ClearBridge
Investments

Large Cap Growth Strategy

Peter Bourbeau
Managing Director,
Portfolio Manager

Margaret Vitrano
Managing Director,
Portfolio Manager

Key Takeaways

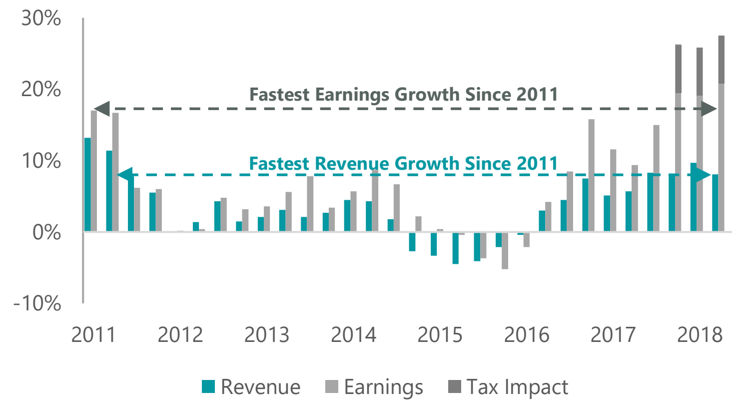
- Slowing global growth and signs of weakness among the market leaders of the last several years sent stocks to sharp losses.
- The portfolio was supported by our allocation to stable growth companies and diversification across the information technology sector.
- We took advantage of elevated volatility to initiate several new positions and add to existing positions at attractive prices.

Market Overview

Volatility rose sharply in the fourth quarter, sending U.S. equities to broad losses as investors fretted over risks related to slowing global growth, rising interest rates and stumbles by some of the market's largest companies. The S&P 500 Index suffered its second-worst December on record (-9.03%) to finish down 13.52% for the fourth quarter and register its first annual loss (-4.38%) since the global financial crisis. The Russell 1000 Index fell 13.82% for the quarter and 4.78% for 2018 while the Russell Midcap Index declined 15.37% for the quarter to finish down 9.06% for the year. The benchmark Russell 1000 Growth Index fell 15.89% for the quarter, underperforming its value counterpart by 417 basis points. The benchmark was down 1.51% for 2018.

Recent market action also reflects a return to normalized valuations and earnings growth rates as monetary and fiscal stimulus measures are simultaneously removed from the economy. The Federal Reserve raised short-term interest rates for the fourth time in 2018 in December as it continued a path of tightening. Meanwhile, the boost to corporate earnings from late 2017 tax reform is starting to wear off as EPS growth is forecast to decelerate and companies face tougher quarterly comparisons (Exhibit 1). Add to this mix the uncertainty over trade and tariffs, which is causing corporate managements to delay capex, and it's no surprise that volatility remains elevated.

Exhibit 1: Revenue & Earnings Could Be Peaking



Source: Credit Suisse. YoY growth. Data as of Sept. 30, 2018, most recent available as of Dec. 31, 2018.

Valuations, especially among momentum-driven large cap information technology (IT) companies, had reached unsustainable levels as markets touched new highs in the third quarter. Signs of weakness among these market leaders — slowing iPhone sales for Apple, ongoing privacy concerns and regulatory risks for Facebook and Alphabet — caused a sharp de-rating among the FAANG stocks (Facebook, Amazon.com, Apple, Netflix and Google/Alphabet) and the sectors where they now reside. IT (-18.81 %), communication services (-17.30%) and consumer discretionary (-17.17 %) all underperformed the benchmark in the fourth quarter.

The portfolio has meaningful exposure to the FAANGs and we believe several are great long-term businesses. We added to our positions in Amazon and Facebook during the quarter as market swings provided attractive entry points.

Amazon remains our largest holding and a slight overweight compared to the benchmark. While down 25% for the quarter, the stock was up 29% for the year. At current levels, we believe the company is undervalued relative to the sum of its parts. Amazon continues to dominate and innovate at very high levels across its businesses, with particularly strong positions in three key areas related to the Internet: e-commerce, cloud infrastructure with Amazon Web Services (AWS) and advertising. Its Prime service has over 100 million subscribers globally and is growing. AWS is building off an already large lead in workloads moving to the cloud, a total addressable market in the hundreds of billions of dollars. The company also has a new, evolving business in advertising and marketing that features high profit margins and is largely not accounted for by the market.

We are at the point late in the market cycle when it is critical to separate business models and identify companies that can move higher based on strong fundamentals rather than passive fund

flows. Bulk retailer Costco, for example, runs a unique, subscription-driven business that has performed well in both healthy and unsettled environments. We consider Costco a stable growth stock, one of three types of growth companies we target in the portfolio to provide diversification and exposure to organic growth through all types of market conditions. Stable growers like Coca-Cola also provided balance to the portfolio during the quarter as pricing power and strong execution enabled it to deliver a positive return in a quarter that saw all 10 sectors in the benchmark suffer losses.

Owning companies with defensible businesses will become more important as growth slows and liquidity shrinks.

We added to the stable bucket in the quarter with the purchase of IHS Markit, a provider of business and information services to enterprise customers across transportation, financial services, energy and similar industries. The company operates a diverse set of businesses with consistent growth and high barriers to entry, including the CarFax vehicle history service, and produces geological reports that are a standard research tool for oil & gas exploration and production companies.

Global brewer Anheuser-Busch InBev and communications chipmaker Qualcomm, meanwhile, fall into our cyclical growth bucket of companies facing near-term headwinds that we believe are fixable and will lead to a step change in growth. Anheuser-Busch has derated on weakness in its core Latin American and South Africa markets, dollar strength and volume declines in the U.S., but the company is unmatched in its ability to generate cash and maintain a strong moat around its business. Any improvement in Brazil should lead to significant upside for the stock. Qualcomm, meanwhile, has multiple options to accelerate earnings that are mostly independent of the smartphone market it serves.

Select growth stocks make up our third bucket and are companies generating above-average growth rates through disruption and innovation. These stocks also carry higher multiples and higher risk. We further diversified our IT exposure in the quarter with the addition of two select growth names, Nutanix and Nvidia.

Nutanix holds significant market share in a software solution for cloud computing called hyperconverged infrastructure (HCI) that enables storage, computing and networking to operate as a single platform. HCI increases the efficiency and scalability of data centers and its usage as a low-cost solution is expected to more than double in the next several years. The company is transitioning into a software-only vendor of on-premise and cloud solutions, which should result in a better long-term business. We also took advantage of an earnings driven selloff to initiate a position in Nvidia, a leading developer of graphics processing units (GPUs) for some of the most attractive markets in technology: PC gaming, data center and artificial intelligence applications.

Outlook

Owning companies with defensible businesses and self-help characteristics will become more important as growth slows and liquidity shrinks. Instead of using excess cash to buy back shares — an action responsible for about 40% of S&P 500 earnings this past year — we believe companies will start paying down debt. Capex is also expected to slow as the tax benefits of immediate depreciation fade and uncertainty over tariff impacts cause company managements to delay non-critical projects. We will be closely monitoring fourth-quarter earnings reports for guidance on how and when companies plan to deploy their cash flow in the year ahead.

From a portfolio standpoint, we remain positioned for positive GDP growth but at a slower pace than the 3.4% rate in the third quarter. We are significantly underweight the industrials and consumer discretionary sectors. The energy sector has also been a headwind to performance as lower demand from slowing global growth and oversupply from U.S. shale drillers, Saudi Arabia and Russia contributed to a more than 35% decline in crude oil prices. Both exploration & production and oil service companies suffer in this type of environment with the market only rewarding energy companies with the best balance sheet discipline. The hesitance of both U.S. and international drillers to spend on new projects may be further hampered by sharply lower commodity prices.

Many of the tailwinds that have driven equities higher through the long-running bull market are turning into headwinds. In this generally less advantageous environment, we believe it is essential to be much more selective in choosing companies to own for the long term. As mentioned earlier, the portfolio is pivoted toward companies and industries capable of generating visible and durable growth and that are more insulated from macro risks than the general market, which today include biotechnology, enterprise software, e-commerce and select names across communication services.

Portfolio Highlights

The ClearBridge Large Cap Growth Strategy outperformed its Russell 1000 Growth Index benchmark during the fourth quarter. On an absolute basis, the Strategy had losses across all 10 sectors in which it was invested (out of 11 sectors total). The primary detractors from performance were the IT, health care and consumer discretionary sectors.

On a relative basis, overall stock selection and sector allocation contributed to performance. Stock selection in the IT sector was the primary driver of relative returns. Stock selection in the communication services and materials sectors also helped. On the

negative side, stock selection in the real estate, health care and energy sectors and an overweight to energy weighed on performance.

On an individual stock basis, leading individual contributors in the fourth quarter included positions in Red Hat, McCormick, VMware, Nutanix and Coca-Cola. The biggest detractors from absolute returns were Amazon.com, Apple, Schlumberger, Facebook and Celgene.

Past performance is no guarantee of future results. Copyright © 2018 ClearBridge Investments. All opinions and data included in this commentary are as of December 31, 2018 and are subject to change. The opinions and views expressed herein are of the portfolio management team named above and may differ from other investment professionals, or the firm as a whole, and are not intended to be a forecast of future events, a guarantee of future results or investment advice. This information should not be used as the sole basis to make any investment decision. The statistics have been obtained from sources believed to be reliable, but the accuracy and completeness of this information cannot be guaranteed. Neither ClearBridge nor its information providers are responsible for any damages or losses arising from any use of this information.

Performance source: Internal. Benchmark source: Russell Investments. Frank Russell Company (“Russell”) is the source and owner of the trademarks, service marks and copyrights related to the Russell Indexes. Russell® is a trademark of Frank Russell Company. Neither Russell nor its licensors accept any liability for any errors or omissions in the Russell Indexes and/or Russell ratings or underlying data and no party may rely on any Russell Indexes and/or Russell ratings and/or underlying data contained in this communication. No further distribution of Russell Data is permitted without Russell’s express written consent. Russell does not promote, sponsor or endorse the content of this communication.