



Small Cap Growth Strategy



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Key Takeaways

- ▶ Small cap growth equities posted their third-best quarterly gain in 20 years, fueled by AI enthusiasm, biotech strength and gains in high-beta, high-momentum stocks amid elevated retail trading volumes.
- ▶ The Strategy underperformed its benchmark despite strength in several AI-exposed and idiosyncratic growth stories given the magnitude of the IT, and particularly semiconductor, rally.
- ▶ New idea generation was robust amid an unusually large Russell rebalance, as we remain focused on identifying companies with durable, distinctive growth drivers and the capacity to invest in significant opportunities.

Market Overview

The Russell 2000 Growth Index rose 25.6% in the second quarter, its third-best quarterly gain in 20 years and only the fourth quarter over that span with a return above 20%. Unlike the prior instances, which followed severe market declines including the rebounds from the Global Financial Crisis in 2009 and the COVID recovery cycles in 2020, this quarter's performance followed a very modest first-quarter decline. Its speed and magnitude likely reflects the evolving market structure dynamics, including elevated retail volumes (2x the 2024 averages in May and June), benchmark concentration and narrow thematic leadership.

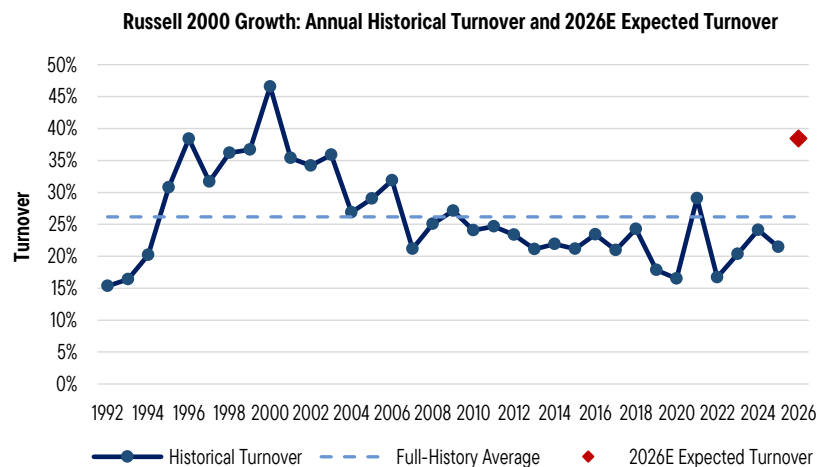
Elevated risk appetite helped produce one of the strongest first halves of relative performance for small caps versus large caps since 2001. Leadership again favored the highest-beta (+62%), most expensive (+37% for the highest P/E quintile) and non-earning stocks (+26%), with momentum continuing to outperform quality. This created a challenging backdrop for active management broadly, and for quality-oriented growth strategies, as many of the strongest-performing areas of the benchmark were segments that disciplined bottom-up investors have historically approached with selectivity.

While the first quarter of the year reflected an encouraging broadening in performance drivers, this quarter saw benchmark-level performance narrow back toward the familiar set of themes that fueled gains for much of 2024 and 2025, namely artificial intelligence (AI). Increasingly, investors sought out exposure to bottlenecks and perceived winners across memory, optical and networking, CPUs and high-performance compute capacity. Debates continue around the future pace of AI infrastructure investment, on the return on AI investment and who will ultimately garner the lion's share of economic return. But broader

enthusiasm for this generational technology investment continues to overwhelm an otherwise complicated macroeconomic backdrop. The second quarter experienced continued geopolitical volatility impacting oil prices and inflation, along with forward expectations for monetary policy, much of which remains unsettled.

The quarter also included one of the largest Russell rebalances in the last two decades, with elevated turnover at nearly twice the historic average (Exhibit 1). At a benchmark level, many of the perceived AI winners across both the industrial and technology sector graduated out of the small cap growth universe, while biotechnology representation increased materially alongside a larger cohort of lower-quality or more cyclical growth companies as energy, materials and consumer discretionary also saw increased sector weightings in the new benchmark.

Exhibit 1: Russell 2000 Growth Index Rebalance Turnover



As of June 30, 2026. Source: ClearBridge Investments, FTSE Russell.

Portfolio Performance

The ClearBridge Small Cap Growth Strategy generated strong absolute returns of over 21% (gross of fees) but underperformed the Russell 2000 Growth benchmark, which gained nearly 26% for the quarter. Idiosyncratic weakness in select health care and financials holdings, software pressure and under-exposure to high-beta and high-momentum AI-exposed stocks overcame the Strategy's winners across AI-exposed businesses and several strong company-specific execution stories.

In health care, weakness was concentrated in a few idiosyncratic holdings, despite a strong quarter for biotech. Long-standing biotech holding Insmed gave up some of the prior year's strength driven by concerns around the pace of key drug Brinsupri's launch. We remain confident in the meaningful long-term peak sales potential and believe recent weakness has been overly punitive. Insulet, the maker of insulin patch pumps, also detracted amid broad medtech weakness, minor product quality issues and rising concerns around potential future competition. Conversely, TG Therapeutics, a commercial-stage

Discipline matters
when narratives
move faster
than fundamentals.

biopharmaceutical company producing a multiple sclerosis treatment, posted strong gains following better sales for its key product alongside positive clinical data for a subcutaneous version that could expand its addressable market.

Information technology (IT) was another area of relative weakness despite exceptionally strong performance from several holdings across semiconductors and security software. We saw material gains in semiconductor holdings such as Allegro MicroSystems and Lattice Semiconductors, both of which benefited from recovery in previously depressed industrial and automotive end markets alongside increasing content gains in newer AI server architectures. Within security software, data governance software provider Varonis Systems was buoyed by potential demand tailwinds tied to increasing AI utilization, as well as rumors of potential takeover interest. However, these gains could not fully keep pace with benchmark strength (+47% for IT with semiconductors +98%) as over one-quarter of the 41 benchmark semiconductor holdings doubled and nearly half were up by over 50%.

AI disruption concerns continued to weigh on several software holdings including Wix.com, a website creation, commerce and business management software platform, amid fears of AI-native competition and the investment required to develop its own AI capabilities. Similar disintermediation concerns affected alternative asset managers that have funded software go-private transactions, including Hamilton Lane.

Industrials and materials positively contributed, though results were mixed by subsectors. The Strategy saw strength in AI infrastructure enablers such as Bloom Energy, whose alternative fuel cells are increasingly used to help data centers address constraints in grid access. Specialty chemicals and materials provider Element Solutions also rose, supported by cyclically recovering end markets and increasing semiconductor demand. Beyond AI tailwinds, Xometry, an online marketplace for on-demand manufactured parts, gained on continued acceleration in growth and profitability, as well as a new partnership with Siemens which should provide an incremental growth channel.

Portfolio Positioning

New idea generation remained strong, with activity elevated by the Russell rebalance. We added 13 new positions during the quarter: Argan, Axsome Therapeutics, Cipher Digital, D-Wave Quantum, DigitalOcean Holdings, Hut 8, Kymera Therapeutics, Legence, Liftoff Mobile, MaxLinear, MYR Group, Praxis Precision Medicines, and Solaris Energy Infrastructure. Below are several highlighted additions.

- Axsome Therapeutics, in the health care sector, is a high-growth, commercial-stage biotechnology company focused on central nervous systems disorders. We believe that its key drug, Auvelity, has a large commercial opportunity with approval in Major Depressive Disorder and recent expansion into Alzheimer's Disease Agitation.
- MaxLinear, in the IT sector, is a fabless semiconductor company focused on high-speed communications networks, with deep radio

frequency and signal processing expertise. We expect strong earnings growth as prior R&D investments support opportunities in the AI transceiver market.

- **Solaris Energy** Infrastructure, in the energy sector, provides behind-the-meter, modular natural-gas power generation for AI data centers and other users through a power-as-a-service model. Accelerating data-center power demand, grid reliability issues and long lead times for traditional generation support demand for its solutions, which offer high-margin contracted cash flows and attractive returns.

During the quarter we exited holdings for company-specific, portfolio construction and M&A-related considerations including e.l.f. Beauty, Ensign Group, IonQ, Limbach Holdings, and Penumbra, which was acquired by Boston Scientific.

Outlook

We are encouraged that small cap securities have continued to recover from one of their longest losing streaks on record, with the Russell 2000 Growth Index up over 77% from the Liberation Day lows versus 56% for the Russell 1000 Growth Index. According to Jefferies Equity Research, relative valuation versus large caps still sits in the 21st percentile, suggesting there could be further runway to reverse the multi-year small cap underperformance. Elevated retail and quantitative fund participation in such an indiscriminate risk-on environment has challenged active managers, although such pressure is common in reversal periods. Given investor appetite for undiscovered growth stories, innovation, an AI investment cycle with related opportunities and risks and a possible cyclical recovery, we see potential for continued small cap outperformance.

At the same time, the market is contending with rapid disruption, geopolitical headlines and reversals that complicate consumer and business investment cycles, as well as a reassessment of perceived winners and losers. Debates around AI capital spending and which elements of the supply chain capture the most economic return will persist, and this technological arms race appears likely to dominate the market's attention. Importantly, the next phase of opportunity may extend beyond the companies building AI infrastructure to the companies using AI effectively. Businesses in transportation, biotechnology, financial services and other industries may be able to unlock cost savings, productivity gains or new revenue opportunities that are not yet fully reflected in stock prices. In a market where leadership can change quickly and narratives often move faster than fundamentals, our bottom-up discipline is designed to separate durable growth from temporary momentum.

Portfolio Highlights

The ClearBridge Small Cap Growth Strategy underperformed its Russell 2000 Growth Index benchmark during the second quarter. On an absolute basis, the Strategy posted gains in all nine sectors in which it

was invested (out of 11 sectors total). The primary contributors were the IT, industrials and health care sectors.

Relative to the benchmark, overall stock selection detracted the most from performance. Stock selection in the health care, financials, IT and consumer staples sectors, as well as overweights to the consumer staples and energy sectors, weighed on performance. Conversely, stock selection in the materials, energy, industrials and consumer discretionary sectors and an underweight to the health care sector contributed positively.

On an individual stock basis, the leading contributors to relative returns were Allegro MicroSystems, Bloom Energy, Lattice Semiconductor, Xometry and Varonis Systems. The primary detractors were Wix.com, Insmad, Matador Resources, Hamilton Lane and BWX Technologies.

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