ClearBridge Investments

Select Strategy

Aram Green
Managing Director,
Portfolio Manager

Key Takeaways

- Companies we consider evolving opportunities were leading contributors to performance during the quarter and a key part of our portfolio repositioning.
- We took advantage of volatility amidst a strong rally for growth stocks to establish new positions in several companies we consider market share taking disruptors.
- Maintaining a consistent sell discipline has been a major factor in the portfolio's recent success.

Market Overview and Outlook

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 3000 Index rose 9.10% in the quarter and 31.02% for 2019. 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. Growth topped value by 959 bps for the year. Growth's dominance was similar among the mid and small cap growth stocks that comprise much of the Select Strategy portfolio.

One difference in the fourth quarter from previous growth rallies this year was the participation of health care (+14.91%). 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, +14.01%) and communication services (+9.16%) 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.

Innovative and established growth companies make up the majority of the portfolio, categories we describe as disruptors and steady compounders. To provide balance and broader exposure to asymmetric returns, we also target companies considered more classic value stories that are facing temporary headwinds or going through a restructuring or similar change. We categorize these companies as evolving opportunities, several of which were leading contributors to performance during the fourth quarter.

When vetting such stocks, we identify a series of catalysts that need to occur in a reasonable time period for our investment to work. Cardtronics, an operator of standalone ATMs in retail and similar locations, is a good example. The stock fell sharply in 2017 on fears that cash usage and retail spending were declining and due to poor reception to expensive acquisitions. When an activist investor took a stake, the company began to improve execution and focus on improving its financial structure by paying down debt, buying back stock and avoiding dilutive deals. Cardtronics is now enhancing the services it offers ATM customers in locations like Target, accepting deposits and providing store coupons to incentivize greater cash spending. Surgery Partners, which operates standalone surgical centers in 31 states, is another evolving opportunity that performed well recently where a private equity investor has been pushing for change.

We consider broken IPOs as evolving opportunities and took advantage of attractive entry points to establish positions in newly public Uber Technologies and SmileDirectClub. Shares of Uber, the global rideshare leader, have been impacted by competitive concerns in the Uber Eats food delivery business, noise around labor regulations concerning the employment status of drivers and IPO lock-up related overhangs. We are encouraged by Uber's moves to exit money-losing businesses like food delivery in India and increased management discipline that should drive it to profitability sooner than anticipated. SmileDirect stock fell quickly after its September IPO due to regulatory concerns and associated costs, but we believe the company has a lot of optionality to grow from here.

Having the discipline to sell when a turnaround is not advancing as we expected has been a key performance driver over the last year. We exited a position in eBay in the fourth quarter for this reason. The online auction e-commerce company accomplished the first part of its restructuring by putting a number of non-core businesses up for sale and prioritizing stock repurchases under new senior leadership. Key initiatives to turn around the U.S. business, however, have not gained traction which became a concern. We chose to close out the position prematurely with a gain as we felt the next key catalyst to propel value for shareholders had become elusive.

Portfolio repositioning was not limited to evolving opportunities, as we added a total of eight new companies during the quarter. In our disruptors camp of fast-growing businesses creating new markets or upending existing ones, we participated in the IPO of Sprout Social, a social marketing and engagement provider that is growing rapidly. Sprout and new addition HubSpot, which develops marketing automation software, were pressured by the rotation out of software-as-a-service companies late in the quarter but we like the opportunities ahead of both as they expand software offerings. Casual footwear and apparel maker Crocs was another new buy in the steady compounders camp. The company has a differentiated product line but had been mismanaged prior to the arrival of a new CEO from Reebok in 2017, who has improved production and amped up the social influencers promoting the brand.

Crocs is an example of the importance of company management when researching new ideas. We have greater confidence investing alongside a successful CEO or management team we know, if they join a new company or start a new venture. Following former Honeywell CEO David Cote led us to invest in a special purpose acquisition company or SPAC he now runs that is backed by Goldman Sachs, GS Acquisition Holdings. The SPAC will convert into a common stock company in the first quarter, offering power management and heat management solutions for data centers, an area with good growth rates in supporting cloud adoption.

It can be easy to get market vertigo in a U.S. equity market that's continued to rise, hitting new highs on a regular basis. The market can be perceived as expensive because of this, but quality companies will always find ways to continue to grow and the markets they serve will continue to expand. In the Select Strategy, we want to own companies focused on innovative growth in products and services that are thinking long-term in deploying capital today for future growth and use volatility to build positions in these stocks. After scaling back exposure to disruptors on price concerns through 2019, we were able to increase our exposure to these innovative companies late in the year as prices worked in our favor, providing a constructive setup for the year ahead.

Portfolio Highlights

The ClearBridge Select Strategy outperformed its Russell 3000 Index benchmark for the fourth quarter. On an absolute basis, the Strategy had gains in eight of nine sectors in which it was invested during the fourth quarter (out of 11 sectors total). The main contributors to performance were the information technology (IT) and health care sectors.

In relative terms, the Strategy outperformed its benchmark due to stock selection and sector allocation. Strong stock selection and an overweight allocation in IT contributed the most to relative performance during the period. Stock selection in the consumer discretionary and health care sectors also helped. Conversely, stock selection in the consumer staples and communication services sectors detracted the most from relative returns.

On an individual stock basis, the largest contributors to absolute returns during the fourth quarter were Surgery Partners, Cardtronics, Shopify, Fortinet and Carvana. Positions in Expedia Group, Pinterest, SmileDirectClub Inc, BJ's Wholesale Club and Constellation Brands were the greatest detractors from absolute returns.

In addition to the transactions mentioned earlier, the Strategy initiated new positions in Bank of America in the financials sector and Luckin Coffee in the consumer discretionary sector. We also closed positions in Twilio, Citrix Systems and salesforce.com in the IT sector, Yelp in the communication services sector and Medidata Solutions in the health care sector.