ClearBridge Investments

Webinar: PM Perspectives: Aggressive Growth and Multi Cap Growth 1Q Update

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With Aggressive Growth and Multi Cap Growth Portfolio Managers Evan Bauman (EB) and Richie Freeman (RF) and Portfolio Specialist Corey Hardie (CH)

CH: Good afternoon, everyone. Welcome to the Aggressive Growth and Multi Cap Growth update conference call. Again, my name is Corey Hardie. I am a member of the portfolio specialist team here at ClearBridge Investments and I'll be your host for today's call. Joining me I have Co-Portfolio Managers of the Aggressive Growth Fund and Multi Cap Growth Separately Managed Account Richie Freeman and Evan Bauman. Richie has over 40 years of investment industry experience and has been managing both the fund and the SMA since their inception. Joining him is his colleague Evan Bauman who has over 20 years investment industry experience and has been working with Richie as a co-manager on the strategy for over 15 years.

As a quick refresher on the strategies, Richie and Evan strive to deliver authentic active management through meaningful investments in a concentrated number of companies that they believe exhibit strong growth characteristics over the long-term. The result is a high-active share, high-conviction, low-turnover portfolio that they feel will generate returns that are very differentiated from the benchmark.

Today, Richie's going to kick off our conference call by providing some of his thoughts surrounding the challenges and opportunities of the current market and then Evan is going to provide an update on the portfolio's current positioning and an outlook for the strategy. We will then try to turn it over to Q&A. We have a couple of Q&A questions already queued up for the PMs to answer.

Thank you to the financial advisors out there who submitted questions in advance to give us direction for today's call, but again, if you have questions as we go through, please feel free to submit them on the web-based platform. With that, I'm going to turn it over to Richie for his outlook on the market.

RF: All right, thank you very much, and hello there, everybody. I always enjoy doing these calls because this is the one time that Evan an I have a chance to really communicate what we think to you, and we like to always incorporate what – some of the questions that we're asked pretty much on a daily basis.

So we're going to try to stick to the format of questions that are popping up. We want to really get what's on your mind. But I always like to try to review the last call that we did. Back it was December 4. At that time we said that I'm not a big believer in cycle theory, but the one cycle that I have found that has worked for the last 50 years and so far it hasn't failed and, in retrospect, we'll see if that remains correct, is the four-year bottom. The markets tend to bottom in an off-presidential election year and it's done that going back to 1960 – 1962 I should say, and I learned that back in 1974.

On December 4, we said we think that the market is at a very, very important juncture. We thought it

would not surprise us to see the market have a dramatic rally that could last not just for weeks but for a number of years. And no sooner that we say that, then the Fed raised rates if you remember and the market went down a very, very quick 10 percent. At that point, the Fed realized they overreacted and we think that the market realized it and the market basically told the Fed that they overreacted.

The market made its bottom on Christmas Eve. Psychology was incredibly negative, not that dissimilar to what we witnessed back in February of 2016, and the investors intelligence number – which is something which comes out every Wednesday – percentage of (both) bottomed in the 20s. Anytime it gets under 40, it's usually a good buying opportunity, under 30 it's very, very rare and it's always been historically a good buying opportunity.

The market had a pretty good snapback rally early in the year, and a lot of people said it's just a rally within a bear market. Be careful. The economy is weakening. Interest rates are going to go up again. There were a lot of naysayers. We have felt and we have said that we thought that the market had potential not just to retrace to go back to the old highs but to make significant new highs, and the pattern has really been fitting that. The economy was weakening in the fourth quarter, weakened in to the first quarter pretty much because of what the Fed was doing.

So in terms of earnings, we though that the best scenario would be if earnings come in a little bit weaker than expected and stocks act very, very resilient in the face of that, and we've seen that with some of the cyclical technology companies, the drive companies, the storage companies, memory companies. They've acted very strongly in the face of what would be disappointing earnings because we think that people are going to be looking ahead six months out to the next up cycle. So in terms of just the overall stock market remain very, very bullish.

We can't tell you what the next 2 percent or 3 percent or 4 percent is going to be, but over the next year or two we think the potential is there for the market to repeat what it's done in past four-year cycles and be dramatically higher well in advance of 30,000 on the Dow. So Evan, you want to take over some?

EB: Yes, sure. Thanks, Richie, and thanks to everybody listening today. It's always a pleasure for us to get together and talk. I think Richie gave the view we have on the market, where we were, where we think we are, and where we think we're going. For those of you who know the strategies – the Aggressive Growth and the Multi-Cap Growth strategies, I think what we try to get right and the way that this portfolio is managed has been really consistent for decades.

Going back to the early 80s, again, I'm the new guy having started here in the mid-90s working with Richie for the majority of that time, but I think what we've done very well over time is think of ourselves as business owners. Long-term, engaged shareholders of companies and many of the names that we own today, as many of our long-term clients know, we've owned since the 80s, 90s, and in some cases for the better part of the last 15 or 16 years. So the goal is to get the businesses right. The goal is to get the earnings right. And I think what's important to today's discussion is kind of where risk reward is today of the particular companies that we own. And again, we're happy to talk macro and we're happy to talk about our views on the stock market, but over time I think what we've really always tried to do is get the businesses right, look for sustainable or durable growth businesses that are disruptive, that are innovative ultimately to generate a lot of free cash flow over long periods of time and buy companies either when they might be controversial or contrarian-type ideas or buy them before they're widely known or followed by your generalist investor or even by Wall Street. So that, I think, when you talk about framing today's discussion, I think the idea is this is a product, it's a process of philosophy and, ultimately, people that have been consistently running money in this strategy through bull markets and bare markets, and today we continue to do that.

I think as you look at the slide that's up on the web, Slide 7. For those of you who don't have it in front

of you, what the result of that process is a very different looking portfolio. For better or worse, this is a portfolio with sizeable overweights in certain areas. And we'll get more granular on what and why we own some of these areas, but it really is the result of stock picking and business owner's type methodology results in a very different looking portfolio from many other – more traditional growth products with shorter time horizons and more benchmark-centric holdings.

Our active share is and has always been very high. Today it's almost 96 percent. So it's really a different looking portfolio with sizeable overweights in areas like healthcare and media, exposure to tech all be it not some of the tech exposure is very different looking from the index, and then areas like energy where we have exposure which are pretty much zero in the index, and there are also some big underweights. And what that can speak to you is this is where we're seeing – as we speak today in late April, this is where we're seeing opportunity for a long-term – again, long-term opportunities, positive risk reward, and good opportunities both for growth and valuation support.

The interesting point about the bottom chart which speaks to valuations on the portfolio today – and again, we'll get into some of the greater detail as the questions come in – this is a period where the market actually as we're speaking is approaching all time highs. There's – in fact, I think we just broached the – or breached the previous closing high on the S&P. And as Richie made reference to in his opening comments, there's clearly reasons to be bullish on U.S. stocks generally speaking or broadly speaking long-term.

I think again when you look at the valuations on our portfolio on both an absolute and a relative basis, we feel very good about the fact that while we've had decent returns on an absolute basis both this year and the last few years, the risk reward set with companies trading near their growth rates so growing double digits, trading at less than 16 times and in some cases less than 10 or 12 times earnings. Growing double digits with positive free cash flow yields approaching 7 percent and other metrics like price-to-book, price-to-cash flow, price-to sales, dramatically below the market.

I think when you look at the types of results that we've been able to demonstrate and the opportunity set for both and I know we'll talk about some specifics here as well, consolidation in certain industries, rerating higher of some of these sectors and subsectors that have underperformed albeit into strength and earnings growth. We think that this again, a very opportune time to be having this call.

We think the risk reward looks very favorable for some of these areas including tech but also in a market that's really been rewarding mega gaps particularly in tech and internet. There's a lot of companies underlying that in areas like media and areas like biotech which we've had exposure to since the '80s that offer tremendous risk reward. So it's an interesting time.

It's 10 plus years now into the bull market that you could say started in early March of 2009. You're far – I think when you look even at the metrics on the benchmark, you're far from the bubble in valuations for the market broadly speaking. You're far from a bubble in sentiment. In fact, the fourth quarter was a reminder – the fourth quarter of last year as Richard pointed out was a reminder that you've been climbing a wall of worry for now 10 plus years.

Every meaningful, as we look at it, meaningful correction of 10 – 15 and in that case about 20 percent is met with panic and outright negativity and that's generally indicative of a great buying opportunity long term. So you've got reasonable valuation. You've got reasonable sentiment, actually somewhat skeptical or negative in every part of the market other than maybe mega cap technology, i.e. FAANG and then again you have the Fed which really did pose a major threat to the equity markets in the late third quarter.

Stepping to the side, rates have come back in and we feel like the opportunity for stock pickers like us, high active share managers like ourselves, is actually quite good right now given the absolute and the

relative metrics on the portfolios.

So questions are coming in, actually quite a number of them. Corey I know had compiled some of the earlier questions that had come in before the call but that's really what the purpose of this is to spend time answering any questions that are out there on sectors, individual companies, the market, anything on your mind.

CH: Great. So this first question, I think speaks to the spirit of what you had mentioned a moment ago as in about how cheap the portfolio's valuation metrics look relative to the benchmark. So if you look at slide 7 at the bottom, the portfolio's metrics are extremely cheap relative to the benchmark but unfortunately for the last several years the market has been more momentum focused than valuation focused.

So with momentum off to such a strong start again this year, how do you guys think about how the portfolio is positioned? Do you think about it relative to the benchmark at all?

RF: Let me make a comment on that – our goal or anybody's goal in the stock market should always be to buy a company that's at a great value point and eventually, if you're right about the earnings, it will become a momentum stock and a very good example of that is today. Go back last week, Twitter was – didn't have momentum as the stock is concerned. People say well let's buy something which has better price momentum. Well stock being up 17 percent today all of a sudden has made it a momentum stock. Now does that make Twitter a better buy today than it was at 30 when we added to it?

Obviously you want to be adding to something when it's not at a momentum level, when it's not being widely touted, when you think you have some kind of downside cushion and then you'll enjoy the fruits of it becoming a momentum stock. We've seen many of them in the portfolio. We don't talk about them often but you go back a couple of years ago, (Cree) was selling in the 20's. People said you should really be buying other semi-conducted companies that have better price outlooks, better momentum. In the 60's it became a momentum stock. (Autodesk) which we owned in the portfolio in the 1980s and sold and Evan put it back in back in the early 2000s I want to say, went from a value stock to a momentum stock.

So we have momentum stocks. I do not remember a time and people are going to say, "Well we're tired of hearing you say it Richie," but I'm going to say it again, I don't remember a time when the portfolio as we have it constructed it right now has a big a disconnect to the stock market value as it does right now. And my definition of disconnect is, many stocks in the portfolio can rally 50 to 100 percent and not be what I would consider overvalued.

That sounds like heresy but we have a number of companies that are selling at single digit multiples where if they would have doubled, they would not be selling at dramatically higher levels than the overall stock market. That sounds like wishful thinking but we've seen it and we'll touch on some of the names that we think are particularly attractive valuation point later.

Everybody's goal should be you buy value and you enjoy them when they become momentum and we're seeing that more and more now actually on a daily basis; Twitter being the latest example.

EB: I'll just add that I think the point Richie is making is that if you buy something at 100X or 600X cash flow the way some companies are trading in the market today, you can make a lot of money but you had better know when to get out. You better know when to sell those stocks and you'd better not just rely on market momentum to continue to basically feed the beast. I mean I think what you've had is not the 1990s. It's different. That was a true market bubble, right. In hindsight the NASDAQ which ironically had its last sort of blow off rally in March of 2000, not completely different from what we're seeing now with the NASDAQ leading everything higher. It's different this time around because its

companies that have earnings. But clearly you're getting some pockets of froth in certain areas of the market. We'd rather buy names at 2X book or 10X earnings that are growing or 7 – 8X cash flow where there's so many things that can go right. Now there's going to be a period, or there can be a period of time where we look foolish, right? It doesn't mean you get paid the very next day. It doesn't mean you get paid within 12 months. But I think when you look at the balance sheet characteristics of the companies that we own, you look at the fact that these are companies which are executing and growing and there might be some political risk.

There might be some headline risk and as Richie referenced with Twitter, there might be an appetite for other names at a particular time but you look at the brand value. You look at the value of the free cash flow of the companies that we own and ultimately there's a clearing price. Either the stock market is going to come around to some of these beaten down areas and there's a slide on the screen right now that shows the metrics on a relative basis of the strategy. And this is – we get a lot of questions today, is the benchmark appropriate for you guys?

You don't own a lot of the big benchmark holdings that have driven the returns. You look more like a value or a core fund. Well to me that's what you want to ultimately be buying is as Richie made reference to, growth companies that are trading like value stocks. Again, when momentum runs its course and you ultimately start to see repositioning of the indices and things like that. I think there's so much focus right now on benchmarking.

There's so much focusing by managers who are frankly afraid to not own some of those stocks and so they take passive bets on names because they've driven returns to the point where one third of the index returns are coming from six stocks and I think to be in some of the areas that we own might feel lonely for a while but ultimately you're going to get paid in those areas and this is – you look over 35 years of history, it's why we said up front. We have – we try to get better. We try to adapt. The market has gotten very short sighted and I think managers have gotten very much obsessed with how they're relatively positioned.

We look at companies. We look at valuations and ultimately we engage with managements. We engage at times to make sure that the business is being run properly but if we do that right, we're going to get paid either through M&A or through a rerating of that chart that you're seeing where – where this hasn't always been a product where the valuation looked this cheap vis-à-vis the market. It's really just in terms of point in time. This is—I think this is one of those days you look back at and you say, "Wow, that was a tremendous opportunity to buy some of these companies at some of these multiples."

RF: It's always good look back in history, and we don't really have to go back that far, to see other examples of stocks in this portfolio that we thought were at good value points that eventually became momentum. And one of the best stocks this portfolio has really had has been Broadcom. Broadcom made what was considered an unpopular acquisition bid of Computer Associates last year and the stock sold off dramatically after being a great quote-unquote momentum stock, it sold off from the 280 down close to 200. At which point people said, well, let me wait until we see the earnings come back, let's see if they can integrate the companies, then we'll come back. Well, not only did it come back but it's gone on to all time highs in excess of 300 because the one thing that did not change throughout that whole period – this was a company that we thought was well managed, that was demonstrating that they're throwing off sizeable free cash flow and that free cash flow was being returned to us, not just with stock buybacks but with a sizeable dividend.

So if we're getting paid to wait, the stock that it has great valuation metrics with a good management team that's exceptionally cheap. We like having it become a value stock for a while? No. But if we're confident it will return once again to a strong performing stock, we're going to own it and I think the

Broadcom example just illustrates that – I think it's more insightful to cite companies that we've had in the portfolio that your clients have seen that they might have questioned you on and questioned us on, rightfully so – we second-guess ourselves all the time.

What are we doing wrong, would we own that name, but it's always not to lose sight of the fact that end of the day you're buying a company's ability to generate free cash flow.

CH: So with that said, as we've been talking here, we've been getting a good amount of questions from folks on the line, which we really appreciate.

One of them that we've gotten quite a bit that keeps coming up over and over again is healthcare related. So healthcare, specifically biotech has been a volatile area lately. Can you speak a little bit about your conviction in the sector and what your outlook is from here?

EB: Yes, I'll make a few points – this is Evan – and then Richard, you've owned the sector since the early '80s, so you can give some color around it as well. So I think there's a reason we've invested in that space for such a long period of time. I mean, I think a lot of investors, they love tech but they're fearful of buying companies involved in the more complicated, if you will, areas of innovative medicine.

And one of the reasons we're more attracted to it for decades is the fact that while there are a lot of unmet needs, big addressable markets, big global unmet needs, the companies that we own I think are the true innovators in the U.S. in treating disease. It's areas like neurology, areas like cancer, M.S., rare disease. And I think what's attractive as a long-term business owner is the fact that you get exclusivity if you're the first to treat a disease or you find a new method of treating disease or ultimately delivering that disease to the body, but I think there's so many breakthroughs occurring today on the science side that it's exciting.

What you have contrasting that is valuations of the big profitable companies in the space today are incredibly attractive. Probably I'd say the companies – the big guys are the most profitable can say for sure that they've ever been and they're at some of the cheapest multiples if not the cheapest multiples that they've ever traded at. And that goes back many, many years. There's a chart now up that just shows the discount both to the big pharmas as well as to the broad market. So valuations are good. Growth has actually surprise to the upside for many of the companies that we own and innovation remains robust.

Of course with any big addressable market – and we'll speak to Biogen specifically, because that's a name we've owned I guess since 1991, so it goes back almost 30 years – is with any of these big addressable markets, these big clinically unmet needs, medical unmet needs there's also a risk, especially when you move through the clinic with some of these programs. The Alzheimer's market is probably the biggest unmet need, globally speaking, that exists. Company had a disappointing clinical readout about a month ago, stock got hit significantly. I think what we have to say is in a case like that, that was a high risk high reward program. It was not the only drug in their pipeline and in fact, the company has about $30 per share in earnings power in terms of their base business. So where the stock trades today – you're talking about a company that trades at about eight times – and we'll get further color on some of this tomorrow when they report. But trades at about eight times base business earnings, has a number of other drugs in their pipeline for rare disease and neurology that we deem to be – again, while there's always risk, I think they're high risk, high reward kind of programs in areas like ALS and some smaller rare diseases where they have unique mechanisms to treat those diseases.

But it's another case where I think that is a sector or subsector of the market where you've seen consolidation this year. Bristol Celgene was the first megadeal that we've seen in probably 10 years. You've seen companies on the bigger side, the Roche, Novartis, Merck, Pfizer companies looking for

product, looking for innovation, looking for growth and they've been paying a big price to buy to acquire some of those earlier stage companies. We've been privy in the strategy to have some names that have been acquired for big numbers, albeit some earlier stage companies. And we think, again, if you look at the risk/reward on the sector today, I think that it's very under-owned, very underappreciated, very undervalued piece of the market that we think there's a lot that can go right. Five years ago you had a lot of generalists that loved biotech. Today I think it's a very under-owned and underappreciated part of the market.

And as we talked about earlier, we'd rather buy companies at sub 10 times earnings generating billions of dollars of free cash flow with the opportunity – because of an unlevered balance sheet, the way Biogen did, to take stock off the market at these single digit multiples. And I think there's quite a good risk reward in that part of the market right now. So we've actually taken advantage recently of some of the disconnects. Between what we think the businesses are worth, what they might be worth to third parties to continue to build up some of these positions in the near-term political risk volatility we've seen in the last few weeks.

RF: Specifically one more thing on Biogen. The Alzheimer's product I should say clinical failure was not only disappointing from a stock standpoint but from a societal standpoint as well. It's something which many companies have tried and failed on. We have other companies that are working on mechanisms. Ionis we know is working together with Biogen on a different mechanism, but have we ever seen a stock go down this much before and come back?

Well, you have to go back maybe over 10 years ago and it was Biogen as well. Biogen had a new drug, Tysabri for M.S. and walked into work one day and the drug was voluntarily pulled off the market because a few people died from it. And that was – stock declined roughly the same, probably 35 percent that day and most people said this is a stock that you don't want to go near, you'll go near it once things clear up and once things cleared up that drug was put back on the market. And that would have been a much bigger growth driver at that time, because the company – that was transformational in a similar way as the Alzheimer drug would have been transformational. Tysabri could have been used in multiple diseases. But the company got through it and the stock price roughly got down to a similar multiple.

Anytime you can buy something at seven- or eight-times earnings, you're not being paid at all for any risk in the pipeline, you're being paid – as we've said, I talk about the 50 to 100 percent rule. Could a stock go up by 50 to 100 percent and still be a cheaper multiple in the market. This would be one of the cases. Couple of other areas we've been asked a lot about. A single payer system with what's happening now in the Democratic primaries, people saying -- Bernie Sanders, et cetera saying that we want to do away with the insurance companies and just have a single payer. Do we think that's likely? They've tried it twice. We've had precedents for this. Stocks got hit both times. Back in the 1990s, if you remember, Hillary Clinton was put in charge when President Clinton was president to try to revamp the healthcare system, again with a single payer. Stocks got hurt, it was a great buying opportunity, they obviously came back because single payer never developed.

Back in 2009 into 2010 the risk was, again, are you going to have a single payer system. And that was -- you had the Democrats ran the House at that time, didn't get it through, and you had Obamacare and companies prospered very well after that. Do we think it likely that it's going to happen? We think the odds are remote at this time, but anytime you present an uncertainty like that, the knee jerk reaction is to sell. And you saw United Healthcare, which reported better than expected earnings, another beaten raise, became the poster child for single payer system and the stock declined dramatically in spite of good quality and raising estimates.

I think it's going to work its way through. I can never try to forecast politics, but I just think from a

pragmatic standpoint, healthcare is too large a portion of the economy to totally disrupt it and to have a single payer system. I do not think it would work in the United States. If I'm going to be wrong in three years, we're going to see. It would take years and years and years before they could ever affect anything like that.

One thing that is developing, which I think is different this time compared to five years ago or 10 years ago, healthcare companies in general do not have the same pricing power that they did, and I think a lot of that is voluntary on their part, and I think they're doing it to try to head off some more draconian things that could come out of Washington. And the fact that companies have lost a lot of pricing power, they still want to grow, and if they're going to grow, I think it increases the chances that they're going to consolidate the industry. There are too many companies going after the same targets – same clinical targets.

It makes sense to have consolidation, we've seen it over the years, and I think it makes much more sense when you can't raise prices on your existing drugs, and if you're going to grow, you can either do it through your internal R&D or a lot more quickly, you do it – you augment it with product line acquisitions. We saw it this year, one of our companies Spark Therapeutics. (Marshall Gordon brought that name to us), it's been a great name, it was acquired this year. That was an early stage company and it was monetized. We think that there could be a number of those kind of names, so pricing power is important.

Another name which has been negative to portfolio this year – I'm trying to get as many of your questions answered, maybe even before they're asked – is Allergan? Why are you holding on to Allergan? The stock has been very, very disappointing, no stock price momentum, what do you see there? Well, we see a company which is earning between $16 and $17 a share this year, and the stock is not only selling under 10 times earnings, it's probably eight times earnings. We think they have a phenomenal franchise in the aesthetics business. A lot of it is non-reimbursable, which means it doesn’t matter what the government says, your wife or your girlfriend is still going to use Botox and more and more people are using it at an earlier age. We think they have a pretty strong moat, that is a very, very strong product that's been used by doctors for a long time.

But in this case, the stock has done very, very poorly; many of the healthcare companies have done poorly. Oftentimes when stock prices lag, it forces consolidation. You go back to when Genentech got the bid from Roche, it was because one of their drugs, TPA was disappointing, they fell into the arms of Roche back then.

Another name that we had was Chiron. Chiron had a big problem in their flu vaccine in Liverpool, England. Stock price declined dramatically, it gave Novartis the opportunity to swoop in and buy Chiron. We saw Celgene, which we have not owned in the portfolio. Celgene's stock price had lagged because of some product disappointments. That was the avenue for Bristol-Meyers to consolidate them.

Whether we're going to see the same thing with some of the companies that I just mentioned, remains to be seen, but the probabilities increase the longer stock prices stay down, provided that they give you strong free cash flow, I think the consolidation activity will be -- could become very, very robust.

CH: Thank you, Richie. One quick housekeeping item, we've been getting a couple of questions on the slides that some of you have in front of you. Yes, those will be available to you after the conference call.

And then moving on, switching gears a little bit here to technology; that's been another area where folks have been asking a lot of their questions. Specifically we’re looking at how over – in this case,

underexposed we are relative to the quote, unquote, FAANG stocks and how are you guys thinking about your tech exposure going forward?

EB: Yes, so I think one of the misperceptions is, we own healthcare and media and we don't really own tech and that's why we've trailed. And I think there's – we talked about some of the individual names, but there's a real fallacy there, it's not that we won't own tech, but if we're going to own a more cyclical part of the space, like information technology, we're going to be very careful what we pay for growth, we're going to be very careful what the metrics on a valuation basis look like, and we're going to try to identify franchises that are unique and defensible.

And again, when we buy, we buy for long periods of time, so we're really looking for big addressable markets, we're looking for patents and we're looking for companies that for companies that generate a lot of cash. There are plenty of tech stocks that either become obsolete overtime or ultimately get – lose a lot of market share as the bigger players get involved, but we made reference to some of the areas we do have exposure to. We talked about Twitter. We bought Twitter, I guess for the first time in 2015, on its way down to the low teens, when we saw tremendous value in the brand. And it really is a very differentiated type of product versus a lot of its social media peers. But we continue to like the name, because again, it was a very out of favor, I think very misunderstood company and it remains that way. And you see the cash flow numbers that they're able to report, they're dramatically higher than consensus expectations.

Richie talked about Broadcom. There's a company which is trading at 12 times earnings, despite having the sharp rebound, post the CA acquisition, generates a lot of free cash, returns that free cash to us as shareholders, and still trades at a big discount to the market, for a very diverse business with good mid to single digits top line growth and double digit growth on an earnings per share basis. We talked about (cream), we talked about some of the other names that we under significant pressure because of one piece of their business, and ultimately since new management has come in, have seen a major turnaround in their business, on the silicon carbide power chip side, many of which go into electric vehicles.

So big addressable market and great opportunity for them to capture and keep their strong market position in that area. Autodesk, Citrix, some of the other names in the software space, again, looking for differentiation where there's minimal competition and again, franchise value. At the end of the day, it's all about free cash flow, and I think that is the key to those stories and the growth there. So we always get asked about artificial intelligence and virtual reality, markets like that, and actually companies like Autodesk, and in fact, Broadcom, big beneficiaries from some of those emerging technologies, but with a good base business or a good sustainable business growth around that.

So about a quarter of the portfolio is in technology, it's more mid-cappy than the indices. We talked again about how we structurally invest, which is buy them early and then allow them to grow, but the other big area is the storage names, and Richie talked about earlier, about the rebound in some of the (drive) stocks, which were left for dead in the fourth quarter. At the time, we looked at businesses that were between Seagate and Western Digital, essentially in a duopoly for cloud-based storage.

We heard the numbers being used to justify market caps and multiples on some of the bigger cloud service providers, and we said we like technologies where there's rational markets, there's minimal competition, companies at the low point of the cycle were generating free cash flow, had good cost management, and we saw, as typically happens in a cyclical area like tech, we saw the businesses, the cost, the inventories, ultimately being normalized, and now even before business has turned around, there's just a hint of (green chutes) in some of the areas, both flash memory and drives in terms of demand. We're starting to see the stocks outperform.

Both names are up over 30 percent year to date and still cheap on a valuation basis. So paying

meaningful dividends out of free cash flow, in good markets that we think for the next 10 years, if you think about the growth of data and the growth of storage, just meaningfully speaking for the next 10 years, which is going to be probably tenfold growth over the next 10 years for data, this is the best way to play it at big discounts to the market. So we've had good stock picking in technology, obviously the lack of the big stuff has hurt on a relative basis, but that's not the way we think.

RF: My wife accuses me of having artificial intelligence.

CH: Great. And then so another common question we keep getting on the polling line is energy centric. So with respect to energy, that sector – the stock prices have broadly trailed a recovery in the price of crude oil. So can the two of you speak a little bit about why you think that has been the case, and do you think that there is anything that could change that dynamic in the near future.

RF: You're right, it was an area that was – we found to be frustrating. We saw the recovery and the price of oil this year. We didn't see a (common) increase in the stock prices until two weeks ago, a week and a half ago. A name which we've had in the portfolio for quite some time.

We've spoken ad nauseam on calls like this. Was Anadarko, we always thought – we've said that either Wall Street will recognize the value of it or the stock market will monetize it. Well, the stock market didn't monetize it, somebody else came along.

Chevron made a bid for Anadarko at a premium to where it was selling for, still at a discount to where the stock was selling for last year. So, the discount, as we think, is starting to be corrected, and this is an example, similar to what I mentioned about healthcare companies, when stock prices lag for a period of time it makes them more susceptible to consolidation activity, either management's capitulate or shareholders pressure them to capitulate. It might have been some of both. So, we like to see the Anadarko announcement, we'll see if anything further happens. We owned another company last year, Newfield, which merged with Encana. So, it was a space which was very ripe for consolidation and we're glad that we're seeing now.

EB: Yes, this is Evan, I just say, this is a strategy that has had over 100 companies now acquired from it over 35, 36 years. And we're the antithesis in a lot of ways to activists, who's trying to buy something they think can get bought. We're trying to buy something that we think is mispriced in the public markets and ultimately buy more if we think that discount or that disconnect widens.

And that was great example on the Anadarko front, where business was good, they were generating more free cash flow at $60 oil than they were at much higher oil prices cause of good cost management in terms of corporate and end extraction costs, but the market wasn't recognizing that. And the interesting thing is, we were having discussions with our energy analyst here, Dimitry Dayen saying, unlike 2016 when everybody was very levered and everybody was, including the majors, were just worrying about paying out their dividends. Actually, the health of the industry was actually pretty good. Balance sheets were, for the most part, relatively clean, companies were generating a lot of free cash flow and there was a clearing price for good assets.

And so, Chevron paid a meaningful premium for a great asset, what we think is a great asset in Anadarko, but there's going to be more consolidation in some of these areas. And there's a ton of money, nearly a $1 trillion in the hand of private equity. Balance sheets of the bigger majors, again, in very strong condition and there's truly a disconnect between the 50 percent rally in the price of oil that we've seen off the lows and where multiples are for a lot of these companies. We never know who it's going to be.

Again, we don't seek to buy takeover targets. We seek to buy great businesses that the market is not monetizing. And over time, you're going to get paid through the stock market revaluation or you're going to get some of these types of deals. And we can see it, the way we've seen it in media. I'm sure

there are questions about that as well. We've seen in technology where some private equity money is starting to emerge and we talked about the overwhelming likelihood that you're going to continue to see deals in the healthcare space. I think the energy stocks needed a rerating, the majors are smart, in my view, to be taking advantage of the discount in terms of where the public equities are right now being valued.

But as many of you know, we also have significant exposure in the service space, where you're starting to see and Schlumberger talked about that on their most recent call, after what essentially has been three and a half years of depressed CapEx spending, you're seeing inventories down at minimal levels, you're seeing new demand for new drilling techniques and technologies and smarter equipment, and hat should benefit some of the equipment and some of the service names that we own there.

You should see, first quarter is always seasonably weak, but you should see demands starting to build, particularly onshore and shallow water initially in the international markets. You should start to see demand starting to perk up, especially in the second half of this year for some of the service and the drilling names. And obviously, many of you have asked about specifics there, but that should benefit everybody in that space. It's another area where you could see consolidation, but more likely you're just going to start to see demand building and that should benefit what's been a difficult environment for those stocks, to say the least, the last three or four years.

RF: We never duck a question. The elephant in the room has been Weatherford, it's clearly been the thorn in the side, it's on management to continue to see benefits from the transformation program of theirs.

They should start to see a significant pickup in the international business in the second half of the year and it's on them to make the transition to free cash flow in 2019. So, (we'll) see that happen this year.

CH: Great. And I hate to transition back to technology after that conversation, but we did get a question from a participant that asked, is the Facebook weighting a mistake on the slide five?

And I actually think this is a great question to highlight the way that Richie and Evan think about their buy discipline. So, Facebook is a very tiny position in the fund, but maybe you can speak about the day you guys made the decision to buy Facebook versus how you think about it today.

RF: Go ahead Evan.

EB: Yes, it was the fall of 2012. The stock was trading in the low 20s on its way down to the high teens, and that was the – the market cap at the time was about $50 billion, so generally we're buying them small and midcap, but what we – we can go anywhere and that was an example in the Aggressive Growth strategy where we thought, if you put on TV and you looked at the way the IPO was handled and you listened to the media talk about the price of the stock, it was really just a matter of time or it was a (fada) complete of the stock was going to go the way of MySpace or some other social media companies and was going to continue to decline. And that was the case where we thought the franchise had tremendous value.

The stock was clearly oversold and I think one of the – and it's funny, just looking at some of the words we've used today, disconnect, dislocation, discount, oversold, the idea of what we do is to buy these great businesses when they're underappreciated, undervalued and under-owned. So, we bought it in the low 20s, we bought – remember buying 1 million shares at 18 and our trader, Lisa Utasi saying, you can take as much stock as you want at this level.

It's trading millions of shares for sale at this point and we took a meaningful position in the name. It was, I believe it got as high about, over – it was certainly well over two percent of the fund and the strategy at one time and we've taken profits. I think what we were buying as a very underappreciated, under-owned, underappreciated name in the six-year subsequent to our purchase became much more of a consensus long. Never really got expensive on a valuation basis, but we though a lot of the

upside that we were seeing early was getting priced into the name.

So, whereas we talked about Twitter as having tremendous upside from these levels as a name that's really institutionally under-owned and underfollowed and still, I think, you look at the market cap of Twitter's sub 30 billion, whereas Facebook is over 500 billion. And so, there was a name where we bought a meaningful position, we took some profits and we redeployed into some areas that we think had better risk reward.

So – and even just final – to put a bow around tech, it's not that we don't own a lot of the suppliers to the (inaudible). I mean we own storage, we own con-activity, we own a lot of the emerging, enabling technology, speak recognition that goes into a lot of those big guys, we simply don't own the big guys necessarily. We own names that we think have potential over time to grow into those.

RF: And a name that never gets – it's not categorized in technology, but probably the most important high tech area is L3 Communications in the portfolio, which is going to be merging with Harris. And when we bought L3 many years ago, it's the premier defense electronics company. Most of their programs are classified.

But again, it's been exceptionally well managed since we've owned it. They throw up a lot of free cash flow and it's one company that we can say is protecting all of us. Not in the technology are, it's classified as industrial, but there's no more high-tech than L3.

CH: All right, and with that, we are basically butting up against the end of the hour here. So, I want to be mindful of everyone's time. I did want to take a second and say thank you to everyone who took the time to dial in today's call.

As a quick housekeeping item, there will be a replay dial-in for this call, so that will be sent to you if you were registered for the call.

So, please feel free to share that with colleagues that maybe didn't have the time to dial into the call today. I did want to say thank you on behalf of Evan, Richie and myself for dialing today to today's call, we do appreciate the partnership.

And as always, if there are any lingering questions after today's call, please feel free to reach out to your Legg Mason partners or the Clearbridge Specialist team, again, that I work on. So, thank you again everyone and have a great day.

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