ClearBridge Investments

Podcast: ESG Approaches in Small Cap

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With Small Cap Portfolio Manager Brian Lund, CFA (BL) and Investment Strategist Jeffrey Schulze, CFA (JS)

JS: Hello and welcome to the latest ClearBridge Podcast. This is Jeff Schulze, CFA, Investment Strategist at ClearBridge Investments. ClearBridge is a global equity manager with 146 billion in assets under management, committed to delivering long term results through authentic active management. ClearBridge tailors our strategies to meet three primary client objectives in our areas of proven expertise: high active share, income solutions, and low volatility. We integrate ESG considerations into our fundamental research process across all strategies.

So earlier this year we published the ClearBridge 2018 Impact Report, which highlights the power of company engagement and the integration of ESG considerations into fundamental analysis at ClearBridge. And it's available on our website, www.ClearBridge.com. If you haven't checked it out already, I very much encourage you to do so. And in it, we note that we are seeing further development of our engagements with small cap companies. Now smaller caps, they represent for us the next generation of company engagements. They offer challenges in the fact that they typically have fewer resources to devote to sustainability, but also opportunities that as active managers we have the chance to cultivate these relationships and nurture ESG practices from the ground up.

So I'm excited to be joined in the podcast booth today by Brian Lund, Portfolio Manager for the ClearBridge Small Cap and Small Cap Value Strategies. He's here to give us an update on the small cap environment in the strategies positioning. We're also going to discuss how he and the small cap team are integrating ESG considerations into the research and what they're finding there. Brian? Thanks for being in the booth here with me today.

BL: Thank you for having me.

JS: And the topic of today's podcast is, ESG Approaches in Small Cap. So we'd love to get your feedback about topics we cover and how we can make our podcast better. So you can contact us with questions, comments and suggestions by emailing us at Podcast@ClearBridge.com. So Brian, thanks for taking the trip up here to New York. How's your summer going so far?

BL: It's very nice. Thank you.

JS: I was hoping for a nice calm, relaxing summer, but Mr. Market has another idea.

BL: Yes. Not in the cards.

JS: (Laughs) Obviously we've seen trade wars flare up last week and the markets have not particularly enjoyed it. I think maybe this year may be where the old adage, "Sell in May and go away" comes true?

BL: Maybe. I mean we saw a pretty big rise in the market in June, and we're still up nicely in the year. We came into the year after a pretty turbulent fourth quarter, and we were starting to find really good values in the market, and that was pretty quickly erased by a nice rise. You know, it feels good when stocks are going up, but as a stock picker, it makes it a lot harder to find opportunities that are undervalued.

JS: Yes. I mean in the 4th quarter we saw the Russell 2000 down 20 percent. But even with the volatility today, year to date, it's up 10 percent.

BL: Yes.

JS: But I'm sure that you were getting excited as a portfolio manager now that some of these stocks have come down quite a bit in three or four trading days.

BL: Yes. I mean, when they're not the ones you hold already, it's very exciting. (Laughter) I think, as you say, Mr. Market is a manic depressive, and these days he's really off his meds, because …

JS: (Laughs) I like that. A manic depressive.

BL: We're seeing stocks that any sign of weakness, any falter that any company has, a couple of bad credits at a bank, the stocks are going down 20, 25 percent. And it's painful when you own them, it gives great opportunities when you don't, but the market is really intolerant of any sort of risk. It's got a strange combination of being ebullient on the one hand, about growth and the powerful economy, and then on the other hand if you show any weakness, your stock gets demolished. So where we're seeing opportunities now are in those things, and in other companies that have maybe what we might say a little hair on them. High debt, some sort of secular challenge that the market perceives anyway.

JS: Some sort of bottleneck in the growth story.

BL: Some bottleneck in the growth story. Something that's just a little off. And those things are being thrown out with the bathwater. If you're a software company that's beating expectations on a regular basis, your stock has become almost … completely untouchable …

JS: Untouchable.

BL: … because the multiples are just insane. I mean we're seeing 40 times earnings … I'm sorry, 40 times sales on a number of companies.

JS: Which is kind of crazy if you think about it.

BL: I do think about it, and it is kind of crazy. Yes. We're going to look back on it and say, "What were we thinking?" But at the moment what the market is thinking is, this is a safe company that … quote unquote "safe" … that is going to protect me if something goes wrong. And it's really fleeing to safety. I mean the equity market is fleeing to safety just the way the bond market is fleeing to safety right now. So you know, where it sees weakness, that's where we're getting the opportunities. But you know, it makes it so that your portfolio becomes a little skewed. You know, so we have to be very careful about making sure we don't just go all in on valuation solely as a factor as opposed to earnings quality or capital deployment, we need to keep a balance. But it's getting harder and harder.

JS: Now do you think the volatility that we've been experiencing, you know, 4th quarter drawdown. We had a six percent drawdown last quarter, this quarter we already have a five percenter. Do you think that this volatility's going to be with us to the end of this cycle, whenever that may be?

BL: I have no idea. (Laughter) But I am going to presume so, yes.

JS: Yes, I would have to agree with you on that.

BL: I mean I think that is where the market is. It feels that things have been too good for too long and something's going to go wrong, and it's shooting first and asking questions later. So I think that is a recipe for volatility.

JS: Now one area that we're shooting first and asking questions later has happened in the last couple of days is small cap financials.

BL: Mm-hm. (Affirmative)

JS: Up until the last couple of days they were performing pretty well in light of lower treasury rates and an inverted yield curve, but they've really sold off aggressively in the last couple of days. Now I know that scenario that you have found a little bit of value in, how do you view that space? Do you think the Fed cutting will help small cap financials? I mean if you think about areas of the market which, do you think it's a fair statement to say that small cap financials are the most hated part of the equity market?

BL: (Laughs) You're talking about banks, I take it.

JS: Yes.

BL: In particular, yes. I don't know if I'd say that they're the most hated. I think actually high leveraged companies are the most hated. (Laughter) But yes.

JS: They're the cousin.

BL: They're the cousin, yes. Banks are pretty well hated. And you know, like I say, the market is anticipating things going wrong. And there are two things about banks that don't look good right now. One is the inverted yield curve, which is going to put pressure on net interest margins for the company's lending portfolios.

JS: And from a regional bank perspective, that is one of the most important characteristics of profitability.

BL: Oh, for sure, yes. As opposed to a big bank that's got a trading platform and all that kind of stuff. Investment bank asset management. Most regional banks don't have that stuff. They've got loans.

JS: Sure.

BL: And deposits. So deposit costs still haven't come down much from having risen just last year. They're starting to come down, but haven't come down much. But any variable rate loans have come down as LIBOR has dropped. And LIBOR dropped even before the Fed did, even before the short term interest rates. So yes, they're getting NIM compression, net interest margin compression, and that is pressuring profitability and scaring people, but it's only going to get worse as the Fed signals more cuts in the future. And the second issue is credit. Where credit has been pristine now for almost a decade.

JS: Which is crazy.

BL: Yes. And I mean many regional banks, small community banks, basically showing now provisions anymore. I mean they can't reserve anymore, because their reserves are too high already. So ...

JS: And who would have thought, coming out of '08, that that would be the case? (Overlap/Inaudible)

BL: Yes. I mean there were … actually I'm going to say that we did think that (Laughter) because one of the things we were really bullish about financials coming out of the crisis was that they were going to have this new discipline. It's been good and great, even, to the point where there's almost no provision in earnings. Which means that as soon as we start to get provisions, as soon as actual losses come, and reserves deplete, and they have to take revisions again, we're going to see that affect earnings. And that means the multiples are going to be going up. And you know, with no beneficial offset. So I think the market's looking at the situation and saying, this is too good right now, we're going to get worse on NIM, we're going to get worse on credit, and it's going to be bad in the future. So I understand why the banks are disliked for that reason. We are a little bit underweight. But we have been able to find some opportunities as the market has been really hammering things that have had bad credit. Bank OZK was one. It's been a fantastic lender for many, many decades. Went through the crisis very successfully. Showed two bad credits last winter. And the stock went down 30 percent, it was trading close to tangible book value …

JS: Wow.

BL: We were able to buy that and it's been good, even though it still has not recovered to the degree that it ought to. We're just trying to make sure that we diversify, that we try to get as many geographies covered as we can, see if we can get any specialty services. We've got one bank that's got a huge private loan business, where they hold securities against loans that they're giving to individuals. It's almost riskless. It's basically 100 percent collateralized. And when things go wrong, that stocks going to be okay. So we're just trying to keep it clean, keep it diversified, and hope for the best.

JS: Now is there anything from a geographic standpoint? Are you finding better regions of the US that are holding up better from like a pricing perspective or maybe even a delinquency perspective?

BL: No, not particularly. Everybody's, you know, credit these days is very broad. It's not very regional, even for a local community bank. Because they will participate in national credits that somebody else sponsors, and so you can get hit from anywhere by anything. You know, if you've got a Wisconsin bank, it can suddenly have a couple of bad energy credits that you thought that's why you avoided Texas. But I think we see that geography is … obviously there are some economies that are stronger than others, but bad credit can pop up anywhere, and that will hurt you.

JS: I know that the strategy's underweight IT. Have you been underweight IT for a while?

BL: We've been underweight IT for less than a year, I would say. For many years we were overweight. In fact, I think we imagined that we would kind of always be overweight IT, because we do, part of our investment process is that we really take a long term view toward valuation. And traditionally IT has been a good place where you could find a differentiated company that was earning great excess returns over a long period of time. But what's happened is, as I said earlier, we're getting to the point now where we bought a lot of good companies, RingCentral, Q2, they were all very successful and they got to the point where the valuations are just kind of ridiculous.

JS: They're still good companies, they're just not …

BL: They're still good companies. They're great companies. They're doing great work. But yes, the expectations are beyond what we think they can achieve. And so I mean we actually, those two companies we still own, but we own them in a much lower weight than we used to. So yes, that's the trouble with IT right now. We're a little heavy on the semi-conductor, which has been a weaker part of the market. But in software and services it's really hard to find ideas.

JS: Now I know there's a couple of names that you have in IT right now. Advanced Energy Industries and Itron. Tell me a little bit about those stories.

BL: Sure. Advanced Energy is a supplier of power supplies, basically. So what they provide is very specialized, very clean, very pure persistent power to applications that really need that level of precision in their power supply. Traditionally this was a semi-conductor market. So they were a semi-conductor capital equipment supplier. They still are. Still a good business. It's cyclically depressed right now, but it's still a very good business for them. They have since branched much more into industrial power supplies. And that has given them a nice balance that in both businesses they're a very strong cash flow generator. So even in downturns they are able to keep the cash flowing pretty well.

JS: There's a stability from the industrial side.

BL: Right. And even in the semi-cap side. It's just this is a thing that you must have if you're a semi equipment maker. So if there's something wrong with your power supply, you've got to buy a new one. So we like the business, we like the price especially, and that's why it's one of the bigger positions in the portfolio.

JS: How about Itron?

BL: Itron is a maker of meters. So gas, water meters. Electric meters. The big legacy business has been good for a long time. They do have a differentiated product and also generates nice cash. It's not very cyclical, obviously, because it's driven by the utility companies and municipal spending.

JS: Sure.

BL: So that's a really nice, balanced business. It is a fairly low growth business though. What they've done now is invest in trying to get to higher tech level of business in the metering business. So that now they're providing sort of smart grid solutions, the software, the powers, the smart grid. So we see that as a big secular kind of theme that is going to be able to play out for a longer time.

JS: Sure.

BL: And have a little bit more growth on top of what is already a good meter business. The stock has done pretty well lately, and so we've cut it back a little bit. But that's still one of our favorite tech names. And we call it tech, but it's really a utility business essentially.

JS: Well, I think the market may give you an opportunity here. (Laughs)

BL: Yes.

JS: Over the next couple of weeks. With Itron's business it's obviously their ability to improve the efficient use of resources, as you mentioned, electricity, natural gas and water. In it, it has a positive ESG profile.

BL: Right.

JS: Because of that. So are there other names that you own whose maybe product or service will lend it to a sustainability type of goal?

BL: Yes, I mean I think there are a lot of them. One that we've owned prominently for some time is HealthEquity. They provide health savings accounts solutions for companies.

JS: HSAs.

BL: HSAs. So that you can invest better and you can make better healthcare decisions. They make a big point about bringing in information about pricing, about choices, about your medical care versus other people's medical care. How your bills compare and what you can do better to spend better and to save better. They also allow you to buy a wide variety of investment options in your savings account. So they're really key to I think helping society manage its healthcare costs better right now. So we really like that about them. There's another one, Quotient, they're just getting confirmed now. They've got their CE market in Europe to be able to sell in Europe.

JS: They're a healthcare company?

BL: They're a healthcare company. They make a healthcare device. It's a blood testing company. So they both type the type of blood that you have … So if you're a healthcare donation provider, you're the Red Cross, you buy their machine, you test the blood, it will type the blood, tell you any serological issues that exist in the blood, and it does it all at a very, very rapid rate. So obviously the Red Cross has been testing blood forever.

JS: Sure.

BL: But it's got multiple machines to do it, it's got multiple people. It's a very manual process. Very high cost process. This is going to be a much, much faster and much cheaper approach to typing and screening.

JS: That's great.

BL: Yes.

JS: Now thinking about this ESG. Obviously, it's a big part of the process, not only ClearBridge but with the portfolio. How do you incorporate ESG considerations into your company research? We've talked about a couple of companies that have sustainability as one of their goals. But how do you throw it into your research process and decide whether or not a company is a good fit for you?

BL: Yes. I mean I think people think of ESG as a kind of touchy-feely, you know, like trying to do good for the planet thing. It is, but it's also a good business. So we've always thought in ESG terms, because those are areas of risk for a company. If you've got serious environmental issues, that's a liability that I have to consider as an investor. I might still invest, but I need to investigate your environmental practices. If you're doing something that's not sustainable, it's probably not going to sustain. And eventually we're going to have to pay the price. If you're having social impact that's negative, if you're a gun manufacturer or even a fast food company that makes food that is not very healthy, or a cigarette company, I need to take into account that this could end up bad.

JS: The ramifications (Overlap/Inaudible).

BL: We've seen it before with tobacco companies and that's a liability that I need to consider. If you've got bad governance, you're at risk of making poor capital allocation decisions. I need to know, for example, if your stock-based comp is really high, that might be okay, but first of all I need to consider that, I have to value those shares that you're giving your employees, and not just ignore them in adjusted earnings. And two, I need to know that you understand the value of your equity as a company. If you're making bad capital allocation decisions with stock-based comp, you might make them somewhere else as well, and really damage the value of the company. So to me, ESG is really about value. It's key to my valuation of the risks of the company.

JS: Now has your focus been more on … depending on the company you're talking about … on the environmental, social or governance? Or would you say you take all three and you try to incorporate them into each company, and look at it from all different types of angles?

BL: Obviously you know, some are more appropriate to some companies than to others. You know, when you talk about Healthequity, I don't really have to worry about their effect on the environment that much. So there it's more social and governance. But yes, governance comes into play everywhere, obviously. That is the one thing that every company does have. But as far as environmental and social impacts go, when there's an issue, we want to consider it. So we talk about these things with companies all the time.

JS: Talking a little bit about the engagement, I think that's what really differentiates ClearBridge as a firm. That highlights the approach that you take from an ESG perspective. I know you've had a pretty good engagement with Silgan here recently.

BL: Yes.

JS: Tell me a little bit about that.

BL: Yes, well, with them, they have both a metal can business and a plastics business. And we have to consider what the future of those businesses is. So obviously we can talk about recycling with metal cans and what they can do to make recycling easier for their cans. If they make a can that can't be recycled that is going to end up being an issue we believe over time. But specifically, lately, we've discussed the issue of plastics with them, because obviously there's a big move against single use plastics now, as there should be, because we're creating a great deal of environmental contaminant with them.

JS: Of course.

BL: So we want to know what they're going to do with that business. If they can be in it, they can continue to make it, and we consider the potential risks and that's fine, but we want to know how they're thinking about that risk, where they're investing in plastics now, how they can make them more sustainable, are there other materials they can use, biodegradable plastics, etc. So we've had that discussion with them and they are very thoughtful about it. They understand that it's a big risk to their future, and they're thinking on it.

JS: And then also Sprouts Farmer's Market. I've actually been to a Sprouts when I was in Arizona. I absolutely loved it. How has your engagement been with them from an ESG perspective?

BL: Well, they're very up front about it. They're a natural food market, so they are very conscious of the issues that they have. They've had a very strong push into making sure that their food waste doesn't go to waste. It might not be shelf ready anymore, but first they try to give it to any food pantries or anything else for people in need.

JS: Sure.

BL: If it's not acceptable for that, then they can put it towards animal feed. If it's not acceptable for that they can put it towards compost. And their target is 100 percent zero waste in their food.

JS: That might be a first in the food industry.

BL: Yes. I believe it would be. And they're working their way toward it. They're not there yet, but they'll get there. They also are very conscious of their social impact. They're very involved with community. They do everything they can to promote healthy living for their customers. And finally they also have a very good governance. They're very diversified. They have a diverse set of inputs. That's something that we didn't talk about before. You know, diversity is part of the governance issue and we think that that is really important for good decision making. If you are a company that only has business majors who grew up ...

JS: Went to the same school.

BL: … in a socioeconomic status … Yes, exactly, went to the same school. All men. They probably all think in a very similar way. You need different perspectives to be able to make better decisions. So having women on the board of directors is not a cute, nice to have, powering thing. It's the ability to make better decisions and to think about half of the market in a different way. So yes, we think diversity in governance is very important.

JS: Maybe the last question that I have for you here today is where are you seeing the most exciting opportunities for a sustainability standpoint?

BL: You know, it's really across the market. I think everybody is thinking differently about sustainability now. From food companies to canning companies. I think everyone now realizes that the old ways of doing things are not going to be acceptable anymore. I think there's a great opportunity for a company that could make sustainability in agriculture better. I don't know who that is yet. But that is something that we really would like to see.

JS: And hopefully you guys find them before they grow into a large cap company. (Laughs)

BL: Our goal would be to find them early, yes. And we have looked, and some have come around. Like for example, companies who are trying to make ethanol from a more sustainable product than corn. These have existed, and unfortunately, they haven't cracked the code yet. But one day somebody will, and it will be good.

JS: Well, Brian, that's all the questions that I have for you here today. Thanks for making the trip up here to New York.

BL: My pleasure.

JS: Next time that you're up here, the markets will be calmer and it won't be raining. (Laughs)

BL: That would be nice.

JS: And thank you everybody for dialing into this version of the ClearBridge Podcast. If you have any questions, comments or suggestions, please come to Podcast@ClearBridge.com. We welcome your feedback. So everybody, hope you have a great summer. And we hope to have you on the next ClearBridge Podcast.

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