ClearBridge Investments

Actively Managing Mega Cap Exposure

November 1, 2021

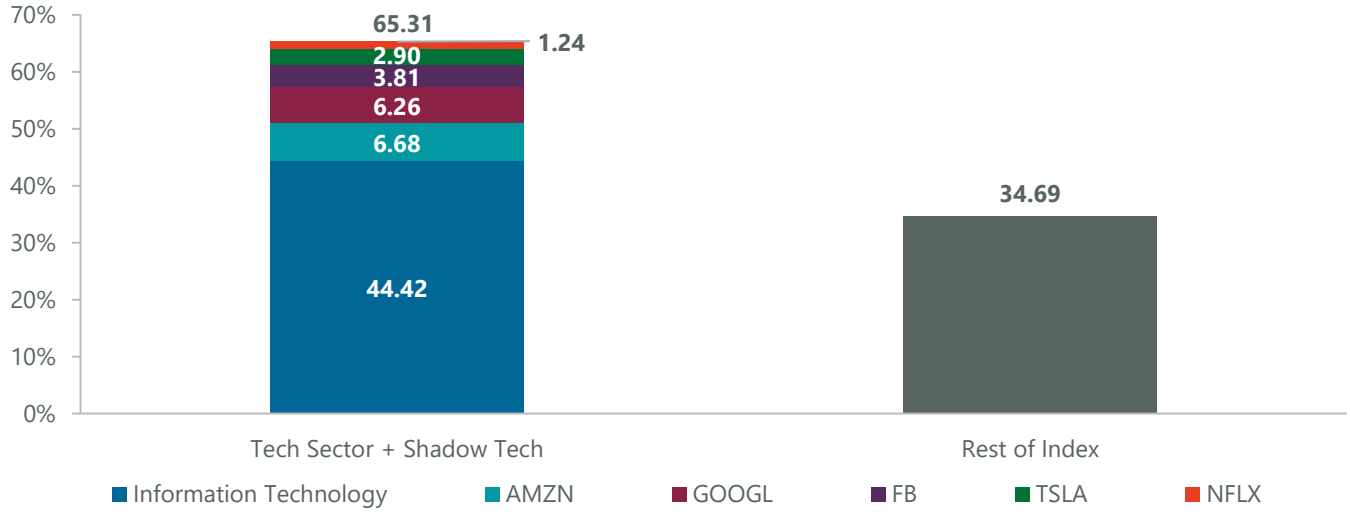
Key Takeaways

- We want to maintain mega cap growth exposure to participate in the burgeoning cloud and digital services markets but are sizing our positions commensurate with our views regarding fundamental business outlook and valuation.
- Our structural underweight to mega caps is less about a bear case on any of the companies and more about maintaining portfolio diversification and targeting a greater number of opportunities among companies with distinct growth drivers.
- Facebook and Amazon, our active overweights in the group, have what we consider to be highly attractive revenue and profit growth profiles trading at attractive valuation levels. We also believe new portfolio addition Netflix has an underappreciated opportunity to sustain subscriber growth while expanding margins.

Concentration Risk Remains High in Growth Benchmark

The ClearBridge Large Cap Growth Strategy manages against a Russell 1000 Growth Index benchmark dominated by a handful of mega cap companies. The index's concentration has reached historic levels due to strength in the FAAMG stocks (Facebook, Apple, Amazon.com, Microsoft and Google) over the last several years. We strive to run a diversified portfolio that can produce consistent results through a complete market cycle. Maintaining market weights to the largest names in the index – Apple at 10.4% as of September 30 and Microsoft at 10% – would heighten concentration risk and threaten the diversification integrity of the portfolio.

Exhibit 1: Russell 1000 Growth Index Dominated by Technology



Data as of Sept. 30, 2021. Source: Russell Investments.

Instead, we have chosen to actively manage our mega cap exposure, with a structural underweight to the group that is less about a bear case on any of the companies and more about maintaining diversification in the portfolio. We maintain high-conviction overweights to Amazon.com and Facebook and underweights to Apple and Microsoft.

While Amazon.com and Facebook have underperformed in recent periods, we maintain conviction in these businesses. Facebook faces regulatory risks, although we believe that the worst-case scenarios are unlikely, while the digital advertising market remains healthy. The company expects a short-term slowing in ad revenue as the advertising industry adapts to Apple's new iOS privacy controls which we believe Facebook is well-positioned to navigate. Facebook is also investing heavily in its newer metaverse business which has a long payback horizon but has compelling long-term attributes. From a secular standpoint, Facebook's cash generation, secular growth, and competitive moat all remain in place, giving the stock one of the most attractive risk-reward profiles among the FAAMGs.

Amazon has seen revenue growth slow in 2020 as e-commerce trends have normalized with reopening while operating costs are elevated due to labor shortages, supply chain constraints and elevated freight and shipping costs. At the same time, Amazon's Amazon Web Services (AWS) and nascent digital advertising businesses remain sturdy, adding high margin revenue streams to partially offset retail cost pressure. As Amazon laps this recent period of elevated cost pressure, we believe return on investment and stock returns will improve.

Our underweights are partly balanced by our underlying business exposures. For example, our underweight to Microsoft is less pronounced given our participation in its two primary revenue drivers — cloud and enterprise technology spending — through owning Amazon.com and enterprise software companies. Amazon's AWS division is the leading cloud service provider with a third of total market share compared to less than 20% for Microsoft Azure and less than 10% for Google Cloud. AWS revenue continues to grow over 30% with close to 30% operating margins and is accelerating across a broad range of customers. Given AWS's position and the expected growth trajectory of cloud, on some measures Amazon could be considered undervalued at current levels.

Similarly, we prefer to play the secular growth trends in digital advertising through Facebook rather than Google, which we no longer hold. Facebook has multiple products that can continue to drive attractive revenue growth including direct e-commerce solutions, payments, AR/VR and monetizing WhatsApp. In addition, the dismissal of the government's antitrust case against Facebook (even though the case was subsequently re-filed) supports our view that antitrust action against the company will be difficult to achieve. At the same time, regulatory action against Google and Apple may be underappreciated by the market given Google's dominant market share in search and the growing focus around Apple/Google app store economics.

In 5G, we see better visibility for Qualcomm over Apple, where we are concerned about the pull-forward of demand from the 2022 and 2023 iPhone models. Qualcomm has diversified away from Apple and into the mid and low tiers of the market where 5G penetration has yet to take hold. This should enable Qualcomm to still grow as 5G expands through different manufacturers and market tiers, even if the high end of the market remains flat. Qualcomm is also positioned for strong content growth on Apple phones as well as other manufacturers as 5G ramps up.

Netflix is often included in the mega cap growth category but until recently we deemed it too expensive to own. We initiated a position in the third quarter at a level where we believe the risk/reward is compelling after the stock traded sideways since mid-2020 due to muted subscriber growth resulting from COVID-19-related content production delays. Netflix operates a high-quality subscription business with room for continued growth in a large addressable market. We believe Netflix has a strategic advantage in scaling its business given its large content library and its lead in establishing local content studios and partnerships. The company is also entering the video game market with a focus on mobile games, which could open up new growth opportunities and lower subscriber churn over time. Despite still-heavy content investments, Netflix was free cash flow positive in 2020 and is expected to grow free cash flows in 2022 and beyond.

We believe diversification among different types of growth companies allows us to perform well through a business cycle and varying styles of market leadership. The FAAMGs have traded almost as a group over the past several years, though we believe the market will become more selective and business models will start to separate. In this type of environment, we believe actively managing our mega cap growth exposure is the best way to promote consistent long-term results.

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