ClearBridge Investments

Aggressive Growth Strategy

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Key Takeaways

- Momentum continued to dominate performance in a snapback rally, expanding the widest dispersion between growth and value investment styles since the bursting of the dot.com bubble in early 2000.
- Communication services and health care were detractors for the quarter but are positioned to benefit long-term from changes caused by the COVID-19 pandemic and an increase in M&A activity.
- We have made meaningful moves over the last year to concentrate the portfolio in our highest-conviction ideas and better participate in a number of secular growth trends.

Market Overview

Equities staged a vigorous rebound in the second quarter, boosted by abundant liquidity from aggressive stimulus measures that helped narrow most of the losses suffered in the COVID-19-induced downturn. The S&P 500 Index delivered its best 50-trading day performance in history from bear market lows in late March (+39.6%) and finished up 20.5% for the quarter, its strongest showing in 22 years. Momentum and growth once again led the way, with the benchmark Russell 3000 Growth Index soaring 28% during the quarter to finish the first half up 9%. The growth index outperformed its value counterpart by more than 1,300 basis points (bps) for the quarter and is ahead over 2,550 bps year to date. The market has not seen such dispersion between investment styles since the late 1990s into early 2000 (Exhibit 1).

Exhibit 1: Russell 3000 Growth vs. Value Over the Last 25 Years

As of June 30, 2020. Source: Bloomberg, ClearBridge Investments

The ongoing dominance of the mega cap and momentum trade has created challenges from a relative performance standpoint but it has not dissuaded us from an approach that has created long-term value for our shareholders over nearly four decades. The Aggressive Growth Strategy underperformed in the second quarter because, with an active share of about 96%, the portfolio looks very different from the benchmark. As long-term business owners, we seek to buy and hold attractively priced, profitable growth companies with high levels of free cash flow across the market capitalization spectrum. This creates a portfolio with a weighted average market cap of $60 billion compared to over $400 billion for the Russell 3000 Growth Index. The valuation discount of our holdings versus the index also remains among its widest in 20 years across most metrics, including forward price/earnings and price/sales ratios.

In the second quarter, stock selection within communication services was a primary detractor from performance. Twitter and Discovery saw strong engagement driven by stay-at-home consumer activity while Liberty Broadband and Comcast benefited from growth in high-speed broadband connections into homes. However, these strengths were more than offset by lower advertising spending due to a lack of live events and sports as well as increased cord cutting. The medium-term underperformance of programming companies AMC Networks and Discovery leaves both stocks with record-high free cash flow yields and record-low valuations. Longer-term, these gaps between public and private market values could lead to multiple expansion as well as the potential for M&A or leveraged buyout activity. We expect advertising growth to resume ahead of a broad economic recovery, aided by the return of live sports, which should provide a boost to the sector. Additionally, many programmers are now expanding internationally and bringing content direct to consumers through streaming platforms to capture a higher degree of the economics.

Our IT exposure is focused on the long-term themes of 5G, digital storage, cybersecurity, electric vehicles and speech recognition.

The Strategy's health care exposure was also a headwind to relative results, a recurring situation for most of the last five years due to fears over prescription drug pricing and broad government health care reform. The primary laggard in the second quarter was Biogen, our largest health care holding, which traded lower due to a court ruling that ruled its patent for multiple sclerosis treatment Tecfidera invalid. The decision comes after the company won a similar patent judgement in the first quarter. The Tecfidera patent has been challenged repeatedly and will now go to a Federal appeals court. The larger catalyst for Biogen remains aducanumab, its experimental Alzheimer's treatment that it expects to file for FDA approval this quarter.

We believe the innovative drugs being developed by Biogen, Vertex Pharmaceuticals and smaller holdings like gene therapy pioneers Voyager Therapeutics and Ultragenyx Pharmaceutical will ultimately be recognized for their ability to treat unmet needs earlier in disease progression, which can lead to significant cost savings in a health care system struggling with soaring costs. We expect the sector to resume leadership as a main driver of solutions to the COVID-19 crisis, including the need for more investment in early detection of disease by companies such as portfolio holding Guardant Health and prevention through vaccines to avoid future crises. The global pandemic also highlighted the need for greater investment to move critical components of the health care supply chain back to the U.S.

The IT and Internet segments are where we look most different from the benchmark due to our lack of exposure to the mega cap FAANG stocks and more recently, the high-multiple momentum names that surged in the second quarter as the Fed rewarded the market with liquidity. We have always believed that the primarily consumer markets served by Apple, Google and Netflix, for example, face significant competitive and regulatory pressures and the bidding up of their stock prices by passive investors makes them less attractive compared to many of the companies that enable their growth in the storage and connectivity markets. We are not averse to owning market leaders in this space, as we took an initial position in Facebook in 2012 when the company was facing risks of obsolescence as it had not yet developed a viable monetization strategy. We built the stock into a significant holding before taking profits on most of the position over time as its prospects became more fully understood.

Our IT exposure is currently focused on the long-term themes of 5G and infrastructure buildout through communications chip maker Broadcom, digital storage (Seagate Technology and Western Digital), cybersecurity (FireEye), electric vehicles (Cree and TE Connectivity) and speech recognition (Cerence and Nuance Communications). We are also participating well in the work-from-home theme that has been accelerated during the pandemic through long-time holding Citrix Systems, which offers remote access to technology applications. All of these stocks were strong performers in the quarter and all have the fundamentals to maintain and grow leadership positions in their respective end markets.

Portfolio Positioning

In light of the decline in oil prices caused by the coincident supply and demand shock recently, we exited our position in Occidental Petroleum. The portfolio originally received shares in Occidental through the Anadarko acquisition last year, of which approximately 80% of the proceeds were paid in cash. While the company has taken aggressive steps to manage costs during this period, with a meaningful dividend cut and an approximate 50% cut to capital spending in order to reduce the oil price required to generate free cash flow, significant near- and long-term debt levels remain. Given the lack of visibility on a long-term recovery in oil prices or on near-term asset sales to reduce leverage, we felt it prudent to exit the position and used it as a source of funds to reposition the portfolio in names with better lines of sight to growth with less balance sheet uncertainty.

We have made meaningful moves over the last year to concentrate the portfolio in our highest-conviction ideas. These have included reducing the number of positions we hold from 74 a year ago to 53 as of June 30, focusing on companies with better earnings visibility and lower leverage. With the sale of Occidental, our energy exposure is the lowest in 20 years. Meanwhile, our weighting in the IT sector, an area where we are well-positioned to participate in innovative trends such as electric vehicles, has increased by 700 bps. Going forward, we are confident the stocks we own have the fundamentals and leading market positions in areas with durable growth characteristics to deliver consistent long-term returns for our investors.

Outlook

We are surprised at the speed of the market recovery and the fact that stocks have not retested their March lows. Equities are responding to abundant stimulus and liquidity, but this could result in unintended consequences (as speculation has grown and excessive valuations are being largely ignored in certain sectors). We are also less constructive on a rapid, V-shaped economic recovery barring the discovery of a vaccine or scientific breakthrough to treat COVID-19. Many stocks and sectors are already pricing in a quick recovery to full economic growth and others looking very expensive. Some companies in software and Internet services now trade at 20x to 40x sales with little or no profits, while other sectors like health care and media are mired at historically low multiples.

The market is experiencing a heavy degree of retail participation and speculation analogous to the height of the dot.com bubble. From what could be a near-term market peak, we expect mean reversion in valuations and a rotation to different sector leadership, similar to what occurred in the aftermath of the Nasdaq meltdown in 2000 and 2001. As shown in Exhibit 1, more value-oriented stocks whose multiples did not get out of hand during that period outperformed more speculative growth stocks from 2000 to 2006. We expect more M&A, both public deals and leveraged buyouts by private investors, will be a driver of change going forward.

Portfolio Highlights

The Aggressive Growth Strategy underperformed its Russell 3000 Growth Index benchmark in the second quarter. On an absolute basis, the Strategy generated gains across the eight sectors in which it was invested (out of 11 sectors total). The primary contributors to performance were in the IT, communication services and health care sectors.

Relative to the benchmark, overall stock selection and sector allocation detracted from performance. In particular, stock selection in the communication services, health care, IT and industrials sectors, an underweight to the consumer discretionary sector and an overweight to health care detracted the most from results. On the positive side, stock selection in the financials sector and an underweight to the industrials sectors supported relative performance.

On an individual stock basis, positions in Autodesk, Vertex Pharmaceuticals, Cree, Broadcom and Comcast were the leading contributors to absolute returns during the period. The lone detractors were Biogen, L3Harris Technologies and AMC Networks.

During the quarter, we gained shares in AbbVie in the health care sector following its acquisition of portfolio holding Allergan and shares of Madison Square Garden Entertainment following its spinoff from portfolio holding Madison Square Garden Sports.