ClearBridge Investments

Multi Cap Growth Strategy

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Key Takeaways

- The coronavirus outbreak sparked a monolithic asset liquidation that led to the most oversold equity market in close to 40 years.
- We used the spike in volatility to consolidate and reposition the portfolio, establishing a new position in health care and adding to several others across information technology and communication services.
- While many stocks and sectors appear cheap, we want to own companies with strong market positions, balance sheets and free cash flow to weather the economic downturn and fund growth once normal business resumes.

Market Overview

Stocks suffered a waterfall decline in the first quarter as the spread of the coronavirus pandemic, combined with the outbreak of an oil price war, sparked historic volatility and ground parts of the U.S. economy to a halt. The S&P 500 Index dropped 19.60% for the quarter, its worst three-month decline since 2008, while the benchmark Russell 3000 Growth Index fell 14.85%. Growth stocks held up better than value shares with the growth benchmark outperforming its value counterpart by a substantial 1,247 basis points.

A breakdown in talks between OPEC and Russia over cutting crude oil production caused Saudi Arabia to cut prices in a period of severely reduced global demand, sending commodity markets sharply lower. Energy (-54.73%) was the worst performer in the benchmark, as oil plummeted 66% to end the first quarter at $20 per barrel.

Information technology (IT, -11.68%) was the best relative performer among sectors with a significant presence in the benchmark as mega cap growth stocks held up better than the rest of the market. Real estate (-12.36%), health care (-13.15%) and communication services (-14.08%) also held up relatively well.

We have managed through many periods of extreme volatility and economic disruptions. While each period has elements that make it different than others, there are analogies to today in three distinct markets where investors had never seen such a downturn before: the crash of 1987, the bursting of the Internet bubble and the Global Financial Crisis. Unlike those other bear markets, what

is happening economically today is something unique: an exogenous event that has mandated the shutdown of economic activity that likely has pushed the U.S. into recession.

In terms of many sentiment measures, the March decline resulted in the most oversold market since 1983. While that does not mean the levels seen in late March will not be breached or retested at a later date, it does indicate that the initial market lows were most likely seen. The market is now discounting an enormous economic slowdown (the scale and duration of which are still to be determined) and the Fed and the government are taking significant action to support individuals and corporations.

We are encouraged by the policy responses so far. The Fed did something extraordinary with its expansion of quantitative easing and stepped up purchases of fixed income securities to ensure close to unlimited liquidity throughout the financial system. The Fed has assured investors that it can and will do more to ensure orderly markets. Few remember that after Black Monday in 1987, the Fed discussed the possibility of purchasing index futures to prop up stocks. The $2.2 trillion fiscal stimulus package passed by Congress is also crucial to getting consumers and small businesses through the downturn.

The decline in March was fueled in part by emotional selling and deleveraging of certain vehicles and was exaggerated by a buy side vacuum. We used the volatility to take a new position in Guardant Health, a leader in liquid biopsy used for therapy selection and early-stage cancer detection. Guardant is poised to benefit from the increased focus and spending on diagnostics. Health care stocks, especially biopharmaceutical companies, should be well-positioned in the current environment given their lack of economic sensitivity and the obvious need for investment in innovation, especially in prediction and prevention of diseases. We expect drug companies will be part of the solution to find a vaccine and treatment for the COVID-19 virus now ravaging many parts of the country and the world. Such a discovery would highlight the scientific breakthroughs and new therapeutic treatments that have caused us to be overweight the health care sector for some time.

In the midst of the indiscriminate, waterfall selloff, many companies with leverage have fallen the hardest, regardless of liquidity or interest coverage ratios. For example, communications chip maker Broadcom sold off despite generating $13 billion of operating cash flow per year and $9 billion of free cash flow. We now have global coordinated monetary and fiscal easing, and the market is discounting an economic/credit scenario that could be much worse than reality. We remind investors that economic conditions and balance sheets before the decline were quite strong.

Additionally, some of our media holdings declined due to the near-term reality of fewer live events and sports and pressure on advertising budgets. What is overlooked is many of these businesses are well-positioned for an environment of increased content consumption and broadband demand. Unless we go into a sustained recession, many media stocks are at valuation levels that are draconian in terms of cash flows and business conditions. We expect consolidation and emergence as private equity investors may monetize some of these public market dislocations.

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In our universe, many companies appear inexpensive relative to their intrinsic value. During a time like this, where economic uncertainty is unprecedented, it's essential to be knowledgeable, patient business owners and focus on a company's financial strength. Individuals' behaviors will change as a result of this crisis, some temporarily and others more permanently, and our goal is to seek out long-term winners. Near term, the market has not yet been selective, but we want to own companies with unique and dominant franchises and free cash flows to fund growth once normal business resumes. We could be close to a bottoming period, but do not believe the markets will necessarily turn on a dime. Markets rallied to close the quarter but they could retest the lows hit on March 23. We have seen that happen in the past. This is a time we will look to upgrade portfolios with both additions to existing holdings and opportunistic new investments in companies we view as long-term winners.

Portfolio Positioning

Mega caps have held up surprisingly well, especially in the areas of IT and communication services that led the way through the latter part of the 11-year bull market that came to an end in March. While stock selection in IT was a detractor for the quarter, we continue to like beneficiaries of long-term, device-agnostic trends like Broadcom, that supplies components, infrastructure, and security, and Seagate Technology, which is a leading participant in the growth of memory and demand for storage in the cloud and operates in a virtual duopoly with Western Digital.

In communication services, Twitter has been unfairly punished around fears of event cancellations, glitches in its targeting software and management credibility. Yet the company's accelerating engagements and growing cash flows have sparked the interest of activist investors who are attracted to a unique business that could either be monetized by a large media company or by continued growth in users and engagement. We added to our position during the volatility as Twitter's variable cost structures and insurance policies will help weather event cancellations. We also added to our position in cybersecurity firm FireEye.

We closed a position in Fluor, a global engineering and construction firm serving the energy, chemicals, mining and related industries, after the company delivered a negative fourth quarter financial update. In the update, the company revealed eight to 10 projects with significant cash outflows expected over the next two years, an SEC investigation into past accounting and a delay in reporting fourth quarter earnings and its annual 10K filing. Additionally, the planned sale of the company's government business was cancelled, which would have strengthened the balance sheet. Given the recent degradation of fundamentals and uncertainty created by recent macro developments, we believe any turnaround will take significantly longer than expected and used the sale proceeds as source of funds in areas where we have higher conviction.

Outlook

Major shakeouts in the stock market have typically resulted in a broadening out of contributors and leadership change. We expect new leadership in a rebound rally. Comcast's broadband business, for example, could explode higher as a result of the increased demand for connectivity and consumption. Health care should become the leader in long-term investment for innovation and scientific breakthroughs. If doctors and labs can start to screen, detect, and prevent certain diseases, this will reduce spending on late-stage patients. We believe this will help catalyze behavioral change in the market dynamic and investor focus on health care. Incremental investor money has been placed in risk-averse areas like remote connectivity and cybersecurity, where we hold Citrix Systems and FireEye, a long-term trend that was emerging and will accelerate in this stay-at-home environment. Some companies will see long-term benefits from this increased focus on new technology.

We are in a position to buy great businesses right now at some of the best risk/reward opportunities in years. We expect an uptick in consolidation, increased focus on balance sheets and cash flows and new paradigms in terms of investor behavior. The magnitude of the market's decline has priced in a worst-case scenario for a lot of businesses. The fear is an extended recession for months, but we believe we have enough stimulus for the economy to stabilize after the initial decline and eventually have a significant rebound.

Right now, we're in the heart of the uncertainty; this is a health crisis that requires a massive policy response. For our companies, the goals are to tighten their business and preserve liquidity. We expect distress in any company with debt but many of our holdings with robust free cash flow like Discovery and UnitedHealth Group have been disproportionately hurt in the selloff. The economy is likely to experience one of its more severe downturns in the second quarter yet many of our companies

came into the coronavirus outbreak very lean. We believe they are well-positioned to potentially make some bigger deals coming out of the downturn and gain permanent market share. Market crashes like this one come along roughly every decade and as active managers with the orientation of long-term business owners, we view the current conditions as a chance to differentiate the Strategy for the foreseeable future.

Portfolio Highlights

The Multi Cap Growth Strategy underperformed its Russell 3000 Growth Index benchmark in the first quarter. On an absolute basis, the Strategy had losses across the seven sectors in which it was invested (out of 11 sectors total). The primary detractors from performance were in the IT and communication services sectors.

Relative to the benchmark, overall sector allocation contributed to performance but was offset by negative stock selection effects. In particular, stock selection in the IT, communication services and materials sectors and an overweight to the energy sector detracted the most from results. On the positive side, stock selection in the health care and industrials sectors and an overweight to health care drove relative performance.

On an individual stock basis, positions in Citrix Systems, Vertex Pharmaceuticals and Biogen were positive contributors to absolute returns during the period. The largest detractors included Comcast, UnitedHealth Group, TE Connectivity, Twitter and Western Digital.

During the quarter, in addition to the transactions mentioned above, we closed a position in LogMeIn in the IT sector ahead of its acquisition by private equity investors.