ClearBridge Investments

SMID Cap Growth Strategy

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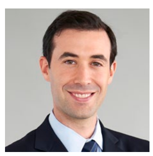

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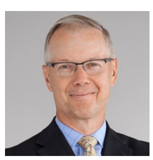

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Key Takeaways

- A focus on de-risking investments prior to purchase and managing position sizes has supported absolute and relative results through recent market turbulence.
- With this mosaic as backdrop, we continued to find companies with disruptive products and services, sound leadership and capital adequacy, adding six new positions.
- Small and mid cap growth stocks are expected to deliver higher earnings growth rates relative to larger companies and remain positioned at the nexus of innovation.

Market Overview

While mid and small cap stocks generated positive returns for the fourth quarter, elevated uncertainty and increased volatility drove investors to favor the safety of larger cap companies. The S&P 500 Index rose 11.03% for the period, while the benchmark Russell 2500 Growth Index managed a 0.20% gain. Investors also shifted their preference from growth stocks into value, with the Russell 2500 Value Index outperforming its growth counterpart by 616 basis points. As a result, small and mid cap value further extended its lead over growth for 2021 to over 2,200 basis points.

Sentiment toward growth companies, whose earnings are discounted farther out into the future, had been unraveling through the fourth quarter and turned into a rout in mid-December as the Federal Reserve gave its strongest signals since the start of the pandemic of a shift away from accommodative monetary policy. Fed Chair Jerome Powell announced that the central bank would be accelerating its tapering of government bond purchases and its latest dot plot projected three interest rate increases in 2022, a much more aggressive tightening program than expected just three months ago. Fearful that the Fed was behind the curve, investors rotated out of higher-growth, higher-multiple names into more inflation- and interest-rate-sensitive areas.

The year encompassed a number of equity market crosscurrents:

- Initial public offering volume was prolific with approximately 400 IPOs priced and over $142 billion raised.
- Secondary placements from private equity holders also surged while new private buyouts exceeded historic levels.

- The SPAC/de-SPAC phenomenon led to the listing of many companies with uncertain prospects yet capital to invest. Over 600 SPACs listed, raising as much as the IPO marketplace, while approximately 200 private companies became listed through mergers into SPACs.
- Companies (primarily larger cap) flush with capital bought back record amounts of stock.
- Corporate insiders, conversely, sold in some cases massive quantities of personal holdings as record stock prices coincided with the likelihood of higher personal capital gains tax rates.
- Flows into ETFs were very healthy, pushing a few mega cap stocks into uncharted capitalization territory.
- Leveraged investors significantly delevered as the Omicron variant spread.

The ClearBridge SMID Cap Growth Strategy continued to deliver strong absolute and relative returns as our focus on de-risking investments prior to purchase and managing position sizes has made a difference through recent market turbulence.
Trex, a manufacturer of outdoor decking made from extruded sawdust and recycled plastics, is the largest position in the Strategy but the only stock with a weighting of over 3% in a diversified growth portfolio of about 80 names. Trex has successfully convinced consumers about the virtue of composite decking (durability, environmental impact) versus virgin lumber construction. The stock was boosted recently by exceptionally strong third quarter results that handily topped expectations on a variety of metrics as well as strong guidance. Substantial capacity additions have been adroitly deployed and absorbed, and the company is planning for its third U.S. manufacturing site.

Strategy outperformance, for both the quarter and the year, was driven by our health care exposure in an otherwise tough period for small and mid cap health care stocks. Health care (-8.79%) was the second worst performing sector in the benchmark in the fourth quarter. In particular, biotechnology and gene therapy companies were pressured by disappointing clinical trials, FDA approvals being pushed out, potential drug price limitations out of Washington and simply too much supply with more than 140 health care IPOs during the year.

Our aversion toward early-stage biotech proved productive as did our approach of emphasizing the enablers and selected, profitable medical technology companies. Strong contributors during the fourth quarter included contract research organization ICON whose recent acquisition of PRA Health Sciences should augment underlying business growth as well as Penumbra, a developer of stents and related products to treat aneurysms that saw it shares recover from a product recall earlier in the year.

New Relic, which develops observability software including application monitoring, infrastructure and network monitoring capabilities, was another strong contributor. After a long evolution to a consumption-based pricing plan and rejuvenation of its tech platform, New Relic shares were boosted by quarterly results that topped expectations on strength across a number of metrics including consumption and churn.

Strength in companies like New Relic offset weakness in higher-multiple growth names that were dragged down by negative sentiment or short-term execution issues. Shares of Wix.com, for example, continued to lose momentum after a surge in demand for its web-based tools to create and manage desktop and mobile websites during the height of pandemic lockdowns. A leading beneficiary of a shift to a digital work and home environment, Wix sold off as it faced tough comparisons to the year ago period and was hurt by a rise in yields that impacted most long duration growth companies. Avalara, which offers online tax compliance software for small and medium size businesses and increasingly enterprise customers, also saw its stock lose altitude with many high growth technology companions as some investors reduced financial leverage, although we are unaware of any fundamental disappointments. We continue to believe companies like Wix and Avalara will be key players in the democratization of e-commerce.

Portfolio Positioning

With this mosaic as backdrop, we continued to find companies with product and service innovation, sound leadership and capital adequacy. For the second year in a row, managements were tested with a harrowing array of shortages in both labor and products, higher input costs and the continuing mutations of COVID-19.

Most companies in the Strategy came through with strong profit growth but inevitably some businesses struggled as the year progressed. Other companies had "tough comps" versus the above-normal growth of 2020.

We added six new positions in the fourth quarter, the largest being WillScot Mobile Mini in the industrials sector. WillScot is the leading manufacturer in the modular office and storage end markets. The company has a multitude of idiosyncratic growth drivers that should support a doubling of free cash flow per share over the next four to five years. Another new addition was Western Alliance Bancorp (WAL), an Arizona-based community lender. WAL maintains our banking exposure as we have begun to exit SVB Financial due to capitalization. WAL has made a number of strategic niche acquisitions in the past decade and continues to demonstrate above-industry loan growth and good credit metrics.

We also purchased shares of two disruptive software companies that came public earlier in the year. Paycor, a software company

Companies with high returns on equity tend to do better in tightening cycles and that plays well to our strengths in the Strategy.

in which we previously held a private investment in other portfolios, provides a product offering spanning core payroll & HR tools, with additional bundles that assist with talent management, employee engagement, benefit administration and workforce management tools. We see next-generation cybersecurity provider SentinelOne, although early in its growth lifecycle, as capable of taking share from legacy players in the antivirus and broader cybersecurity industry.

We also closed out of four names during the quarter. Cornerstone OnDemand was taken private while CoreSite Realty was acquired by cell phone tower operator American Tower. We exited auto maintenance and repair provider Monro due to inconsistent execution, management churn and as a source of capital for other opportunities and took advantage of the rally of energy stocks to take profits in MRC Global, a distributor of pipes and valves for the exploration and production industry.

Outlook

Strategists always look to a New Year and forecast outcomes. In our view, the likely range of outcomes in 2022 is wider than normal; we expect more of a "grinder" overall market if interest rates head higher and as fiscal stimulus abates. Year two of a presidential term, meanwhile, has historically produced anemic returns. About the only 2022 prediction of absolute certainty is for heated political rhetoric as the country heads toward next November's midterm elections.

Companies with high returns on equity tend to do better in tightening cycles and that plays well to our strengths in the Strategy. Finally, innovation is still centered in small and mid cap companies and with $3 trillion of cash sitting on corporate balance sheets, that provides plenty of dry powder for M&A activity as larger companies and strategic investors seek to buy growth.

In a rising rate environment, we believe the best solution is to continue relying on the strong fundamental analysis that guides our active management approach. While visibility to the future is limited, we stress the importance of basing our investment decisions on what we can see: the strength of a company's balance sheet, the predictability of its cash flows and the potential size of its market opportunity. By basing our portfolio construction on companies that can generate consistent growth across any kind of macro environment, we are able to focus on seeking out the best risk-adjusted returns in the market.

Portfolio Highlights

During the fourth quarter, the ClearBridge SMID Cap Growth Strategy outperformed its Russell 2500 Growth Index benchmark. On an absolute basis, the Strategy had gains across seven of the 10 sectors in which it was invested during the quarter (out of 11 sectors total), with the industrials sector the leading contributor, while the consumer discretionary and IT sectors were the primary detractors.

In relative terms, overall stock selection contributed to performance. Specifically, stock selection in the health care, communication services, consumer staples, industrials and financials sectors was the primary driver of returns. Conversely, stock selection in the IT and consumer discretionary sectors detracted from relative performance.

The leading contributors to absolute returns during the fourth quarter included Trex, New Relic, Live Nation Entertainment, ICON and BJ's Wholesale Club. Meanwhile, Everbridge, Avalara, Chegg, Wix.com and Five9 were the greatest detractors from absolute returns.

In addition to the transactions mentioned above, we purchased Definitive Healthcare in the health care sector and Freshworks in the IT sector.