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Small Cap Growth Strategy

Key Takeaways

- ▶ The market rally of May and June continued in the third quarter as waning policy uncertainty, a Fed rate cut and animal spirits fueled by retail enthusiasm for high-growth-potential markets (AI, quantum computing and nuclear energy) drove another quarter of double-digit gains.
- ▶ The Strategy lagged a benchmark that was driven by names with the smallest market caps, lowest returns on equity and highest beta. Within the Strategy, particularly weak performance from some software and consumer holdings offset strong results from industrial and health care positions.
- ▶ We are encouraged that greater certainty on government policy, tariffs and incremental rate cuts could support a broadening out of what has remained a very narrow market, but we remain mindful of continued fragility in many pockets of the economy.

Market Overview

After the roller coaster performance of markets during the second quarter, the third quarter was a steadier grind higher, with the benchmark Russell 2000 Growth Index closing the quarter up 12.2%, performing similarly to its value counterpart and outperforming the 10.5% return of the Russell 1000 Growth Index.

Performance was paced by low-quality constituents: the lowest-return on equity quintile (+22%), non-earners (+23%), stocks with no sales (+19%), the lowest market cap quintile (+22%) and highest-beta stocks (+23%) according to Jefferies Equity Research, as is typical coming out of a (brief) bear market. Meanwhile, the Goldman Sachs High Retail Sentiment Basket returned over 29% in the quarter and is up nearly 75% year to date. These factors have coalesced into a very difficult six-month period for active small cap growth managers, the worst six-month performance period in a 25-year dataset.

From a macro standpoint, waning policy uncertainty with the passage of the reconciliation bill (OBRR) as well as a variety of trade deals lowered the temperature on the market's angst. Most macroeconomic datapoints suggest the U.S. economy is weathering various policy shocks with solid consumer spending and business activity. Moreover, second-quarter earnings suggested that while inflation has modestly perked up and the labor market has cooled, most businesses are not seeing meaningful incremental negative headwinds, with results not as bad as previously feared just after

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Liberation Day. However, our conversations with management teams suggest that many industries have yet to see definitive reacceleration and that economic growth is being narrowly driven by AI infrastructure investments, reshoring and early-stage markets like high-tech defense and space.

This relative stability, coupled with the softening labor market, has led the Federal Reserve to embark on another rate-cutting cycle with an initial 25 basis point cut in September, and the “dot plot” suggests two more rate cuts in 2025. These dynamics have buoyed animal spirits, supporting a reopening in the capital and M&A markets and driving equity markets to new highs.

Portfolio Performance

With the benchmark up over 12% during the quarter, the ClearBridge Small Cap Growth Strategy was unable to keep pace and underperformed. Strong stock selection in industrials and health care was overwhelmed by weakness in information technology (IT) and consumer discretionary holdings, along with underexposure to metals and mining, which benefited from torrid gains in the underlying commodities.

Within the consumer discretionary sector (and impacting holdings that serve those end market, like Shift4 Payments), weak traffic data — particularly at restaurants — and general concerns around the health of the low-income consumer weighed on a variety of holdings. Throughout the quarter, real-time sales data suggesting weaker same store sales at two of our larger restaurant holdings, Dutch Bros and Wingstop, presented headwinds to performance. We believe these two companies remain among the best opportunities in the sector on the basis of both unit economics and store growth and that both possess idiosyncratic growth drivers that should support stronger future stock price performance into 2026, rebounding from current cyclical pressures.

Within IT, performance remains acutely divergent between perceived AI winners/losers, as well as extreme performance in pockets of more early stage/retail sector growth stocks. Most of our software stocks saw weak performance, even those with strong beats (such as Klaviyo) amid renewed concerns around potential AI disintermediation. While we acknowledge it will take time to disprove this bear thesis, we continue to believe a balanced group of differentiated vertical and horizontal software applications, and particularly those serving enterprise customers, will eventually accrue many benefits on the other side of the AI buildout.

The Strategy saw particular strength across two of our three largest sectors: industrials and health care. Performance was positive across almost every industrial subsector, with strength in several of our aerospace and defense holdings (FTAI Aviation, Karman and BWX Technologies for example), as those end markets remain healthy and

our holdings are executing against a variety of new business opportunities. Longstanding holding Bloom Energy, held since its July 2018 IPO, saw exceptionally strong performance as its alternative power solutions are increasingly viewed as a time-to-market advantage for electricity-starved data centers, including an initial data center deal with Oracle.

Health care was another positive callout with positive relative performance in biotech. This occurred during a period where the index's biotech industry gained approximately 22%, largely due to positive trial results, M&A and improving investor sentiment. Biotech contributions came from Inmed, Mirum Pharmaceuticals and Rhythm Pharmaceuticals, which delivered on positive data and commercial catalysts. Rebounding performance was also seen in previously beaten-down picks and shovels providers like Medpace and ICON.

Portfolio Positioning

We continued to deliver strong new idea generation, adding seven new investments in the quarter: Karman Holdings, Kratos Defense & Security Systems, Avidity Biosciences, CG Oncology, Credo Technology Group, Rigetti Computing, and Cellebrite DI. Below are several highlighted additions:

- Kratos Defense & Security Systems is an aerospace and defense supplier focused on unmanned aerial drone systems, hypersonic missiles and missile defense, propulsion and space. With key exposures to high-priority areas of the defense budget, a nimble first-to-market manufacturing strategy and proactive capacity investments, we see the potential for significant growth and margin expansion in the coming years.
- Avidity Biosciences is a biopharmaceutical company with multiple late-stage development programs leveraging RNA technology to treat a variety of muscular dystrophy conditions. With promising early data, we believe the company is well-positioned to benefit from several upcoming clinical trial results.
- Credo Technology Group is a semiconductor connectivity company providing solutions primarily to support data transfer inside of data centers. Credo has the leading market share within a niche industry and is benefiting from the unprecedented AI infrastructure buildout and exponential growth in data transfer needs.
- Cellebrite DI is a software company providing a platform for digital investigation primarily for law enforcement customers. As a market leader in digital forensics, the company has made logical additions to its platform that should unlock incremental future growth at attractive profitability.

We exited a number of positions during the quarter, two due to acquisitions (Blueprint Medicines and Integral Ad Science), as well as Vaxcyte, Jamf, Viking Therapeutics, Novanta, Oscar Health,

Abercrombie & Fitch, Ultragenyx Pharmaceuticals, Fluor, Voyager Technologies and Lantheus due to idiosyncratic fundamental and portfolio construction considerations.

Outlook

We remain committed to identifying strong companies with growth opportunities and attractive returns irrespective of the macro backdrop. The guiding principles that have informed our investment process and philosophy remain at the core of our process: to exercise “judgment and patience” to ensure that we have 1) the right balance of opportunity and risk in the Strategy and 2) appropriately capitalized investments with substantial intermediate to long-term growth opportunities.

We take some comfort that the elevated uncertainty of the first half of the year has improved with the passage of the OBBB and various trade deals coming to fruition over the summer. While policy and tariff dynamics remain fluid and prone to unexpected announcements, this improved stability should allow businesses, investors and consumers to plan with greater confidence. This is partially reflected in the third quarter’s M&A activity, which was up nicely with IPOs tracking upward of 80% year over year.

The economy and stock market continue to be more narrowly driven than headline results might suggest, with AI and other early-stage growth markets getting the lion’s share of investment. Signs of green shoots in traditional industrials, consumer and health care markets remain mixed, but we are cautiously optimistic that several factors are aligning for a broadening out that would favor the types of higher-quality businesses the Strategy has greater exposure to. We continue to believe the Strategy’s focus on companies with idiosyncratic growth and profitability levers, self-funded balance sheets and a balanced spectrum of growth across portfolio construction should position us well across a variety of market outcomes.

Portfolio Highlights

The ClearBridge Small Cap Growth Strategy underperformed its benchmark in the third quarter. On an absolute basis, the Strategy posted gains in six of the nine sectors in which it was invested (out of 11 sectors total). The main contributors were the industrials and health care sectors, while the main detractors were the financials and consumer discretionary sectors.

Relative to the benchmark, overall stock selection and sector allocation effects detracted. Stock selection in the IT, consumer discretionary, financials, energy and materials sectors, as well as an overweight to the consumer staples sector, weighed on performance. Conversely, stock selection in the industrials, consumer staples and

health care sectors, and an underweight to the communication services sector, proved beneficial.

On an individual stock basis, the leading relative contributors were positions in Bloom Energy, Lattice Semiconductor, Inmed, Mirum Pharmaceuticals and Xometry. The primary detractors were Wingstop, Shift4 Payments, Dutch Bros, BJ's Wholesale Club and Klaviyo.

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