ClearBridge Investments

Large Cap Growth Strategy

Peter Bourbeau
Managing Director,
Portfolio Manager

Margaret Vitrano
Managing Director,
Portfolio Manager

Key Takeaways

- Maintaining a diversified approach to growth companies proved a headwind in the narrow market that characterized the fourth quarter and the full year.
- Stock selection and an underweight to technology stocks weighed on relative performance but we remain confident in the IT companies we own in areas like software.
- Consumers should continue to support the overall economy and the portfolio is well exposed to consumer spending across several sectors.

Market Overview

Growth equities turned in their strongest performance in a decade in 2019, with the largest growth stocks delivering the highest returns. The S&P 500 Index advanced 9.07% in the fourth quarter to finish up 31.49% for the year while the benchmark Russell 1000 Growth Index rose 10.62% in the quarter and 36.39% for 2019, its best performance since the initial recovery from the global financial crisis in 2009. Despite a brief shift in leadership to more cyclical and value-oriented shares in the third quarter, growth resumed its dominance in the fourth quarter, with the Russell 1000 Growth Index outperforming its value counterpart by 321 basis points. Growth topped value by 985 bps for the year.

One difference in the fourth quarter from previous growth rallies this year was the participation of health care (+16.23%). The sector was the best performer in the benchmark as political fears of an overhaul to the U.S. health care system (Medicare for All) and the potential impact on drug prices abated. Information technology (IT, +14.40%) and communication services (+10.89%), home to most of the FAANG stocks that have paced market performance over the last several years, also kept pace.

Markets rallied over the final three months of 2019 as many uncertainties weighing on equities began to recede. Optimism about a phase-one trade deal between the U.S. and China, reassurance from the U.S. Federal Reserve that economic results did not warrant further rate cuts (following its third cut of the year in October) and signs of improvement in the manufacturing sector after an extended period of contraction acted as catalysts for stocks to resume a vigorous rally following a slowdown in the third quarter.

What's been most surprising to us about the current rally is the degree of price-to-earnings multiple expansion we've seen, especially among the market's largest stocks. The Fed's rate cuts served as a big component of that multiple expansion. Earnings per share for the S&P 500 are projected to be up about 1% this year and the index is up over 30%. Apple's earnings before interest and taxes were down 10% for the 12 months ending in September while the shares gained 88% for all of 2019, illustrating the impact of multiple expansion.

The Large Cap Growth Strategy trailed its benchmark during the quarter and for the full year, due to both stock selection and our differentiated IT exposure. This is an anomaly for the portfolio as relative performance dispersion over the last decade has been primarily a function of stock selection rather than sector allocation. We alluded last quarter to how active risk taking has proved detrimental in the short term as several portfolio holdings have failed to live up to our theses for owning them. In an effort to deliver differentiated performance and alpha over time compared to passive strategies, we make daily judgment calls about owning every stock in the portfolio. In cases where we believe near-term headwinds impacting a company are transitory and fixable, we will hold the stock or add to the position at attractive prices. Cloud software maker Nutanix is a good example. The leader in the market for a cloud technology called hyperconverged infrastructure that combines multiple computing tasks has struggled to shift its business to a subscription model as competition intensifies. However, Nutanix shares rallied nearly 20% in the fourth quarter due to closing larger deals, strength in new product sales and greater operating visibility and we continue to own it.

Similarly, we added to top holding Amazon.com in the fourth quarter as the e-commerce and cloud services provider underperformed its FAANG peers. While Amazon is off its mid-summer highs, we still have conviction about results through 2020.

In other cases, when it becomes clear our thesis no longer works, we will aggressively exit positions and invest the proceeds in better opportunities. This was the case most recently with Grubhub, the largest online and mobile food ordering and delivery company in the U.S. We sold the stock during the quarter after the company revealed competitive risks and customer churn had increased more than they had expected. We were aware of Grubhub's investment cycle to gain a presence in new markets and the near-term impact on margins when we purchased shares in early 2019. However, the extent of competition in online food delivery and the level of further investment required to maintain share provided poor visibility into long-term profitability.

As an active manager, risk management is a key driver of performance and where we can distinguish ourselves over time.

Maintaining a diversified portfolio of growth companies is also important and can be a headwind in a narrow market like we experienced over the last 12 months. Controlling risk and being mindful of valuations has caused the portfolio to be underweight IT relative to the benchmark for the last several years. The portfolio's IT allocation was approximately 550 basis points underweight the benchmark at year end, the largest under our tenure as managers of the Strategy. This divergence is partly attributable to the June rebalancing of the Russell 1000 Growth Index, which brought our IT exposure down 300 bps compared to the benchmark. While we maintain meaningful exposure to the FAANG stocks, the portfolio's underweight to several – Apple in particular – has detracted from results as the iPhone maker saw its stock zoom 88% in 2019. Our concern with Apple has been a maturing smartphone cycle and slowing growth rates. We added to the stock in the fourth quarter to keep our position within range with the benchmark, yet remain close to 500 bps underweight. We are also approximately 250 bps underweight Microsoft, a company we like for its recurring revenue model and growing cloud business yet at close to eight percent of our benchmark, its valuation is less compelling than what we are seeing elsewhere.

The other concern related to technology is that it encompasses more than just the economic sector categorized as information technology. We also consider many of the Internet and media companies that are now categorized in the communication services and consumer discretionary sectors as technology stocks. Taken together, these stocks comprise over 50% of the benchmark, which is approaching the 55% level of TMT (technology, media, telecom) stocks we saw in the benchmark in 1999 ahead of the Internet bubble. Such a large technology weighting makes us uncomfortable and has turned some passive products that track growth benchmarks into closet tech funds. We prefer to be diversified and selective in our stock selection and like what we own in technology.

Portfolio Positioning

Software-as-a-service (SaaS) has been a successful theme for the portfolio as more providers and enterprise customers transition to a subscription model. Microsoft and Adobe have jumpstarted growth by transforming their business models while information security firms Palo Alto Networks and Splunk are in the midst of the move from licensing to subscriptions. No company has arguably been more successful in the SaaS space than salesforce.com. We had been following the company for several years but were uncomfortable with valuation until the stock retraced its gains in the middle of 2019, providing an attractive entry point to establish a position.

We have rarely been underweight health care and the sector is too big with too much growth potential to downplay.

Salesforce.com is the leader in the global SaaS market for enterprise sales, service and marketing functions that could reach $200 billion by 2022. The company has underperformed over the last year but stands out for its high customer retention and expansion beyond salesforce automation to include customer service, marketing automation, commerce, and application development. It has also added integration capabilities with the recent acquisition of Mulesoft and data analytics with the purchase of Tableau. We believe the company has a continued runway for strong top line growth and significant room for margin expansion which should support sustained EPS growth. The stock's valuation makes it susceptible to a weaker enterprise spending environment while slowing growth in its core business could force it to engage in more dilutive acquisitions. We will be watching these trends closely as we build our position.

In addition to the salesforce addition, we closed out of Chipotle Mexican Grill as the burrito maker's shares reached what we consider full valuation. The stock has performed well since our initial purchase in 2016, outperforming the market by a meaningful margin as the fast-casual Mexican chain effectively addressed its previous food quality and customer services issues and successfully launched mobile ordering.

Like IT, the recent trend in our health care positioning has been unusual. The portfolio became underweight the sector in the second quarter of 2019 as we sold out of three biotechnology holdings (Celgene, Regeneron Pharmaceuticals and Biogen) for company-specific reasons. We have rarely been underweight health care over the last decade and the sector is too big with too much growth potential to downplay. The challenge today is price as portfolio holdings UnitedHealth Group, Zoetis and Thermo Fisher Scientific are trading near all-time highs. Nevertheless, we are actively researching new health care ideas and expect to add to the sector as attractive entry points arise.

Outlook

As we enter the new year, equity markets are in a strange place. Valuations are stretched nearly everywhere we look, with any stock that appears cheap likely saddled with serious problems. The global economy is getting better but we are by no means off to the races in terms of robust growth and end demand. Accommodative monetary policy and a catch up from the late 2018 selloff were the main catalysts driving global stock price appreciation, which was largely the result of P/E multiple expansion

The current level of ebullience in the market reflects the strength of the consumer rather than the economy as a whole. Unemployment remains at 50-year lows, wages are growing and consumer confidence remains near recent highs. The portfolio is well exposed to consumer spending through such companies as

Amazon, Disney and Costco. The business side of the ledger is more problematic with ISM New Orders weak and the trucking market also flashing warning signs about economic activity. Compared to consumers, CEO and CFO confidence is downbeat. Where and when they direct capital spending, see final demand and become certain trade and policy rules won't change will be major determinants of company performance going forward. If markets remain on stable footing, we're likely to see higher inflation and if it leads to higher interest rates that could be a major headwind for stocks.

We continue to maintain a diversified portfolio in a non-diversified growth market. While our top 10 holdings account for about 40% of portfolio assets, the five largest stocks in the benchmark make up 30% of assets, exposing passive investors to greater company-specific risk than they probably realize.

Portfolio Highlights

The ClearBridge Large Cap Growth Strategy underperformed its Russell 1000 Growth Index benchmark during the fourth quarter. On an absolute basis, the Strategy had gains across nine of the 10 sectors in which it was invested (out of 11 sectors total). The primary contributors to performance were the IT and health care sectors while the lone detractor was the consumer staples sector.

On a relative basis, overall stock selection and sector allocation detracted from performance. Specifically, stock selection in the IT, consumer discretionary and consumer staples sectors and an underweight to IT had the most significant negative impact on results. Meanwhile, stock selection in the industrials and energy sectors contributed to relative performance.

On an individual stock basis, leading individual contributors to absolute returns in the fourth quarter included positions in UnitedHealth Group, Apple, Facebook, Microsoft and Adobe. Grubhub, Anheuser-Busch InBev, Akamai Technologies, Home Depot and Advance Auto Parts were the biggest detractors.