ClearBridge Investments

Appreciation Strategy

Scott Glasser
Managing Director, Co-Chief Investment Officer, Portfolio Manager

Michael Kagan
Managing Director, Portfolio Manager

Key Takeaways

- Our bias toward larger companies with strong credit profiles contributed to outperformance during the selloff, while the Strategy performed in line for the quarter.
- From a stock perspective, many of our largest active weight positions contributed strongly during the quarter.
- We are dollar cost averaging our way into several new names that we expect to be market leaders in the next bull market and adding to our highest-conviction ideas.

Market Overview

Today's global humanitarian crisis has shaken us all. To our readers, we hope you and your loved ones are safe and healthy.

The COVID-19 shock to global economic activity created unprecedented market volatility across all asset classes in the first quarter. Although we could discuss this topic ad nauseum, the S&P 500 Index's 30% decline in 22 trading days — the fastest drop of this magnitude in history — does well to sum up the market effects. The severity and swiftness of this market selloff caught us by surprise.

The current market decline differs from prior ones insofar as it appears no asset class or industry has been spared. Assets across the board have seen losses on a global basis. The U.S. equity market selloff is somewhat frustrating to date given little differentiation, at least in terms of many factors that historically indicated a defensive stock: quality, beta, dividends. Larger stocks have outperformed smaller, and companies with stronger balance sheets have done better than companies with leverage. Behind the record selling, which was highly correlated and indiscriminate, was a liquidity event. Commodity trading accounts, volatility funds, risk parity funds and other quant-oriented funds, as well as hedge funds, levered ETFs, MLPs — you name it — de-levered in March. Going forward, we expect lower stock correlations as investors re-engage and re-populate portfolios from the bottom up.

The Appreciation Strategy performed roughly in line with the S&P 500 in the first quarter as outperformance during the February and March selloff recouped ground lost in the January rally. Outperformance during the selloff came from a combination of risk attribution and stock selection, while sector selection hurt us. Our bias toward larger companies with strong credit profiles

contributed to outperformance. From a stock perspective, many of our largest active weight positions contributed strongly during the quarter. For example, Microsoft — our largest holding — outperformed the information technology (IT) sector by 1,200+ basis points (bps). Adobe, where we have a large active weight, outperformed by 800+ bps. Away from IT we had material outperformance over their sectors from Berkshire Hathaway, Walmart, American Tower, Home Depot, Travelers and Air Products and Chemicals. Finally — and importantly — we were underweight or had no holdings in many of the hardest-hit industries such automobiles, hotels, restaurants & leisure and energy equipment & services.

The features that make a company robust in a slowdown are the same when demand stops — a strong balance sheet and a dominant franchise.

Our process remains unchanged. We continue to look for high-quality stocks with strong balance sheets and sustainable growth. Volatile markets give us the opportunity to add great companies that were too expensive at the previous peak and to further upgrade the portfolio and focus on long-term strategies. We are dollar cost averaging our way into several new names that we expect to be market leaders in the next bull market and adding to our highest-conviction ideas. That said, we are being deliberate and mindful in our actions because the economy we have today differs significantly from the one we knew in 2019.

During the quarter we initiated a position in Ball Corp, a company we have been eyeing for some time and that the market decline finally provided us opportunity to invest in. This leading aluminum beverage can manufacturer should see accelerated growth over the next several years as the world phases out single use plastic bottles. We also initiated a position in T-Mobile as we view the combined T-Mobile/Sprint as a long-term share gainer due to its cost advantage and potential as a 5G leader. We increased our position in Salesforce.com as we viewed the cash flow story as undervalued by the market, and Arista Networks as we view their switches as well positioned to benefit from increased cloud demand at key customers. We exited PNC Bank, MetLife and American International Group, as we believe low interest rates, which challenge their earnings power, are likely to persist for several years. Being cautious on the outlook for a quick recovery in autos, we sold out of a small position in Illinois Tool Works.

Outlook

Markets are trying to make a bottom, but that is a process and not a day. The five-day 17.4% rally off the March 23 market low (the second-best five-day rally in market history) helped establish a short-term low. Ultimately, though, before any rally can be sustained, we believe markets will require the spread of COVID-19 to slow, signs of stabilization in the global economy and an indication aggressive fiscal and monetary actions are reducing the overall economic fallout (especially regarding employment

and bankruptcies). If China and South Korea are any indication, the U.S. may be only a couple of weeks away from a slowing infection rate and within two months of returning to a more "normal" daily routine. This is our best estimate of what the market currently discounts.

As portfolio managers, we and the global markets are attempting to map out a path forward for which there are few if any historic parallels. Businesses are accustomed to demand slowdowns but not outright stoppages. As such, our forecasts have wider than usual potential outcomes. This — in turn — means a more challenged assessment of risk and wider asset valuations. But the features that make a company robust in a slowdown are the same when demand stops — a strong balance sheet and a dominant franchise. We believe the Appreciation Strategy's conservative approach to investing and portfolio of high-quality earnings compounders with quality balance sheets and durable competitive advantages is well-positioned in these uncertain times.

Portfolio Highlights

The Appreciation Strategy performed in line with the benchmark in the first quarter. 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 utilities, real estate and consumer discretionary sectors. The financials, communication services and industrials sectors were the main laggards.

In relative terms, sector allocation detracted from performance, but was offset by positive stock selection. In particular, overweights to the financials, materials and energy sectors and stock selection in the communication services sector detracted from relative results. Conversely, stock selection in the consumer discretionary, IT, energy and real estate sectors were beneficial to relative performance.

On an individual stock basis, the biggest contributors to absolute returns during the quarter included positions in Amazon.com, Microsoft, Ball, Fidelity National Information Services and Gilead Sciences. The greatest detractors from absolute returns were positions in JPMorgan Chase, Raytheon Company, PPG Industries, Comcast and Berkshire Hathaway.

Aside from portfolio activity mentioned above, during the quarter we initiated positions in Fidelity National Information Services and Cognizant Technology in the IT sector, American Express in the financials sector and Pinterest in the communication services sector. We closed positions in W.W. Grainger in the industrials sector, Corteva and Dupont De Nemours in the materials sector, Schlumberger and Phillips 66 in the energy sector, Gilead Sciences in the health care sector and McDonald's in the consumer discretionary sector.