ICON, Rubrik, Doximity and Light & Wonder. The largest contributors to relative returns were Regal Rexnord, Casey's General Stores, Clean Harbors, Vertiv and EQT.

In addition to the transactions listed above, we initiated new positions in Robinhood Markets in the financials sector, Monolithic Power Systems in the IT sector and Leonardo DRS and United Rentals in the industrials sector. We exited positions in Alnylam Pharmaceuticals and Penumbra in the health care sector, SailPoint, Dynatrace, Tyler Technologies, GPGI and Qorvo in the IT sector, Coinbase Global and Blue Owl Capital in the financials sector and CoStar Group in the real estate sector.

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