ClearBridge Investments

Large Cap Growth ESG Strategy

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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.
- Taking a life cycle approach to the beverage container's challenges brings home how there are several entry points for action that can reduce environmental impact.
- 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.

Software-as-a-service (SaaS) has been a successful theme for the portfolio as more providers transition to a subscription model.

The Large Cap Growth ESG 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. 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. We are also 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.

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.

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 ESG 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 contributor to performance was the IT sector while the lone detractor was the consumer discretionary sector.

Several large beverage makers have begun to make the shift from plastic to aluminum with some of their water brands.

On a relative basis, overall stock selection and sector allocation detracted from performance. Specifically, stock selection in the consumer discretionary and IT sectors, underweights to IT and health care and an overweight to materials had the most significant negative impacts on results. Meanwhile, stock selection in the health care and industrials sectors and an underweight to consumer discretionary contributed to relative performance.

On an individual stock basis, leading individual contributors to absolute returns in the fourth quarter included positions in Apple, UnitedHealth Group, Facebook, Microsoft and Nvidia. Grubhub, Akamai Technologies, Home Depot, Advance Auto Parts and C.H. Robinson were the biggest detractors.

ESG Highlights

As a follow-up to our 2018 commentary on plastic waste, given growing beverage consumption and declining recycling rates, we take a closer look at beverages, in particular plastic bottles and other container options. Americans are increasingly choosing water beverages (both still and sparkling) over soda, and most water for purchase is still bottled in plastic containers. The beverage container touches many industries, upstream and downstream, pre- and post-consumer, presenting logistical and environmental challenges at each step. Taking a life cycle approach to the beverage container's challenges, however, brings home how there are several entry points for action that can reduce environmental impact.

The Beverage Recycling Conundrum: What's on the Outside Counts

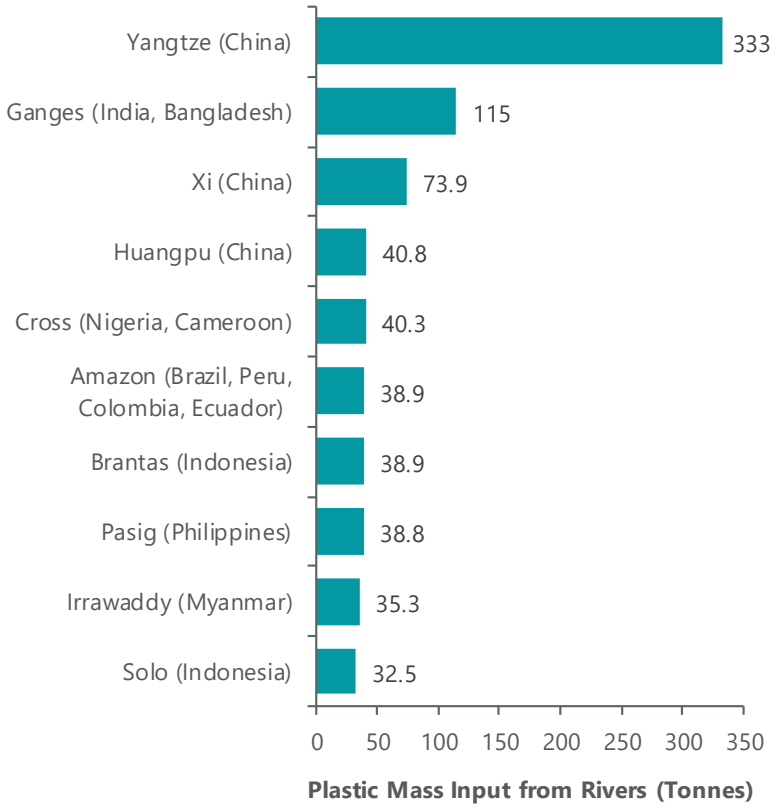
From a production and logistics standpoint, plastic bottles can make a lot of sense: they are durable and versatile, enable long shelf life, are easily molded and are light, which makes them easy to transport and lowers the carbon footprint from transportation costs. A polyethylene terephthalate (PET) bottle costs roughly half as much as a standard 12 ounce can (which costs $0.09–$0.10)[1] and produces 77% less greenhouse gases than a glass bottle (which are heavier to transport and can break during shipping).[2]

This convenience comes with some major challenges, however, the biggest being recycling, as increased use results in high levels of plastic waste. Globally, only 12% of plastic waste is recycled. Sixty percent of plastic waste stays in the environment, entering urban areas, rivers and landfills around the world (Exhibit 1) — an alarming level given that it takes 450 years for a PET bottle to decompose. Another 28% of plastic waste is incinerated, resulting in significant

[1] https://www.bottledwater.org/water-use
[2] Goldman Sachs Investment Research 2019

greenhouse gas emissions.[3] In the U.S., the 29% recycling rate for PET bottles is higher than the global rate, but still dismal.[4]

Exhibit 1: Top Ten River Sources of Plastic Waste in Oceans (2015)



Source: Hannah Ritchie and Max Roser (2020), "Plastic Pollution." Retrieved from https://ourworldindata.org/plastic-pollution. Data originally published by Lebreton, L. C., Van der Zwet, J., Damsteeg, J. W., Slat, B., Andrady, A., & Reisser, J. (2017). River plastic emissions to the world's oceans. Nature Communications, 8, 15611.

The increased use of single-use plastics is another major challenge. A third of all plastic produced is for single use, but because these single-use items have a short shelf life they generate 42% of waste.[5] Bottled water consumption helps illustrate the single-use challenge. We consume 100 billion gallons of bottled water globally each year. The U.S. consumes 14 billion gallons, of which 70% comes in single-serve bottles (the average American opens six water bottles per week).[6] Consumption in the emerging markets tends to skew more toward bulk retail and is often a result of limited access to clean water as opposed to convenience. More single-serve plastic use means a higher plastic consumption intensity per gallon of bottled water consumed, increasing the scope of waste generation.

[3] Ibid.
[4] National Association for PET Container Resources (NAPCOR).
[5] Goldman Sachs Investment Research 2019
[6] https://www.bottledwater.org/water-use

What are the Solutions?

While there are several solutions available to the individual consumer — use less plastic, and use less often; if you use, reuse (consider having your own bottle); finally, recycle — there are several ways businesses can improve the situation up and down the beverage container supply chain. For plastic bottles in particular, we can use alternate substrates, use more recyclable content, use less plastic packaging or improve recycling itself, either by increasing consumer awareness or investing in technology to better recycle content.

Using Alternate Substrates

One much-discussed option to reduce the amount of plastic water or beverage bottles produced is to switch some uses to aluminum cans, which have much higher recycling rates (75% globally) than plastic bottles. This shift is being made possible in part by ClearBridge portfolio companies Ball Corporation, the largest manufacturer of recyclable aluminum beverage cans in North America, and Crown Holdings, a global leader in the production of steel and aluminum cans for food and beverage products. These companies are helping meet the demand for aluminum beverage packaging, which, with aluminum becoming both a consumer and recycling package preference over plastic bottles, we expect to increase dramatically.

In a November 2019 call with Ball CEO and investor relations on its business and sustainability we discussed how the environmental challenge posed by packaging is a key driver for growth for the business. We see Ball as an innovator within the aluminum can industry. Ball will be the first company to build a fully dedicated aluminum cup company — partnering with vendors to introduce recyclable aluminum cups to be used in stadiums and event venues across the U.S. They are also pioneering the development of new aluminum products such as resealable aluminum containers that will help increase penetration in the bottled water segment.

While aluminum is more carbon intensive to manufacture and it releases greenhouse gases in its production process, it is infinitely recyclable, which indicates the overall life cycle impact would be less than that of plastic. Several large beverage makers, such as ClearBridge portfolio companies Coca-Cola, PepsiCo and Nestle, have begun to make the shift from plastic to aluminum with some of their water brands.

Investing in Technology to Increase Recyclable Content

Still, to the extent that plastic will continue to be used, there are ways to improve its use. Some beverage companies are working to improve the recyclability of plastic. PepsiCo, for example,

announced in June 2019 that its LIFEWTR brand will be packaged in 100% recycled PET or rPET. Using more recycled plastic could start a virtuous cycle of raising plastic's waste value, encouraging more recycling.

In addition, several companies across the plastic packaging value chain, ClearBridge portfolio company Unilever among them, have formed a new group aiming to accelerate the commercialization of BP Infinia, a technology for recycling certain types of PET plastic waste, such as highly colored and opaque plastic bottles or food trays, until now difficult to recycle. The technology is designed to turn these types of PET plastic waste into higher-quality PET packaging that can be recycled repeatedly without losing quality. In October 2019, BP announced plans to construct a $25 million pilot plant in the U.S. to prove the technology before progressing to full-scale commercialization. Higher recycling rates would reduce both virgin production and waste ending up in landfills and oceans or incinerated.

At a recent event with Coca-Cola C-suite members and head of sustainability, we discussed how plastic packaging remains a large sustainability focus area. Coca-Cola and several other large staples companies have invested in Circulate Capital, a firm that finances and invests in companies and infrastructure that prevent plastic from entering our oceans. Key technological focus areas include chemical recycling and increasing the capability to use post-recycled plastic content in new packaging. One of the big outstanding non-technological barriers is that in China and India regulators do not allow post-recycled plastic to be used for food and beverage purposes; Coca-Cola continues to work with industry players and NGOs to try and amend those regulations.

We also discussed how using returnable glass packaging is a competitive advantage in certain markets, and how this system allows the cost of the packaging to be amortized over 10+ uses, which gives the consumer a >30% discount versus a single-serve offering. Recycling infrastructure, however, remains crucial. A lack of glass recycling capability in the U.S., for example, limits the glass-packaged beverages Coca-Cola can sell in the U.S. market.

Challenges to Improving Recycling Practices

Whether we're using plastic or aluminum, recycling practices likewise show considerable room for improvement. Recycling rates in the U.S. have been flat at 35% since 2012, with the latest data available being 2017.[7] Recycling for PET and high-density polyethylene (HDPE) liquid containers is 29%, down from 31% in 2012.[8] Aluminum can recycling has also declined

[7] Environmental Protection Agency.
[8] NAPCOR.

to 49% from 56% in 2014.[9] Overall plastic recycling rates are holding steady at 8%–9%.[10]

Higher costs have made it difficult for some municipalities to recycle.

Adding to the stress on the recycling system, China, hitherto the largest importer of waste plastics, accounting for 26% of the global market, imposed significantly higher contamination standards, in effect banning the import of several types of waste, including plastics, in early 2018. Municipalities, deprived of Chinese demand for their waste, have seen prices of recycling commodities fall precipitously, in effect raising the cost of recycling.

In a December 2019 engagement with ClearBridge portfolio holding Waste Management, an integrated waste services company, we discussed how contamination — non-recyclable material or garbage that ends up in the recycling system — has increased as more people have begun recycling. The company estimates contamination rates at 25%, up from 10% in recent years. Since the ban, Waste Management and other U.S. recyclers have improved contamination in their recycling basket, although this has raised costs for municipalities even as the commodity value of recycling has collapsed, in some cases threatening recycling programs. Processing costs today are as much as $75–$85/ton, which compares to average landfilling costs of $55/ton. Higher costs have made it difficult for some municipalities to recycle.

Another waste disposal option is waste to energy. ClearBridge portfolio company Covanta, for example, operates energy-from-waste facilities that convert over 21 million tons of waste into power for over one million homes and recycles roughly 400,000 tons of metal every year. On a recent onsite visit with Covanta at one of its garbage collection sites, we discussed emissions comparisons for energy-from-waste versus landfilling and learned about the energy-from-waste process, from the intake of waste to energy generation. Energy-from-waste takes non-hazardous waste that would otherwise go to landfills, combusts it in boilers, then recovers the heat to generate steam to use in power generation. After the combustion takes place, Covanta recovers metals from the remaining ash and re-sells them. This recycling prevents the carbon-intensive production of new metal products and saves more than 1.2 million tons of greenhouse gases each year, the equivalent of removing 113,000 cars from the road for a year, according to Covanta.

There are, of course, trade-offs with the energy-from-waste process as well, as combustion does release CO_2 into the atmosphere, albeit less than would be generated by the waste going to a landfill over a very long time.

[9] The Aluminum Association: Key Sustainability Performance Indicators, Sept. 2019.
[10] Roland Geyer et al. "Production, use, and fate of all plastics ever made," Science Advances, July 2017.

The ultimate driver of improving recycling rates and lowering the cost of recycling may start in the home and office. If consumers were to increasingly recycle properly, the resultant higher recycling rates would lower costs in a virtuous cycle. Downstream industries using more recycled commodities outside the U.S. as feedstock would also help by boosting the value of recycled commodities and therefore lowering the cost of recycling to the consumer.

The practices of recycling and, to a lesser extent, combustion with energy recovery have grown in the past 30 years (especially outside the U.S.), helping slow the amount of waste entering landfills. To help continue this trend, ClearBridge takes a life cycle approach to the challenges surrounding the beverage container. This approach offers several entry points for driving change, and as active investors we seek this change through working with companies producing beverages, those producing their containers and those working to improve recycling practices. All are part of an international effort that is gaining strength.

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