ClearBridge Investments

Sustainability Leaders Strategy

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Key Takeaways

- The U.S. equity market reached record highs, buoyed by trade progress, accommodative monetary policy, and a solid U.S. economy, and the portfolio exhibited strong relative performance.
- Our utilities and real estate holdings performed well in a quarter that saw these sectors trail significantly in the market.
- Taking a life cycle approach to the beverage container's challenges isolates several entry points for action that can reduce environmental impact.

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 3000 Index gaining 9.10% for the quarter and 31.02% for the year. Returns were driven by the partial removal of several uncertainties that had weighed on stocks throughout 2019: the U.S. and China reached a "phase one" trade agreement, the Federal Reserve, cutting interest rates by another 25 basis points, indicated it would hold rates firm through 2020, and the UK inched toward a Brexit resolution. Investors' optimism pushed Treasury yields from as low as 1.53% to 1.92% and steepened the yield curve.

Underpinning trade progress and accommodative monetary policy, the U.S. economy remained solid. While slowing, U.S. GDP growth stayed strong relative to developed nation peers. Nonfarm payrolls showed healthy increases, the unemployment rate remained near 50-year lows and average hourly earnings continued to grow at roughly 3%, a rate maintained since August 2018. The manufacturing sector has been in contraction territory since August 2019, although it showed signs of steadying in October and November, according to the ISM Manufacturing PMI, and trade progress should further help demand.

In the all cap Russell 3000 Index universe health care and IT sectors led the market by a wide margin, helped by reduced political attention and trade progress, respectively. Yield-oriented sectors trailed, with consumer staples lagging significantly and utilities and real estate nearly flat.

The health care sector rallied on strong earnings and softened political rhetoric that had earlier in the year focused on Medicare for All and lower prescription drug prices. Portfolio company

UnitedHealth Group was a primary beneficiary and reached new highs as investors focused again on this market leader's secular growth potential and stable free cash flow generation. As we have highlighted in the past, we believe the service innovations UnitedHealth has put in place, such as providing support for underserved populations to address chronic disease issues, are part of the solution to managing health care costs. Any significant changes to health care would need to rely on UnitedHealth's expertise and infrastructure. Biotechnology company BioMarin, which focuses on rare diseases, was driven higher by product developments for two pipeline candidates; one for achondroplasia, which is the leading cause of dwarfism, as well as one for an innovative drug that uses gene therapy as a new paradigm for treating hemophilia.

In the IT sector, Apple rose on optimism for its iPhone 11 sales ahead of the 5G cycle and on the success of its AirPods, and Microsoft continues to benefit from the shift to public cloud and adoption of its Office 365 platform. Both Apple and Microsoft have global facilities that are 100% powered by renewable energy. Apple's retail stores, offices, data centers and co-located facilities in 43 countries use 100% clean energy. Lam Research rose on an improved demand outlook for NAND flash memory related to 5G-related technology, set to begin rolling out in 2020. Lam Research's technologies are essential to the miniaturization of semiconductor technology, which reduces device size and energy consumption for chips.

Our utilities and real estate holdings performed well in a quarter that saw these sectors trail significantly in the market. While the Strategy is overweight utilities relative to the benchmark, which dampened relative performance, our stocks in that sector significantly outperformed. Brookfield Renewable Partners LP, a renewable energy company focused on hydroelectric power in the U.S., Canada and Brazil rose almost 16%. Mid cap commercial real estate services firm Jones Lang LaSalle also had an excellent quarter, advancing 25% as it expanded its global capital markets business with the completion of its recent acquisition of HFF. Jones Lang LaSalle has a best-in-class ESG record in its industry, excellent financial and accounting disclosure and a well-established governance disclosure practice. It is also a champion in promoting environmental and social sustainability, with a management focus on environmental protection and on encouraging diversity and equality initiatives at the company and subsidiary levels.

Large cap bank holdings such as Bank of America, committed to inclusive and responsible growth, and First Republic Bank, which has had a focus on excellent customer service, rallied on strong earnings, an improving growth outlook and a higher 10-year Treasury yield. Meanwhile, insurance companies such as portfolio company Progressive, one of the most transparent insurers in the

Still water, a much bigger market than carbonated, is mainly packaged in plastic, but could be delivered in aluminum as well.

industry, were weighed down by relatively less economic sensitivity and rising loss costs. Staples giants Unilever and Colgate-Palmolive suffered along with defensive areas of the market and were modest detractors. Unilever has committed to sourcing 100% sustainably certified raw materials by the end of 2020, working with smallholder farmers to improve agricultural practices. Colgate has a long history of providing free oral health care to developing market communities, which has set roots for national product loyalty.

Ecolab was down mid-single digits as the manufacturing sector of the economy slowed and Ecolab saw a deceleration in its top line. We remain very constructive on Ecolab going forward; it will be divesting its energy services business in the coming year and focusing on its core sanitation and cleaning franchises, which have strong potential.

There are several sustainability and ESG themes expressed throughout the Sustainability Leaders Strategy, including climate change, water conservation, financial inclusion, responsible materials use and improving health care. One more recent exciting opportunity is in sustainable packaging. During the quarter we added Ball Corporation, one of the largest manufacturers of aluminum beverage cans in North America. Ball has several good growth drivers on the horizon. Ball is a leader in packaging carbonated beverages, where volumes are moving meaningfully toward aluminum. It is also pursuing the market for aluminum cups, where demand is growing. In addition, still water, a much bigger market than carbonated, and which is now mainly packaged in plastic, could be delivered in aluminum as well.

We also added Hain Celestial, which owns over 50 natural and organic brands focusing on health and wellness and prioritizes sustainable packaging. Hain hired a new CEO with a strong operational track record in 2019 and has since been taking positive steps to improve margins, re-accelerate EBITDA growth and derisk the balance sheet. So far, these steps have been rewarded by the market.

Looking ahead, we see progress on international trade as a potential catalyst for a manufacturing recovery. We also anticipate that continued accommodative monetary policy and a strong and confident consumer will be supportive of economic growth and in turn equity prices. At the same time, we are mindful of risks in an election year as concerns grow about potential policy changes, as well as valuations that are above average. Our focus on companies with high-quality financial characteristics and those that have leading sustainability profiles and robust ESG practices embedded in the business makes us optimistic on the outlook for the portfolio. We believe companies with these characteristics should do well over the long term regardless of the economic environment.

Portfolio Highlights

The ClearBridge Sustainability Leaders Strategy outperformed its Russell 3000 Index benchmark during the fourth quarter. On an absolute basis, the Strategy had gains in eight of the 10 sectors in which it was invested (out of 11 sectors total). The primary contributors were the information technology (IT), health care and financials sectors. The materials and consumer staples sectors were the sole detractors.

On a relative basis, overall stock selection contributed positively to performance and was partially offset by sector allocation. Stock selection in the IT, utilities and real estate sectors helped relative results the most. Conversely, stock selection in the materials, consumer discretionary and consumer staples sectors detracted from relative returns. In terms of sector allocation, an overweight to the utilities sector proved detrimental.

On an individual stock basis, Apple, Microsoft, Bank of America, Lam Research and UnitedHealth Group were the largest contributors to absolute performance in the quarter. The main detractors from absolute returns were positions in Progressive, Home Depot, Herman Miller, Colgate-Palmolive and Trex.

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.

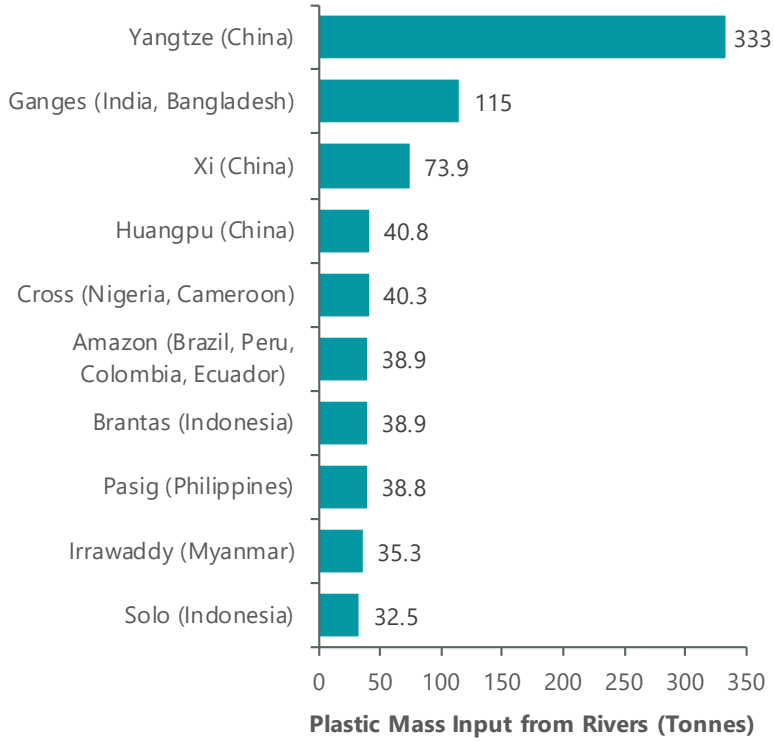
Plastic Upstream to Downstream

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]

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

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 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



Estimated for the year 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

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

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.

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.

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

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

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.

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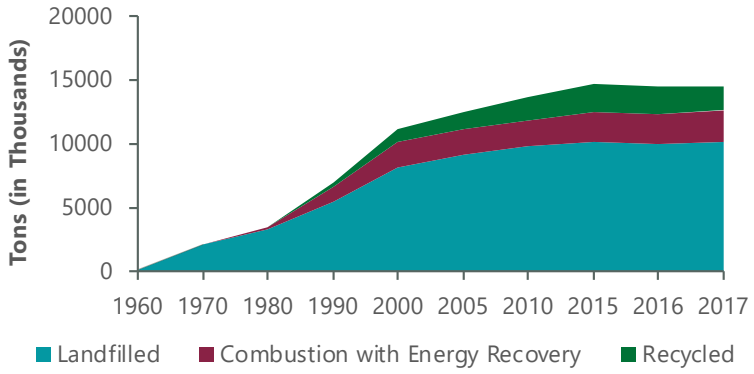
[7] Environmental Protection Agency.
[8] NAPCOR.
[9] The Aluminum Association: Key Sustainability Performance Indicators, Sept. 2019.
[10] Roland Geyer et al. "Production, use, and fate of all plastics ever made," Science Advances, July 2017.

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.

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.

Exhibit 2: Total Plastic Containers and Packaging Municipal Solid Waste by Weight



As of 2017. Source: American Chemistry Council and NAPCOR.

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 (Exhibit 2). 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.