ClearBridge Investments

Dividend Strategy

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Key Takeaways

- The market rose 14% and recovered most of the declines suffered in the fourth quarter of 2018.
- Lower interest rates boosted markets worldwide as weaker economic indicators drove the Fed to give more accommodative guidance.
- While no company is fully insulated from the economic cycle, we actively emphasize companies with less cyclicality and more predictability.

Market Overview and Outlook

The first quarter of 2019 was terrific for the stock market and Dividend Strategy. The market rose 14% and recovered most of the declines suffered in the fourth quarter of 2018. Equities were not the only asset class that bounced in the first quarter — indeed, the risk-on trade suffused markets around the world. Global equity markets rose, oil prices increased over 30% and the high-yield sector (also known as "junk bonds") enjoyed one of its best first quarters in decades.

The driver of this asset reflation was not an improvement in economic fundamentals. Headline economic indicators continued to slow both in the U.S. and abroad. Further, many of the policy-related storms that we have been tracking continue to loom just off shore: trade wars, Brexit, geopolitical turmoil, increased political polarization, to name a few.

The U.S. economy grew at an annualized rate of 2.6% in the fourth-quarter: still positive, but lower than earlier in the year. U.S. manufacturing activity, as measured by the PMI, fell in March to the lowest level in nearly two years. Inflation continued to decline, as did housing starts. Internationally, central banks grew more dovish, with the European Central Bank lowering its inflation projection and growth forecast and China weighing more aggressive stimulus measures to stem weakness.

Ironically, it was precisely the deterioration in economic fundamentals and the persistence of policy concerns that forced the Fed to drop its plan to increase interest rates, thereby catalyzing markets' recoveries. Just three months ago the Fed anticipated two rate hikes in 2019, whereas now it forecasts none.

The bond market reacted sharply to the Fed's pivot. The 10-year Treasury yield fell to 2.4% from a recent high of 3.2% just five

months earlier. As the threat of rising rates receded, equity markets rallied briskly. Longer-term interest rates declined below short-term rates, resulting in an inverted yield curve. The yield curve is normally upward-sloping, which means that as the term of a loan increases the interest rate goes up. Intuitively this makes sense. All else being equal, lenders should charge more for lending money over longer periods. With an inverted yield curve, however, the opposite is true.

In previous market cycles the presence of an inverted yield curve for an extended period has frequently presaged a recession. The past is often predictive of future events, but of course it is not always so. Will the first quarter's inverted yield curve prove to be a temporary anomaly? Does the inverted yield curve mean a recession is around the corner? Or, is it continued spillover from the unprecedented monetary policy of the last decade?

The answers to these questions will drive a significant portion of investment returns across asset classes over the next 12–24 months. Yet, as bottom-up investors, we do not spend an inordinate amount of time perseverating over these questions. Instead, we work to construct a diversified portfolio of idiosyncratic investment ideas. We focus on great companies in growing markets with: strong balance sheets, dominant market positions, recurring/predictable revenues, pricing power, high returns on invested capital, significant free cash flow, great management teams and (finally) the ability to compound earnings and dividends at healthy levels over the long term. While no company is fully insulated from the economic cycle, we actively emphasize companies with less cyclicality and more predictability. This should make our portfolio more defensive if volatility returns.

While the inverted yield curve has dominated discussion of late, we have spent as much time considering the longer-term implications of the Fed's about-face. Ten years past the Great Financial Crisis, interest rates remain radically below their pre-crisis levels and growth remains structurally slower. We hold out hope that growth ultimately returns to higher levels — which would permit the Fed to safely raise rates to more normal levels — but we underwrite investments to the status quo to provide an appropriate margin of safety.

The last six months have been a roller coaster. The market cratered in the fourth quarter and soared in the first quarter. As we survey the current state of the markets and the world, we take comfort in the fundamental building blocks of our portfolio: a current dividend yield above Treasury bonds, expected dividend growth in the high single digits and dividend support providing ballast for turbulent seas.

Portfolio Highlights

We hold out hope that growth ultimately returns to higher levels — but we underwrite investments to the status quo to provide an appropriate margin of safety.

The ClearBridge Dividend Strategy underperformed its S&P 500 Index benchmark during the first quarter. On an absolute basis, the Strategy had gains across the 11 sectors in which it was invested for the quarter. The main contributors to Strategy performance were the information technology (IT), energy and financials sectors. The health care and real estate sectors, meanwhile, were the laggards.

On a relative basis, stock selection added to performance for the quarter but was offset by sector allocation. In particular, an underweight to IT and an overweight to the financials sector weighed on relative results, as did the Strategy's cash position. An underweight to the health care sector, meanwhile, was additive. Stock selection in the communication services and consumer discretionary sectors detracted from relative returns, while stock selection in the energy, utilities and materials sectors contributed positively.

On an individual stock basis, the largest contributors were Williams Companies, Microsoft, American Tower, Blackstone and Mastercard. Positions in Berkshire Hathaway, Pfizer, and Coca-Cola were the sole detractors from absolute returns in the quarter.

During the quarter, we established positions in United Technologies in the industrials sector and closed positions in Brookfield Renewable Partners in the utilities sector, Healthcare Trust of America in the real estate sector and PepsiCo in the consumer staples sector.

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