ClearBridge Investments

Appreciation ESG Strategy

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Key Takeaways

- Stocks recorded strong returns, completing the best first half since 1997, while Treasury yields declined and the inversion of the yield curve indicated real concern about the economy.
- We still feel that the robust U.S. consumer will keep us out of recession in 2019, and the market's technical picture is good.
- ClearBridge combines engagement with proxy voting to encourage stronger gender diversity measures in our holdings across all sectors and market caps.

Market Overview and Outlook

During the second quarter the stock and bond markets sent very different signals about the health of the world economy. Stocks recorded returns of 4.3%, completing the best first half since 1997, up 18.5%. By contrast the decline in 10-year U.S. Treasury yields from 2.40% to 2.01% and the inversion of the yield curve indicated real concern about the economy. Gold prices echoed bond market worries, spiking from $1,220 to $1,332. Oil prices fell only slightly for the quarter, from $59.3/bbl to $58.5, but prices were volatile, ranging between $51 and $66. Apart from oil and gold, commodity prices were down.

Two themes drove stock performance during the quarter. We saw a safety trade through May caused by economic fears, and then a "don't fight the Fed" rally in June. The strongest sectors were financials, materials and technology, a bit of an odd mix. Financials stocks were volatile during the quarter, showing strength on first-quarter results, weakness on yield concerns, then a rebound in June. Technology stocks benefited from confidence in continued strong earnings growth, especially in the software sector. Materials stocks with defensive characteristics such as specialty chemicals and gold led that group higher. The commodities portion of materials were some of the worst stocks in the market. The weakest sectors were energy and health care. Health care stocks were hurt by polls indicating that President Trump could be vulnerable in the 2020 election, and discussion of "Medicare for All" by some of the most liberal of the Democratic candidates.

U.S. economic data weakened in the second quarter, with the significant caveat that the most important component, employment, remained excellent. Consumer data continued to be stronger than manufacturing.

Manufacturing was weak worldwide. Two-thirds of the countries that report Purchasing Managers Indexes (PMIs) showed numbers below 50, indicating shrinking manufacturing sectors. The trade dispute with China and President Trump's periodic threats of tariffs with numerous countries made it difficult for producers to make capital investment decisions. Companies questioned their supply chains, uncertain what costs would be. The June U.S. ISM manufacturing fell to 51.7, down from the high 50s seen last year. Hurt by the industrial economy, S&P 500 profits are expected to decline in the second quarter and again in the third.

Consumer numbers saw some very modest fraying at the edges. Employment results remained robust. Payroll employment gains were weak in May at 75,000 but bounced back in June to 224,000. Unemployment claims rose from a 40-year low of 201,000 in early May to 222,000 in late June, but the absolute level is very low. Continued strength in employment will limit Federal Reserve rate cuts going forward. There were sharp declines in the June University of Michigan consumer sentiment survey and the Conference Board's consumer confidence survey, but the absolute results are still very good. Auto sales of 17.1 million were better than expected. Housing starts and permits were down low single digits versus a year ago. We need to wait until the key months of September and October to see if lower rates will stimulate housing sales.

Stock valuations are full. The Buffett Indicator, the market cap of the S&P 500 divided by U.S. GDP, at 1.3:1, is the second highest in history. In general companies with strong prospects see them reflected in their stock prices. However, valuations alone have a poor record of forecasting future market returns. U.S. bank balance sheets are very strong and the group is one of the few areas of the market with real valuation support. If the U.S. does not go into recession banks will outperform. The risk that a Democrat is elected president next year has hurt health care stocks. Valuations of selected drug and HMO stocks are compelling if a moderate Democrat is elected or if President Trump is re-elected. The several-year decline in consumer staples volumes seems to be easing. Increased inventories at retailers are necessary to support one-day deliveries. Earnings estimates for the group do not yet reflect the improved prospects.

We still feel that the robust U.S. consumer will keep us out of recession in 2019, and the market's technical picture is good. The market's advance to all-time highs has been broad. The period after a yield curve inversion usually generates good stock market returns — especially if no recession occurs. However, the deterioration in the worldwide industrial economy must be monitored. The Appreciation ESG strategy of owning large, highquality stocks is well-suited for today's market, offering upside participation if the economy continues to grow and preserving capital if global weakness becomes more problematic.

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Portfolio Highlights

The ClearBridge Appreciation ESG Strategy had a positive return during the second quarter of 2019, outperforming the Strategy's benchmark.

On an absolute basis, the Strategy had gains in all 11 sectors in which it was invested during the quarter. The primary contributors to the Strategy's performance were the information technology (IT), financials and consumer staples sectors. The industrials and real estate sectors were the main laggards.

In relative terms, the Strategy outperformed its benchmark due to stock selection. Stock selection in the energy, IT, consumer staples and financials sectors added the most to relative performance. Conversely, stock selection in the industrials sector detracted from relative returns.

On an individual stock basis, the biggest contributors to absolute returns during the quarter included positions in Microsoft, Walt Disney, Anadarko Petroleum, JPMorgan Chase and Costco. The greatest detractors from absolute returns were positions in 3M, Alphabet, United Parcel Service, UnitedHealth Group and W.W. Grainger.

During the quarter, we exited our position in Anadarko Petroleum. The Strategy also received but did not retain shares of Corteva (CTVA) and Dow (DOW) following their spin-off from holding DowDuPont (DWDP), the remaining segment of which is now called DuPont de Nemours (DD) and is held in the Strategy.

ESG Highlights

It has been three years since we published our last commentary on gender in the workplace, and we are encouraged to find new evidence of the benefits of gender diversity as well as the progress made toward it both in society at large and within our portfolio holdings. Though much work remains to be done, we see ample evidence of the value of the efforts made by research groups and governments. In our own role as an active shareholder, we continue to work to further improve gender parity in the workplace through active ownership of leaders in gender diversity and engagement with companies we own.

Value of Gender Parity Is Becoming Clearer

Recent research confirms the persistence of a positive relationship between diversity and business performance. In its 2015 study, Why Diversity Matters, McKinsey found that companies in the top quartile for gender diversity on executive teams were 15% more likely to have above-average profitability than those in the fourth quartile. Expanded and updated data shows this likelihood has increased to 21%, with these companies also 27% more likely to have superior value creation.[1] Another study found that companies with higher scores for board and management diversity saw consistently higher future returns on equity than those with lower scores (Exhibit 1).

Exhibit 1: Board Diversity and Women Managers Lead to Higher Returns

Gender Diversity in the Workplace Is Improving

Recent statistics on gender in the workplace show some progress is being made. In leadership, female directors have made strides (Exhibit 2). In 2018, on average, boards had 2.6 female directors, compared with 1.7 a decade earlier, and 40% of new board directors were women, a new high since 1998 and a notable increase from 36% in 2017.[2]

Exhibit 2: Female Leadership Gains

	2016	2018
Number of boards with no female directors	1.0%	0.5%
Woman % of directors	21%	24%

Source: Spencer Stuart.

[1] McKinsey, "Delivering through Diversity," January 2018.
[2] 2018 United States Spencer Stuart Board Index.

A robust and repeatable scoring system for measuring gender diversity enables the year-to-year tracking crucial to making improvements.

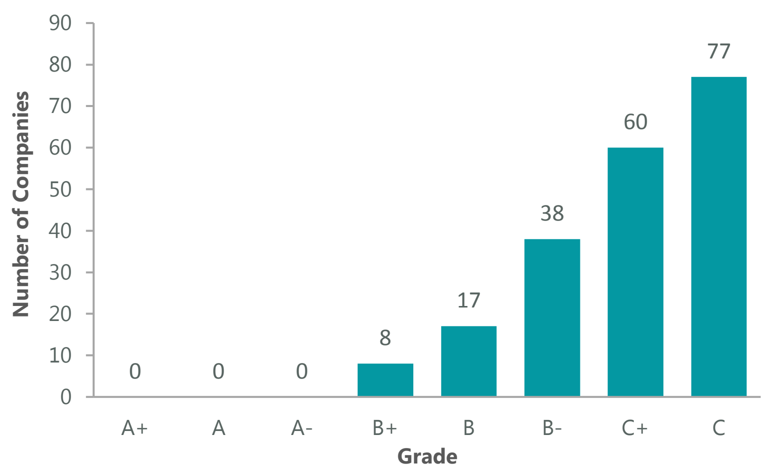
In terms of gender pay, one study shows the U.S. adjusted pay gap has narrowed since 2016, from 5.3% in 2016 to 4.6% in 2018.[3] But progress has been slow, and using optimistic estimates, the same study predicts the U.S. pay gap will not close until 2035. Using conservative estimates, it will not close until 2070.

But There Is More Work to Be Done

The range of estimates for achieving gender equality in the workplace underscores just how much work is needed to achieve even a modest improvement. Equileap, an organization providing data and insight on gender issues in the workplace, has offered a valuable step forward by developing a scoring and ranking system to show companies' commitment to gender equality.

Equileap's scoring system uses 19 data clusters divided into four categories that measure a) gender balance in the overall leadership, management and workforce of a company, b) equal compensation and work life balance, c) policies promoting gender equality and d) commitment to women's empowerment, transparency and accountability. The latest scoring is one indication of the lengths we need to go, but we are encouraged by the robustness, and more importantly the repeatability, of the scoring system, which will help enable the year-to-year tracking necessary for making improvements (Exhibit 3).

Exhibit 3: Top 200 Companies by Grade



As of 2018. Source: Equileap.

International Markets Making Gains

Efforts to make further gains toward gender equality in the workplace are now taking different forms in different markets around the world. In Europe, there is a trend toward requiring

[3] Glassdoor Economic Research, "Progress on the Gender Pay Gap: 2019." The adjusted pay gap adds "statistical controls for differences in education, job titles and other factors aside from gender that affect pay."

transparency in gender pay data and addressing significant disparities. France recently passed legislation dictating that companies with 50 workers or more publicly assess their gender pay parity. The methodology for measuring pay gaps involved five weighted indicators that take into account the percentage pay gap (factoring in age, type of job and all forms of remuneration), proportions of men and women receiving pay raises and promotions, the granting of pay raises after maternity leaves if such raises were given in the interim, and the proportion of men and women among the most highly paid employees in the company. If a company scores below a certain level three years in a row, it may have to pay a penalty of 1% of the company's annual payroll.

Mandatory gender pay gap reporting also applies in the U.K. and is being considered in Ireland. In Portugal, as of February 2019, employers with more than 250 employees must assess male and female salaries annually and justify or correct salary differences.

Japan, meanwhile, is suffering from labor shortages, which have brought to light the large number of women absent from management levels of the workforce and who are necessary to help solve Japan's productivity woes. The Japanese government has responded with labor reform policies that dramatically improve parental leave benefits and aim to fix daycare shortages in order to get mothers into the workforce. Policies are also designed to increase the labor participation rate by encouraging the inclusion of female workers and provide safety net programs (for both elder and child care). While the gender pay gap remains, the female labor participation rate has grown in the past six years, from 48% in 2012 to 52% in 2018.[4]

At the same time, one study found regulatory support alone is not enough to generate positive effects of diversity; there must also be strong cultural support of working women.[5] Japan still has a historical patriarchal work culture that restricts normative acceptance of working women and likely limits the benefit for firms of increased regulatory support for gender parity in the workplace.

ClearBridge holding Shiseido, a Japan-based cosmetics and beauty care provider, is an outlier, however, and is well ahead of its peers in having women exceptionally represented as directors, board members and corporate officers. In meetings with Shiseido in Japan and in our New York office we have discussed Shiseido's ESG goals and its communication of them to the markets. We believe Shiseido is interested in improving women's social status and embraces the UN's Women's Empowerment Principles. Aware of gender pay issues, the company has changed its pay methodology from a seniority status approach, common in Japan,

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[4] The World Bank, International Labour Organization, ILOSTAT database. Data retrieved April 2019.
[5] Letian Zhang, Harvard Business School. "An Institutional Approach to Gender Diversity and Firm Performance," forthcoming in *Organization Science.*

to performance-based pay. In general, Shiseido has gone above the Japanese corporate governance code and we expect that effort to continue as it further improves its gender policies.

Creating Gender Parity Through Ownership and Engagement

Trends toward gender parity are affecting our international investments and should soon have a larger impact in the U.S., both through exposure of U.S. companies to these trends abroad and through potential similar developments domestically.

While the U.S. may be behind other countries in its regulatory support for parental paid leave — it is the only developed country to not mandate paid family leave — some companies are making progress on their own. ClearBridge holding Etsy, the e-commerce services company brokering handmade and vintage items such as clothing and housewares, supports parents regardless of their gender with a 26-week gender-blind parental leave policy that is available to all Etsy employees globally. The company also established hiring and training guidelines to help create gender equity in the workplace; both the board of directors and the executive team are at least 50% women, 55% of Etsy employees are women (as of December 2017) and Etsy's engineering team is almost a third women. Etsy's business itself empowers women around the world as well: 87% of sellers on its platform, versus 33% small business owners who are women in the U.S.

ClearBridge is working to further improve gender parity in the workplace through both active ownership of leaders in gender diversity and through engagement with companies we own on specific gender-related topics. For example, while finance has been slow to embrace gender parity in investment roles, ClearBridge holding Bank of America is a representative financial services company that has made notable strides in addressing gender diversity representation and support, as well as the gender pay gap. Our financials analyst engaged with management recently on the topic of gender diversity and other sustainability matters. In this discussion, management addressed the company's commitment to diversity and inclusion of its workforce, including that 51% of global employees and 42% of global management are female. Bank of America explained that it is focused on driving sustainable "Responsible Growth" by enacting policies and practices to support its diverse workforce, such as investing in their Women Leadership Council for senior executives and employee networks for women at all levels to support recruitment, development, networking and culture. The company was named the 2019 Catalyst Award winner by Catalyst, a global nonprofit working with CEOs and companies to help build workplaces that work for women.

We also promote gender diversity leaders especially in areas where this has historically been lacking, such as in smaller companies.

We also promote gender diversity leaders especially in areas where this has historically been lacking, such as in smaller companies. ClearBridge is a top shareholder of Agios, a small biotech company that develops small-molecule anti-cancer therapeutics targeting cancer cell metabolism. With a female CEO and above-average gender representation on the board versus industry peers, Agios is a leader in achieving gender diversity among biotechnology firms. It is far above average for companies of similar market cap size and with similar tenures as public companies, and scores better than many more mature, large-cap biotech companies that have had more time and resources to improve their diversity.

Engagements are a critical part of our approach to ESG investing, and engagements on gender can have a material effect on our own ESG rating for a company. One of our information technology analysts reached out to the management of an infrastructure software holding and addressed allegations of gender pay disparity. The discussion was less transparent than anticipated, given the company's previous history of open dialogue. Because of the company's unwillingness to discuss the basis of the allegations, the analyst downgraded the company's ESG rating and has committed to monitoring and engaging management on this issue.

We also combine proxy voting with engagement to encourage stronger gender diversity measures in our holdings. For example, our media analyst and several portfolio managers have met with Discovery Communications over the past few years and discussed gender diversity and the representation of women on the board of directors. As the top shareowner of the stock, ClearBridge portfolio managers voted 100% of the firm's shares in previous years in support of a shareholder proposal to request the board to adopt a policy for improving board diversity. This engagement process was in line with the company's long-standing commitment to support its female workforce: 55% of its managers and 47% of its executives are women. In addition, the company offers work flexibility, advancement mentoring, family support policies and up to 22 weeks of paid maternity leave, which is among the highest of publicly traded companies in the U.S.

We are encouraged by the progress toward gender parity in which we have participated through our active ownership of leaders in gender diversity such as Shiseido, Etsy, Bank of America, Agios, Discovery Communications and others, and through engagement with the companies we own across geographies, market caps and sectors. While there are still milestones ahead, our long-term ownership approach affords us several avenues to make gains as we continue to work with our portfolio companies to close the gender gap, and to drive the returns gender diversity has proven to spur.