Aggressive Growth Strategy

Key Takeaways

- Low correlation to the market was a performance headwind for the quarter and the year, most significantly in energy, media and health care.
- The primary areas of investment for the portfolio remain underowned and undervalued compared to peers and the market and we believe are well positioned for a re-rating higher.
- We believe a change in market leadership could be sparked by increased M&A activity and greater capital spending as companies now have clarity on their tax situation.

Market Overview

U.S. equities finished off the year near all-time highs, with the S&P 500 Index advancing 6.64% for the quarter and 21.83% for the year. The broad market Russell 3000 Index added 6.34% in the fourth quarter while the small cap Russell 2000 Index gained 3.34%. Growth stocks outperformed value stocks by a wide margin, with the benchmark Russell 3000 Growth Index returning 29.59% for the year, its best performance since 2013.

Momentum buying was a significant driver of equity returns during the year, especially among a select group of mega cap information technology (IT) and Internet names (Apple, Microsoft, Facebook, Google and Amazon) that comprise more than a fifth of the benchmark’s weighting. The IT sector of the Russell 3000 Growth Index gained 40.21% in 2017, outperforming the next best sector – industrials - by over 1,000 basis points. The last time IT was so dominant was in the initial recovery from the global financial crisis in 2009.

The portfolio has little exposure to the largest technology and Internet names and is underweight the IT sector by about 1,100 basis points compared to the benchmark. We believe these companies operate in cyclical, competitive areas with a risk of price deflation. Record inflows into passive strategies have also supported the so-called FAANG stocks, a concern we believe is overlooked as more investors view passive strategies as low risk. We have chosen instead to own IT companies with wider moats in terms of market share, such as Seagate Technology and Western Digital in the hard disk drive and storage market, and diversified...
businesses that serve as suppliers to the larger tech companies, like chip maker Broadcom.

We act as long-term business owners, with a contrarian approach to growth investing which often causes the portfolio to look and perform very differently from the market. This low correlation posed a significant headwind to relative performance in a year where the portfolio was still up approximately 15%. In addition to IT, our more than 900 basis point overweight to energy, the worst performing sector in the benchmark in 2017, was a significant detractor from the portfolio's relative returns as was an overweight to health care (+2,100 bps).

Being valuation conscious means trying to avoid crowded and expensive sectors in the market. Interestingly, while the market is at or near all-time highs, three of the four areas we target – health care, energy and media – remain generally uncrowded and undervalued (Exhibit 1). We believe this is due to money flow – investors abandoning entire industries in favor of what’s currently working, a force accentuated in the fourth quarter by tax-loss selling – as much as fundamentals. While turnover has stayed low over the last 18 months, the portfolio valuation has gone from a premium or parity to the benchmark on a forward P/E basis to trading at only about 65% or 70% of the market’s multiple leaving it at the biggest discount to the benchmark in over a decade. Sectors like biotech and media, where earnings continue to grow, have experienced significant multiple compression.

Exhibit 1: The Strategy Trades at a Significant Discount to its Benchmark

As increasing demand moves global oil markets to an undersupply situation, capital discipline should benefit E&P stocks.
encouraged by company fundamentals and their ability to compound cash flows at above-average rates over the long term.

Specialty pharmaceutical maker Allergan has been pressured in the second half of the year by perceived threats to two of its key therapies, Botox for aesthetics and Restasis for dry-eye conditions. While real competitors to Botox are still several years from coming to market and the drug continues to grow and expand its indicated treatment areas, this has been overshadowed by extreme negative sentiment. Even with the potential loss of exclusivity for Restasis, shares are trading at just over 10 times earnings, with little credit being given to its pipeline treatments for unmet needs like chronic migraines and liver disease. Given the innovation among biopharmaceuticals that remains available at very attractive prices, we also continue to like the risk/reward of portfolio holdings Biogen, Amgen and Vertex Pharmaceuticals among others.

Energy has also faced headwinds from tax-loss selling and a rotation out of the oil patch, a clear disconnect given that crude prices rallied 15.7% in the fourth quarter and are up 37% since mid-June. The exploration & production companies we own have been among the leaders in shoring up their balance sheets, and steering away from unprofitable production growth to focus on returns on capital and cash flow generation. Over the next several years, as increasing demand moves global oil markets to an undersupply situation, that capital discipline should benefit stocks like Anadarko Petroleum. On the oilfield services side, we’ve seen several companies like National Oilwell Varco make smaller acquisitions and leverage their financial flexibility to drive improved technology and to expand geographically. The industry is also regaining pricing power, which supports higher cash flows. Should global markets fail to reach equilibrium and crude remains in a trading range, the productivity enhancements undertaken by our portfolio companies should still enable them to generate positive free cash flow.

Our media exposure was the primary detractor from results in the fourth quarter. But again, we believe short-term weakness masks positive developments among programmers. Media has become bifurcated like technology with valuations of larger companies like Netflix becoming extended while companies like Discovery Communications are trading at historically depressed multiples on a free cash flow basis. Owners of content rebounded late in the year on the passage of tax reform legislation while diversified names like Comcast are seeing solid growth in high-speed broadband and wireless as well as their content assets. We think the backdrop should continue to improve through less regulation and lower taxes for the programmers with high structural tax rates. Additionally, we think the industry will continue to seek
scale through mergers, and media conglomerates, like Disney, will continue to be aggressive acquirers.

Outlook
We are bullish on the U.S. equity market due to the fear and skepticism that remains prevalent despite stocks touching all-time highs. Markets rarely top out when investors are nervous and growth stocks have done very well without a lot of the euphoria we saw during the technology-led market of 1999-2000. Fundamentals are solid with companies holding high levels of cash. Completed tax legislation will now allow companies to budget and spend that cash, which we believe will lead to increased capital spending and M&A.

While interest rates remain historically low, and a tailwind to the market, valuations remain more mixed with certain sectors and subsectors extended and others cheap versus historical standards. This sets up an environment where we believe investors will be better off focusing on individual companies and feel sector selection is at a premium rather than simply owning the market. Conditions are becoming conducive to a leadership change from the crowded areas of the market to those that are underappreciated. Potential catalysts for this change could be undervalued companies re-rating higher or increased M&A activity that monetizes these mispriced assets. As we have said in the past, we are more constructive on the portfolio holdings than the overall market and the biggest reason is valuation. At this type of discount to the market, we are encouraged by the risk/reward of the companies we own.

Portfolio Highlights
The ClearBridge Aggressive Growth Strategy underperformed its Russell 3000 Growth Index benchmark during the fourth quarter. On an absolute basis, the Strategy had gains in six of the eight sectors in which it was invested (out of 11 sectors total). The main contributor to performance was the IT sector.

Relative to the benchmark, overall stock selection and sector allocation detracted from performance. In particular, stock selection in the consumer discretionary, health care and industrials sectors and an overweight to health care had the most significant negative impacts on results. Among positive drivers, stock selection in the IT and materials sectors contributed to relative returns.

On an individual stock basis, positions in Allergan, Amgen, Autodesk, Liberty Broadband and AMC Networks were the greatest detractors from absolute returns during the quarter. The largest contributors to absolute returns included UnitedHealth...
Group, Seagate Technology, Broadcom, Twitter and TE Connectivity.

During the fourth quarter, we closed a position in Teva Pharmaceutical in the health care sector and received shares of Sterling Bancorp in the financials sector following its acquisition of portfolio holding Astoria Financial.