

# ClearBridge Investments



**Scott Glasser**  
Managing Director, Co-Chief Investment Officer,  
Portfolio Manager



**Michael Kagan**  
Managing Director, Portfolio Manager

## Appreciation Strategy

### Key Takeaways

- ▶ Investors embraced relative certainty on trade, lower for longer interest rates and an expanding money base to push U.S. equity markets higher in the fourth quarter.
- ▶ In a risk-on quarter, higher-beta technology names were top contributors, while those with less economic sensitivity generally underperformed.
- ▶ Although we have subdued expectations for the U.S. economic outlook, we expect a low-growth economic expansion through at least the first half of 2020.

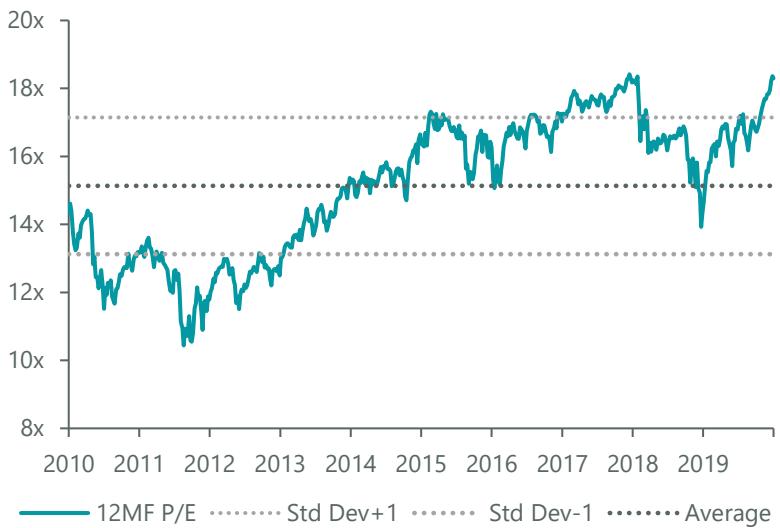
### Market Overview

The season of giving was prosperous for U.S. equity markets. In the final quarter of 2019 investors were treated with resolution — at least partially — to many key concerns: the U.S. and China reached a phase one trade agreement; the Fed cut interest rates by another 25 basis points and resumed expansionary monetary policy to address malfunctioning repo funding markets (but don't call it quantitative easing); and the UK inched toward a Brexit resolution.

The result was a steady grind higher for equities resulting in a robust 9.07% return for the S&P 500 Index. Volatility was noticeably absent: there were only five trading days with >1% swings in the market, the least in over a year.

The quarter's impressive return can be almost exclusively explained by an expansion of the market multiple as investors embraced relative certainty, lower for longer interest rates and an expanding money base. S&P 500 earnings estimates for 2020 and 2021 were revised lower by 2.24% and 1.72%, respectively, over the past 90 days as the market rallied. As a result, the 12-month forward P/E multiple expanded from 16.8x to 18.3x during the quarter (Exhibit 1). The expanding market multiple is noteworthy because the current S&P 500 P/E multiple is within an earshot of the peak post-crisis multiple (18.4x in December 2017) and 1.5 standard deviations above the 15.1x average forward multiple. In our view, markets will be more dependent on a rebound in earnings to drive the next leg of market returns.

Exhibit 1: S&amp;P 500 Index 12-Month Forward P/E Multiple



As of Dec. 31, 2019. Source: ClearBridge Investments, Bloomberg LP.

Not surprisingly, as key investor concerns diminished, consumer and business confidence measures improved steadily. The University of Michigan's consumer confidence survey increased from 93.2 in September to 99.3 by year-end, while the NFIB Small Business Optimism index also improved from 101.8 in September to 104.7 in the most recent reading (end of November). The bottom line is investor mindsight shifted from "when" a recession will begin to "if" a recession is within a forecastable horizon. Given the market rally on expanding multiples, investors clearly concluded the longest U.S. economic expansion on record (10.5 years and running) has legs as we enter 2020. Supporting this concept, the New York Fed's Probability of a Recession model, which looks ahead 12 months, declined from 34.8% in September to 23.6% at last reading in December. This measure never surpassed 12% during the 2009–2018 timeframe so concern remains elevated, just less so than at mid-year. This data is consistent with ClearBridge's [Recession Risk Dashboard](#), which turned to a more cautious "yellow" signal in June, indicating a more mixed economic picture but not an imminent recession.

Increased confidence played out in the form of a bullish change in market leadership. Information technology (IT) regained leadership from defensive sectors — REITs and utilities — which led the market during a choppy third quarter. Of note, health care recouped some 2019 year-to-date underperformance as the specter of a Warren or Sanders Democratic nomination diminished. The 2020 Presidential election, meanwhile, remains a focal point for U.S. equity investors. In sum, the fourth quarter's leadership change is another sign investors placed bets for a continuation of U.S. economic expansion in 2020.

The Appreciation Strategy maintains a conservative approach to investing and focuses on both upside participation and downside protection. We tend to focus on high-quality earnings compounders with quality balance sheets and durable competitive advantages. These are not the types of stocks short-term investors gravitate to in a renewed risk-on or expanding multiple environment. For example, two of the five largest fourth-quarter detractors were Travelers and McDonald's: both had idiosyncratic issues that catalyzed underperformance, and they are also businesses with less sensitivity to a changing economic landscape. Meanwhile, higher-beta stocks Apple, Microsoft, Facebook and Adobe were four of the top six contributors.

On an individual stock basis, the single largest contributor to our return was Apple. However, our 4%+ portfolio weight in Apple remains roughly 50 basis points below market weight, despite being the second-largest position in our portfolio. As such, Apple's 1,700 basis point outperformance versus the IT sector weighed against our relative performance. Microsoft was the second-largest contributor to Appreciation's total return (and our largest absolute and relative position), however the company performed only in line with the IT sector and therefore didn't contribute to our relative return despite a robust 13.8% total return in the quarter. Meanwhile, UnitedHealth Group was our third-largest contributor to performance and our best relative performing stock. The position is a roughly 120 basis point active weight that outperformed the health care sector by over 2,100 basis points during the quarter.

During the quarter we initiated a position in Arista Networks (ANET) as we viewed soft demand for its networking switches from cloud providers to be temporary. We anticipate a ramp up in demand in the second half of 2020 and believe risk/reward supports initiating a position today. We funded this purchase by trimming Cisco Systems as we view the growth outlook for Arista Networks relative to risk/reward increasingly compelling relative to networking hardware peers.

## Outlook

Although we have subdued expectations for the U.S. economic outlook, we believe actions taken in recent months will support a low-growth economic expansion through at least the first half of 2020. Lower interest rates support a benign credit outlook (though we remain concerned about total leverage and interest coverage should rates rise). An expanding monetary base should keep liquidity ample while trade placidity could provide a much-needed boost to corporate capex. Finally, employment trends remain encouraging with the unemployment rate at 50-year lows, total payroll growth steady and initial claims near cycle lows.

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The fourth quarter's leadership change is another sign investors are betting on continued U.S. economic expansion in 2020.

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Considering consumer spending accounts for three quarters of U.S. GDP, steady employment data should buoy consumer spending.

While we believe the U.S. is in the late stages of its current economic expansion (the longest economic expansion on record at 10+ years), we also believe actions in the fourth quarter likely support further modest growth in early 2020. We continue to focus on investing in high-quality, large cap companies with quality balance sheets and stable free cash flow. We believe this to be especially important given late-cycle dynamics and elevated political risk as we look to the November 2020 election.

### Portfolio Highlights

The Appreciation Strategy lagged the benchmark in the fourth quarter as the market's return to a risk-on mentality proved relatively challenging for the portfolio, an outcome not overly surprising given the market environment.

On an absolute basis, the Strategy had gains in all 11 sectors in which it was invested during the quarter. The main contributors to the Strategy's performance were the IT, health care, financials and communication services sectors.

In relative terms, the Strategy underperformed its benchmark due to stock selection. In particular, stock selection in the IT and consumer discretionary sectors detracted the most from relative performance. Conversely, underweights to the utilities and consumer discretionary sectors were additive.

On an individual stock basis, the biggest contributors to absolute returns during the quarter included positions in Apple, Microsoft, UnitedHealth Group, JPMorgan Chase and Facebook. The greatest detractors from absolute returns were positions in Travelers Companies, Home Depot, McDonald's, Cisco Systems and International Business Machines.

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