ClearBridge Investments

Large Cap Value Strategy

Robert Feitler
Managing Director, Portfolio Manager

Dmitry Khaykin
Managing Director, Portfolio Manager

Key Takeaways

- A strong fourth quarter for U.S. equities, driven by trade optimism and an accommodative Fed, capped a year of sound gains and record highs.
- Managed care companies in the portfolio rallied on softened political rhetoric that had earlier in the year focused on Medicare for all and lower prescription drug prices.
- Underweights to yield-oriented areas of the market, which our discipline has found fully valued, helped performance amid rising bond yields and a return to cyclical stocks.

Market Overview and Outlook

A strong fourth quarter for U.S. equities capped a year of sound gains and record highs, with the benchmark Russell 1000 Value Index gaining 7.41% for the quarter and 26.54% for the year.

News of progress toward a "phase one trade deal" between the U.S. and China got the market off to a good start in October. This coincided with the Federal Reserve cutting the federal funds rate for the third and final time in 2019, while corporate earnings came in better than expected. In December, further progress toward an initial trade deal, in the form of reduced existing tariffs and cancelled planned tariffs from both the U.S. and China, and indications the Fed would hold rates firm in 2020 sustained the rally. Investors' optimism grew, pushing Treasury yields from as low as 1.53% to 1.92%, steepening the yield curve. The favorable economic backdrop pushed energy prices higher as a barrel of WTI crude oil rose from $54 to $61.

Underpinning trade progress and accommodative monetary policy, the U.S. economy remained solid. While down from recent highs of 3.5% in mid-2018, U.S. GDP growth averaged 2.4% in the first three quarters of 2019, strong relative to developed nation peers. Nonfarm payrolls showed healthy increases, the unemployment rate remained near 50-year lows and average hourly earnings have been growing at or above 3% since August 2018. The manufacturing sector has been in contraction territory since August, although it showed signs of steadying in October and November, according to the ISM Manufacturing PMI.

Accommodative stances from global central banks and investor optimism toward a U.S.-China trade resolution (or at least a de-escalation) have somewhat eased fears of slowing global

growth and driven international equity markets higher. A large majority win for Prime Minister Boris Johnson in the UK appeared to remove some uncertainty on the UK's path to exiting the European Union, further helping the pound and UK stock indexes.

Strategic exposures to cellular towers and spectrum should grow in value as 5G ramps up.

In the U.S., the health care sector led the broad market in the fourth quarter, rallying on softened political rhetoric that had earlier in the year focused on Medicare for all and lower prescription drug prices. More moderate views emerging from the Democratic presidential primary campaigns and strong third-quarter earnings helped the managed care sector, including portfolio holdings such as Anthem and UnitedHealth Group. Anthem is a high-quality company trading at a reasonable valuation for what we view as a relatively stable, cash-generative and growing business as the company is realizing benefits of insourcing its pharmacy benefit business. For UnitedHealth, medical costs appear under control, a reversal following some pressure in the second quarter, and its Optum services business continues to grow nicely.

With fears of a global slowdown subsiding we saw a rotation into cyclical stocks in the fourth quarter, with information technology (IT) and financials being the main beneficiaries. In IT, our active bets on Microsoft and Apple, high-quality companies that should continue to benefit from the secular transition to the cloud and to 5G, respectively, made strong contributions, while our overall focus away from the highly cyclical semiconductor industry limited our participation in the tech rally somewhat. Motorola Solutions, which continued its strong multiyear run with a 40%+ return for the year, paused in the fourth quarter as management issued guidance modestly below expectations and, against the backdrop of a sharp rally, was a detractor. We continue to have confidence in its long-term prospects.

In financials, our overweight to high-quality banks such as JPMorgan Chase and Bank of America was rewarded as these stocks rose on strong earnings, an improving growth outlook and a higher 10-year Treasury yield. Meanwhile, relatively less economically sensitive insurance holdings Progressive and Travelers, which have also been pressured by rising loss costs, were modest detractors. Both companies remain well positioned competitively and are expected to create long-term value for shareholders.

Fuller valuations in the more yield-oriented areas of the market have led us to maintain an underweight to the utilities, real estate and consumer staples sectors; this was a positive in a quarter in which rising bond yields and a return to cyclical stocks caused these sectors to underperform. Portfolio holding Anheuser-Busch InBev, meanwhile, fell on softness in Asia that we believe is transitory.

During the quarter we added Keurig Dr Pepper, a large player in the flavored soft drink market. The company maintains dominant share in the growing single serving coffee business and is rapidly

deleveraging and executing cleanly. We sold our position in Xerox as it reached our price objective on continued strong cash flows and speculation on a merger with HP.

As we enter 2020, we continue to look for high-quality companies that are well-capitalized and trade at reasonable valuations. We see broad opportunities in the transition to 5G and are currently positioned to take advantage of this secular trend with high-quality names such as Apple, which we expect to be a primary beneficiary, as well as American Tower and Dish Network, whose cellular towers and spectrum, respectively, should only grow in value as 5G ramps up. At the same time, we are managing portfolio exposures given political uncertainties ahead of the 2020 presidential election. Ten years into a bull market, we believe it is prudent to maintain a disciplined investment approach that focuses on competitively advantaged companies with strong business franchises capable of generating superior returns across cycles.

Portfolio Highlights

The ClearBridge Large Cap Value Strategy outperformed its Russell 1000 Value Index benchmark during the fourth quarter. On an absolute basis, the Strategy had gains in 10 of the 11 sectors in which it was invested for the quarter. The largest contributions came from the financials and health care sectors. The consumer discretionary and consumer staples sectors were the main laggards.

On a relative basis, sector allocation contributed to performance, while overall stock selection detracted. In particular, underweights to the consumer staples, utilities and real estate sectors and an overweight to the IT sector added to relative returns. Stock selection in the health care sector also contributed to relative performance. Conversely, the Strategy's stock selection in the IT, energy, industrials and consumer discretionary sectors proved detrimental.

On an individual stock basis, the largest contributors were JPMorgan Chase, Bank of America, Anthem, Charter Communications and Apple. Positions in Anheuser-Busch InBev, Motorola Solutions, Travelers Companies, Home Depot and Progressive were the greatest detractors from absolute returns in the quarter.