ClearBridge Investments

Small Cap Growth Strategy

Aram Green
Managing Director, Portfolio Manager

Jeffrey Russell CFA
Managing Director, Portfolio Manager

Key Takeaways

- While mean reversion led to a September rally for value stocks across U.S. equity markets broadly, growth outperformance persisted among small caps.
- We made six additions during the quarter, largely financed through trimming successful existing holdings, with our purchases centered in health care and technology.
- The Strategy, which customarily lags in strong up markets and defends well in sharply lower markets due to our quality bias, outperformed the benchmark meaningfully in a quarter of above-average returns.

Market Overview

What a nine months we've experienced, with manifold uncertainties clearly in sight:

- The COVID-19 (C-19) pandemic (over 208,000 known domestic casualties)
- Economic shutdowns in the U.S. and elsewhere
- A flash recession that exceeded the Great Depression in speed and severity
- Speedy, coordinated fiscal and monetary policy response which led to a brisk, if incomplete, recovery with roughly half the jobs lost at the depth recovered
- High velocity capital-raising by corporates given the uncertainty of the C-19 disease progression
- Police shootings and high-level social protest causing America to reexamine its diversity and inclusion efforts
- Political dissension about the outcome of the looming November national elections as well as the composition and size of the U.S. Supreme Court
- A C-19 super-spreader event in the Rose Garden leading to the hospitalization of the president
- The acceleration of a variety of secular trends relating to digital experience (telemedicine, work from home, cloud adoption)

If we were focused solely on these macro factors, our heads would assuredly be spinning. That's why we concentrate on companies and their opportunities as well as capable management execution throughout the many abnormal challenges.

During the third quarter, growth stocks continued to outperform. The overall market moved into positive territory year to date, with the Russell 3000 Index up 5.4%, despite earnings during the second quarter declining by roughly one third. While earnings will still be lower year over year for the next two quarters, the gradient is positive and underwritten by GDP, which may increase as much as 30% or more sequentially versus the second quarter.

On the differentiation between growth and value, small cap growth stocks outperformed by about 460 basis points, comparing the Russell 2000 Growth Index and its value equivalent. Many strategists and investors question the durability of that trend and we're the first to admit mean reversion could happen any time, as we've experienced some sharp daily reversals. Indeed, during September, the Russell 3000 Value Index outperformed the Russell 3000 Growth Index; but at least in the small cap Russell 2000 universe, growth outperformance persisted.

Overall, companies have adapted rapidly to 1) protect their employee's safety, 2) serve their clients, 3) be thoughtful about their community responsibilities, and 4) ensure their capital adequacy.

Portfolio Positioning

We made six additions during the quarter, largely financed through trims in existing successful larger cap holdings, of which six remain in the portfolio at quarter end.

Three new positions are in health care, where we have been searching for companies to replace the four names taken out in acquisitions over the last two calendar years. Cryoport provides a full, standard-setting cold supply chain management service for regenerative medicine life science customers. The majority of revenue is from biopharmaceutical shipping (temperature, location, condition) mostly used in gene and cell therapies and clinical trials. The company also has a cold storage and sample management network for biopharma products. CareDx is a genomics test provider primarily for heart and kidney transplant patients. CareDx's tests monitor for organ rejection, have higher accuracy and are less invasive for the patient (compared with standard biopsy); they also enjoy established reimbursement from Medicare and commercial payors. American Well has over 40 prepackaged telehealth programs with over 100 use cases ranging from primary and urgent care to high acuity specialty consults (telestroke, telepsychiatry, neonatal). These programs can be embedded into patient/member portals and launched natively from electronic health records while handling payer eligibility and claims/system integration.

While in the IT sector, Model N also has a health care angle as its revenue management software with a purpose-built platform helps primarily life sciences customers maximize revenues, reduce compliance risk and improve channel visibility. Model N replaces disjointed manual processes for pricing, contracting, incentives, rebates, channel management and regulatory compliance with a product suite that has transitioned to the cloud. Also in IT, Jamf is a cloud software platform focused on management of Apple devices (Mac, iPhone, iPad, Watch) in enterprises and educational use. Jamf's software helps organizations to administer the Apple devices of their end users with minimal friction and ease. At its July initial public offering, Jamf had more than 40,000 customers administering 17 million devices.

We have been searching for new ideas in health care, where four names were taken out in acquisitions over the last two calendar years.

We also purchased shares of RBC Bearings in the industrials sector, which manufacturers highly engineered precision bearings/components used in a diverse range of machines, aircraft and mechanical systems. While the business is cyclically challenged due to end market exposure (over 60% tied to aerospace,) we see this as a strong recovery investment with 60% of revenues from sole-source, proprietary products with long-term contracts.

During the quarter, two existing holdings agreed to strategic mergers. After a meteoric ascent abetted by C-19, specialist telemedicine provider Livongo Health, which was added in the first quarter, agreed to be acquired by Teladoc Health. Airport retailer Hudson, meanwhile, agreed to be acquired by its Swiss parent Dufry.

Outlook

We manage the portfolio without conscious or explicit macro tilts. Our investment process is grounded by derisking individual investments; returns are from a concentrated portfolio that embeds a variety of growth rates.

Stock market multiples are high by absolute standards. Yet compared with paltry fixed income yields and a sub-1% 10-year Treasury yield, there is still good value to be captured in stocks. U.S. unemployment is receding, forward inflation expectations appear quiescent and fixed income and equity capital availability is ample.

Ongoing risk management remains of paramount importance, assessing how exogenous events and factors can affect specific investments in the Strategy. Our attention to sustainable business dynamics, backed up by robust capital discipline, is an elemental ClearBridge philosophy that we will continue to apply to the existing portfolio and new growth opportunities that we foster.

Portfolio Highlights

During the third quarter, we're pleased that the Small Cap Growth Strategy outperformed the benchmark by over 390 basis points. The Strategy customarily lags in strong up markets and defends well in sharply lower markets due to our quality bias.

On an absolute basis, the Strategy had gains across nine of the 10 sectors in which it was invested during the quarter (out of 11 sectors total), with the health care, IT and industrials sectors the leading contributors.

In relative terms, outperformance was primarily driven by stock selection while sector allocation was also beneficial. Specifically, stock selection in the health care sector was the primary driver of results, while stock selection in the IT and communication services sectors and an underweight to health care also aided performance. Conversely, stock selection in the consumer discretionary and industrials sector and an overweight to IT detracted from relative performance.

The leading contributors to absolute returns during the third quarter included Trupanion, Bandwidth, Insulet, HubSpot and Invitae. Positions in Monro, New Relic, Fox Factory, Western Alliance Bancorp and Syneos Health were the greatest detractors from absolute returns.

In addition to the transactions mentioned above, we closed positions in Revolve Group in the consumer discretionary sector and Copart in the industrials sector.

Descriptive Title:	**Delivering Alpha Through Uncertainty**

Page Description (for AEM Page Properties):	While mean reversion led to a September rally for value stocks across equity markets broadly, growth outperformance persisted among small caps.
Description for Each Chart and Graphic:	
Graphic Quotes:	**Jeffrey Russell, CFA** "We concentrate on companies, their opportunities and capable management execution through many challenges." **Aram Green** "While earnings will still be lower year over year for the next two quarters, the gradient is positive."
Pull Quotes (optional):	