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Small Cap Strategy

Key Takeaways

- ▶ The Strategy underperformed its benchmark as detractors in the consumer discretionary and communication services sector overcame positive contributions from the utilities sector.
- ▶ High levels of retail trading create difficulties for fundamental-based active managers as low-quality, no-earnings and meme stocks surge, while fundamentals are cast aside.
- ▶ The economic uncertainty on the horizon — tariffs working their way through the economy, potential inflation and the whirlwind of policy changes — look like a storm worth bracing for.

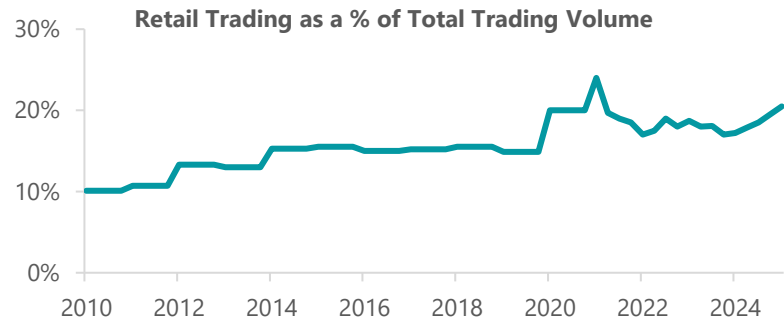
Market Overview

Small cap stocks experienced whipsaw performance in the second quarter, as April's "Liberation Day" market decline was swiftly followed by a rally — with the Russell 2000 Index recovering to within 10% of its record November 2024 highs in merely 55 days, driven largely by growth, momentum, high-beta and low-quality stocks. Although small caps rose higher on the broader market rally, they failed to keep pace with larger cap peers due to their perceived greater sensitivity to macroeconomic shocks, like the highest tariffs imposed since the Smoot-Hawley Tariff Act of 1930.

The Russell 2000 returned 8.5% for the quarter compared to the 11.1% of the Russell 1000 Index, extending its decade-long underperformance that has left it 7.3 points behind the Russell 1000 annually — the widest performance gap dating back to 1935. Growth stocks returned to leadership on the back of continued strong demand for AI beneficiaries and a junk rally that left value and defensive stocks struggling to keep up, with the Russell 2000 Growth Index returning 12.0%, 700 basis points ahead of the Russell 2000 Value Index.

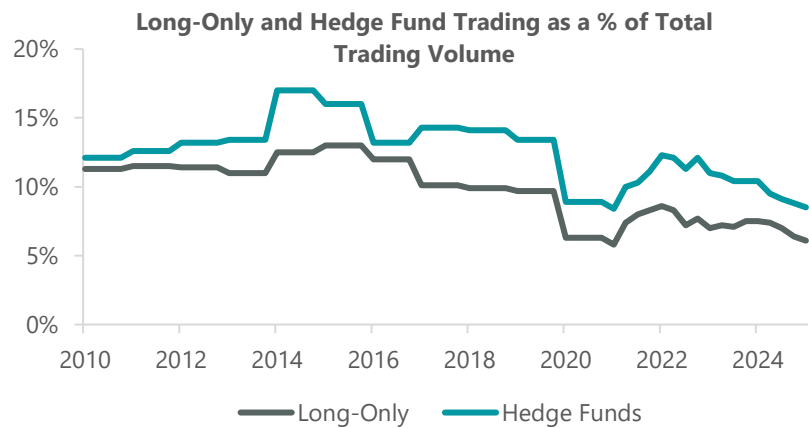
However, this rise — propelled by risky and speculative assets — suggests that the market has reached a level of euphoria and exuberance that is somewhat reminiscent of the post-COVID days of meme stocks and NFTs. While corporate buybacks and foreign investors have certainly played their part, of particular note is the surge in retail trading volumes, which have more than doubled since 2010 and now make up nearly 21% of total market volume, while long-only managers and hedge funds find themselves losing share.

Exhibit 1: Retail Investors Are Throwing Their Weight Around...



As of March 31, 2025. Source: Jefferies.

Exhibit 2: While Managers See Declines



As of March 31, 2025. Source: Jefferies.

However, what is more interesting is how retail investors are positioned and the kinds of stocks they are buying. According to Jefferies, the profile of the companies purchased by retail investors are approximately half the size of the Russell 3000's average market cap, and nearly 45% are zombies — companies with no earnings. For instance, Regencell Bioscience, a Chinese herbal medicine company with no revenue, no regulatory approval and not even a single patent was up more than 7,000% in the quarter and carried a \$40 billion market cap. Not to mention the emergence of "space stocks," whose goal of developing Martian biomes or 3D-printed tools are sound investments... once we reach Mars and they can prove their value. All of this points to a concerning point — mere online chatter has given low-quality, no earnings "meme" stocks the power to soar once again and has left fundamentals looking more and more like a four-letter word.

Markets featuring high levels of retail trading are difficult for fundamentals-based active managers like us as quality significantly lags. However, we were not alone in this — only 18% of small cap core managers beat their benchmarks in the second quarter according to Jefferies.

Portfolio Performance

Amid this turmoil, the ClearBridge Small Cap Strategy underperformed its benchmark in the second quarter as detractors in the consumer discretionary and communication services overcame positive selection in the utilities and select health care companies.

Stock selection within consumer discretionary sector reversed after a strong first-quarter performance, as several idiosyncratic headwinds weighed on holdings Murphy USA and Oxford Industries. Longtime positive contributor Murphy USA, a convenience store and gas station operator, came under pressure in the quarter after reporting weaker than expected earnings due to lower fuel volumes, rising store operating expenses and a decline in same-store sales (despite an increase in total merchandise sales). However, Murphy's focus on rising fuel margins while maintaining its low-cost operating discipline, as well as its investment in store remodels and geographic expansion, continue to drive consistent growth at high incremental returns. Oxford Industries, an apparel company that includes brands such as Tommy Bahama and Lilly Pulitzer, also stumbled due to increased tariff costs and softening consumer spending. However, while near-term tariff pressures and lower guidance have weighed on the stock, management's focus on accelerating its supply chain away from China (with an expected full exit by 2026) and its focus on brand innovation and core customer engagement leave us optimistic about the company's future.

Several holdings in the communication services sector also detracted from performance. Criteo, which helps businesses show personalized ads to people based on their browsing behavior, was hurt by growing investor concerns over the company's long-term growth and profitability forecasts after its largest retail media client announced it would significantly reduce the scope of Criteo's services beginning in November. Meanwhile wireless communications company Anterix drifted lower despite exceeding earnings expectations for its fiscal third quarter, as revenue came in lower than expected and net margins declined. However, we believe that the company's expansion agreement with the Lower Colorado River Authority, which will expand broadband coverage to 102 counties in Texas, highlights the scale of its spectrum capabilities.

Performance in utilities was led by Talen Energy, an independent power producer primarily serving the Pennsylvania-Jersey-Maryland region. The gem of the company's generation portfolio is the ~2.5 GW Susquehanna nuclear facility, which is uniquely positioned to benefit from tightening supply due to rising AI data center power demand, including potential direct supply agreements with hyperscale computing companies. We believe the value of company's highly reliable, non-emitting generation will produce significant cash flows that are undervalued by the market.

Another top contributor was biopharmaceutical company Verona Pharma, which rebounded from a difficult first quarter. After the company received favorable designation from the FDA for its Ohtuvayre drug treatment for chronic obstructive pulmonary disease patients, as well as applications treating cystic fibrosis and asthma, Merck announced that it would acquire Verona at a premium.

Portfolio Positioning

We continued to be very active in adapting our positioning within the financials sector. We elected to exit Home BancShares, which operates as the holding company for Centennial Bank, for a new position in UMB Financial, which also offers banking services and asset servicing. Although we think that Home BancShares remains a solid business, UMB Financial increases the quality of our exposure to regional banks due to its differentiated fee business and superior return potential with its greater geographic and business diversification. We also exited our position in alternative asset manager Abacus Global. Since initiating the position, the company has transitioned its strategy to focus on its brokerage division and has further raised concerns about performance after lowering its discount rate to improve margins in the first quarter of 2025. With declining conviction in the company, a short report alleging Abacus had inflated the value of policies purchased through a conflict of interest with its third-party valuation partner prompted us to exit the position.

We also added a new holding in AGCO, in the industrials sector, which manufactures and distributes agricultural equipment and replacement parts. With a diversified manufacturing footprint globally and approximately 80% of the company's sales outside of the U.S., we believe AGCO stands to benefit versus more domestically oriented peers, like John Deere, given the new trade and tariff policies under the Trump administration.

Outlook

Markets certainly exhibit pendulum-like traits, and sooner or later the tide will ebb and many of those who espoused the low-quality, no-earnings "meme" stocks that led the second quarter will be caught holding the bag. While we believe that trying to time this reversion is a fool's errand, the economic uncertainty on the horizon — the impact of tariffs working their way through the economy, a potential pick-up in inflation and the continued whirlwind of government policy changes — certainty looks like a storm worth bracing for. As such, we continue to lean on our philosophy of focusing on high-quality stocks with strong balance sheets, attractive cash flows and substantive long-term catalysts for growth and improvement. While there will be periods like the second quarter where we find ourselves trailing, these fundamentally sound companies will be the ones sought out when the eventual tipping point occurs.

Portfolio Highlights

The ClearBridge Small Cap Strategy underperformed its Russell 2000 Index benchmark during the second quarter. On an absolute basis, the Strategy had gains in six of the 11 sectors in which it was invested during the quarter. The leading contributors were the industrials and information technology (IT) sectors, while the communication services sector was the main detractor.

On a relative basis, overall stock selection and sector allocation effects detracted from performance. Stock selection in the consumer discretionary, communication services, IT, industrials, consumer staples, financials, health care and materials sectors weighed on performance. Conversely, stock selection in the utilities and real estate sectors and an underweight to the health care sector proved beneficial.

On an individual stock basis, the biggest contributors to relative returns in the quarter were Verona Pharma, MP Materials, Talen Energy, Primoris Services and Terawulf. The largest detractors were Corcept Therapeutics, Murphy USA, Criteo, Hain Celestial and Anterix.

In addition to the transactions listed above, we initiated new positions in Jefferson Capital in the financials sector, Tarsus Pharmaceuticals in the health care sector, Apple Hospitality REIT and SmartStop Self Storage REIT in the real estate sector, nCino in the IT sector and Valvoline in the consumer discretionary sector. We exited positions in RLJ Lodging Trust in the real estate sector, Crescent Energy in the energy sector, Olin in the materials sector, Keros Therapeutics and Insmed in the health care sector, Helen of Troy in the consumer discretionary sector and Hain Celestial in the consumer staples sector.

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