ClearBridge Investments
A Legg Mason Company

2Q 2019 | Product Commentary

CLEARBRIDGE SMALL CAP FUND

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Portfolio Managers

Average annual total returns and fund expenses (%)

as of June 30, 2019

Class A	3-mo	1-yr	5-yr	10-yr	Since Incept. (02/03/09)	Expenses Gross	Expenses Net
Excluding sales charges	2.64	3.42	8.71	13.65	16.02	1.23	1.23
Including effects of maximum sales charges	-3.27	-2.52	7.43	12.98	15.36	1.23	1.23
Russell 2000 Index	2.10	-3.31	7.06	13.45	N/A	-	-

Performance shown represents past performance and is no guarantee of future results. *Current performance may be higher or lower than the performance shown. Investment return and principal value will fluctuate, so shares, when redeemed, may be worth more or less than the original cost. Class A shares have a maximum front-end sales charge of 5.75%. If sales charges were included, performance shown would be lower. Total returns assume the reinvestment of all distributions at net asset value and the deduction of all Fund expenses. Total return figures are based on the NAV per share applied to shareholder subscriptions and redemptions, which may differ from the NAV per share disclosed in Fund shareholder reports. Performance would have been lower if fees had not been waived and/or reimbursed in various periods. Returns for less than one year are cumulative. For the most recent month-end information, please visit www.leggmason.com.*

Gross expenses are the Fund's total annual operating expenses for the share class(es) shown.

Net expenses are the Fund's total annual operating expenses for the share classes indicated and would reflect contractual fee waivers and/or reimbursements, where these reductions reduce the Fund's gross expenses. These arrangements cannot be terminated prior to December 31, 2020 without the Board's consent. In periods of market volatility, assets may decline significantly, causing total annual Fund operating expenses to become higher than the numbers shown in the table above.

The Gross and Net Expenses listed include 0.12 of Acquired Fund Fees and Expenses (AFFE) that are required to be shown in the Fund's prospectus. AFFE reflects the Fund's pro rata share of fees and expenses relating to its investments in acquired funds; however, AFFE are not incurred directly by the Fund. Therefore, AFFE are not reflected in the Fund's audited financial statements or financial highlights.

The **Russell 2000 Index** measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index. Investors cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges.

Key takeaways

- The quarter was marked alternatively by fears of economic slowdown and exuberance over a potential interest rate cut from the Fed.
- Even though the U.S. 10-year bond rate fell 40 basis points to 2.0%, inverting the yield curve, small-cap banks outperformed REITs and matched utilities, which are both considered bond proxies.
- We plan to remain broadly diversified and to resist the temptation to express a macro view in our portfolio. That would require us to be right not only about future rates but also about how the market would react to them.

Market overview

The Russell 2000 Index sloshed up and down in the second quarter but ended up just a little over 2%. Our strategy outperformed, thanks to a variety of financial and consumer discretionary stocks, offset by the reversal of first-quarter outperformance in health care and energy companies.

The quarter was marked alternatively by fears of economic slowdown and exuberance over a potential interest rate cut from the Fed, which led to an odd collection of industry performances. Even though the U.S. government 10-year bond rate fell 40 basis points to 2.0%, inverting the yield curve, small-cap banks outperformed REITs and matched utilities, which are both considered bond proxies. It's a reminder that, even if one can guess right about something like the direction of interest rates, market expectations may have already anticipated that change and more.

Too often investors start to believe the often-repeated forecasts and start to think they have insight into what the market is about to do. If the market is falling and commentators say it will continue, they pull their money out. If biotechnology stocks are soaring and pundits say the train is leaving the station, they hop on board. Following the crowd like this is usually not a profitable strategy over time.

That's why we always start with the expectations embedded in the stock price, i.e., what growth, investment rate and incremental return on invested capital does the company need to earn to be worth what it's trading for. Then we can consider whether we have reason to believe the company can outperform those expectations, based on a probabilistic view of the future.

Predicting the future is a probabilistic enterprise, not a deterministic one. This is very clear in, say, horseracing, where there may be a favorite, but every horse in the race has some odds (set by the bettors) to win. It's a fact that the value of a bet is the probability of the horse to win times the price of the bet. Yet even in that arena, experienced bettors and novices alike very often pick the horse they think will win, then bet on it no matter what the price, believing that knowing the horse is the important part. But, as professional handicapper Steven Crist says,

The issue is not which horse in the race is the most likely winner, but which horse or horses are offering odds that exceed their actual chances of victory. This may sound elementary, and many players may think they are following this principle, but few actually do. Under this mindset, everything but the odds fades from view. There is no such thing as "liking" a horse to win a race, only an attractive discrepancy between his chances and his price.[1]

As of this writing, the bond market and economists surveyed are both in near-unanimous agreement that the Federal Reserve will cut interest rates at its July meeting and the fed funds rate will decline almost 100 basis points in the next year, compared with a 60% chance of a rate increase in November 2018. That's a remarkable change, given that: 1) unemployment remains near the lowest ever recorded; 2) rolling averages of non-farm payroll net additions have changed very little over the past year; and 3) inflation (as measured by the Consumer Price Index) remains stable very near the Fed target of 2%.

Will we, therefore, position the portfolio contrary to expectations of a rate cut? No. We plan to remain broadly diversified and to resist the temptation to express a macro view in our portfolio. That would require us to be right not only about future rates, but also about how the market would react to them. Going into the second quarter, the market priced banks in anticipation of interest rates declining, hurting bank profits. When they did, bank stocks outperformed the broader market. It's better not to play the game of guessing the future, but instead to value stocks based on their long-term earnings potential and buy when the odds are in your favor.

Fund highlights

During the second quarter of 2019, the ClearBridge Small Cap Fund – Class A shares generated a total return of 2.64%, excluding the effects of sales charges. In comparison, the Fund's unmanaged benchmark, the Russell 2000 Index, returned 2.10%.

On an absolute basis, the Fund had gains in seven of the 11 sectors in which it was invested for the second quarter. The largest contributors to the Fund's performance were the financials, industrials and consumer discretionary sectors. The energy, health care and consumer staples sectors contributed the least.

On a relative basis, the Fund outperformed its benchmark driven by stock selection effects. In particular, stock selection in the financials, consumer discretionary and materials added to relative results, while stock selection in the health care and energy sectors detracted.

On an individual stock basis, Foundation Building Materials, Itron, Lithia Motors, Aaron's and Washington Federal were the greatest contributors to absolute returns in the quarter. 2U, Gray Television, Smart Sand, Akebia Therapeutics and Dynavax Technologies were the largest detractors from absolute performance.

During the quarter we initiated positions in WesBanco, Wintrust and Palomar, in the financials sector, Twin River and OneSpaWorld, in the consumer discretionary sector, and CommVault Systems, in the information technology (IT)

[1] Steven Crist, "Crist on Value," in Beyer, et al., Bet with the Best, (New York: Daily Racing Form Press, 2001), 64.

sector. We closed positions in LegacyTexas, in the financials sector, and Methode Electronics, in the IT sector.

Top contributors

Foundation Building Materials (FBM), in the industrials sector, distributes building products and tools to contractors across North America. The company has been executing well and benefiting from strong homebuilding trends in the first half of 2019, as declining mortgage rates have bolstered the housing market.

Itron (ITRI), in the IT sector, provides end-to-end solutions in energy and water resource management. The stock rose sharply on first-quarter earnings and revenue beats. Margins returned to form, driven by product mix, including higher-margin software deliveries, and as Itron began to solve component shortages that had weighed on the stock previously.

Lithia Motors (LAD), in the consumer discretionary sector, is the third-largest U.S. auto dealer. Lithia Motors has been lifted by an impressive streak of acquisition-driven growth and looks to be seeing synergies from the deals, as it has delivered three consecutive earnings beats. The company's fundamentals, benefiting from its favorable competitive position, strong organic and inorganic growth, and solid operational execution, are also above average.

Bottom contributors

2U (TWOU), in the IT sector, provides cloud-based software services for nonprofit colleges and universities. 2U dropped after it reduced its full-year guidance in May, citing softer average enrollments in some of its large domestic graduate programs. It delivered better-than-expected first-quarter results, however, including a 32% year-over-year quarterly revenue increase, and it has formed some promising new partnerships, such as those with Arcadia University and Case Western Reserve University.

Gray Television (GTN), in the communication services sector, pulled back after recent gains due to uneven advertising results across different providers. Gray remains very well positioned to capitalize on the revenue potential of the 2020 election cycle, given its station footprint across multiple competitive states.

Dynavax (DVAX), in the health care sector, is a biotechnology company developing immunotherapies based on toll-like receptor (TLR) biology. Dynavax has been achieving underwhelming results with its hepatitis B vaccine, Heplisav-B, which had been championed as a successor to GlaxoSmithKline's aging hepatitis B vaccine Engerix-B, thanks to its pronounced dosing and potency advantages over the current market share leader.

Top 10 equity holdings (%)	
Amarin Corp PLC	3.6
Black Hills Corp	1.8
Aaron's Inc	1.8
SkyWest Inc	1.8
Cadence BanCorp	1.7
Advanced Energy Industries Inc	1.7
Quotient Ltd	1.6
WNS Holdings Ltd	1.6
Summit Hotel Properties Inc	1.6
Murphy USA Inc	1.6

Sector allocation (%)	
Financials	19.1
Industrials	14.4
Information Technology	12.7
Consumer Discretionary	12.1
Health Care	12.0
Real Estate	6.6
Materials	4.7
Communication Services	3.7
Utilities	3.7
Energy	3.2
Consumer Staples	3.2
Cash/Other	4.5

Percentages are based on total portfolio as of quarter end and are subject to change at any time. For informational purposes only and not to be considered a recommendation to purchase or sell any security.

Definitions and additional terms:

Please note that an investor cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges.

A **basis point (bp, or bps)** is equal to 1/100th of 1%, or 0.01%.

The **Consumer Price Index (CPI)** is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food, and medical care.

The **Federal Reserve Board ("Fed")** is responsible for the formulation of policies designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

Real estate investment trusts (REITs) invest in real estate or loans secured by real estate and issue shares in such investments, which can be illiquid.

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The **yield curve** shows the relationship between yields and maturity dates for a similar class of bonds.

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What should I know before investing?

Equity securities are subject to price fluctuation and possible loss of principal. Small- and mid-cap stocks involve greater risks and volatility than large-cap stocks. International investments are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging markets. The manager's investment style may become out of favor and/or the manager's selection process may prove incorrect, which may have a negative impact on the Fund's performance.

Active management and diversification does not guarantee a profit or protect against market declines.

Any information, statement or opinion set forth herein is general in nature, is not directed to or based on the financial situation or needs of any particular investor, and does not constitute, and should not be construed as, investment advice, a forecast of future events, a guarantee of future results, or a recommendation with respect to any particular security or investment strategy or type of retirement account. Investors seeking financial advice regarding the appropriateness of investing in any securities or investment strategies should consult their financial professional.

Portfolio holdings and sector allocations may not be representative of the portfolio manager's current or future investment and are subject to change at any time.

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BEFORE INVESTING, CAREFULLY CONSIDER A FUND'S INVESTMENT OBJECTIVES, RISKS, CHARGES AND EXPENSES. YOU CAN FIND THIS AND OTHER INFORMATION IN EACH PROSPECTUS, AND SUMMARY PROSPECTUS, IF AVAILABLE, AT WWW.LEGGMASONFUNDS.COM. PLEASE READ THE PROSPECTUS CAREFULLY.