ClearBridge Investments

SMID Cap Growth Strategy

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Key Takeaways

- A coterie of companies with products and services advantaged or accelerated by the COVID-19 shutdowns and likely long-term evolutions of work-from-home policies and e-commerce were stellar performers.
- We continue to closely evaluate existing holdings and source new ideas, sticking with fundamentally sound businesses having the balance sheets to endure through short-term disruptions and using volatility to add stocks well exposed to secular growth trends.
- Companies have adapted rapidly to protect their employees' safety, serve clients, thoughtfully address community responsibilities and ensure capital adequacy.

Market Environment

This past quarter proved how little anyone can accurately predict overall macroeconomic and concurrent financial market dynamics in advance. A severe recession, with a horrific spike of the national unemployment rate to the mid-teens, was blunted by massive policy response to support incomes. The overall U.S. market rallied remarkably, much to the surprise of many commentators and experienced investors, from a record speed bear market bottom in mid-March.

The COVID-19 (C-19) pandemic, barely on the U.S. horizon at the turn of the year, engulfed us during the first quarter with widespread mobility restrictions, the best-known tactic to battle the invisible foe. While the trend of C-19 importantly buffeted markets and management actions during the most recent quarter, the movement for social justice and improved economic equality was the bigger pivot that emerged during the second quarter.

During the second quarter, the aphorism that "it's a market of stocks, not a stock market" became abundantly clear. While the overall market rose sharply, dispersion widened considerably.

Another hallmark of this past quarter was the voracious capital market raising by U.S. corporations, whether in the fixed income, convertible or equity markets. For established issuers, we view these capital raises as "single premium term life insurance" which leads to relatively minor dilution to ensure long-term survival. We're onboard with these capital raises given a very uncertain disease progression and recovering financial market prices.

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Energy (+62.3%) was the best-performing sector in the benchmark, boosted by a more than 90% rebound in crude oil prices as OPEC+ agreed to additional production cuts to cope with depressed demand due to the pandemic. The consumer discretionary (+47.6%) and information technology (IT, +40.7%) sectors also outperformed. The SMID Cap Growth Strategy's stock selection in and overweights to both sectors proved beneficial during the quarter. More defensive real estate (+16.6%) and consumer staples (+17.5%) lagged the index in an environment of abundant liquidity most conducive to long-duration growth assets.

On the simple differentiation between growth and value, growth stocks outperformed by about 12 percentage points as measured by the Russell 2500 Growth Index versus its value counterpart. Sectoral relative performance was also wide. Various custom indexes and structured offerings highlight the stark performance difference between "work-from-home (WFH) stocks," "stay-at-home stocks," "initial reopening stocks" and more secularly challenged businesses. Factors also had influence with growth/momentum dominating most days, but occasionally value stocks had their moment to shine.

Performance Overview

A coterie of companies with products and services either advantaged or accelerated by the C-19 shutdowns and likely long-term evolutions of WFH policies were stellar stock market performers as near-term earnings and growth prospects accelerated. About 35% of the portfolio's assets fall into this category. Examples include technology providers DocuSign and Smartsheet and BJ's Wholesale in consumer staples.

E-commerce became the exclusive way for many consumers and businesses to buy and sell during the lockdown period, with stocks enabling or leveraging online sales among the portfolio's best performers. Wix, which provides software tools for small businesses to establish a commercial website and e-commerce capabilities, reported accelerating business trends on its first-quarter earnings call, partially the result of COVID-19. Small and medium size businesses recognize the need for a web presence, so registered users accelerated in recent months with good conversion to paid subscribers, reduction in churn from the existing subscriber base, as well as accelerating transactions on Wix's payment platform. Etsy, meanwhile, which operates an e-commerce and sales support platform geared to entrepreneurs and other small merchants saw accelerating sales growth in recent months, supported by the company nimbly updating search algorithms and calling on sellers to produce more in-demand items. MercadoLibre is the leading e-commerce portal serving Latin American markets. The company experienced a

material acceleration in transaction volume across its platform while a variety of its financial services offerings have also seen accelerated adoption.

A larger swath of the equity market has had modest to severe impact. And a bankruptcy wave is coursing through a number of industries (energy the most visible example) as companies were ill prepared from the perspective of financial structure for the C-19 shutdowns and macro demand shocks that ensued.

Some of our weaker second-quarter performers were in the epicenter of the social distancing and shelter-at-home restrictions that have closed many businesses and led to the cancellation of sports, concerts and other large public gatherings. Live Nation Entertainment has seen a sharp drop in ticket sales and advertising revenues during the lockdown. We maintain confidence that the concert promoter and ticket retailer will come back strong due to its solid balance sheet and better positioning than competitors. Core-Mark Holding, a supplier to convenience stores in the U.S. and Canada, was impacted by store closures and restricted access for its client base. Longer term, the company maintains a leading position in the convenience store market that in a normal recessionary period sees resilient sales.

Portfolio Actions

We made three new investments during the second quarter across IT and health care. Black Knight enjoys a near monopoly in mortgage software, as the only end-to-end provider across "homeownership lifecycle." The company's value add is its ability to streamline the highly regulatory/clerical aspects of the mortgage process, which has been amplified post-the financial crisis. Its product is an industry standard, which helps customers automate and reduce costs around mortgage servicing. Mimecast is the best positioned offering in email safety and has plenty of runway for growth given its low penetration in existing markets (about 7%) and growing opportunity in new markets. Mimecast's proprietary operating system is a key differentiator, which comes with a lower cost of ownership, ease of implementation and seamless third-party integrations.

Hologic is a diagnostics and medical device company focused on women's health. Its molecular COVID-19 test for active infections will likely more than offset short-term disruption of the base business. We view the company as one of the most attractive ways to capture upside from testing demand while providing downside protection through a base business that should steadily recover off April lows.

Easily overlooked in strongly positive periods like the last three months is the need to be a disciplined seller when our thesis for owning a stock is not playing out at the pace we expected. This was true of Advance Auto Parts, which we exited as its margin turnaround and store productivity story has been pushed out again. Restaurant review and directory website Yelp was sold due to pressures on its local advertiser base, concerns on sales force execution and management churn. We also liquidated Sensata Technologies due to significant revenue growth deceleration at the developer of industrial sensors and controls and to fund other purchases in the portfolio. In addition, we closed a position in WisdomTree Investments due to ongoing struggles to generate net positive flows in its ETF business.

Outlook

Overall, companies have adapted rapidly to 1) protect their employees' safety, 2) serve their clients, 3) thoughtfully address their community responsibilities, and 4) ensure their capital adequacy. The vibrancy of the economic recovery will depend on the re-absorption of furloughed workers, with an average of 70% of layoffs over the past three months being classified as temporary job losses.

We persist in a market predominantly concerned with top-down drivers, with investors awaiting clarity on C-19 treatments and a vaccine. If we don't get substantial progress, equities are vulnerable to setbacks. The presidential election five months away poses uncertainty as policy positions and priorities of the candidates appear very different. If we get better news on virus treatments and continued progress on a vaccine, workers will be brought back off furlough and the economy should recover nicely. That has implications beyond the consumer as equities do not look stretched if we see a strong recovery.

Portfolio Highlights

During the second quarter, the ClearBridge SMID Cap Growth Strategy outperformed its Russell 2500 Growth Index benchmark. On an absolute basis, the Strategy had gains across eight of the 10 sectors in which it was invested during the second quarter (out of 11 sectors total), with the IT and consumer discretionary sectors the leading contributors.

In relative terms, stock selection was the primary driver of performance while sector allocation was also beneficial. Specifically, stock selection in the IT, consumer discretionary and industrials sectors and an overweight to consumer discretionary had the most significant positive impacts on results. Conversely, stock selection in the health care sector detracted the most from relative performance.

On an individual basis, the leading contributors to absolute returns during the second quarter were Etsy, Wix.com, DocuSign, MercadoLibre and Carvana. Meanwhile, Live Nation Entertainment, Core-Mark Holding, Advance Auto Parts, Summit Materials and WisdomTree Investments were the largest individual detractors from absolute returns.