Market Overview and Outlook

In the first quarter, equities experienced high levels of volatility and correlation as stocks endured a 10% correction and subsequent rebound to finish in positive territory. The broad-based Russell 3000 Index returned 0.97% during the quarter while the S&P 500 Index added 1.35%. The most beaten-up sectors benefited from a combination of buyers scooping up stocks at bottom-of-cycle valuations and massive short covering. Energy, materials and dividend-paying stocks were the top performers in this significant market repositioning.

In a return to the more macroeconomic-driven environment that has characterized much of the post-financial crisis period, four primary factors dictated market direction in the first quarter: the tone of the Federal Reserve, growth in China, oil prices and the presidential election cycle. China’s failure to stabilize its currency and capital markets heightened concerns about slowing growth in the world’s second-largest economy and sent stocks reeling to sharp January losses. Fears of weak worldwide demand drove crude oil below $30 per barrel, its lowest level in 12 years.

The Fed cited global turmoil as a risk for the economy during the quarter and scaled back its planned interest rate increases for the year from four to two. Meanwhile, the uncertainty surrounding who will become the next president continued to pressure highly-regulated industries including biopharmaceuticals and banks.

We are encouraged that high-quality stocks did well on a relative basis during the quarter. Other factors served as a bit of a headwind for our strategy, including the market’s shift from growth to value and the above average performance of sectors to which we are under-exposed, such as energy, industrials, and telecom services. Conditions will likely remain unsettled as the Fed grapples with how best to support or stay out of the way of a strengthening U.S. economy and the election looms closer. Recent employment trends bode well for consumer spending and inflation as the labor participation rate has increased for four straight months and wage growth is beginning to pick up. As we shared last quarter, consumers are in the best shape since the financial crisis and an improving job and wage picture should provide an impetus for spending. Despite uncertainty regarding global economic conditions and the political regime in the U.S., we feel conditions are such that well-capitalized companies with sustainable profiles should manage just fine.
Portfolio Highlights

The Sustainability Leaders Strategy had a modest loss during the first quarter of 2016, while the Russell 3000 Index, the Strategy's benchmark, returned 0.97% during the quarter. On an absolute basis, the Strategy had gains in five of the eight sectors in which it was invested during the first quarter (out of 10 sectors total). The main contributors to performance were the industrials, utilities, and information technology (IT) sectors, while the main detractors from returns during the quarter were the financials, health care and materials sectors.

In relative terms, the Strategy underperformed its benchmark due to both overall stock selection and overall sector allocation. Stock selection in the financials sector detracted the most from relative returns. The consumer staples sector hampered relative returns driven by stock selection, while both stock selection and an overweight allocation in the materials sector also hurt returns. Stock selection in the consumer discretionary and health care sectors also reduced relative performance. Conversely, strong stock selection and an overweight allocation in industrials sector names contributed the most to relative performance during the period. An overweight allocation to the utilities sector and an underweight to the financials sector also helped relative performance.

On an individual stock basis, the largest contributors to absolute returns included positions in Trex Co., NextEra Energy, 3M Co., UnitedHealth Group and W.W. Grainger. Meanwhile, the greatest detractors from absolute returns during the first quarter included positions in American Express Co., Alexion Pharmaceuticals, Citizens Financial Group, Biogen and Charles Schwab.

During the quarter, after the sharp sell-off in the first six weeks of the year, we saw a subsequent rally in the equity markets beginning in mid-February. Industrial companies were among the better performing sectors, which benefitted our holdings in Trex, 3M and W.W. Grainger. The utilities sector was one of the strongest performers during the quarter, likely due to lowered expectations for interest rates, and our position in NextEra Energy was a beneficiary of this trend.

UnitedHealth Group, a leading managed care organization, did well following a strong quarterly earnings report and comments that they were on track to meet or exceed their annual earnings guidance, as the problems they had experienced with the public exchange business were contained. This was a stark contrast in a sector that did poorly during the quarter, as concerns about the election and drug pricing persisted, which pressured our biotechnology holdings Biogen and Alexion.

The second worst performing sector during the quarter was financials, as interest rates came under significant pressure. This led to negative performance for our more interest-rate-sensitive financials holdings, including Citizens Financial Group and Charles Schwab. American Express also did poorly during the quarter as competitive pressures became more intense and reduced the likelihood that the company can meet its lofty financial objectives. We made the difficult decision to exit our position in American Express as a result of these factors.

We also eliminated several other positions during the quarter. We exited our position in Novozymes, an enzyme manufacturer in the health care sector, as a number of factors were negatively impacting its growth rate and we felt the valuation did not adequately reflect the worsening fundamental picture. We also exited our position in Roche due to concerns about its ability to sustain performance in products that were subject to competition from biosimilars.

We established two new positions during the quarter. We added Becton Dickinson, a leading medical technology company with leading franchises in medical products, diagnostic solutions and biosciences. We were attracted to the steady, recurring financial profile of the business, as well as its leadership in ESG factors, particularly its focus on improving health outcomes and promoting a safe environment for health care workers and patients.

We also established a new position in Disney, a leading entertainment company, as stock weakness related to concerns over the ESPN franchise provided an attractive buying opportunity. We view Disney as an incredibly valuable consumer franchise with dominant positions in many categories and significant brand equity. The company is also a sustainability leader with well-developed ESG policies ingrained throughout the organization, including four teams focused on corporate citizenship reporting to the CFO. Disney aims to be admired for the integrity of its content management and ability to positively influence young viewers.

Sustainability Discussion on Carbon Footprinting: An Overview

This quarter, we examine the emergence of the “carbon footprint” measurement and its role in an investment portfolio. The term emerged in the 1990s out of academic discussions aimed at measuring the ecological impacts of human activity and, while definitions can vary, generally denotes the total set of greenhouse gases (GHGs) produced by a particular individual, event, organization or product, and is typically expressed...
We believe that carbon footprints may be a useful starting point for some asset owners as they begin to look at the carbon emissions associated with their investments. In terms of carbon dioxide equivalent (CO₂e), in an investment context, carbon footprint often refers to measuring either the emissions of a particular company or the combined emissions of a given investment portfolio.

While measuring the carbon footprint of a portfolio is an idea that has been around for over a decade, it has risen in prominence only in the last couple of years in conjunction with debate around investment risk associated with climate policy around the world and increased interest from investors in climate change — as both a societal issue and an investment issue. Several recent and significant industry initiatives have also promoted the growth of carbon footprinting. The Montreal Pledge is an initiative set up in 2014 by the United Nations Principles for Responsible Investment (PRI), where investors pledge to measure and disclose carbon footprint of investments, and to use the information to engage with companies or set reduction targets. Some prominent signatories include pension funds in Europe and Australia as well as the California Public Employees’ Retirement System (CalPERS) in the U.S.

Another such initiative is the Portfolio Decarbonization Coalition (PDC), an initiative co-founded by the United Nations Environment Programme Finance Initiative (UNEP FI), Swedish pension fund AP4, CDP (formerly the Carbon Disclosure Project), amongst others. Signatories of the PDC commit to “concrete and quantifiable carbon footprinting as well as portfolio decarbonization targets.” The PDC members now account for over $600 billion in assets under management (AUM) as membership has expanded, including several European and Australian pension funds.

The Asset Owners Disclosure Project (AODP) is an independent not-for-profit global organization whose objective is to protect retirement savings and other long-term investments from the risks posed by climate change by improving disclosure and industry best practice. While not focused on portfolio carbon footprinting per se, the group is relevant to the intersection of climate change and investing and could become for asset owners what the CDP is for companies. The AODP asks asset owners to disclose information on their climate change policies and actions, and then ranks them with a “Climate Rating” based on their responses to the survey. The group also promotes a best-practice methodology to raise the standards of climate change management inside their member organizations. What’s key with this initiative is that much of the directive for actionable change in portfolios needs to be signaled from asset owners as the end investor and fiduciary. One legislative factor contributing to the recent growth of carbon footprinting was the introduction in France, in May of 2015, of mandatory carbon reporting for pension funds, insurance companies and other institutional investors. The law requires an annual report with information on how their investment decision-making process takes ESG criteria into consideration, and the means implemented to contribute to the financing of the ecological and energy transition. This includes risks induced by climate change, including the GHG emissions associated with assets owned, the contribution to the international goal of limiting climate change, and the contribution to the realization of the ecological and energy transition.

One common issue with carbon footprinting arises when investors try to use the data to make performance comparisons between companies. Because most carbon accounting frameworks were not designed to compare one company to another — they were originally designed to measure one company’s performance over time, effectively comparing it to itself — this can lead to compromised or inaccurate conclusions. Because there are often complex underlying assumptions and varying methodological decisions included in the company-specific numbers, this makes it challenging to determine with any accuracy whether one company is really more efficient than another with respect to CO₂e.

Emissions intensity does not necessarily predict the aggregate carbon risk of investments. Even if one can identify the companies with the highest emissions intensity, this does not provide much information about risk to the overall performance of the portfolio and it is only one factor out of many that would be needed to understand the total risk associated with GHG emissions that a company produces. To their credit, many carbon footprint service providers have been upfront about these limitations of the ratings they offer.

On this front, the World Resources Institute, UNEP FI and the Two Degrees Investing Initiative (a multi-stakeholder think tank working to align the financial sector with 2°C climate goals) published a comprehensive report in late 2015 that summarized the current landscape titled Climate Strategies and Metrics: Exploring Options for Institutional Investors. This report rates high on our recommended reading list for asset owners wanting to learn more about how climate change relates to their investing activities and makes a useful distinction that applies to carbon footprinting.
efforts and other climate change-related initiatives. Namely, investors need to be clear what their objectives are for carrying out a carbon footprint and should not “try to kill two birds with one stone.” It is important for investors to distinguish between two climate change-related objectives which can be broadly categorized as a risk-based strategy or a responsibility-based strategy. On one hand, investment risk objectives encompass those activities used to understand investment risks associated with carbon emissions and climate change. Meanwhile, societal responsibility objectives cover those activities to assess the “climate-friendliness” of a portfolio. The report concludes that carbon footprints can be a useful communication tool for assessing “climate-friendliness” of portfolios, but they are not useful for assessing investment risk. Carbon footprinting methodologies are also not the best tools to identify investment opportunities in companies whose products and solutions are helping address climate change, because analyzing a company’s own emissions does not necessarily tell you whether its products are helping others reduce emissions. For example, a wind turbine manufacturer’s emissions could be within the same range as other industrial sector companies, and a carbon footprint would not necessarily identify or account for the positive GHG impacts of the company’s products.

Conclusions
As of this writing, there is significant momentum around a whole host of climate-related investment initiatives, and carbon footprints will likely play a debatable role in this space. On the upside, we believe that carbon footprints may be a useful starting point for some asset owners as they begin to look at the carbon emissions associated with their investments. However, in order to identify companies that are truly at risk due to their carbon emissions, or to identify companies that have opportunities to benefit from producing low-carbon solutions, we believe that much more in-depth analysis is required.

We believe that ClearBridge’s research analysts are well-suited to identify climate change-related risks and opportunities within the industries that they cover, through the systematic application of ESG ratings to companies that are held in the strategies or are recommended by an analyst for investment. These ESG ratings are internal scores intended to signal to investment teams how well a company has executed its ESG practices, including climate change-related practices. ClearBridge also uses information on carbon emissions, climate change policies and other ESG issues to inform our engagement actions with companies. Looking ahead, we will continue to be active participants in client and investment industry discussions on issues of climate change and how to address it in investment portfolios.