ClearBridge Investments

Large Cap Growth Strategy

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Key Takeaways

- Rapid expansion of the coronavirus outbreak beyond Asia, combined with an oil price war, triggered the most volatile period for equities in over a decade.
- A thorough stress testing of all holdings gives us confidence that our diversified portfolio of growth companies remains well positioned for the turbulent environment ahead.
- We are less focused on how bad near-term results could be and instead are evaluating what are good long-term businesses and where we see good entry points into these companies.

Market Overview

The emergence of a global coronavirus pandemic (COVID-19) in the first quarter sparked historic volatility and the sharpest equity selloff since the Global Financial Crisis, likely sending the U.S. economy into recession. The S&P 500 Index dropped 19.60% for the quarter, its worst three-month decline since 2008, while the benchmark Russell 1000 Growth Index fell 14.10%. Growth stocks held up better than value shares with the growth benchmark outperforming its value counterpart by a substantial 1,263 basis points.

Several defensive sectors were the best relative performers in the benchmark through a violent period for equities, led by real estate (-10.03%) and health care (-12.40%). Information technology (IT, -11.40%) also held up better than the overall market. Consumer staples (-14.54%), traditionally an area of stability in turbulent periods, underperformed, as did industrials (-26.06%). Energy (-52.96%) was the worst performer, hurt by the start of a price war that sent crude oil plummeting 66% to finish March at $20 per barrel.

We initially viewed the COVID-19 outbreak as more likely a regional versus a global issue and believed that the global economy and markets could handle it. There was a sea change on March 8, however, with the dispute between Russia and Saudi Arabia on oil production leading to a plunge in commodity prices, along with the outbreak becoming much more prevalent and tangible in the U.S. The speed of this change has been breathtaking. The market went from 52-week highs to multiyear lows in just 22 days.

We always talk about bond markets seeing these stresses first, and we knew there was a lot of leverage in the system due to a sustained period of abnormally low interest rates, but what occurred was a wash-out of any risk-based assets, and even traditional safe havens like gold and U.S. Treasury bonds. We believe the growth of passive, as well as commodity trading accounts and risk parity strategies, the latter often accompanied with leverage, helped exacerbate the massive unwind over the first three weeks of March.

Global economies are just beginning to feel the negative impacts of aggressive government and business actions to contain the spread of the virus. Social distancing policies as prevention measures have caused the shutdown of all but the most vital businesses across the U.S. and wide swaths of Europe. This has led to closure of schools and cancellation of events and travel, resulting in widespread job losses and profit warnings from companies across sectors. The U.S. saw its highest number of initial jobless claims on record (6.6 million) in late March, manufacturing slowed and first-quarter GDP will likely be significantly impaired as well as the subsequent quarter.

From the latest equity market peak on February 19 through the trough on March 23, the ClearBridge Large Cap Growth Strategy held up better than its Russell 1000 Growth Index benchmark by about 130 basis points. That outperformance during the worst of the selling enabled the Strategy to make up ground against the benchmark, reducing the underperformance for the quarter. Results were supported by a rebound in more defensive areas as the selloff accelerated as well as contributions of companies like Akamai Technologies (web usage and streaming) and Amazon.com (cloud workflows and e-commerce) supporting the change in work and personal lifestyles due to the disruptions caused by stay-at-home policies. Trimming exposure to second derivative energy companies and interest rates ahead of the downdraft also helped.

Several of our more defensive positions in stable growth companies like media conglomerates Comcast and Disney and managed care provider UnitedHealth Group did not hold up as well as we would have expected early in the selloff. We have dedicated much of our time over the last two months to stress testing these and all portfolio holdings to maintain a focus on good businesses that can perform well through a difficult market cycle and thrive over the long term. We analyzed our companies under the scenario of a longer than expected recession that assumed a 50% reduction in operating income. This process, done in collaboration with our sector analyst team, helped us understand if any companies could have liquidity issues, what percentage of their costs are variable versus fixed and what lines of credit they have available. The exercise gave us confidence that the diversified portfolio we own across stable, select and cyclical growth companies remains well positioned for the turbulent environment ahead.

Portfolio Positioning

The dynamic nature of markets — which we have seen in an extreme way this past month — makes it imperative to not only stress test existing portfolio holdings but also identify potential new growth ideas. We typically do our homework well ahead of the actual purchase of securities, thoroughly vetting and de-risking companies until we gain enough confidence to add to our whiteboard of stocks we want to own at a certain price. The trigger point for a purchase is usually a price move or company-specific news that confirms our thesis and provides an attractive entry valuation. The unprecedented recent volatility has given us several such opportunities and we have been very active since mid-February, initiating four new names across consumer, longer-cycle industrials and health care sectors, with a theme of upgrading even further in quality. Such trading activity led to above average portfolio turnover for the quarter, continuing our recent repositioning efforts. We have been finding names that we believe have a better chance to accelerate revenue growth when the economy rebounds and that are less dependent on pricing to drive revenue and earnings growth from here.

We are less focused on how bad the first and second quarters could be and instead are evaluating what are good long-term businesses and do we see good entry points into these companies. We initiated a new position in Aptiv, a supplier of high-end auto components and systems, which is growing at 8–10 points faster than the overall auto industry. We have been following the company for four years and became more interested after it split off its cyclical Delphi Automotive division in late 2017 to form a business focused on high value automotive components. Autos have been in a bear market for the last two years due to trade and tariff risks and Aptiv shares had underperformed the market prior to the recent selloff. The additional stock price drop in the past weeks gave us the chance to own a leader in advanced auto components at a point where auto production is approaching levels last seen during the Global Financial Crisis and could be near a bottom. Aptiv is well-positioned to participate in the growth of active safety, lane departure assist and other safety features along with high voltage harnesses to support the electrification of the automobile, whether it is an internal combustion, hybrid or full electric vehicle.

New portfolio holding United Technologies (UTX), a leader in aerospace and defense whose merger with rival defense contractor Raytheon should create multiple long-term growth catalysts, also occupies a unique position as a global producer of high-value aircraft components. UTX purchased former portfolio holding

Rockwell Collins in 2018, gaining a leading position in avionics, and is on track to add more capabilities through the highly accretive merger with Raytheon into the combined entity Raytheon Technologies (RTX). As part of the deal, UTX will spin off its Carrier HVAC and Otis elevator businesses, leaving a pure aerospace company. Completion of the merger will give RTX significant market share in all the areas that matter in aerospace and defense, including the Department of Defense's hypersonic programs and advanced weaponry systems. These are higher-margin, longer-tail programs that should provide steady top- and bottom-line growth for years to come.

The unprecedented recent volatility has given us several opportunities to purchase stocks on our whiteboard and we have been very active since mid-February.

Other new additions include Monster Beverage in the consumer staples sector and Amgen in the health care sector. Monster is a marketer and distributor of carbonated and non-carbonated energy drinks, shakes and teas. We have been following the company for several years, thoroughly evaluating the stock from both a health risk and competitive market standpoint and are convinced it is a clean long-term growth story with a better upside than spices and seasonings maker McCormick, which we exited to make way for Monster. The energy beverage maker is positioned to gain share against existing caffeinated sodas and is a leader in the new "performance energy" category that is attracting more users as a pre-exercise beverage. It is attractively priced compared to similar food & beverage companies, positioned to deliver high-single digit revenue growth and generates high gross and operating margins with a capital light business model and a debt-free balance sheet. Its fundamental strength and free cash flow profile also provide optionality to use share buybacks as needed. Monster operates in a basic duopoly in the energy beverage market with Red Bull and is minority-owned by Coca-Cola, giving it an attractive global distribution platform. Key risks include a slowing of the energy drink market and lower margins outside the U.S.; however, we believe the category remains underpenetrated compared to soda and coffee. We also expect China to become a significant market for Monster going forward.

While we have not seen a shift in leadership away from IT, bear markets tend to be a catalyst for such change. The health care sector could emerge from this crisis in a strong position and we continue to look to add exposure through stocks like Amgen, a biotechnology company that focuses on developing therapies for use in oncology, endocrinology, hematology and neurobiology, as well as the treatment of infectious diseases, arthritis and inflammation. The recent drawdown created an attractive entry point to own an innovative biotech embarking on a multiyear acceleration in revenue growth after years of a stagnant top line. Amgen should have a series of pipeline readouts for its three lead internally developed therapies in 2020. In addition, the company is a leader in biosimilars given its extensive domain expertise in manufacturing large molecules, and it will target some of the largest commercial branded drugs with its biosimilar strategy. Amgen has a very strong balance sheet that will allow it to enhance its pipeline and bring drugs to market over time at a scale few can match. Amgen replaces Johnson & Johnson, a global pharmaceutical and personal health products maker we exited as we transition from defense to offense in health care.

As part of our portfolio upgrade, we fully sold four positions during the extreme volatility (and five in total for the first quarter) as well as trimming or adding to several other positions. In addition to the swaps in consumer staples and health care, the sales were concentrated among cyclical companies that could take time to rebound as their businesses are closely tied to macro conditions. These included Linde, a global manufacturer and distributor of industrial gases, whose shares have performed better than the overall market over the last several years and have become expensive relative to the company's growth. The demand outlook for industrial gases has weakened and we do not see significant upside in the near-to-medium term. We also sold out of database software maker Oracle to concentrate on names with a higher growth profile. Early in the quarter, we exited a position in global asset manager BlackRock, a leveraged play on the equity market where we saw greater economic uncertainty as a risk to earnings growth. We also see headwinds ahead as revenue growth is likely to come from lower fee sources, which may constrain the company's ability to drive margin expansion going forward.

Outlook

Equity markets have been so volatile in the last six weeks that we saw an 11-year bull market evaporate into a short-lived bear market that soon gave way to a new bull market. These are really semantics more than a sign that the worst is behind us for the market and the U.S. economy. We expect first-quarter corporate earnings will be weak and mark the start of what could be a multi-quarter downturn in profits. Shocks to the system right now are very broad and encompass delays and disruptions to global supply chains, which mostly impact IT and industrial companies. On the demand side, consumer confidence is weak and people are focused on things other than buying right now. The tremendous growth of the U.S. energy industry has turned the sharp drop in oil prices from what would normally be a stimulative impact into a significant headwind for employment in the shale basins across the country.

On the macro level, we are focused on two main areas: financial support for the economy and the trajectory of the virus outbreak. In addition to the significant monetary stimulus from the Fed, we are encouraged by the $2.2 trillion fiscal stimulus coming out of Washington which could bridge the gap from recession to recovery. The key is how quickly those moves can help the consumer. We also need to see evidence of a slowdown in the growth of the virus. Flattening the slope of virus contraction means that businesses and consumers can pivot to focusing on recovery.

We expect to hear about a broad range of impacts from companies. Our goal is to focus on what's going to work on the other side of the recession because we know that the corporate results will not look good for a while. As active long-term growth investors, we can buy good businesses and good business models right now at good prices, which sets a foundation for long-term appreciation potential.

Portfolio Highlights

The ClearBridge Large Cap Growth Strategy underperformed its Russell 1000 Growth Index benchmark during the first quarter. On an absolute basis, the Strategy had losses across nine of the 10 sectors in which it was invested (out of 11 sectors total). The only contributor to performance was the real estate sector while the primary detractors were the IT and communication services sectors.

On a relative basis, overall stock selection and sector allocation detracted from performance. Specifically, stock selection in the communication services, financials and consumer staples sectors, overweights to the industrials and energy sectors and an underweight to IT had the most significant negative impact on results. On the positive side, stock selection in the industrials, consumer discretionary, real estate and IT sectors contributed to relative performance.

On an individual stock basis, leading individual contributors to absolute returns in the first quarter included positions in Amazon.com, Nvidia, Akamai Technologies, Equinix and Alcon. Facebook, Walt Disney, Visa, Advance Auto Parts and Anheuser-Busch InBev were the biggest detractors.

In addition to the transactions mentioned above, we also added a position in Alcon in the health care sector.