ClearBridge Investments

Dividend Strategy

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Key Takeaways

- The extraordinary breadth and depth of the selloff made it difficult to meaningfully differentiate performance both within equities and across asset classes.
- While social distancing impacts all companies, our portfolio has relatively less exposure to the types of consumer discretionary companies that will be most impacted, such as air travel, movie theatres and coffee shops.
- While we expect the growth rate of dividends to slow, we do expect that in aggregate our portfolio companies will grow their dividends.

Market Overview

The first quarter was chilling for both the capital markets and the world at large. The year started well, and the market rose 5% to an all-time high on February 19. As the coronavirus pandemic unfolded, the market then declined 34% through March 23 before bouncing back 16% to close the quarter down 20%.

The Dividend Strategy modestly underperformed the market during the quarter. The extraordinary breadth and depth of the selloff made it difficult to meaningfully differentiate performance both within equities and across asset classes. Stocks declined, credit spreads widened and gold sold off. Initially, selling was concentrated in those companies most directly impacted by the virus and social distancing, such as travel, retail and lodging companies. Later, investors dumped everything, including utilities and staples, as panic spread and liquidity became paramount.

Our investing thoughts over the last month have been focused on four new risks that have emerged: 1) a synchronized global contraction; 2) ultra-low interest rates; 3) ultra-low oil prices; and 4) social distancing. While a recession seemed unlikely just six weeks ago, it is now clear that the global economy will contract significantly in the short term. Unemployment will skyrocket, spending will collapse and credit will deteriorate. The unprecedented fiscal and monetary stimulus unleashed by policy makers will mitigate some of the blow and in relatively short order people will emerge from their homes.When they do, economic activity will recover meaningfully but we do not think it will fully recover to previous levels. A couple of weeks ago, the market expected a sharp snapback in the relatively near term, but

We are focused on new risks to the market, such as a synchronized global contraction, low interest rates and oil prices and social distancing.

it now seems likely that a recovery may take longer and be less robust than most anticipated just a short time ago.

The Fed's policy of low interest rates is supportive of asset prices and economic activity but negatively impacts the earnings power of financial companies. Our financial holdings fall into three buckets: alternative asset managers, insurance companies and banks. We believe alternative asset managers are in a good position to capitalize on the disruption as they have significant amounts of undrawn capital that they can opportunistically deploy. They may also be the recipient of increased allocations from clients. Insurance companies should be able to weather the storm courtesy of their bond portfolios, which should prove resilient. Banks will suffer as credit deteriorates and lower rates depress earnings. The banks we own are extremely well-capitalized and best in class, but we feel the sector overall will face headwinds. Bank stock prices already reflect much of the pain we expect, but on the margin we may reduce our exposure over time.

The crash in oil prices will leave a mark on the energy industry. At $20 per barrel, nobody profits and many firms experience acute distress. Longer term, we still believe in the U.S. shale story, though we believe the growth trajectory will be much lower than before. Within energy, we own a small position in Exxon Mobil and three pipeline companies. Exxon Mobil will suffer from lower commodity prices, but it is one of the few companies that is sure to make it to the other side. The pipeline companies, while not immune to swings in commodity prices, are largely insulated due to the contracted nature of their business. Further, most of our pipeline exposure is in natural gas, which should prove more defensive in the short term and which we favor over the long term because of its lower carbon footprint.

While social distancing impacts everybody and all companies, our portfolio has relatively less exposure to the types of consumer discretionary companies that will be most impacted by social distancing, such as air travel, movie theatres and coffee shops. We trimmed our exposure to McDonald's early in the period and exited our position in Sysco due to concerns about both the short-term and long-term health of the restaurant industry.

Outlook

As we think about positioning for the future, we are most focused on sectors with greater resilience and less exposure to transactional consumer business. These types of companies have always been our focus and during the quarter we worked to strengthen this posture through new positions in Becton Dickinson, Boston Properties and Broadcom. While this stance did not aid performance in the quarter, we expect that it will going

forward as markets begin to distinguish which companies are well-positioned for the current environment.

One of the questions we hear most from clients right now is what we expect of dividends in the current year. On this front, the news is good. While we expect the growth rate of dividends to slow dramatically, we do expect that in aggregate our portfolio companies will grow their dividends. For the last many years dividends have grown in the high single digits. This year, we expect growth in the low single digits. Nevertheless, the current environment is highly dynamic and we will remain disciplined in assessing companies' dividend profiles. While history is no guarantee, we believe the Global Financial Crisis (GFC) should prove somewhat illustrative. During the GFC the portfolio had just two dividend cuts (General Electric and JPMorgan Chase), while in aggregate it saw low single-digit increases over the course of the crisis.

Portfolio Highlights

The ClearBridge Dividend Strategy underperformed its S&P 500 Index benchmark during the first quarter. On an absolute basis, the Strategy had losses in all 11 sectors in which it was invested for the quarter. The least negative detractors from Strategy performance were the real estate, consumer discretionary and utilities sectors. The financials, industrials and consumer staples sectors, meanwhile, were the primary detractors from absolute results.

On a relative basis, sector allocation detracted from performance for the quarter, while stock selection was beneficial. In particular, overweights to the energy and financials sectors and an underweight to the information technology (IT) sector weighed on relative results. Stock selection in the consumer staples, financials and communication services sectors also dampened relative returns. Conversely, an overweight to the consumer staples sector and stock selection in the energy, real estate, IT and consumer discretionary sectors were beneficial.

On an individual stock basis, the sole positive contributors were Broadcom, Boston Properties and Microsoft. Becton Dickinson and NextEra Energy were also relatively strong contributors. Positions in Anheuser-Busch InBev, American International Group, United Technologies, Raytheon and JPMorgan Chase were the main detractors from absolute returns in the quarter.

Beside portfolio activity mentioned above, during the quarter, we closed positions in 3M in the industrials sector and Anheuser-Busch InBev in the consumer staples sector.

Performance source: Internal. Benchmark source: Standard & Poor's.