ClearBridge Investments

All Cap Value Strategy

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Key Takeaways

- Given the policy response to COVID-19 and the reversal of globalization as a major deflationary force, there is potential for a major change in economic and market dynamics.
- During episodes of such market stress, we tend to get very active as we look to take advantage of the price volatility and resulting dislocations between price and underlying value.
- Even after the recent compression in valuation spreads, from current levels the forward 12-month relative performance opportunity in favor of value has averaged almost 30% historically.

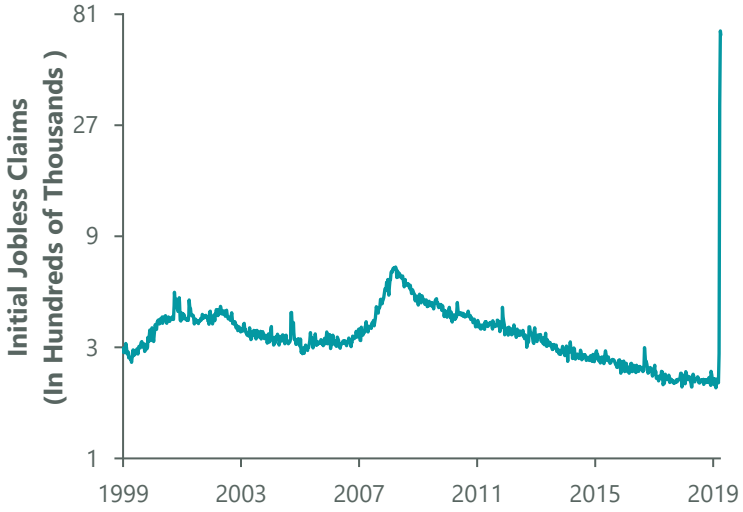
Market Overview and Outlook

The COVID-19 crisis will almost certainly be one of the most dramatic events we will experience in our lives, if not the most dramatic. What makes a global pandemic so frightening and challenging is that pandemics are not linear, but rather exponential, enemies. The continuous compounding of COVID-19 resulted in cases doubling almost every two days in the early stages of the crisis, and even now cases are still doubling roughly every nine days in the U.S. Tackling an enemy that doubles every few days has quickly altered the world as we knew it, as the scale of many things — virus outbreak, economic slowdown, market selling, policy response — has blown up well beyond all past experience. The physicist Albert Bartlett argued that "the greatest shortcoming of the human race is our inability to understand the exponential function." To tackle this natural shortcoming, we will explore how the virus has exploded the scale of recent economic and market events, and how we are adapting as long-term valuation-disciplined investors.

We will spare our readers any real math, but the proper way to handle data that varies widely, which is almost always the case with exponential growth, is to use a logarithmic or log scale on all charts. A log is the inverse function of an exponential, and its basic power is its ability to reverse the effects of exponential growth so that you can more easily compare data across time. In almost all cases a log scale will squeeze the drama out of a long-term chart by flattening a curve and making it look linear. Unfortunately, the scale of the ongoing fight against our exponential enemy has not been tamed in any way by a log scale.

Despite the intensity of the Global Financial Crisis (GFC) in 2008, in which jobless claims rose almost threefold (Exhibit 1), scarring most investors and profoundly affecting behavior and policy over the ensuing market cycle, it did not prepare us for the scale of what we have experienced over the past few weeks. By contrast, the thirty-fold increase in claims in April 2020 turns the intense job stress of the GFC into a noticeable but modest foothill by comparison.

Exhibit 1: Initial Jobless Claims Soar in 2020



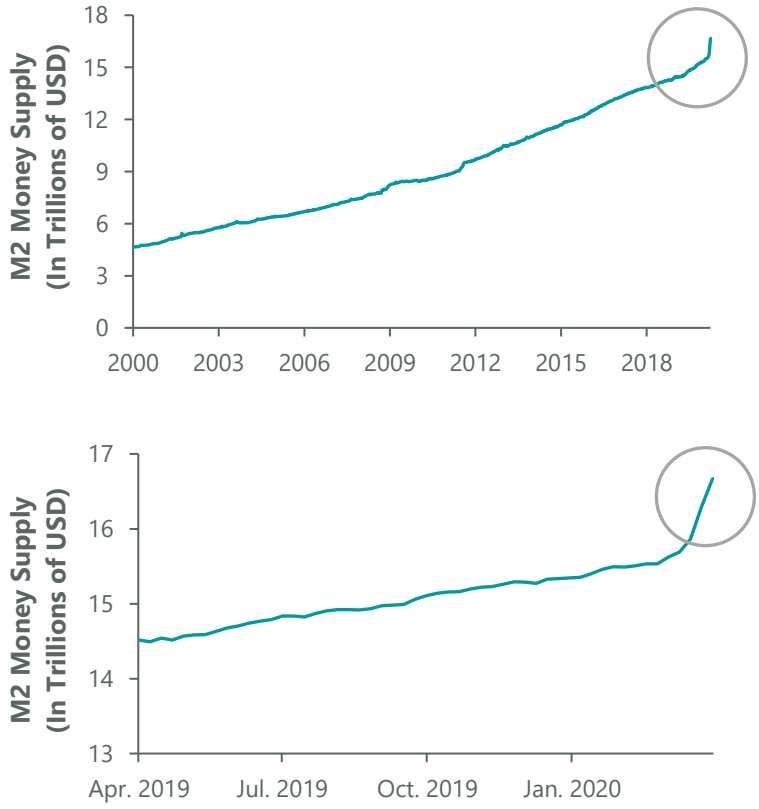
As of April 11, 2020. Source: ClearBridge Investments, Bloomberg.

When 20 years of experience gets amplified by a 10-fold multiplier, it quickly becomes clear we need a new map. The real challenge is that we are still somewhat early in this process, and we are facing many unknowns around the ultimate duration and magnitude of the crisis. Clearly, however, we are witnessing the largest decline in global economic activity ever over such a brief period, as the virus's exponential nature has been dictating the pace of the crisis. Left to run its course, this pace would quickly run the global economy into a depression.

Fortunately, the economic fallout of the crisis is being met by a fiscal and monetary response that is also historic in its scale and speed. The key objective for policy is to fill the historic gap in economic activity, and, with the combination of monetary and fiscal policy now adding up to 35% of the U.S. economy, the response has been massive. The other objective of policy is to buy time to fight the virus. As a natural system, the virus has the advantage of continuous compounding, but natural systems have the disadvantage of organic limiters. We may face several COVID-19 infection waves, but the virus will ultimately burn itself out as we attain herd immunity with time and ultimately the aid of a vaccine. In addition, with each wave we will have more diagnostic information to isolate outbreaks and balance the economic response.

As importantly, policy has the advantage of being a man-made system, which has no organic limits — at least over the short to intermediate term. Money supply historically used the gold standard as a natural limiter, but money is now free to follow its own exponential path. This freedom has allowed the Federal Reserve (Fed) to grow the money supply over this crisis at an unprecedented rate. The following chart shows the M2 broad money supply over the last 20 years. This chart may not look as dramatic as the previous chart, but that vertical line at the far right is truly shocking on a long-term log chart of this scale. Over the past 20 years the Fed has grown the money supply at roughly 6% annually. Over the past two weeks the Fed has increased the money supply by roughly $1.2 trillion or 7.5%, which is almost 200% annualized. More importantly, the Fed has pledged to provide whatever it takes and has followed up with its continuously expanding interventions across asset classes to ensure ample liquidity. We expect the exponential battle between the economic fallout of the virus and the policy response to swing back and forth over the coming months, but ultimately policy and time will win out over the virus. We are certainly not gold bugs, but we do think the long-term cost of the policy response is an unknown that will linger long beyond COVID-19.

Exhibit 2: Money Supply Growth Is Unprecedented



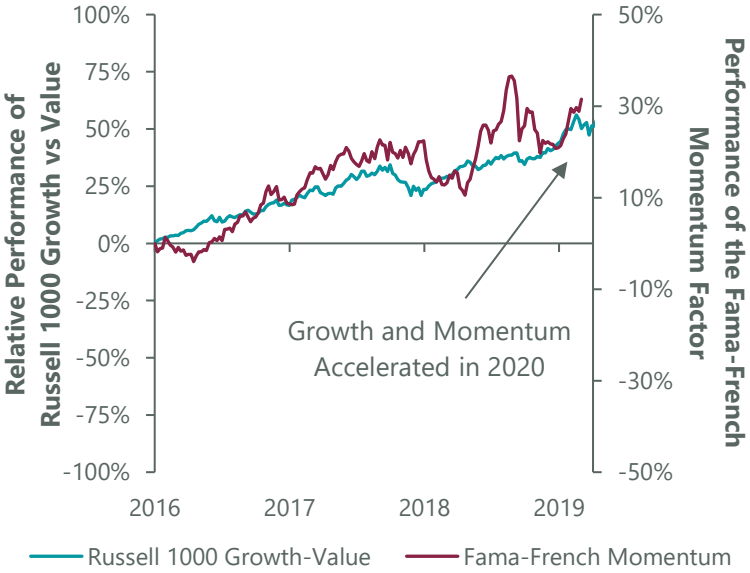
As of April 11, 2020. Source: ClearBridge Investments, Bloomberg.

Despite the terrible nature of this economic crisis, new market cycles always emerge from the pain and fear of downturns. However, in the early stages of this crisis, pre-existing market trends in favor of growth and against value accelerated. Value as a broad category has been suffering mightily since 2017 (Exhibit 3), but this suffering accelerated into a value collapse in March that was arguably the worst period for value on record. However, as the battle between policy and the virus ensued, value started to bottom and fight back (Exhibit 4). Fortunately, our relative performance started to rebound materially with the better performance of value, but we still have a long way to go to restore long-term relative performance after facing such intense headwinds over this market cycle and the recent crisis. The key question is how to dimension the potential for a value cycle?

Exhibit 3: Value Stocks Have Suffered Since 2017

As of April 11, 2020. Source: ClearBridge Investments, Bloomberg.

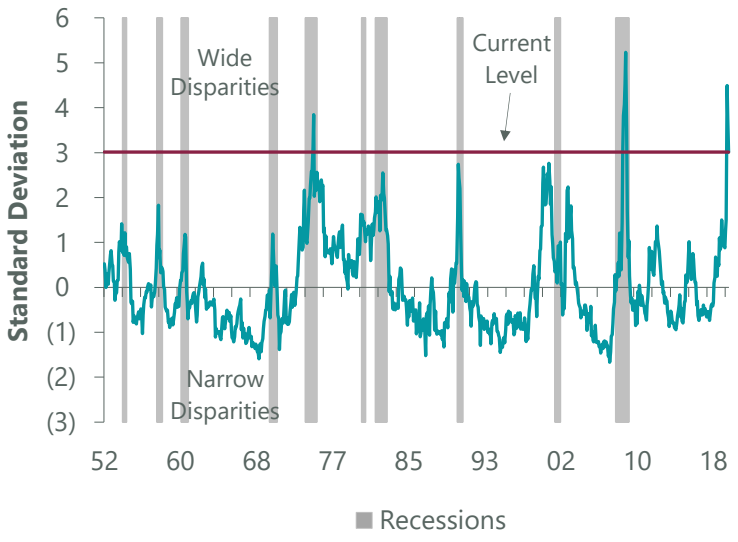
Exhibit 4: Value Vs. Growth Trend Accelerated



As of April 11, 2020. Source: ClearBridge Investments, Bloomberg.

To measure value cycles, we have long used the following valuation spread chart from Empirical Research Partners (Exhibit 5). The chart tracks the cheapest 20% of the market over time. When the line is rising, value is underperforming materially, but it sets up major opportunities for value outperformance when the spread compresses. Value cycles are violent in nature, characterized by sharp peaks and reversals. The nature of value cycles requires the discipline and temperament to stick with value when it is at its most painful moments. As valuation spreads rise, the math becomes easier while the emotional stress intensifies. Therefore, most people understandably lose confidence in value and value managers at exactly the wrong time, and this behavioral response is ironically one of the critical ingredients powering a value cycle.

Exhibit 5: Valuation Spreads Peaked at Third-Highest Ever



As of April 1, 2020. Source: National Bureau of Economic Research, Empirical Research Partners Analysis. Measures U.S. large cap valuation spreads, top quintile compared to the average

Valuation spreads peaked in mid-March at their third-highest level ever and have recently compressed to just over three standard deviations. Even after the recent compression in valuation spreads, from current levels the forward 12-month relative performance opportunity in favor of value has averaged almost 30% historically.

However, if there is one clear message here, it is that we are dealing with a scale of events that we have never witnessed. When you see the exponential moves in log scale highlighted in the charts above, you are clearly dealing with some very fat tails, and the range of possible outcomes is incredibly wide. With such ongoing uncertainty we cannot be sure that the equity market has truly bottomed and that valuation spreads will not widen again before a new market cycle begins. Especially with so much economic pain and dislocation headed our way.

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What we do know is that ultimately there will be a very big tactical move in favor of value strategies like ours as policy and time win the battle over the virus. There is also the distinct possibility that the next cycle could favor value strategically if the historic merging of fiscal and monetary policy at an unprecedented scale gives birth to a higher level of inflation (although stagflation is a possibility). To be clear, as we navigate this deflationary collapse in the economy, there is zero evidence of inflation, and technology and demographics will continue to be structurally deflationary. However, given the emerging policy response and the reversal of globalization as a major deflationary force, there is potential for a major change in economic and market dynamics. For now, our goal is to survive this cycle in order to take full advantage of a tactical value cycle, while gauging if the current uncertainty gives rise to a longer-lasting opportunity for value down the road. How are we doing this?

As the crisis steamrolled through financial markets, daily volatility rose to historic levels and valuation spreads exploded higher at a record pace. During episodes of such market stress, we tend to get very active as we look to take advantage of the price volatility and resulting dislocations between price and underlying value. Given the magnitude and pace of this crisis our portfolio turnover rose significantly, as we established seven new positions and sold five.

In the very early stages of the crisis our focus was on minimizing direct risk to the most virus-exposed market areas, and we sold Boeing while reducing financial and energy exposure. These were prudent moves, but with hindsight we wish we had done even more.

A primary process transition in every crisis is that equity analysts quickly become credit analysts. Accordingly, we had the team stress test every position in the portfolio. The simple goal is to make sure that each company can survive this historic collapse in economic activity, as price and value cannot converge if a company cannot survive. The added challenge of this crisis is that stress tests had never included multiple cases of company revenues collapsing toward zero. In the few cases where we thought balance sheets would become too stressed, we exited or reduced positions. Especially in certain energy and credit-sensitive companies. To be clear, as the wave of economic pain is still cresting, stress testing will be iterative and ongoing. Our goal is simply to maintain a healthy gap between the price and value of portfolio positions, but while continually reducing liquidity and solvency risk.

Given the high level of uncertainty and such an incredibly wide range of future outcomes, we are extremely well-diversified while staying true to our valuation discipline. The portfolio now has roughly 5% in international equities, and we added Wheaton Precious Metals, making our gold exposure over 1%. As we commented previously, we are not gold bugs by any means, but if there was ever a time to own gold, we think this is it.

We also added Comcast and Reynolds Consumer Products, whose core businesses should hold up very well during the crisis. These high-quality businesses should also do well over the long term if deflation intensifies.

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Despite the intense focus on managing risk by stress testing companies and adding diversification to an already highly diversified portfolio, the portfolio's valuation potential remains extremely high and fully reflects our valuation-driven investment process. As a result, we should do well in a wide range of future scenarios, and we are certainly positioned to navigate the crisis and enjoy an eventual compression in valuation spreads. The biggest risk to relative performance remains continued headwinds to value, which were historically intense until very late in the quarter.

Dimensioning the historic scale of this crisis is critical context for investors, but we remain intensely aware of the stress and toll this crisis is having at the individual level. We will, however, beat this exponential enemy with an exponential policy response, time and the greatest strength of humans: our ability to organize at a global scale to tackle our collective challenges. As this crisis fades, we hope our global efforts are energized to tackle the other great challenges we face. At a smaller scale, we also hope for a restoration of value.

Portfolio Highlights

The ClearBridge All Cap Value Strategy had a negative return during the first quarter, underperforming the Strategy's benchmark Russell 3000 Value Index.

On an absolute basis, the Strategy had losses in all 11 sectors in which it was invested during the quarter. The least negative contributors to the Strategy's performance were the consumer staples, materials and utilities sectors. The financials, energy and industrials sectors were the main laggards.

In relative terms, the Strategy underperformed its benchmark primarily due to stock selection decisions during the quarter. Stock selection in the financials, industrials, utilities and information technology (IT) sectors detracted the most from relative returns during the period. Conversely, stock selection in the energy, consumer staples and consumer discretionary sectors proved beneficial. In allocation, overweights to the energy and financials sectors and an underweight to the consumer staples sector weighed on relative results.

On an individual stock basis, the greatest contributors to absolute returns during the quarter were positions in Reynolds Consumer Products, E*TRADE, Sprouts Farmers Markets, Arista Networks and AbbVie. Synchrony Financial, Citigroup, OneMain Holdings, Wells Fargo and American International Group were the largest detractors from absolute performance.

Besides portfolio activity mentioned above, during the quarter we initiated positions in Western Digital in the IT sector, Equitable Holdings and Progressive in the financials sector and AbbVie in the health care sector. We closed positions in Ovintiv and Schlumberger in the energy sector and Bank OZK and E*TRADE in the financials sector.