ClearBridge Investments

Small Cap Strategy

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Key Takeaways

- Recent success in the health care sector shows the value of measuring performance over a three- to five-year period, rather than quarterly or annually.
- Our process is designed to improve our stock selection through probabilistic assessment of the fundamental valuation of companies under a wide variety of future scenarios.
- Our investment in Amarin illustrates how large gaps between price and value continue to exist in the marketplace, but it takes time for them to converge.

Market Overview and Outlook

The Russell 2000 Index rose 3.58% in the third quarter, while our portfolio rose roughly 8%, beating the index by over 400 basis points (bps) and snapping an unpleasant streak of underperformance in each of the four previous quarters. Over those four losing quarters, health care was by far our biggest detractor, costing us 333 bps in relative performance. The sector has caused relative performance volatility, because of the idiosyncratic, hit-driven nature of small-cap pharmaceutical stocks. In the third quarter, we got our own hit from Amarin rising more than 400%, which we discuss below. At the end of the second quarter of 2018, our portfolio had underperformed the health care sector by almost 400 bps since the start of 2014, virtually all of which came from stock selection. By the end of the third quarter, we had outperformed it by over 200 bps since the start of 2014, again virtually all from stock selection. This is a vivid demonstration of the reason performance should be measured over a three- to five-year period, rather than quarterly or annually.

Our goal is to construct a portfolio that can outperform our benchmark in any sort of market environment. We think our advantage comes from our repeatable, broadly applicable investment process. It is designed to improve our stock selection through probabilistic assessment of the fundamental valuation of companies under a wide variety of future scenarios. We don't have any edge in the arena of macro-economic forecasting of interest rates, oil prices, GDP growth, investor sentiment or another such thing on a consistent basis. We may believe the odds favor one direction or another, but we typically express that with very minor confidence. The market has humbled the clear

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majority of participants who thought they could predict the future and bet strongly on one outcome. We prefer to stick to the odds of a company performing better than the market expects, based on a fundamental assessment of its competitive strategy and valuation, and let our process provide our alpha at the stock level, not the macro level.

To that end, we prefer to diversify our portfolio across as many vectors as we can. Ideally, our portfolio would be very close to the market in terms of sector, industry, macro-economic factor, and even with a positive tilt toward quantitative factors that have shown persistence over time, such as low valuation, earnings quality, capital deployment, and high momentum. For the most part, we can achieve broad diversification, so that we can weather storms and profit from upward trends at the market level, while letting our stock selection shine through.

Health care, particularly small cap pharmaceutical and biotechnology stocks, is an area where it is very hard to achieve diversification, because of very low intra-sector correlation. If the industry booms, the performance often comes from a very narrow group of stocks. Many small-cap drug companies don't have products in the market, or are even years away from commercialization, but phase 3 or even phase 1 or 2 trial results can change the market's expectations massively. If one doesn't own that particular stock or class of drug — and we usually own fewer than a dozen out of the hundreds of health-care companies in the market — one generally underperforms that day, even if the portfolio is equal- or overweight drug stocks generally. Diversification provides little protection, and performance comes in bunches.

It's an industry, therefore, that we are willing to underweight substantially if we can't find attractive investment candidates. We were very underweight pharmaceutical stocks in 2014-2015, when the sector boomed and expectations were high, and we underperformed. In 2016, the industry fell sharply, and we outperformed—and increased our weighting after the drop. In 2017, we were much closer to equal weight pharma, but nonetheless, when oncology stocks soared, and we had none, we underperformed dramatically.

Despite these results, we believe our investment process for individual stock selection is applicable in health care. In fact, drug trials lend themselves relatively well to estimating the likelihood of success or failure, based on prior data and base rates. Data readouts offer a good opportunity for updating probabilities based on new information. Potential market size and historical profitability for different types of drugs make construction of a project-based discounted cash flow model viable. There are certainly a lot of assumptions in such models, including likelihood of approval, realized revenue after negotiations with insurance

companies and the government, and doctors' proclivity to prescribe the drug. Nevertheless, it is possible to generate a roughly realistic range of valuations for a company that can form the basis for an investment decision. The range may be extremely wide for an early-stage cancer drug and less wide for a recently approved drug, so that our proclivity is often to invest in the latter with more confidence, but we can use our process for pharmaceutical stocks.

Amarin provides an example of how we approach the industry. When we bought the stock in the second quarter of 2015 around $2.40/share, the company's drug, Vascepa, was already approved for patients with triglyceride (TG) levels over 500 mg/dL. Its market share was low, as it had recently launched, and the largest TG-lowering drug in the category, Lovaza, was newly off-patent, so generic competition was coming. Vascepa had several advantages, though. Unlike other TG treatments, it did not raise LDL ("bad") cholesterol, had no known side effects, was price-competitive with the new generic drugs and had some research suggesting that it could lower the incidence of cardiovascular disease (CVD) in patients. Based on this research, Amarin launched the REDUCE-IT trial in 2011 to study real-world CVD outcomes for patients on Vascepa, but the trial would not be complete until 2018.

We started our analysis with a reverse discounted cash flow model to determine what level of peak sales for Vascepa was embedded in the stock price at $2.40. Even with the full cost of REDUCE-IT, we believed the market expected Vascepa sales to reach roughly $300 million, which would be a little over 10% of the market for patients with TG over 500, for whom the drug was already available. The drug was at about $65 million in sales at the time but growing more than 40% annually. We believed that Vascepa could do better than that, based on its efficacy and safety. In other words, if REDUCE-IT failed, the stock had a reasonable probability of being worth more than it traded for. If Vascepa could make any inroads into the broader population of TG over 150, it could double. If REDUCE-IT succeeded, it would likely be worth many multiples of its value. We were getting a very low-cost option, with a decent valuation floor.

Last month, REDUCE-IT results came out and were far better than expected. In a 7.5-year study of more than 8,000 patients, Vascepa demonstrated a 25% reduction in major adverse cardiovascular events for patients with well-managed LDL through statin treatment, but TG levels between 150 and 500, and with zero adverse effects compared with placebo. While full data are not yet available, this is undoubtedly a seismic result for CVD treatment that should shift the treatment paradigm dramatically. There seems little reason why every one of the more than 70 million people in the U.S. with TGs over 150 should not take this

affordable, safe, highly effective drug. When the stock, which had risen only to $3.00 over our three-year plus holding period, opened at $10, it reflected a fraction of that opportunity. Yes, it was up over three times, but the peak sales outlook had shifted from a range of $300 million to $500 million, with an option for more, to something closer to $3 billion to $15 billion with high likelihood. As such, we continue to hold the stock as our number one position.

The investment in Amarin illustrates two conclusions for shareholders: (1) our investment process is applicable to health care companies, including pharmaceuticals; and (2) large gaps between price and value exist in the marketplace, but it takes time for them to converge. Over our holding period, Amarin was frequently a detractor from performance, lagging the Russell 2000 Health Care Index by roughly 20 percentage points. Eventually, in this volatile, hit-driven sector, we finally got our big hit, and it was a doozy. That's why results need to be measured over many years, not quarterly, because the market is noisy.

Portfolio Highlights

The ClearBridge Small Cap Strategy outperformed the Russell 2000 Index, the Strategy's benchmark, during the quarter.

On an absolute basis, the Strategy had gains in six of the sectors in which it was invested for the third quarter (out of 11 sectors total). The primary contributors to the Strategy's performance were the health care, financials and consumer discretionary sectors. The main detractors from returns during the quarter were the materials and energy sectors.

On a relative basis, the Strategy outperformed its benchmark impacted primarily by stock selection. Stock selection in the health care, financials and consumer discretionary sectors contributed the most to relative returns. Meanwhile, stock selection in the industrials, materials and information technology sectors detracted the most from relative performance.

On an individual stock basis, Amarin, Aaron's, HealthEquity, Sprouts Farmers Markets and Rapid7 were the largest contributors to absolute performance. Venator Materials, Extraction Oil & Gas, Cadence Bancorporation, Smart Sand and Foundation Building Materials were the greatest detractors from absolute returns.

During the quarter we initiated positions in Advanced Energy, Silgan, Sanderson Farms and U.S. Silica. Web.com, HEICO, American Homes 4 Rent, MTS Systems and Team were notable positions closed in the quarter.

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