ClearBridge Investments

Multi Cap Growth Strategy

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Key Takeaways

- The shift we are seeing in market leadership could be the start of a multi-year trend favoring attractively valued companies with robust free cash flow and profit profiles.
- Positive clinical and operating results along with improving sentiment among the portfolio's health care holdings drove strong absolute performance for the quarter.
- Despite an underweight to mega-cap technology stocks, we remain confident in the execution and competitive positions of our technology and media companies.

Market Overview

A robust fourth quarter powered U.S. stocks to their strongest performance since 2013, with mega cap growth stocks leading the way. The S&P 500 Index rose 9.07% in the last three months to finish up 31.49% for the year while the small cap Russell 2000 Index charged 9.94% in the fourth quarter to end up 25.52% for 2019. The benchmark Russell 3000 Growth Index rose 10.67% in the quarter to finish 35.85% higher for the year, 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 3000 Growth Index outperforming its value counterpart by 319 basis points for the quarter and 959 bps for the year.

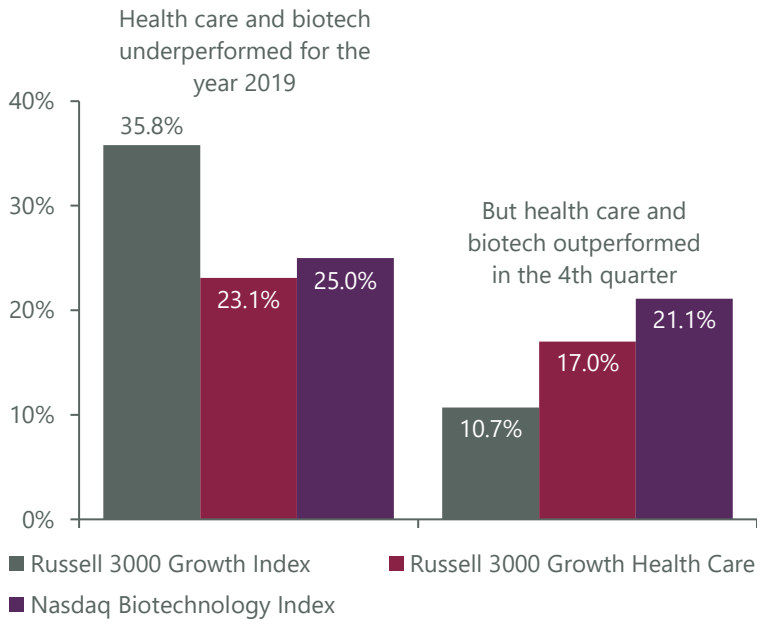
Mega cap stocks in information technology (IT, +14.17%) and communication services (+10.84%) retained their market leadership during the fourth quarter, although they were joined by health care (+17.03%). Passive and momentum investors provided a particularly strong boost to mega cap IT stocks, led by Apple and Microsoft – two companies the portfolio does not own. The underweight to big tech and Internet had a minimal impact on relative performance during the fourth quarter but was a significant detractor for the year.

The Multi Cap Growth Strategy has for years implemented a business owners, benchmark-agnostic approach with a focus on attractively valued growth franchises with solid free cash flow generation and defensible market positions. Within IT, this has led us to overweight companies in relatively non-competitive markets and those with strong intellectual property (IP). We have been pleased with recent performance across our technology holdings,

particularly from design software maker Autodesk and communications chipmaker Broadcom, which have seen their shares approach all-time highs due to strong earnings results and signs of progress in the U.S.-China trade impasse. Supply-demand trends, pricing and margins are also improving in data storage, which should support a continued recovery in the shares of Seagate Technology and Western Digital.

Even more encouraging is the turnaround in health care that has been the main driver of recent portfolio performance. In what could be the start of a multi-year recovery in valuations, the sector was the top performer in the benchmark during the latest quarter. Both therapeutics companies and service providers made up ground lost earlier in the year due to political rhetoric over drug pricing (Exhibit 1) and fears surrounding the proposal of Medicare for All. The snapback shows how negative sentiment has become in the sector at a time when our portfolio companies are positioned to take advantage of a number of favorable long-term trends.

Exhibit 1: Health Care Has Rebounded Recently



As of Dec. 31, 2019. Source: Bloomberg, ChartIQ.

The FDA has become much more flexible in its support of innovative treatments for rare diseases and other unmet needs (like neurology) by fast tracking approvals of certain compounds and allowing companies to file for approval using smaller clinical subsets, provided adequate safety and efficacy. Recent examples include the regulator's approval of Vertex Pharmaceuticals' triple combination therapy for cystic fibrosis five months ahead of schedule and the announcement in October that Biogen would move forward to file for approval of aducanumab in early 2020. If

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approved, aducanumab would represent the first disease modifying agent approved for Alzheimer's disease.
Even following the recent rally, biopharmaceutical stocks still trade at a meaningful discount to the market. We expect this gap to close over time as consolidation enables innovative companies to be monetized and generalist investors return to the sector.

While visibility is improving in health care, the portfolio's media holdings continue to grapple with uncertainty related to new distribution formats and cord cutting. As we discussed in a recent blog, companies that already own the IP, libraries of high-quality content, should remain a key generator of value as the industry moves from traditional cable distribution to a mix of bundles and streaming services. We also believe increasing online media consumption will favor providers of broadband services including Comcast, the portfolio's second largest holding. Over time, these moves should boost the multiples of pure play programmers. We have already seen a rerating at Discovery and believe AMC Networks has the premium content to recover from its currently distressed valuation.

Outlook

Since late August, the stock market has begun to experience a mean reversion that has caused leadership to broaden out. We are heartened by the transition from a market dominated by price momentum and top line growth to one that is beginning to recognize more value and contrarian-oriented stocks and sectors. In addition to the rebound in health care, investors are starting to look past momentum growth companies to deeply discounted cyclical growers like copper miner Freeport-McMoRan and steel maker Nucor.

As high active share managers, our returns often do not correlate to the market or a benchmark. Historically, when our relative performance starts to turn it often leads to a multi-year reversal. While leadership in the market has been relatively narrow for the last few years, we expect different leadership sectors and companies moving forward. We believe a continued robust pace of M&A activity and the gradual closing of the significant discount of the portfolio to the benchmark will drive improved performance in the year ahead.

Portfolio Highlights

The Multi Cap Growth Strategy underperformed its Russell 3000 Growth Index benchmark in the fourth quarter. On an absolute basis, the Portfolio had gains across three of the seven sectors in which it was invested (out of 11 sectors total). The primary contributors to performance were in the health care and IT sectors.

Relative to the benchmark, overall sector allocation contributed to performance. In particular, stock selection in the health care sector, an overweight allocation to health care as well as an underweight to the consumer discretionary sector drove relative results. Conversely, stock selection in the communication services and industrials sectors detracted from performance.

On an individual stock basis, positions in UnitedHealth Group, Autodesk, Biogen, Vertex Pharmaceuticals and Broadcom were the greatest contributors to absolute returns during the period. The largest detractors included Twitter, L3Harris Technologies, Johnson Controls, AMC Networks and Cree.

During the quarter, the Strategy gained shares in Cerence in the IT sector following its spinoff from portfolio holding Nuance Communications.

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