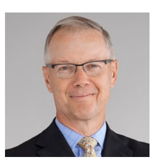
SMID Cap Growth Strategy

Brian Angerame
Managing Director,
Portfolio Manager

Derek Deutsch, CFA
Managing Director,
Portfolio Manager

Aram Green
Managing Director,
Portfolio Manager



Jeffrey Russell, CFA
Managing Director,
Portfolio Manager

Key Takeaways

- A host of negative considerations overlooked previously caught up with stocks in the fourth quarter with small growth companies bearing the brunt of a sharp decline.
- We took advantage of selling pressure to diversify our exposure in the information technology and industrials sectors.
- We have yet to hear of a material slowdown in economic velocity from our companies and private equity investors continue to express interest in their growth dynamics.

Market Overview and Outlook

A legendary investment strategist once famously opined "the market usually does whatever makes the most people most uncomfortable." And that has certainly been the case this fourth quarter as U.S. stocks finished the year with a resounding thud, erasing all gains from earlier in the year. With bond indices also flat to down this year, we've had a year of "profitless prosperity" in financial markets.

Equity markets rallied for the first three quarters of 2018, riding a wave of favorable economic and corporate earnings reports, boosted in part by the tax cut stimulus. A host of negative considerations largely overlooked earlier in the year (tariff conflicts, cost pressures, ascending short-term interest rates, valuation, Washington dysfunction, political issues ex-U.S.) caught up with stocks this quarter and a sharp decline ensued.

Smaller company stocks, which had been the favored "risk on" trade of investors earlier in the year, bore the brunt of selling during the quarter. The Russell 2000 Index declined 20.20% while small and mid cap (SMID) growth stocks in the benchmark Russell 2500 Growth Index declined 20.08%. By comparison larger cap stocks (Russell 1000 Index) declined a more modest but still substantial 13.82%. For the full year, SMID growth stocks declined 7.47%.

The SMID Cap Growth Strategy was not immune from the selling pressure, particularly in the financials and industrials sectors. We seek to stay diversified across the market and that broad exposure provided a measure of balance during the quarter as our information technology (IT), health care and real estate holdings held up better than similar companies in the benchmark.

We believe recent market action reflects a transition to normalized valuations and earnings growth rates as monetary and fiscal stimulus measures are simultaneously removed from the economy. The Federal Reserve raised short-term interest rates for the fourth time in 2018 in December as it continued a path of tightening. Meanwhile, the boost to corporate earnings from late 2017 tax reform is starting to wear off as EPS growth is forecast to decelerate and companies face tougher quarterly comparisons. The uncertainty over trade and tariffs, which is causing corporate managements to delay capex, was another driver of elevated volatility.

> We believe the investments in the portfolio will continue to demonstrate above-industry growth dynamics.

Selling pressure in IT enabled us to establish several new positions. The portfolio had no semiconductor exposure before the purchase of Monolithic Power Systems as our IT holdings were overwhelmingly skewed to software and security. Monolithic is a fabless analog semiconductor design company with diverse and growing end markets including graphics processing units, LEDs, battery management and 5G wireless applications across multiple industries. The company is an above average grower that we believe can continue its solid trajectory.

RealPage is a business services company with technology to improve and optimize the economics of a notoriously low-tech industry, real estate. The company has software solutions which help landlords automate management of renters, manage properties and coordinate leasing and marketing. We believe the company has significant cross-selling opportunities with its existing customers. An asset light model which generates a lot of cash should allow RealPage to delever the balance sheet while showing low double-digit revenue growth.

We also added two new positions in the industrials sector. RBC Bearings makes highly engineered precision bearings/components used in a diverse range of machines, aircraft and mechanical systems. Its products are designed to reduce wear to moving parts, facilitate power transmission, reduce energy loss/damage from friction and control pressure flow. RBC competes in a multi-billion-dollar bearings end market impacted by defense demand, new aircraft build rates/air traffic, and defense budgets, giving it exposure to some cycles removed from the big macro overhang expected in the second half of 2019 in autos and housing. The company maintains a strong moat as it is No. 1 or 2 in over two thirds of its end markets and more than half of its revenue comes from proprietary products with long-term contracts.

We also purchased shares in Bloom Energy, a maker of fuel cells powered by natural gas that provide a cost-effective, off-the-grid energy source, especially in states with high electricity prices. The company has rolled out its fuel cells in about half of the U.S. and should increase coverage as the production cost curve continues to decline.

As we enter 2019, the euphoria from earlier this past year has vanished, supplanted by investor pessimism about decelerating economic growth. Interest rates are higher (modestly) and for the first time in a long while, cash equivalents provide a nominal return worth considering. Equities have experienced a sharp downward price adjustment, with valuations appearing quite attractive in aggregate for growth businesses.

Private equity investors took advantage of the valuation compression in the fourth quarter to make offers for several portfolio holdings with dynamic growth characteristics or whose value is not being realized by current management. PE firms recently have targeted software-as-a-service companies like portfolio holding athenahealth (which has been controlled by activist investors seeking a strategic transaction) and Imperva, a provider of security software for databases and web applications. Meanwhile, we sold shares in Integrated Device Technology, which designs chips for power management in high performance computers, during the quarter following an acquisition offer from a Japanese competitor.

We have yet to hear of a material slowdown in economic velocity from our companies. Instead, opportunities remain abundant. While there have been some dislocations to a variety of items (such as labor constraints, hurricane disruptions) we believe our existing portfolio holdings will continue to demonstrate above-industry growth dynamics while recent additions should provide exposure to additional growth drivers.

Portfolio Highlights

The ClearBridge SMID Cap Growth Strategy outperformed its Russell 2500 Growth Index benchmark during the fourth quarter. On an absolute basis, the Strategy had losses across the ten sectors in which it was invested during the fourth quarter (out of 11 sectors total). The industrials, health care and consumer discretionary sectors were the primary detractors from returns during the quarter.

In relative terms, overall stock selection and sector allocation contributed to performance. Stock selection in the IT, health care and real estate sectors and an overweight to real estate were the primary contributors to returns. Conversely, stock selection in the financials and industrials sectors were the primary detractors from relative results.

On an individual stock basis, positions in Imperva, Tableau Software, Five9, Burlington Stores and athenahealth were the most significant individual contributors to absolute returns in the fourth quarter. Meanwhile, Grubhub, SVB Financial Group, XPO Logistics, Carvana and Fortinet were the greatest detractors from absolute returns.

During the fourth quarter, we initiated positions in Monolithic Power Systems and RealPage in the IT sector as well as RBC Bearings and Bloom Energy in the industrials sector. We also closed positions in Affiliated Managers Group in the financials sector, Coherent and Integrated Device Technology in the IT sector and Forum Energy Technologies in the energy sector.