ClearBridge Investments

SMID Cap Growth Strategy

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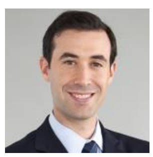

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Key Takeaways

- The Strategy outperformed through a rotation out of growth stocks as our preference for sturdy fundamentals and value-creating management teams provided ballast amid rising speculation in lower-quality names.
- We established nine new positions during the quarter across five sectors, increasing our exposure to innovative growth companies and those geared for a reopening of the economy.
- Recent results reflect the work done over the last several quarters to maintain diversified exposure to small and mid cap growth companies while paying close attention to risk.

Market Overview

A rotation in market leadership that commenced last September continued to gain strength in the first quarter, with efforts to reflate the economy through fiscal and monetary stimulus helping the S&P 500 Index gain 6.2%. The benchmark Russell 2500 Growth Index rose 2.5% but trailed the Russell 2500 Value Index by over 1,400 basis points for the quarter as investors expressed a preference for more attractively priced and cyclical plays over long-duration growth assets. The historic advantage SMID cap growth stocks enjoyed through the depths of the COVID-19 pandemic has evaporated, thanks in large part to the reopening trade that has predominated since "Vaccine Monday" last November. Over the trailing 12 months, the Russell 2500 Growth Index and its value counterpart are both up 87.5%.

From a sector standpoint, energy (+35.2%) was the best performer in the benchmark but accounted for de minimis exposure. Among sectors with broader representation, the cyclical consumer discretionary (+13.9%), materials (+11.2%) and industrials (+10.8%) sectors as well as consumer staples (+12.1%) also outperformed. Meanwhile, the information technology (IT, -2.3%) and communication services (-0.4%) sectors, which thrived in the work-from-home and e-commerce boom during the pandemic, as well as health care (-2.3%) underperformed.

The first quarter brought wild market action and volatility. After robust equity returns during 2020, investor expectations pivoted to a strong U.S. economy during 2021, powered by fiscal stimulus and "easy comps" for a lot of businesses.

> We seek to promote consistency by applying discipline and diligence in managing the construction of the portfolio.

As daily temperatures have started to rise due to the arrival of spring, so too has the 10-year Treasury yield. The benchmark yield has moved up 83 basis points since year end and 124 bps off the August 2020 bottom. While those moves are relatively modest compared to past decades, they are meaningful off a low base. They also reflect heightened awareness that costs have risen, in some cases meaningfully (logistics, commodities), as economic recovery continues. Whether an acceleration of inflation back to Federal Reserve targets or beyond is in the offing remains to be seen. Certainly the increase is flattering the economics of select businesses (i.e., yield-curve-sensitive earners, such as some financials) while compressing the valuation on more open-end high-growth businesses.

The ClearBridge SMID Cap Growth Strategy outperformed in the first quarter as our preference for sturdy fundamentals and value-creating management teams provided ballast amid rising speculation in newly public risk assets favored on online message boards. The work our team has done over the last several quarters to maintain a high-quality, diversified portfolio while paying close attention to risk has contributed to this resilience through the latest market rotation.

Indicative of our focus on targeting dynamic growth companies across the mid cap universe, the top 10 individual contributors for the first quarter were spread across seven sectors. Penumbra, in the health care sector, is a maker of medical devices to treat aneurysms and other neurovascular conditions. The company recovered from a short selling attack and product withdrawal which depressed the stock in the fourth quarter. United Rentals, in the industrials sector, benefited from improving equipment utilization and, as the largest domestic construction equipment rental company, stands to benefit should the Biden Administration's infrastructure plan advance out of Congress. Information security provider Fortinet, in the IT sector, was another significant contributor as many now remote-based enterprises doing more work in the cloud need enhanced threat protection from data breaches and cyberattacks.

We seek to promote consistent performance by applying discipline and diligence in managing the construction of the portfolio. Fourth-quarter 2020 earnings and 2021 guidance (when provided) have been strong, invariably. We have been parsing which companies have come through the challenges of 2020 much stronger versus those enjoying a cyclical recovery. We trimmed back several of our big winners from 2020 and have been vetting growth companies with more reasonable valuations.

Portfolio Positioning

We established nine new positions during the quarter, largely financed through trims in existing holdings.

APi Group, in the industrials sector, was our most significant new addition. APi helps office and industrial buildings ensure their safety and fire alarm systems are operating properly, a largely recurring business where the company has an opportunity to grow market share. Also in industrials, Array Technologies makes mechanical tracking systems platforms for industrial grade solar installations that pivot as the direction of the sun changes to capture the most solar exposure. The company, run by a team with a keen sense of where to offer software around its physical platform, has seen mostly U.S. market share gains thus far and will begin to ramp up its international business this year.

Houlihan Lokey, in the financials sector, is a regional investment bank that advises on mergers & acquisitions and company restructuring as well as capital raising to primarily mid and small cap companies. We added the position based on favorable M&A volumes, a significant presence in the middle market with good diversification across clients and industries, and balanced revenue streams between a cyclical evaluation and more cyclical M&A/restructuring activity.

Cloudera, in the IT sector, provides software to manage and analyze data. The traditionally on-premise data lake company with a blue chip client base has recently added cloud capabilities, which should stem client churn, increase workloads at existing customers, and add new clients, with the potential to reaccelerate revenue growth from the high single digits to 15%-20%.

The Strategy closed out of five positions. RealPage, in the IT sector, is a software maker that automates residential lease documents, payments and service requests. We closed the position ahead of its acquisition by private equity firm Thoma Bravo. Mimecast, also in the IT sector, runs a proprietary operating system that holds a leading position in email safety. We exited the shares based on an elongated small business sales cycle as well as complications from the SolarWinds breach. We also sold BioMarin Pharmaceutical after a number of its clinical catalysts had played out.

Outlook

The changes in Washington have brought a return to more normal policymaking at an overall lower decibel count but with a greater penchant for opening the fiscal purse strings. The $1.9 trillion American Rescue Plan combined with speculated multi-trillion policy initiatives for infrastructure and green spending has caused concern about high deficits, in turn starting the conversation on corporate and individual tax increases. As legendary Illinois Republican Senator Everett Dirksen (apocryphally) once stated, “a billion here, a billion there and pretty soon you’re talking real money.”

Tightening monetary conditions (due to higher interest rates) and eventual tax increases are eventually contractionary. Of course there’s a short-term offset from the present fiscal spending. These evolving policy arcs and the supporting tactics to finance them (i.e., drug pricing) bear watching and may well cap equity returns until better defined.

The bottom-up fundamental work we have completed on target SMID cap growth companies, with the support of our analysts, helps us identify which stocks and sectors are getting expensive, which other areas are more attractive and where we should be participating. We believe this bottom-up approach positions us for whatever policy regime is in the offing, balancing exposure to above-average and underappreciated growers and providing access to companies operating in large addressable markets.

Portfolio Highlights

During the first quarter, the ClearBridge SMID Cap Growth Strategy outperformed the benchmark Russell 2500 Growth Index. On an absolute basis, the Strategy had gains across eight of the 10 sectors in which it was invested during the quarter (out of 11 sectors total), with the industrials and health care sectors the leading contributors.

In relative terms, outperformance was primarily driven by stock selection and sector allocation. Specifically, stock selection in the health care and financials sectors were the primary drivers of results. Stock selection in the materials, communication services and consumer staples sectors, overweights to the consumer discretionary and industrials sectors and an underweight to health care also helped. Conversely, stock selection in the consumer discretionary sector detracted from relative performance.

The leading contributors to absolute returns during the first quarter included Penumbra, United Rentals, SVB Financial, Fortinet and Summit Materials. Positions in SVMK, Everbridge, Farfetch, Ultragenyx Pharmaceutical and Five9 were the greatest detractors from absolute returns.

In addition to the portfolio activity mentioned above, we initiated positions in National Vision Holdings, Vroom, Callaway Golf and Five Below in the consumer discretionary sector and iRhythm Technologies in the health care sector. We also closed positions in Sumo Logic and Cardtronics in the IT sector.