ClearBridge Investments

Mid Cap Growth Strategy

Brian Angerame
Managing Director,
Portfolio Manager

Derek Deutsch, CFA
Managing Director,
Portfolio Manager

Aram Green
Managing Director,
Portfolio Manager

Jeffrey Russell, CFA
Managing Director,
Portfolio Manager

Key Takeaways

- Since the virus outbreak, we have held many conversations with portfolio companies centered on continuity, financial resources and modified operating plans and have reduced positions with heightened financial risk.
- Our investment process remains focused on thoughtfully financed growth businesses that can endure periods of macro dislocation. Competitive advantages may widen during this extraordinary period of national stress.
- We were active through the extreme volatility, adding to positions and scouring the market for beaten down but attractive new investments.

Market Overview and Outlook

There are times when words feel insufficient to adequately capture thoughts and the enormity of events. The 9/11 terrorist attacks and aftermath were one such instance. Now we are confronted by an invisible foe, COVID-19, which has triggered a pandemic, heightened fears of personal safety and caused a global recession.

The pandemic sparked historic volatility in the first quarter and the sharpest equity selloff since the Global Financial Crisis, likely sending the U.S. economy into recession. Mid capitalization stocks materially underperformed larger stocks from the mid-February market peak and by 7.5 percentage points for the quarter as measured by the Russell Midcap Index versus the S&P 500 Index. This is unsurprising given the "dash for cash." Growth stocks outperformed value stocks across the U.S. stock market spectrum, and in the mid cap world the benchmark Russell Midcap Growth Index (-20%) outperformed the Russell Midcap Value Index by nearly 1,200 basis points.

Several defensive sectors were the best relative performers in the benchmark through a violent period for equities, led by consumer staples (-9.5%), real estate (-10.8%) and health care (-12%). Information technology (IT, -16.7%) also held up better than the overall market. Energy (-53%) was the worst performer, hurt by the start of a price war that sent crude oil plummeting by two thirds to finish March at $20 per barrel. Consumer discretionary (-29.2%) and communication services (-28.2%) also underperformed as consumer spending ground to a halt due to social distancing prevention measures.

Lessons learned from the 2008–09 credit crisis left U.S. financial institutions in better condition after the capital building and stress tests of the past decade. Credit spreads have widened materially, and we anticipate financial institutions will work with debtors as covenants are inevitably breached.

During the market selloff (February 20 – March 31) and for the first quarter, the Mid Cap Growth Strategy outperformed the Russell Midcap Growth Index benchmark by 42 basis points and 170 basis points respectively.

COVID-19 Strategy Actions

ClearBridge Investments invoked its Business Continuity and Operational Risk program mid-March with all systems operating, enabling the Mid Cap Growth team and all supporting employees to function remotely. Our investment process remains constant with a philosophical preference for thoughtfully financed growth businesses that can endure periods of macro dislocation. Competitive advantages may widen during this extraordinary period of national stress.

ClearBridge investment professionals have held a series of conversations with portfolio companies centered on continuity, financial resources (balance sheet) and modified operating plans (revenue disruption, expense mitigation, capital spending, responsibilities to employees and communities.) For the next few quarters, the managements of the companies we hold in the portfolio face materially different "facts" compared with when the investments were originally made.

Portfolio Positioning and Outlook

The impact of the epidemic is highly variable, dependent on end market, supply chain and business model:

- Given our bias for recurring revenue businesses and more conservative capital structures, the Strategy has virtually no direct exposure to several of the most affected industries such as casual dining and gaming.
- As anticipated, many of the "steady Eddie" businesses have held up well, both from an operating and stock market perspective.
- Other stocks proved less resilient either due to i) financial leverage, ii) valuation compression or iii) likely blunted new business momentum. We believe these companies have the financial resources to await a resumption of growth in the core business.

- Most of the companies in the Strategy have moderate-to-middling disruption risk. A few investments benefit from either accelerated behavioral changes (cloud adoption) or consumer stocking (staples). And a few companies have significantly higher risk due to end market exposure (i.e., energy, where the Strategy has modest holdings).
- Most companies in the Strategy are "full speed ahead" on product development and innovation spending. Managements continue to see substantial future opportunities while being careful to plan for inevitable shorter-term disruptions.

Companies with the strongest balance sheets, financial flexibility, pricing power and enduring business models will be in the best shape when we get to the other side.

We were quite active during the quarter, taking advantage of heightened volatility to establish nine new positions. These new additions included Ball Corp., a leading manufacturer of aluminum cans which are emerging as a more sustainable alternative to plastic for beverage packaging; Carvana, a disrupter in the online used car marketplace; Bio-Techne, which develops biotechnology reagents and instruments for the global research and clinical diagnostic markets, including the emerging gene therapy and liquid biopsy markets; PPD, a top five clinical contract research organization with a differentiated lab business, that went public in February; and DocuSign, the industry standard for cloud-based electronic signature and contract management which is in high demand in remote work environments. We also established a position in off-price retailer Burlington Stores, replacing competitor Ross Stores, whose market value rose out of the portfolio's upper capitalization range.

In addition to Ross, we eliminated four other positions, several with heightened financial risk or operating challenges (including FLIR Systems in the IT sector and Alaska Air Group in the industrials sector). We exited LogMeIn in the IT sector ahead of its acquisition by private equity buyers.

We anticipate a volatile and bumpy market ahead. While stocks have rebounded somewhat off the March lows due to policy responses, news over the next few months (infections, mortality, unemployment, company revisions, bankruptcies) will be predominantly somber and sobering.

The recent events and market volatility have most often been described as "unprecedented," while all market participants imagine what the world will be like "when we get to the other side." We do not know how long it will take us to get to the other side, nor do we know for certain what, if anything, will be different when we get there. We are highly confident, however, that companies with the strongest balance sheets, financial flexibility, pricing power and enduring business models will be in the best shape.

Portfolio Highlights

The ClearBridge Mid Cap Growth Strategy outperformed its Russell Midcap Growth Index benchmark during the first quarter. On an absolute basis, the Strategy had losses across the 10 sectors in which it was invested (out of 11 sectors total). The consumer discretionary, health care and industrials sectors were the primary detractors from returns during the quarter.

In relative terms, the Strategy outperformed its benchmark driven by stock selection and sector allocation. The leading contributor to relative results at the sector level was IT due to stock selection. Overweight allocations to the health care and real estate sectors were also beneficial. Conversely, stock selection in the consumer staples sector detracted the most from relative returns. Stock selection in health care also weighed on relative returns.

On an individual stock basis, Chewy, Atlassian, Citrix Systems, SBA Communications and Fortinet were the largest contributors to absolute performance during the first quarter. The greatest detractors from absolute returns were positions in US Foods, Jones Lang LaSalle, Aptiv, Syneos Health and Martin Marietta Materials.

In addition to the stocks mentioned earlier, we added positions in Monolithic Power Systems in the IT sector, Americold Realty Trust in the real estate sector and Insulet in the health care sector. We also closed a position in SmileDirectClub in the health care sector.