ClearBridge Investments

Small Cap Strategy

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Key Takeaways

- The market's negative reaction to the spread of the coronavirus and its destructive effects on economic activity hurt small cap stocks in particular.
- We have responded to the crisis by reducing our exposure to travel companies and increasing portfolio quality.
- We continue to believe in our investment process and remain fully engaged amid the market turbulence, seeking to take advantage of recent equity volatility to set up the portfolio for better future risk-adjusted returns.

Market Overview and Outlook

The market's negative reaction to the spread of the coronavirus and its destructive effects on economic activity hurt all equities in the first quarter, small cap stocks especially, with the benchmark Russell 2000 Index falling 30.6%. Due to a confluence of factors, including being poorly positioned for the events and having some bad stock calls at an unfortunate moment, the Small Cap Strategy underperformed materially. These are highly stressful and uncertain times for investors and the world as we grapple with a global pandemic. Of course, we don't know when the coronavirus situation will resolve, how deep the economic impact will be, or how our lives will change on the other side. However, we continue to believe in our investment process and remain fully engaged amid the market turbulence, seeking to take advantage of recent equity volatility to set up the portfolio for better future risk-adjusted returns.

The Strategy bookended the eventful quarter with disappointing monthly relative performance in January and a major disappointment for our largest holding, Amarin, on the last day of March. In between, there was the coronavirus-induced plunge and the start of an oil price war. We closed 2019 more tilted toward value stocks than ever before, as our valuation discipline took us away from high-growth stocks. However, growth strongly outperformed value in January (Russell 2000 Growth Index, -1.1%, versus the Russell 2000 Value Index, -5.4%) and continued to do so in March, as many of the high-multiple software and health care stocks happened to be highly suited to social separation and emergency health needs. At the same time, Saudi Arabia began aggressive oil production to reduce oil prices, blasting already struggling U.S. energy stocks, a meaningful component of the Russell 2000 Value Index. The quarter ended with growth

outperforming value by 9.9%, inflicting broad, portfolio-wide damage. Then to top it all off, Amarin received an extremely surprising and negative ruling from the District Court of Nevada that ruled all of its patents invalid because the invention was deemed "obvious" at the time of patent filing. Needless to say, we strenuously disagree and believe that Amarin has a very good chance of having the ruling overturned in appeal, but this one alone cost the Strategy over 175 basis points in the quarter.

Levels of uncertainty are off the charts about everything, from when we can plan to hold events again to whether we have enough basic supplies to whether we are going to catch COVID-19. The stock market has reflected this uncertainty, demonstrating panic selling, a rush to buy the few companies that appear to benefit from the situation and radically increasing discount rates as investment time horizons collapse.

Fear and flight to safety are completely normal and rational reactions to the current situation. The coronavirus has thrust us into the lowest levels of Maslow's hierarchy of needs, where needs are most basic. We are investing an enormous amount of time and attention in making sure our food supply is secure, our rent can be paid during the sharpest economic downturn in history, our risk of infection is low, etc. Those not properly prepared for an extended drought in cash flow are liquidating stocks at any price, although many appear to have planned appropriately for this interruption and don't need immediate liquidity.

Our investment process calls for us to think about the long-term value of corporations. We always allow for the "black swan" scenarios that can upend our forecasts by avoiding forecasting, instead valuing companies in a probabilistic way that includes a wide cone of possibilities. We may conclude that a stock, say ABC Corp, is worth between $25 and $200, with an average value of $70 when it's trading at $50. Clients occasionally express surprise that the ranges are so wide, but our experience is that the 90% confidence interval of that magnitude (where uncertainty requires a wide range of possibilities) is justified by real-world outcomes. Today, that cone of uncertainty is not wide enough in many industries.

So here we are, having secured our basic needs and looking at the carnage in the market. What to do? The stock market is virtual — no human contact required — and never runs out of inventory, but prices are marked according to demand, with no rules on price gouging. Imagine if the real world were like that. At your local convenience store, hand sanitizer might be available but selling for $20 an ounce, while non-essential items like perfume might be discounted 40%. If you have the means, it's a good time to buy perfume. If you are willing to book a cruise or a trip to Hawaii with non-refundable cash right now, you can get a great deal. The prices are extremely low if the trip is a month from now, when travel may still be restricted, and rise as the timeline extends.

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The market is in a similar condition. Companies with high levels of leverage, indicating less time afforded for things to get back to normal before insolvency, have seen huge stock-price drops. Others with longer timelines but low relevance now have similarly seen big reductions. Companies that appear to benefit from the situation have skyrocketed to levels difficult to justify on estimates of future cash flow. The speed of this realignment has been stunning, creating many disconnects between perceived risk and actual risk.

We have responded to the crisis by reducing our exposure to travel companies and increasing our quality. For example, we cut our position in SkyWest, a regional carrier that takes no load, price or fuel risk, but does depend on flights flying. We sold OneSpaWorld, a cruise-line-based spa company. We bought a former holding, CSG Systems, which has little debt and serves the back office for cable, telecom and streaming services that are seeing growing usage. We also bought International Seaways, a tanker company that is seeing very high day rates, as a market already short of oil tankers is also being used for excess oil storage.

History suggests that this period will end up being a great time to buy certain risk assets. Without question, this crisis is different from any other in our lifetime, exerting enormous stress on the global economy for an indefinite amount of time. It is critical to take those factors into account and be prepared for a long disturbance in normalcy. There will be an end, however, and stocks that make it to the other side will again be priced on long-term potential. We continue to hew to our investment process and seek to diversify in as many ways as we can.

Portfolio Highlights

The ClearBridge Small Cap Strategy underperformed the Russell 2000 Index, the Strategy's benchmark, during the 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 from the Strategy's performance were the consumer staples, materials and utilities sectors. The financials, health care, consumer discretionary and industrials sectors were the main laggards.

On a relative basis, the Strategy underperformed its benchmark primarily due to stock selection. In particular, stock selection in the health care, financials, information technology (IT) and consumer discretionary sectors detracted the most from relative returns. Meanwhile, stock selection in the materials, consumer staples and energy sectors contributed positively to relative performance.

On an individual stock basis, International Seaways, Akebia Therapeutics, NIC, Sprouts Farmers Markets and CommVault Systems were the largest contributors to absolute performance. Amarin, SkyWest, Summit Hotel Properties, Aaron's and Gray Television were the greatest detractors from absolute returns.

In addition to portfolio activity discussed above, during the quarter we initiated several new positions, among them, Physicians Realty Trust in the real estate sector, Health Catalyst and Amicus Therapeutics in the health care sector and Switch and TTEC Holdings in the IT sector. Positions closed included Cadence Bancorporation in the financials sector, PotlatchDeltic in the real estate sector, U.S. Concrete in the materials sector and Patterson-UTI Energy and U.S. Silica in the energy sector.