



**Jeffrey Bailin CFA**  
Managing Director,  
Portfolio Manager



**Aram Green**  
Managing Director,  
Portfolio Manager

## Small Cap Growth Strategy

### Key Takeaways

- ▶ Equity markets pulled off a near-unprecedented comeback as sharp declines in April were erased with strong May and June performance.
- ▶ While the market rally was fueled by lower market capitalization, lower-quality non-earners, and a retail volume surge favoring momentum and the riskiest stocks, the Strategy only modestly underperformed the Russell 2000 Growth Index.
- ▶ Despite the return of animal spirits, it is unclear if the economy is definitively on a firmer footing, with the impacts from tariffs, the tax and spending bills and geopolitical conflicts very much still up in the air.

### Market Overview

This was a quarter of extremes, with “Liberation Day” tariff announcements driving the benchmark Russell 2000 Growth Index down as much 12% in the first weeks of April before a furious rally saw the index end the quarter up 12.0%.

The hallmark of the last three months has been reversals — of trade policy, legislative priorities and sentiment. The stock market has grown somewhat accustomed to the administration’s trade threats and has taken advantage of signs of possible trade deals and progress with key counterparties to price in more benign outcomes than feared in the immediate aftermath of the proposed tariff policies. More recently, progress on the reconciliation bill could also provide tailwinds to several corners of the economy while extending some of the 2017 tax cuts.

Although businesses and consumers are faced with a still-uncertain set of operating conditions, the underlying macroeconomic indicators are not signaling undue stress, with unemployment, inflation and spending trends at manageable levels. One of the most prominent market narratives remains around the generational potential of generative AI to reshape numerous aspects of business and daily life, albeit with a rapidly evolving technological paradigm of winners and losers. With innovation in the technology sector, as well as in exciting growth markets in health care and industrials (such as space), the capital markets are gradually thawing with several successful IPOs and hopes of a steady pipeline over the coming quarters.

Large cap stocks continue to outperform small caps, with the rolling 10-year annualized return gap the largest on record dating back to the 1930s, and relative valuations in the bottom decile. While value leadership emerged to start the year, growth stocks returned to

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The second quarter saw equity markets pull off an unprecedented comeback from sharp tariff-driven declines.

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meaningfully outperforming value in the aggressive May and June rally. The Russell 2000 Growth Index returned 12.0% relative to the 5.0% return of the Russell 2000 Value Index and the 17.8% of the Russell 1000 Growth Index. It's also worth noting that retail investing continues to gain in prominence, with some evidence of a return to the "meme stock" mania seen in early 2021. Retail trading now makes up 20% of daily trading volume versus 10% in 2010. This has manifested in wild gyrations in a variety of sectors across cryptocurrencies, quantum computing and electric vertical take-off and landing (eVTOL) aircraft (aka flying cars). A prominent Goldman Sachs "meme" basket hit an all-time-high, returning over 44% in the quarter to help pace the swiftest-ever recovery for the S&P 500 Index to a closing high after a 15% decline.

### Portfolio Performance

Amid a backdrop of a violent drawdown and an equally sharp rebound led by lower cap and lower quality, the ClearBridge Small Cap Growth Strategy modestly underperformed its benchmark. While we had strong stock selection across much of the portfolio, the unprecedented recovery in the market represented a backdrop that is historically difficult for our quality-focused, high active share portfolio to outperform.

The Strategy largely kept pace with the euphoric benchmark recovery with balanced contributions from names added in more recent repositioning work as well as long-standing holdings. In particular, longstanding position BWX Technologies is benefiting from renewed interest in nuclear technologies as an alternative power source. One of our newer positions, Construction Partners, in the industrials sector, is executing well on its acquisition strategy to enter new geographies and gaining scale to enhance its margin profile. Additionally, we benefited from the announced acquisition of Blueprint Medicines by Sanofi at a healthy premium and are cautiously optimistic that the Strategy could see future benefits from pent-up demand for strategic M&A.

Performance was fairly broad based, with strong contribution from most of the major sectors in which we had investments with only minor headwinds in lower-weight, cyclical sectors (due to our quality bias) like energy and materials. Our most meaningful relative detractor from a sector perspective was information technology (IT), with uneven software and consumer demand outlooks weighing on companies like Wix.com, PagerDuty and Sprout Social. Moreover, several large benchmark constituents with exposure to AI, quantum computing and other high-momentum themes were headwinds to relative performance in this sector.

Several of our top contributors demonstrated continued delivery on idiosyncratic growth drivers such as Wingstop, which is deploying a new kitchen display system to aid speed of service, and Duolingo, which is leveraging AI to offer enhanced language learning to consumers. Similar to last quarter, we are pleased to see that the work

undertaken in 2024 to improve our relative underweight to biotech has been a positive contributor to relative performance, benefiting from an acquisition (Blueprint Medicines), positive clinical data readouts (Insmed) and commercial sales execution (Mirum Pharmaceuticals).

### Portfolio Positioning

We continued to deliver strong new idea generation, adding 11 new investments in the quarter including:

- Universal Technical Institute is a national provider of trade schools across a variety of medical and industrial end markets. We see secular demand for this industry leader to expand its programs geographically and by program type to address skilled employee shortages.
- Boot Barn is a retailer focused on Western and work gear such as boots, accessories and apparel. The company has a long runway to grow at a double-digit pace within a fragmented market while leveraging catalysts such as exclusive brands and margin efficiencies to grow earnings at a healthy rate over the coming years.
- Rhythm Pharmaceuticals is a biopharmaceutical company focused on metabolic conditions related to genetic/injury-related obesity. The company has launched its main product in several rare indications, with likely approval for launching into a much larger indication in the near term. With a variety of pipeline candidates to enhance lifecycle management and address other related illnesses, we see robust growth potential ahead.
- Voyager Technologies is a space and defense supplier with products in missile defense and spacecraft components. Voyager is well-positioned to benefit from the increases in both defense spending and space activities in the U.S. — from both the government and private sectors — which offer an array of growth opportunities.
- Pathward Financial provides banking as a service, operating as one of the largest prepaid card issuance companies. The company leverages these low-cost deposits to serve a variety of niche, specialty lending products, generating very high fee income and robust returns.

### Outlook

While recent performance would suggest the market has grown more sanguine about the impacts from a myriad of macroeconomic policy and geopolitical considerations, we would highlight that our discussions with management teams present a more uncertain outlook, corroborated by mixed quantitative and qualitative macroeconomic indicators. For businesses, consumers and investors the most consistent predictable factor is unpredictability, with major policy and geopolitical priorities and rapid technological innovations influencing narratives and outlooks. We are mindful of the risk that there could be air pockets caused by the changing tariff environment and anticipate another choppy earnings season ahead. Against this backdrop, the Strategy's focus on companies

with idiosyncratic growth and profitability drivers, self-funded balance sheets and a balanced spectrum of growth across the portfolio should position us well for a variety of market outcomes. With valuation and performance for small caps relative to large cap peers near all-time lows, coupled with the potential for faster earnings growth later in 2025, we believe the asset class is well-positioned for improved performance.

### Portfolio Highlights

The ClearBridge Small Cap Growth Strategy performed mostly in line with its benchmark in the second quarter. On an absolute basis, the Strategy posted gains in seven of the nine sectors in which it was invested (out of 11 sectors total). The main contributors were the industrials and consumer discretionary sectors, while the detractors were the energy and materials sectors.

Relative to the benchmark, overall sector allocation effects detracted from performance while overall stock selection contributed. Stock selection in the health care, consumer discretionary, consumer staples, industrials and financials sectors and a lack of exposure to the real estate sector proved beneficial. Conversely, stock selection in the IT, materials and energy sectors, an overweight to consumer staples and underweight to the industrials sector weighed on performance.

On an individual stock basis, the leading relative contributors were positions in Wingstop, BWX Technologies, Construction Partners, Allegro Microsystems and e.l.f. Beauty. The primary detractors were BJ's Wholesale Club, Penumbra, Lattice Semiconductor, Wix.com and Trex.

In addition to the positioning mentioned above, the Strategy initiated new positions in BridgeBio Pharma, ICON and Tarsus Pharmaceuticals in the health care sector, UMB Financial in the financials sector, IonQ in the IT sector, Limbach in the industrials sector. During the quarter we exited positions in Expro in the energy sector and Rocket Lab in the industrials sector.

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