

ClearBridge

Investments

Large Cap Value Strategy



Robert Feitler
Managing Director, Portfolio Manager



Dmitry Khaykin
Managing Director, Portfolio Manager

Key Takeaways

- ▶ In an extremely difficult period, the Large Cap Value Strategy held up better than its benchmark, exhibiting some downside protection across most sectors.
- ▶ In the turbulent second half of the quarter, stable and highly cash flow generative technology companies and financials with less market and interest rate sensitivity were positive relative contributors.
- ▶ As stewards of our clients' capital, we are focusing on longer-term opportunities while managing through an extremely volatile and uncertain period.

Market Overview and Outlook

The global outbreak of the coronavirus (COVID-19) and the dramatic reduction in economic activity resulting from the unprecedented actions taken to slow its spread led to rapid and severe declines in equity markets in the first quarter. The sharp reversal began in mid-February and marked the end of an 11-year bull market that began on the heels of the Global Financial Crisis. The broad-based S&P 500 Index declined 19.6% in the quarter, while the benchmark Russell 1000 Value Index fell 26.7%.

U.S. equities had reached new highs in February as U.S. manufacturing returned to expansion territory, but the subsequent growth of the virus outside China, combined with a collapse in oil prices in early March, soured investor sentiment broadly. The yield on the U.S. 10-year Treasury dropped from 1.9% at the start of the year to 0.7% at the end of the period as investors fled risk assets and drove the U.S. dollar higher over the period.

Governments around the world responded to the crisis with aggressive monetary and fiscal actions. The U.S. policy response added unprecedented amounts of stimulus to mitigate the effects of the virus on financial markets and the real economy. The Fed undertook several extraordinary measures to help ensure liquidity, facilitate the flow of credit and mitigate the supply shock caused by the virus. Short-term rates were cut to a range of zero to 25 basis points from 175 basis points at the start of the period; a \$700 billion quantitative easing program was introduced; the rates for dollar swap lines among major central banks were reduced; and the period for which banks can borrow at the Fed's discount window was lengthened at reduced rates. To help the

credit markets, the Fed signaled it would act as lender to small and large businesses and would potentially purchase unlimited amounts of government debt.

On the fiscal side, Congress passed a \$2 trillion package, the largest economic stimulus package in U.S. history, a quarter of which will support a Fed emergency lending program that could amplify the effective amount of stimulus to \$6 trillion. The package also extends unemployment benefits, sends money directly to individuals and includes support for small and large businesses.

As the quarter ended, U.S. economic data was only beginning to show signs of severe strain. Lockdowns of cities and countries intended to slow the spread of the virus involved the closure of all non-essential services, largely bringing economic activity to a halt, and raising the probability of a U.S. recession. A record 3.3 million initial jobless claims were filed in the U.S. for the week ended March 21. Consumer sentiment fell to 89.1 from 101 in February, according to the University of Michigan Survey of Consumers. U.S. manufacturing also fell in March, according to the ISM Manufacturing PMI.

Defensive sectors led the Russell 1000 Value Index, with consumer staples and health care both down over 12% and utilities declining 14% in the quarter. In addition to having naturally defensive characteristics, the health care sector benefited from the resurgence of Joe Biden's prospects in the presidential race, and lower likelihood for a radical overhaul of the health care industry.

Meanwhile, the energy sector led the decline (-51%) on the back of a two-thirds collapse in oil prices from \$61 dollars to \$20 dollars per barrel over the quarter. Oil prices initially fell when a price war erupted between Russia and Saudi Arabia, both major oil suppliers. A further and even more dramatic selloff was precipitated by the near simultaneous collapse in demand due to global actions taken to combat the spread of COVID-19. Cyclical areas of the market such as consumer discretionary, financials and materials also lagged. The consumer discretionary sector was particularly impacted by its exposure to hotels, restaurants and leisure, including the cruise ship industry and theme parks.

In an extremely difficult period, the Large Cap Value Strategy held up better than its benchmark, exhibiting some downside protection across most sectors. Over the past 12–24 months, we have modestly reduced the cyclical nature of the portfolio while focusing on higher quality, competitively advantaged franchises trading at reasonable valuations. Specifically, we had sold out of our oilfield services holdings before the most recent oil collapse. Our thinking was that even the largest and most technologically advanced companies such as Halliburton, Schlumberger and National Oilwell Varco are price takers in a highly volatile cyclical

We are focused on the best-run companies that are well-capitalized and can outperform in a wide range of scenarios.

industry. Similarly, we exited Freeport-McMoRan, which while being one of the lowest-cost copper producers, is still operating in a highly commoditized cyclical industry.

We are not shying away from cyclical all together; there is plenty of it within our industrials and financials holdings. We are simply focused on the best-run companies that are well-capitalized and differentiated and that can outperform their peers across a wide range of scenarios. In fact, during the first-quarter selloff, we initiated a new position in Lam Research, a leading supplier of capital equipment used in the semiconductor manufacturing process (semi-cap). The company should benefit from the increasing capital intensity of semi-cap and the favorable long-term demand as the world continues to be more digital and interactive. The semi-cap industry is concentrated among a handful of players and is characterized by high barriers to entry and high switching costs. While capital equipment purchases are highly cyclical, Lam Research's service revenue, representing about 25% of total revenue, provides some level of stability. While short-term fundamentals remain uncertain, the company's strong competitive position and pristine balance sheet position it well to generate significant performance over the long term.

In the turbulent second half of the quarter, stable and highly cash flow generative technology companies such as Microsoft, Oracle, Apple and Motorola Solutions; highly profitable and competitively advantaged consumer discretionary holding Home Depot; and financials with less market and interest rate sensitivity such as Progressive and Marsh & McLennan were all positive relative contributors.

As mentioned earlier, the consumer staples sector held up the best during the selloff, although our underweight hurt us. In addition, some of our positions did not hold up as well as we would have expected, notably Anheuser-Busch InBev, whose macro headwinds, intensifying competitive environment and foreign exchange pressures led us to exit our position. We added Reynolds Consumer Products as it took its profitable portfolio of consumer goods public in January, as well as PepsiCo opportunistically in March; both companies show improving fundamentals and trade at attractive valuations. Similarly, our underweight within utilities contributed negatively to relative performance. Somewhat surprisingly, our utilities holdings were less defensive than we would have expected. We have added to our existing holdings on the pullback.

We had a fair amount of portfolio activity within the communication services sector. We exited Fox and initiated positions in Alphabet and T-Mobile. While Fox remains a unique asset focused on live news and sports, its reliance on advertising and its relatively smaller size puts it in a precarious position versus many of its peers. We've long been admirers of Alphabet's

dominant online search position, high level of profitability, strong cash flow and pristine, even overcapitalized, balance sheet. While also exposed to advertising, Alphabet is a scale player and should be a long-term winner.

T-Mobile's recently completed acquisition of Sprint makes it a scaled wireless carrier with arguably the best spectrum portfolio just as the wireless industry embarks on a 5G rollout. Demand for data and spectrum has been rising rapidly under 4G and that should only accelerate with the development of 5G, a competitive advantage for T-Mobile. While the Sprint integration process could be bumpy in the short and medium term, the deal synergy and scale should result in meaningful free cash flow growth. Meanwhile, T-Mobile's spectrum advantage should enable it to remain a share taker.

During the quarter, our long-term holding Dish Network came under pressure, given its need to fund a wireless buildout and its levered balance sheet. We continue to maintain confidence in the underlying asset value of the business, particularly its vast spectrum portfolio.

These are unprecedented times and it is impossible to predict how things will unfold in the near and medium term. As stewards of our clients' capital, we are focusing on longer-term opportunities while managing through an extremely volatile and uncertain period. To that end, we continue to double down on our highest-conviction holdings, while exiting marginal positions. At the same time, we are keeping a keen eye on new opportunities as we attempt to take advantage of market dislocation.

Portfolio Highlights

The ClearBridge Large Cap Value Strategy outperformed its Russell 1000 Value 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 came from the real estate, consumer discretionary and utilities sectors. The financials, industrials and energy sectors were the main laggards.

On a relative basis, overall stock selection primarily contributed to outperformance, while sector allocation was also positive. In particular, stock selection in the real estate, financials, energy, industrials and consumer discretionary sectors added to relative returns. An overweight to the information technology (IT) sector and an underweight to the consumer discretionary sector were also beneficial. Conversely, stock selection in the consumer staples, utilities and health care sectors and underweights to the utilities and consumer staples sectors detracted.

On an individual stock basis, the largest contributors were Reynolds Consumer Products, Microsoft, Lam Research, Alphabet and AmerisourceBergen. Positions in JPMorgan Chase, United Technologies, Dish Network, Bank of America and Suncor Energy were the greatest detractors from absolute returns in the quarter.

Besides portfolio activity discussed above, during the quarter we initiated a new position in Northrop Grumman in the industrials sector and sold positions in Wells Fargo in the financials sector, Phillip Morris in the consumer staples sector and AT&T in the communication services sector.

Past performance is no guarantee of future results. Copyright © 2020 ClearBridge Investments.

All opinions and data included in this commentary are as of the publication date and are subject to change. The opinions and views expressed herein are of the portfolio management team named above and may differ from other managers, or the firm as a whole, and are not intended to be a forecast of future events, a guarantee of future results or investment advice. This information should not be used as the sole basis to make any investment decision. The statistics have been obtained from sources believed to be reliable, but the accuracy and completeness of this information cannot be guaranteed.

Performance source: Internal. Benchmark source: Russell Investments. Frank Russell Company ("Russell") is the source and owner of the trademarks, service marks and copyrights related to the Russell Indexes. Russell® is a trademark of Frank Russell Company. Neither Russell nor its licensors accept any liability for any errors or omissions in the Russell Indexes and/or Russell ratings or underlying data and no party may rely on any Russell Indexes and/or Russell ratings and/or underlying data contained in this communication. No further distribution of Russell Data is permitted without Russell's express written consent. Russell does not promote, sponsor or endorse the content of this communication.