ClearBridge Investments

Dividend Strategy

John Baldi
Managing Director, Portfolio Manager

Michael Clarfeld, CFA
Managing Director, Portfolio Manager

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

Peter Vanderlee, CFA
Managing Director, Portfolio Manager

Key Takeaways

- The market posted terrific returns for 2019, as the Fed cut rates in the wake of the late-2018 market selloff.
- In a familiar pattern, the administration has timed policy to boost economic growth heading into an election year.
- After a year in which market valuations expanded significantly, earnings growth will likely play a more significant role in dictating market returns in the near future.

Market Overview

What a year! The ClearBridge Dividend Strategy and the S&P 500 Index both posted terrific returns in 2019. Strong performance was broad based with every sector of the stock market rising double-digits, led by a 50% return in information technology (IT). Strength was not limited to the equity market, as numerous asset classes performed well. The bond markets generated a total return of 8.5%, gold rose 18%, oil climbed 34% and real estate increased 26%.[1] For Dividend Strategy, stock selection in most sectors contributed to performance while sector allocation detracted from performance (predominantly an underweight to IT — which is not atypical for dividend-centric portfolios — and a drag from cash).

At first blush, it may seem surprising to get such stellar returns in the 11th year of a market cycle. Global economic growth is weak, valuations are fairly full and S&P 500 earnings increased less than 5%. Upon reflection, however, this year's performance is easier to explain. We must start by recalling that the S&P 500 declined 14% in the fourth quarter of 2018. This selloff set the stage for a strong 2019 as it both lowered the bar and, crucially, forced the Federal Reserve to reverse course. After raising rates four times in 2018, the Fed pivoted and cut rates three times in 2019. Investors cheered the rate cuts as they restored the narrative that has animated markets for the last 10 years: in a world of absurdly low interest rates, "There Is No Alternative" to buying equities, real estate and other risk assets.[2]

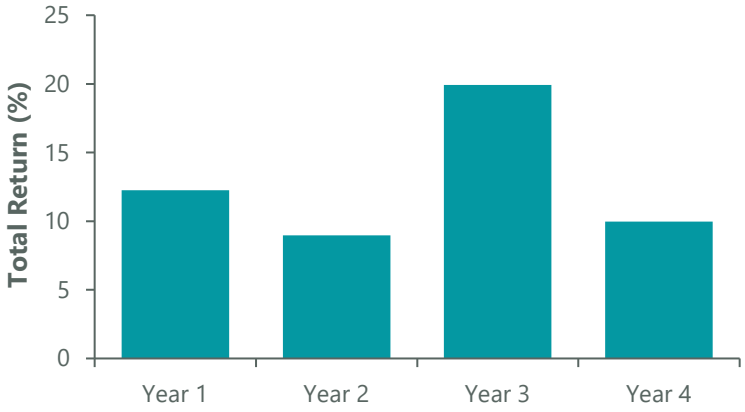
[1] As measured by the iShares Core U.S. Aggregate Bond ETF, gold spot price per ounce, WTI crude oil futures and the MSCI U.S. REIT Index, respectively.
[2] Affectionately referred to as the "TINA trade," proponents of this theory argue that with near-zero yields in high-quality fixed income, There Is No Alternative to pouring cash into equities, real estate, etc.

Interest rates on 10-year Treasurys ended the year below 2% after nearly eclipsing 3.25% at the tail end of 2018. Such low rates support sky-high valuation multiples as financing is cheap and multiples that may have seemed irrational in other eras now look reasonable.

While it may seem counterintuitive, the ongoing trade war with China also boosted markets in 2019. As Washington and Beijing traded barbs (and tariffs) over the last few years, the trade war has weighed on the global economy and worried markets. Over the last few months, however, the tone of the negotiations improved, boosting confidence in the economic outlook and driving markets higher.

The timing of all this is no coincidence, as made clear by President Trump's December 31st declaration that a phase one trade deal was reached and would be signed in mid-January. In a time-tested pattern, the administration implemented policies — in this case the trade war — which served to "artificially" depress the economy in the early years of the President's term and then boost economic growth heading into its re-election campaign.[3] Such policies are not unique to the current administration. Since World War II, most administrations, of both parties, have followed a similar blueprint. The impacts of this stimulus are staggering. While every year and every cycle is unique, this dynamic — where policies depress the economy in the early part of the term and then boost the economy heading into re-election — has produced some of the most astounding return patterns in the market (Exhibit 1). The third year of the presidential election cycle is far and away the best year as market sentiment recovers and investors begin to discount the strong growth expected in year four.

Exhibit 1: Average S&P 500 Returns by Year in Presidential Election Cycles Since 1945



Source: ClearBridge Investments, Bloomberg LP.

[3] The trade war was primarily launched, of course, to reset the terms of trade with China and other countries — not simply to manipulate the short-term economic cycle or election cycle. The timeline of the trade war, however, corresponds well with the election cycle (crescendo in the middle of the presidency only to be resolved and thereby boost growth in the last year of the term heading into re-election).

Valuations are rich relative to history, but not unreasonable when judged against interest rates.

Market Outlook

As we head into 2020, this expansion is another year older. The global economy is weak, but nonetheless growing. U.S. economic growth is below potential, but still better than most other countries. Corporate and consumer balance sheets are in good shape. Governments are overextended, but low rates make interest burdens manageable. Valuations are rich relative to history, but not unreasonable when judged against interest rates.

Consensus expectations currently call for 10% earnings growth in 2020. While it's early to have strong conviction about earnings for the full year ahead, should these estimates prove correct they should portend a solid year for the stock market. After a year in which market valuations expanded significantly (and drove almost 90% of the price appreciation for the S&P 500), earnings growth will likely need to play a more significant role in dictating market returns in 2020.

It is difficult to make predictions, particularly about the future, goes the familiar saying. The current market dynamic could be maintained so long as interest rates remain low, faith in central banks remains firm and the economy continues to grow. Or the longest bull market in history could definitively roll over as any of the litany of risks in the world come home to roost.

Our portfolio of dividend growers should perform relatively well either way. If the economy and markets continue to expand, our group of stable growers should chug along nicely. If the outlook is less rosy, we feel confident that our stocks will hold up relatively well given their yields, strong balance sheets, recurring revenues, lower than average cyclicality and rising dividends.

Portfolio Highlights

The ClearBridge Dividend Strategy underperformed its S&P 500 Index benchmark during the fourth quarter. On an absolute basis, the Strategy had gains in nine of the 11 sectors in which it was invested for the quarter. The main contributors to Strategy performance were the financials, information technology (IT) and health care sectors. The consumer discretionary and consumer staples sectors, meanwhile, detracted from absolute results.

On a relative basis, stock selection and sector allocation detracted from performance for the quarter. In particular, stock selection in the consumer staples, consumer discretionary and communication services sectors contributed negatively to relative returns. Underweights to the IT and health care sectors and an overweight to the consumer staples sector also proved detrimental. Conversely, stock selection in the financials sector added to relative performance, as did an underweight to the consumer discretionary sector.

On an individual stock basis, the largest contributors were Apple, Microsoft, UnitedHealth Group, Blackstone and JPMorgan Chase. Positions in Anheuser-Busch InBev, Home Depot, American International Group, Travelers Companies and McDonald's were the main detractors from absolute returns in the quarter.

During the quarter, we closed positions in General Motors in the consumer discretionary sector, Berkshire Hathaway in the financials sector and Alphabet in the communication services sector.