FRANKLIN TEMPLETON | ClearBridge

Mid Cap Growth Strategy



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Key Takeaways

- Mid cap growth equities delivered strong quarterly returns driven by market leadership tied to AI infrastructure and select cyclical beneficiaries.
- The Strategy outperformed its Russell Midcap Growth benchmark, supported by positive stock selection, industrials strength and competitive IT results.
- We remain focused on identifying durable economic value as AI investment evolves and broader cyclical recovery opportunities continue to emerge.

Market Overview

Mid cap growth equities delivered strong absolute returns in the second quarter, outpacing value and narrowing its year-to-date outperformance. Despite mid cap growth stocks trailing their larger and smaller cap peers, the quarter reflected a healthier backdrop for our opportunity set, with performance led by AI infrastructure, hardware, memory and select cyclical beneficiaries — areas where fundamentals and stock selection mattered.

Market direction remained constructive, but leadership was uneven. Participation broadened beyond mega cap technology, yet returns at both the benchmark and individual-stock levels clustered around AI buildout and cyclical recovery drivers. The market also continued to favor higher-beta, lower-return-on-equity, faster-growing and more expensive companies, creating a challenging backdrop for quality-oriented active management even as the Strategy generated relative outperformance.

AI remained the dominant market theme, although leadership within the ecosystem continued to shift from initial perceived winners of the infrastructure buildout to emerging bottlenecks that can accrue more value such as memory, data connectivity, power players, GPUs and initial infrastructure winners. At the same time, debates continue around AI return on investment, “tokenmaxxing” (the maximizing of AI-token usage, largely used as a proxy for productivity) and where the most durable economic value will accrue.

The strength of this investment cycle helped markets look through geopolitical volatility, oil-related inflation concerns and a leadership change at the Federal Reserve, even as investors moved from expectations for rate cuts entering the year to debating possible rate hikes in the second half. The annual Russell rebalance was also

unusually significant: expected turnover was more than double the Russell Midcap Growth Index's long-term average, with many perceived AI winners graduating into the benchmark, lifting information technology (IT) meaningfully at the expense of consumer discretionary, financials and industrials. This underscores the need to assess not just whether AI investment remains strong, but where the next stage of value creation will occur.

Rather than chasing every fickle new attractive theme, we are focused on identifying where durable economic value will accrue.

Portfolio Performance

The ClearBridge Mid Cap Growth Strategy outperformed its Russell Midcap Growth benchmark during the second quarter, supported by solid stock selection across a variety of sectors and the recovery of several long-standing industrial holdings as the economic backdrop became more constructive for several previously depressed end markets.

Within industrials, long-standing holdings United Rentals, an equipment rental company, and WillScot, a provider of modular space and storage solutions, saw relief as investors grew more comfortable with the durability of infrastructure demand and improving general non-residential activity. This strength was partially offset by weakness in select aerospace and defense holdings, including Kratos Defense & Security Solutions, as the group fell out of favor amid concerns around the aerospace cycle following the Iranian conflict and a reversal in defense sentiment heading into the midterm election cycle.

IT was also an important contributor, with the Strategy keeping pace despite limited exposure to several higher-beta AI-exposed stocks. Patience in select software holdings was rewarded after the first-quarter selloff, as Datadog, a cloud observability platform, Fortinet, a cybersecurity company, and Rubrik, a data security and cloud data management provider, benefited from greater recognition that AI adoption can increase data, security and infrastructure complexity. These gains were supported by contributions from Monolithic Power Systems, a semiconductor company benefiting from rising power needs in AI server racks, and Vertiv, a provider of power and cooling infrastructure for data centers, helped offset relative headwinds from the robust performance of some of the benchmark's fastest-moving AI beneficiaries like Astera Labs, a maker of high speed networking and connectivity chips used in data centers. We added the name late in the quarter but missed most of its 300% plus performance.

Health care also contributed, with positive contributors from both biotechnology and equipment industries. Bio-Techne, a life sciences tools company, was acquired by Merck KGaA against a backdrop of improving demand, while new position Roivant, a biotechnology company developing therapies across a range of conditions, also supported results as investors recognized its repeatable in-licensing and drug development model.

Energy was a modest headwind, as natural gas producer EQT, energy technology company Baker Hughes and oil and gas producer Diamondback Energy gave back prior gains, largely tracking weaker

oil and natural gas prices amid optimism for a potential détente in the Iran conflict.

Portfolio Positioning

The second quarter was another productive period for new idea generation, extending the preparatory work we had done around the Russell rebalance and broadening our exposure to AI infrastructure beneficiaries, as well as an array of idiosyncratic growth stories across varied sectors. Rather than chasing every benchmark shift and emerging hot narrative, we focused portfolio activity on areas where we believe durable economic value can accrue, balancing exposure to AI infrastructure beneficiaries with select industrial and health care opportunities that can compound through a broader recovery.

On the AI-related side, we added Lumentum, a scaled provider of optical and laser products, where valuable capacity in tight areas of data connectivity should benefit from evolving AI data and server architectures. We also added Sterling Infrastructure, a construction and site-preparation company, whose national scale should be increasingly valuable as AI data center campuses require complex excavation and megaproject execution.

Outside of AI infrastructure, we added BWX Technologies, a sole-source provider of nuclear reactors for the U.S. Navy and manufacturer of commercial nuclear components, where steady naval nuclear demand and incremental commercial nuclear opportunities support a durable growth profile. We also added Insmed, a biotechnology company focused on respiratory diseases, where multiple approved potential blockbuster drugs and an attractive clinical pipeline create meaningful long-term growth potential at an attractive price.

On the sell side, we exited SailPoint Technologies, an identity security software provider, as increased competition, uneven execution and uncertainty around its role as a durable AI winner reduced our conviction; Doximity, a digital health platform, amid AI disruption concerns, growth deceleration and management change; and Advanced Drainage Systems, a water management and drainage products provider, to balance non-residential construction exposure given concerns around near-term growth and margins. We also exited Entegris, a semiconductor materials and process solutions company, after strong performance brought shares to our assessment of fair value, redeploying proceeds into companies with greater upside potential.

Outlook

The market is wrestling with an increasing pace of disruption amid a generational investment cycle. Winners and losers are being reassessed quickly, while geopolitical uncertainty is affecting the direction of monetary policy and complicating consumer and business investment planning. We expect volatility to persist, but we also believe the environment can create opportunities for active managers focused on fundamental differentiation.

We continue to see cautiously optimistic signs of a broader cyclical recovery in industrials, health care and the consumer. AI investment will likely remain robust, but the market will need to distinguish between revenue growth and durable economic value creation, especially given the benchmark's higher exposure to AI-related businesses.

We also see opportunities for AI users in transportation, biotechnology, health care providers and financial institutions where productivity gains may not yet be fully discounted. We are mindful of upcoming midterm elections and policy winners and losers, and our approach remains grounded in bottom-up research, selectivity and discipline across diverse business models and growth rates.

Portfolio Highlights

The ClearBridge Mid Cap Growth Strategy outperformed its Russell Midcap Growth Index benchmark during the second quarter. On an absolute basis, the Strategy had gains in nine of the 11 sectors in which it was invested. The largest contributors to absolute performance were the industrials and IT sectors, while the energy and materials sectors detracted.

On a relative basis, overall stock selection drove most of the outperformance. Stock selection in industrials, consumer staples, consumer discretionary and communication services proved beneficial. Conversely, stock selection in the energy, financials, IT and materials sectors and an overweight to consumer staples weighed on performance.

On an individual stock basis, the largest contributors to relative returns were United Rentals, Datadog, Rubrik, Fortinet and an underweight to Insmed. The largest detractors were EQT, Baker Hughes, Chewy, Martin Marietta Materials and an underweight to Astera Labs.

In addition to the transactions mentioned above, we initiated positions in Fabrinet, Lattice Semiconductor, Coherent, Credo Technology and MACOM Technology Solutions. We exited positions in Ryan Specialty Holdings, Shift4 Payments, SBA Communications, Copart and Hilton Worldwide.

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