ClearBridge Investments

Select Strategy

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Key Takeaways

- When equity prices decline rapidly and indiscriminately due to heavy selling pressure from algorithmic traders — as they did in the first quarter — it provides an incredible setup for the Strategy to drive long-term outperformance.
- Our fundamental de-risking approach is in overdrive right now and we are speaking with all portfolio companies which could have business or balance sheet stresses.
- We took advantage of record volatility to target temporarily mispriced software and newly public companies as well as stocks unduly hurt by negative sentiment toward discretionary industries.

Market Overview

Stocks suffered sharp losses in the first quarter as the coronavirus outbreak sparked fear and record volatility. Investors assessing the damage to companies and the economy from social distancing and stay-at-home orders retreated to the relative safety of larger cap companies with the S&P 500 Index down 19.6% and the benchmark Russell 3000 Index 20.9% lower while the small cap Russell 2000 Index plunged 30.6%. Growth stocks held up better than value stocks with the Russell 3000 Growth Index (-14.9%) outperforming its value counterpart by more than 1,200 basis points. We think this broad shift creates opportunities for active managers like ourselves who, in addition to owning some large cap stocks, tilt toward higher-risk small and mid cap companies.

We came into the steep decline more worried about overall market valuations as seen by our decrease in information technology (IT) exposure over the last 18–24 months. We have also been slower to redeploy capital from companies acquired out of the portfolio as evidenced by our higher than average cash position. Despite the repositioning of the past several years, IT continues to represent the Strategy's largest exposure, which proved beneficial during the first quarter downturn as the sector (-12.8%) offered more resilience than any other in the benchmark.

The Select Strategy performed well in the first month and a half of 2020 and then protected well on a relative basis during the early part of the selloff. Given our tilt toward small and mid cap stocks, combined with indiscriminate selling that favored safety sectors including utilities and consumer staples, the Strategy underperformed the broad market during the second stage of the selloff in the middle of March yet held up better than the benchmark overall for the first quarter.

We have spoken to clients about the "dying breed" of fundamental investors and when prices decline this rapidly due to heavy selling pressure from macro/quant funds, it provides an incredible setup to drive long-term outperformance, as we have done post prior market slumps.

Before we make any investment, we spend a disproportionate amount of time on the risks. This is a key part of our management and business evaluation. We also stress test our assumptions under various arduous scenarios to make sure that the companies we own will survive a downturn or any exogenous shocks that come their way. As much as we plan for an inevitable shock to emerge, when more is known about the specific challenge companies are facing, it's critical to re-engage with our management teams to probe on these new circumstances. We believe it's paramount not to be anchored to a single thesis if the facts change and with them potentially the risk/reward. Furthermore, we also have to be cognizant as other opportunities with potentially better value propositions develop.

Our fundamental de-risking approach is in overdrive right now. We are speaking with all portfolio companies which could have business or balance sheet stresses. Companies with strong balance sheet and cash flow strength and forward-looking management teams will do what they need to do to protect in the crisis as well as also invest in the future through new product innovation, retention and future leadership development, coaxing strong talent from competitors, and winning mindshare with customers. This positions our companies to not only ride out the wave of recovery but also go on offense and take market share and mindshare from weaker players.

Portfolio Positioning

We have been spending time looking for new opportunities and we're seeing the majority of promising ideas in three areas: software, newly public companies and quality businesses that have been unduly punished in the selloff.

Enterprise software companies are emblematic of the companies we target as they fulfill a deep need with an innovative solution. These stocks fall into the disruptors category of fast-growing companies taking share or creating new markets through innovative business models, which represents the portfolio's largest exposure. DocuSign, for example, enables remote transactions and business without the need to have physical documents and has been a strong performer during the downturn as a provider of essential software to conduct business remotely. We originally invested in DocuSign in 2015 as a private company, added to the position on the IPO and increased our weighting several more times when investors were skeptical of the company's addressable market and competitive positioning. Such services are in high demand right now due to stay-at-home directives and we expect this will only increase going forward.

Information security is another emerging opportunity due to the shift to remote work and the need for mobile devices to access enterprise systems. Here we are seeing strong performance from companies like firewall provider Fortinet as well as Qualys and Splunk, a new purchase in the first quarter, which help companies manage and monitor cloud applications and other functions.

Many companies newer to market in the last six to nine months have fallen the most during the selloff due to lack of familiarity. Stocks such as data analytics provider DataDog, social media management platform Sprout Social and laser and semiconductor developer nLight are trading at deep discounts to similar peers for no other reason than they are not yet proven entities in the public markets. We've been adding to those names, many of which we consider evolving opportunities, a category of temporarily mispriced companies with positive long-term catalysts.

We are also evaluating companies in the heart of the crisis caused by social distancing that has led to spending reductions or outright shutdowns. Some of these businesses are more cyclical or in areas like ridesharing or travel where stocks are down 60%–70%. We want to own stocks here that have highly variable cost structures supported by strong balance sheets, can maintain if not build on their leadership position and are trading at valuations that imply a much worse outcome over the next few years. Companies like new addition XPO Logistics, a leader in trucking and freight services, are poised to be secular winners in cyclical industries. We also expect revenues to snap back quickly when normalcy returns for stocks like Uber, Expedia and Lowe's.

We were active sellers during the volatile first quarter as well, with 13 companies leaving the portfolio. Music streaming service Spotify held up very well early in the selloff but we saw more risk in the stock than was appreciated by the market and sold the position before it eventually derated as more headwinds to the business became apparent. We also exited IT names Interxion Holdings, ForeScout Technologies and LogMeIn ahead of acquisitions.

Hedging costs spiked measurably during the quarter, causing us to reduce our already small exposure to the alternatives category by closing several short positions with gains.

Outlook

We still believe asset-light businesses (e.g., software) are advantaged given pristine balance sheets and recurring revenues with high gross margins. We remain skeptical of deep cyclicals given there are too many unknowns, and without GDP growth or government intervention have fewer levers to pull on to navigate very choppy waters.

We are monitoring several systemic risks right now to gauge an eventual return to normalcy. We need to see the number of active virus cases start to plateau and come down and health care systems congestion abate. Corporate and government support will also be critical to mitigate the pain for small business and the unemployed and get people back to work as soon as it's safe. As for the market, equity volatility needs to continue to decline and credit spreads start to shrink. We are encouraged by the return of corporate debt deals to the market after being completely shut down for several weeks.

Portfolio Highlights

The ClearBridge Select Strategy outperformed its Russell 3000 Index benchmark for the first quarter. On an absolute basis, the Strategy had losses across all 10 sectors in which it was invested during the quarter (out of 11 sectors total). The materials, communications sectors and energy sectors held up the best while the main detractor from performance was the consumer discretionary sector.

In relative terms, the Strategy outperformed its benchmark due to sector allocation. An overweight to the IT sector, underweights to the energy and financials sectors and positive stock selection in the real estate, industrials and IT sectors contributed the most to relative performance during the period. On the negative side, stock selection in the consumer discretionary and health care sectors detracted the most from results.

On an individual stock basis, the largest contributors to absolute returns during the first quarter were DocuSign, Shopify, BJ's Wholesale Club, Fortinet and Zynga. Positions in Syneos Health, Cardtronics, Advance Auto Parts, Surgery Partners and Crocs were the greatest detractors from absolute returns.

In addition to the transactions mentioned earlier, the Strategy initiated a handful of new positions, the largest being Digital Realty Trust in the real estate sector, Nvidia in the IT sector and Monster Beverage in the consumer staples sector. We also closed several more positions, most notably in Bank of America in the financials sector and Alexion Pharmaceuticals in the health care sector.