ClearBridge Investments

Select Strategy

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Key Takeaways

- Growth companies with disruptive business models were among the leading performers in a robust snapback rally from fourth-quarter lows.
- We took advantage of the market rebound to sell into strength, trimming some winners and repositioning across evolving opportunity companies offering attractive risk/reward profiles.
- We remain opportunistic in sourcing companies that possess innovative and differentiated business models or are making improvements not recognized by the market.

Market Overview and Outlook

U.S. stocks rallied sharply in the first quarter to within a few percentage points of record highs as liquidity returned to the market and recent geopolitical concerns appeared closer to resolution. The S&P 500 Index gained 13.65%, the small cap Russell 2000 Index added 14.58% and the benchmark Russell 3000 Index moved 14.04% higher. Growth stocks resumed their market dominance, with the Russell 3000 Growth Index zooming 16.18% higher, well ahead of the 11.93% return of the Russell 3000 Value Index.

While many trade and global growth issues remain unresolved, the Fed's March decision to go slow on further interest rate increases provided a welcome relief for equities. Investors may well be bidding up stocks in anticipation of better times and improved corporate earnings ahead. Lower rates are a prescription not only for higher equity valuations, but also relief for credit-sensitive sectors of the real economy such as housing and auto loans.

The combination of easier monetary conditions as well as a resilient U.S. consumer was especially conducive to the performance of the group of stocks in the Select Strategy we call disruptors. Through product or business model innovation, these fast-growing companies are disrupting existing markets or creating new ones. Carvana, an online platform that is upending the traditional, mostly unpleasant used car buying experience, saw its shares nearly double during the quarter on the heels of annual results that saw revenue increase 128% year-over-year. Shares of Shopify, which provides merchants a single, unified platform to centrally manage e-commerce activity including payments and shipping, jumped by nearly 50%. Among disruptors targeting enterprise customers, the stock of network security software provider Forescout Technologies rallied more than 60% while shares of cloud-based IT operations software maker ServiceNow were up 40%.

Mindful of the risks in these higher multiple companies, we trimmed our exposure to disruptors and deployed the proceeds across the rest of the portfolio. Our actions included picking up shares of two disruptors trading off past highs. We swapped out Chinese Internet services provider Baidu for Chinese e-commerce conglomerate Alibaba, whose shares have been hurt by the Chinese tariff overhang. Alibaba is a catalyst rich company with multiple assets that it can eventually take public, including electronic payments provider Ant Financial. We also established a position in online restaurant delivery platform Grubhub, which has traded lower due to increased spending to enter new markets.

> We continue to focus our efforts on identifying and owning quality companies that can adapt to changing market conditions and industry dynamics.

Several portfolio companies that were acquisition targets saw their transactions close during the quarter, resulting in a higher than normal cash position that was a drag on performance. We were comfortable maintaining such cash levels as valuations snapped back and multiples for our disruptor names left less near-term upside. At peak valuations, we did not feel comfortable adding to such stocks.

The Select Strategy seeks to invest across a spectrum of companies at different stages of business development. In addition to disruptors, we target stocks we consider evolving opportunities that may be temporarily out of favor but are undergoing changes we believe will lead to better results. We also seek to own compounders that are established, but often misunderstood companies making steady gains in existing markets.

We initiated several new exposures across our evolving opportunities and compounders groups during the quarter. eBay, the e-commerce and auction site, is a self-help story we view as an evolving opportunity. Company management is under pressure to jumpstart results and we are encouraged by eBay's efforts to improve the user experience by bringing its payment system in-house and plans to shed non-core assets like ticket reseller StubHub. BJ's Wholesale Club is another new evolving opportunity stock well positioned to drive margins higher through technology adoption and improved loyalty initiatives. Interxion Holding is a European-based data center operator whose growth is tied to the cloud. We consider Interxion a steady compounder with an underappreciated market position that offers better growth opportunities than CoreSite Realty, a similar data center company that was sold out of the portfolio.

While the rebound in performance in the first three months of the year is encouraging, we remain cognizant of the risks that exist in a broadly positive market that does not discriminate based on fundamentals. We continue to focus our efforts on identifying and owning quality companies that can adapt to changing market conditions and industry dynamics. We will also remain opportunistic in our portfolio positioning, seeking out attractive entry points to add to existing holdings and paring back our exposures when valuations become extended.

Portfolio Highlights

The ClearBridge Select Strategy outperformed its Russell 3000 Index benchmark for the first quarter. On an absolute basis, the Strategy had gains in all nine sectors in which it was invested (out of 11 total) during the first quarter. The main contributors to performance were the information technology (IT), consumer discretionary and health care sectors.

On a relative basis, the Strategy outperformed its benchmark driven primarily by stock selection decisions, while sector allocation detracted from overall returns during the quarter. Stock selection in the health care and consumer discretionary sectors contributed the most to relative results. In addition, both stock selection and an overweight allocation in the IT sector added to relative gains. On the negative side, the primary detractor from relative results was energy due to a lack of exposure to the sector. In addition, the Strategy's cash position detracted from relative returns as cash was tied up in M&A transactions waiting to close.

On an individual stock basis, the largest contributors to absolute returns in the first quarter were Shopify, MercadoLibre, ServiceNow, Carvana and Syneos Health. The greatest detractors from absolute returns were positions in Casa Systems, LogMeIn, Citrix Systems, Omnicom Group and Yelp.

The Strategy initiated seven new positions in the first quarter and closed three positions. In addition to those mentioned above, we purchased LogMeIn in the IT sector and exited a position in MindBody in the IT sector ahead of the closure of its acquisition by a private equity investor.