ClearBridge Investments

Small Cap Growth Strategy

Aram Green
Managing Director,
Portfolio Manager

Jeffrey Russell CFA
Managing Director,
Portfolio Manager

Key Takeaways

- An accelerating rotation into value stocks in the small cap universe and the negative impact of a rapidly steepening yield curve on high-growth businesses contributed to the Strategy's modest underperformance.
- We established seven new positions during the quarter, largely financed through trims or sells of existing holdings whose market values have risen meaningfully.
- Beyond the near-term boost from present fiscal spending, tightening monetary conditions (due to higher interest rates) and eventual tax increases bear watching, as both are eventually contractionary and could cap equity returns until policy arcs are better defined.

Market Overview

Last year we advised investors, "don't succumb to vertigo" as the small cap growth equity market reached record highs after a 28.5% increase during 2019.

The first quarter of 2021 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. The reopening trade has predominated since "Vaccine Monday" on November 9, with value stocks leading the way overall. In the small cap space, the value style outperformed growth by over 1,600 basis points during the first three months of the year, with the Russell 2000 Value Index up 21.2% compared to 4.9% for the Russell 2000 Growth Index. This rotation, plus a few investments with short-term hiccups in stock price, led to the Strategy's modest underperformance during the first quarter.

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 bps 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 increase in yields is compressing the valuation of more open-end high-growth businesses.

The arrival of cherry blossoms in Washington this week are welcome after the ugliness of the Capitol Hill riot early in January and the clamor of the second impeachment hearings. In addition to the Washington ugliness, markets were roiled by the continuing pandemic effects (including the emergence of variants), the Reddit/Robinhood trading spikes, the flow impact of ARK ETFs, and the mixed performance of SPACs later in the quarter.

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/green energy/education/climate change 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.

Portfolio Positioning

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 continue to winnow down our holdings with higher market capitalizations and redeploy assets to constrain market cap in the Strategy. During the quarter we sold Cardtronics and Pluralsight (both were subject to takeovers) and sold the remainder of our long-standing IDEX investment due to its graduation into mid cap range. Meanwhile, we made significant additions to existing positions in Allegro MicroSystems and PagerDuty in the information technology (IT) sector, CareDx and Silk Road Medical in the health care sector, ChampionX in the energy sector as well as RBC Bearings in the industrials sector.

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Four of the additions play roles in the accelerating digital transformation of the sales, marketing and customer development processes. Poshmark, in the consumer discretionary sector, is an e-commerce platform that replicates a physical shopping experience through a socially amplified platform. SEMrush, in the IT sector, is a software provider that help clients optimize their marketing spend across digital search and social media platforms. Viant, in the IT sector, is a software provider that tracks digital consumer media consumption and matches consumer interest with advertisers. With proprietary algorithms, Viant helps advertisers generate superior returns on their spending across various channels. SVMK, in the IT sector and formerly known as SurveyMonkey, provides survey software tools for clients and employees. Surveys have become ever more important in customer retention/success for enterprises.

We also added:

- Shoals Technologies, in the industrials sector, manufactures electric balance of systems (EBOS) components for ground-mounted solar projects. The company has IP protection around a system of EBOS installation that does not rely on licensed electricians for installation and can be installed above ground, thereby offering the customer significant time and labor savings.
- Hayward, in the consumer discretionary sector, is a manufacturer of a variety of pumps, filters, sanitizers and cleaners for the swimming pool industry. The company is asset light, innovative and has significant opportunities to improve underlying economics while participating in the recovery of swimming pool construction and renovation since the 2008–09 collapse.
- Olink, in the health care sector, is a maker of instruments, kits, and provides services for protein detection and biomarker discovery. Its key PEA technology uses antibodies to bind to protein targets.

Performance Highlights

During the first quarter, the ClearBridge Small Cap Growth Strategy underperformed its Russell 2000 Growth benchmark. 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 consumer staples sectors the leading contributors.

In relative terms, overall sector allocation contributed to performance but was offset by negative stock selection effects. Specifically, stock selection in the consumer discretionary and IT sectors and an underweight to consumer discretionary hurt results. Conversely, stock selection in the health care sector, an underweight to health care and an overweight to the energy sector supported relative performance.

The leading contributors to absolute returns during the first quarter included Penumbra, Western Alliance Bancorp, Surgery Partners, Fox Factory and BJ's Wholesale Club. Meanwhile, Trupanion, Amicus Therapeutics, iRhythm Technologies, Bandwidth and Heron Therapeutics were the greatest detractors from absolute returns.

In addition to the transactions mentioned above, we also closed a position in American Well in the health care sector.