ClearBridge Investments

Appreciation ESG Strategy

Scott Glasser,
Managing Director,
Co-Chief Investment Officer,
Portfolio Manager

Michael Kagan,
Managing Director,
Portfolio Manager

Mary Jane McQuillen,
Managing Director,
Head of ESG Investment,
Portfolio Manager

Key Takeaways

- Large and mega cap stocks drove the market to new highs in September, but small and mid cap names lagged.
- We lowered risk in the portfolio by reducing our positions in several stocks with impressive fundamentals but elevated valuations.
- Industrial uses of water are global, large-scale and impactful, making efficient management of water resources critical to the bottom line of public equities.

Market Overview and Outlook

The stock market generated a strong 7.7% return in the third quarter despite trade conflicts and numerous bouts of financial and political uncertainty across the globe. Concerns over the broad-based implications of U.S. trade policy continued to dominate the financial news flow. The first half of the quarter was marked by the U.S. dollar reaching new highs, oil prices declining and the yield curve flattening. That said, a trade settlement with Mexico and Chinese intervention to stabilize the yuan in late August settled the markets' fears, resulting in little change in the dollar and oil for the quarter. As expected, the Federal Reserve raised short-term interest rates by 25 basis points to 2.25% in late September.

The best-performing sectors of the S&P 500 were health care, information technology (IT) and industrials. Energy, materials and the interest-rate-sensitive real estate and utilities sectors lagged. Health care names appeared to benefit from sector rotation while economic strength helped industrial and discretionary stocks. Trade worries limited gains for energy and materials stocks.

U.S. economic indicators are uniformly powerful. Unemployment — at 3.7% in September — continues to be strong and jobless claims hit a five-decade low during the quarter. Unemployment is currently at levels below the commonly accepted non-inflationary rate, putting the Federal Reserve on inflation watch. Wages rose 2.9% and 2.8% in August and September, respectively; levels not yet alarming but the highest of the current cycle. The powerful September ISM indicates real GDP growth of over 4%. Consumer confidence hit a new cycle high and September's seasonally adjusted annual rate of auto sales was 17.4 million, the best in several months. Capital expenditures were also the highest of the business cycle, helped by incentives in recent tax reform. Share

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repurchases for the S&P 500 were $191 billion in the second quarter, the highest ever.

Recent commentary from the Federal Open Market Committee suggests that Fed policy is no longer considered "accommodative" (the federal funds rate now equals the Core PCE deflator, making real short rates 0%). The market currently anticipates one additional 2018 rate increase (25 basis points) in December and two or three more in 2019. The shape of the yield curve remains positive, but not by much.

Higher interest rates are sparking concerns that housing has peaked; homebuilding stocks have come under considerable pressure year to date (down 30%). We recently met with several major homebuilders who suggested that while overall demand growth has slowed, there has yet to be contraction (up low single digits today versus high single digits over the last 18 months). Markets that have weakened include California and Seattle, with less foreign buying, and the Northeast, where reform around state and local tax deductibility have hurt affordability. Importantly, sales continue to rise in the first-time buyer market owing to employment and confidence.

The North American trade outlook is brighter after agreements were reached with Mexico and Canada, while the Chinese situation continues to deteriorate. The "new NAFTA" deal contains adjustments on certain industries (e.g., dairy products, lumber and autos), but — most importantly — the dispute resolution procedure is unchanged. The trade situation with China has worsened as President Trump has steadily ratcheted up tariffs and the Chinese have responded in kind.

While retail stocks were among the best performers in the third quarter, the Amazon threat remains, and we are concerned that these stocks may be ahead of themselves. Caution is warranted in the semiconductor space as there are signs that the cycle has peaked. Some large capitalization pharmaceutical stocks still offer value.

We use market breadth as one indicator of the overall health of the stock market. An expensive market hitting new highs powered by fewer stocks is a warning sign. Market breadth peaked in late August and deteriorated significantly in September. Large and mega cap stocks drove the S&P 500 Index to new highs in September, but small and mid cap names lagged. We lowered risk in the portfolio by reducing our positions in several stocks with impressive fundamentals but elevated valuations.

The sharp market run-up in the third quarter, accompanied by a deterioration in breadth, leaves our outlook more cautious than a quarter ago. Valuations remain at all-time highs on many measures and trade friction with China is not likely to be resolved anytime soon. That said, economic fundamentals are excellent and the yield curve, while flat, is still in a zone consistent with the potential for good market returns. The Appreciation strategy of owning large, high-quality stocks is well-suited for today's market, offering upside participation if the economy remains robust and preserving capital should a trade war erupt or should the Fed's tightening result in an inverted yield curve.

Portfolio Highlights

The ClearBridge Appreciation ESG Strategy had a positive return during the third quarter of 2018, outperforming the Strategy's benchmark.

On an absolute basis, the Strategy had gains in 10 sectors in which it was invested during the quarter (out of 11 sectors total). The main contributors to the Strategy's performance were the information technology (IT), health care and financials sectors.

In relative terms, the Strategy outperformed its benchmark impacted primarily by stock selection. Stock selection in the financials sector, the newly created communication services sector, which expands the telecommunication services sector to include select companies from the consumer discretionary and IT sectors, the IT sector and the consumer staples sector contributed the most to relative performance. Conversely, stock selection in the energy sector dampened relative returns.

On an individual stock basis, the biggest contributors to absolute returns during the third quarter included positions in Microsoft, Apple, Costco, Berkshire Hathaway and TJX Companies. The greatest detractors from absolute returns were positions in Facebook, Vulcan Materials, Anadarko Petroleum, Pioneer Natural Resources and Devon Energy.

During the quarter, we established a position in Broadcom in the IT sector and closed positions in Kraft Heinz in the consumer staples sector, Roche in the health care sector, Lennar in the consumer discretionary sector and Red Hat in the IT sector.

ESG Highlights

Recently at World Water Week, a gathering of key stakeholders in Stockholm to discuss global water-related challenges, participants sized up the world's water challenges: water stress (occurring when demand exceeds supply or when poor quality restricts use) increased between 1996 and 2016 for most countries in the world, and has more than doubled in 26 countries; only 59% of domestic wastewater is collected and safely treated; over 2 billion people lack access to safe drinking water; only one out of five countries is on track to achieve Sustainable Development Goal (SDG) 6 — clean water and sanitation — by 2030 for drinking water, and only one out of 10 for sanitation.

Water usage is ubiquitous. The average American has a water footprint of roughly 2,000 gallons of water per day — not just flowing through the tap, but hidden behind the food we eat and products we buy. A single avocado needs 60 gallons to grow; a hamburger requires 660 gallons to be made; a cotton T-shirt 713 gallons. Statistics like these highlight the importance of water across industries. Industrial uses of water are numerous and impactful, making efficient management of water resources critical to the bottom line and reputation of public equities.

Just as water usage is varied, there are many ways companies can improve water resources. Efforts to improve water resources illustrate how public companies are supporting the UN Sustainable Development Goals (SDGs), a set of milestones established in 2015 to solve some of the world's most significant social and environmental changes and which ClearBridge can reference to help frame our ESG research and guide our engagement efforts with companies — in this case clean water and sanitation (goal 6) and life below water (goal 14). The mandate of SDG 6 is to ensure the availability and sustainable management of water and sanitation for everyone.

Exhibit 1: Clean Water and Sanitation

Source: www.un.org

Water Efficiency Can Make Waves

Owning and engaging with companies that consume water offers ClearBridge meaningful opportunities to have an impact. In March 2018 ClearBridge analysts participated in a panel on water risks hosted by ClearBridge and Principles for Responsible Investment. There we discussed approaches to water conservation and challenges to beverage manufacturers' water supply chains. The event followed closely upon ClearBridge's hosting of a water day for Coca-Cola and other investors to discuss water stewardship in December 2017. As a major consumer of water as an ingredient in its beverages — ClearBridge's consumer staples analyst notes that this makes water a material business risk for the industry — Coca-Cola prioritizes water quality and availability through efforts to improve water-use efficiency in its bottling plants, manage wastewater and water resources in the agricultural supply chain. It also replenishes over 100% of the water it uses in its finished beverages through nearly 300 water projects covering water sanitation, infrastructure and restoration of watersheds. In 2017 and 2018, Coca-Cola replenished almost 250 billion liters of water.

Within technology, water is also a key input in the semiconductor manufacturing process, which uses water to rinse the semiconductor wafer between hundreds of manufacturing steps. Intel, the world's leading chip maker, offers an illustrative case of steps that can be made toward improved water use in semiconductor manufacturing. ClearBridge regularly engages with Intel and has hosted Intel's annual sustainability day for over 10 years. Our hardware sector analyst notes that such sustainability-focused business practices around the IT footprint have affirmed our view that Intel is investing for the long-term. During our investor engagements, we have discussed how, to reduce water use, Intel has pursued internal recycling and efficiency initiatives, such as facility-based reuse of grey water, that recently conserved 3.5 billion gallons in a year. Using highly efficient reverse osmosis to purify water for wafer production, for instance, has also helped the company become over 90% more efficient in many operations. As described in an academic study on Intel, the company's focus on innovation, environment and efficiency have been a competitive advantage in terms of cost savings and environmental regulations.[1]

We also have an impact by owning companies that make water treatment and efficiency their strategy, i.e., companies in the business of water. Xylem, for example, is the world's largest provider of water technology, and it demonstrates how addressing water-related challenges can also be an attractive business proposition.

Xylem and the Water Industry

A core element of Xylem's business proposition is improving resource efficiency in the water industry, as well as improving water quality and the resilience of water infrastructure. Many people don't think of energy use as an issue for the water utilities, but water is a heavy product to move. The wastewater industry is very energy-intensive — energy is the second-largest operating expense for water utilities (behind labor). Xylem pumps and other products are helping reduce operating costs, energy use and associated GHG emissions for its customers.

In 2017 ClearBridge attended Xylem's Investor Day, to discuss one-on-one with CEO Patrick Decker the company's sustainability efforts and to understand use-cases for Xylem products. Xylem's

[1] Curry, Edward and Donnellan, Brian. "Implementing Sustainable IT Strategy: The Case of Intel," March 4, 2014.

own sustainability program prioritizes safety, employee engagement and better tracking of retention stats and engagement scores.

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We discussed with Decker the focus of Xylem's products on improving water efficiency and quality and reducing energy costs. Xylem's new Flygt Concertor, for example, is the world's first "smart" wastewater pump; it includes sensors that monitor operating conditions and automatically adapts the pump speed for optimal efficiency and cost savings. This can lead to energy savings of up to 70% versus conventional pumping systems. As Decker explained, Xylem is also having success in China with its ultra-violet (UV) treatment products, which offer more environmentally sustainable treatment solutions than chemical treatments. Xylem is looking to do the same in India, where water quality is a big focus. The country is pushing to clean up the Ganges River (the river passes through 50 cities in India), and Prime Minister Narendra Modi's Smart Cities Mission aims to improve infrastructure and provide connected technology to increase resilience to extreme weather and reduce resource consumption.

The potential monetization of water creates both challenges and opportunities. On one hand, clean water is a universal human right, and there are risks to monetizing it. At the same time, because there is no pricing around water, much of the developed world takes the value of water for granted; it might not be pressured into conservation unless it becomes more economically necessary. Making the business of water sustainable therefore leads us to ask: where can we as investors capitalize on "making access to water possible"? We ask similar questions about access to medicine and financial inclusion. We don't want those without the means to have to pay for water, but we do want everyone to value water and thus invest for the access to clean water. Such an approach could ensure that clean water will be available during droughts, and for future generations. While this conversation proceeds, as ESG investors and long-term shareholders, we can encourage better water management by both encouraging better corporate behavior toward water broadly and by owning water companies whose business is to make this better behavior possible.

Performance source: Internal. Benchmark source: Standard & Poor's.