ClearBridge Investments

# Appreciation Strategy

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## Key Takeaways

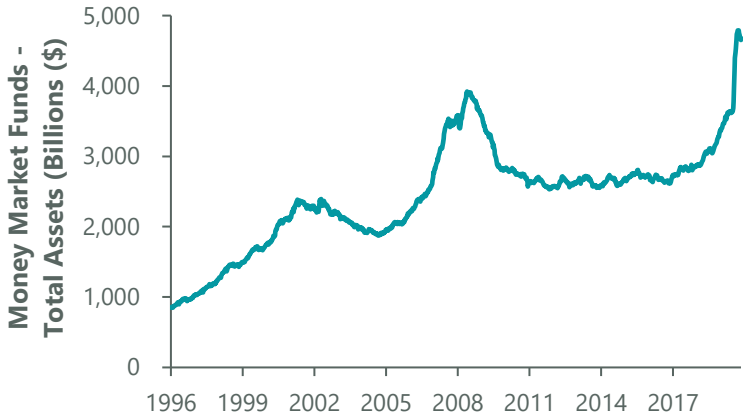
- Given aggressive monetary and fiscal easing, we are not surprised by the resilience of financial asset values in the second quarter, although we were surprised by the power of the market rally.
- We are risk-averse investors, and a key risk we see emerging is market concentration in a very few large technology stocks, reminiscent of what we saw in the late 1990s.
- With the uncertain global economic outlook, we believe diversification and a balanced approach to stock selection, industry allocation and factor exposure are prudent.

## Market Overview

Investors are living in a period without precedent. After the first quarter's historic 30% decline in 22 trading days, the S&P 500 Index roared back in a similarly unprecedented fashion, rising 44% in the 53 trading days between March 23 and June 8. The S&P 500's second quarter 20%+ total return was the best quarter in over 20 years (the NASDAQ also made a record high). Yet some 13% of Americans remain unemployed and those lucky enough to still be working are often doing so from home or in a reduced capacity.

It is our long-held view that liquidity is the match that lights a fire behind broad market advances and declines. Given aggressive monetary and fiscal easing, we are not surprised by the resilience of financial asset values, although we were surprised by the power of the second quarter's market rally. We estimate the Fed has created an incremental ~$2.4 trillion of bank excess reserves since February, a dollar amount roughly equal to money created cumulatively by Fed quantitative easing measures during the financial crisis (2008–2015). In addition, fiscal stimulus has provided a boost to consumers via forgivable small business loans (the "PPP"), extended unemployment and Supplemental Nutrition Assistance Program benefits, direct stimulus payments and mortgage loan forbearance. Money market funds have received over $1 trillion dollars in net new assets year to date, up 30% from year-end 2019 (Exhibit 1). All this despite record unemployment and a severe economic contraction.

Exhibit 1: Liquidity Is Indeed Abundant




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

During the second quarter the stock market was led by a mixture of COVID-19 beneficiaries and stocks that severely underperformed the market during the first quarter. The best-performing groups were consumer discretionary, information technology (IT), materials and energy. On a size basis there was a similar barbell, with the best returns seen in the very biggest and smallest stocks. The weakest areas were the defensive utilities, consumer staples and health care sectors. Market breadth was solid, suggesting that the rally has more room to run. In early June 98% of the stocks in the market traded above their 50-day moving averages, although this breadth has faded since.

We are risk-averse investors, and a key risk we see emerging is market concentration in a very few large technology stocks, reminiscent of what we saw in the late 1990s.

Apple, Microsoft and Amazon.com accounted for one quarter of the S&P 500's 20.5% gain in the second quarter (or 521 of the market's 2,050 basis point increase). Looking more broadly (but still quite narrow), 40% of the S&P 500's second-quarter advance can be attributed to 10 stocks — Apple, Microsoft, Amazon, Facebook, PayPal, Alphabet, Home Depot, Nvidia, Visa and Adobe — despite these stocks representing only 25% of the benchmark's weight (Exhibit 2). In sector terms, IT, communications services and Amazon (a consumer discretionary stock) accounted for 55% of the S&P 500's total return but represent only 41% of the index.

Exhibit 2: Market Concentration is High

| | Weight in SPX (%) | 2Q Return (%) | Contribution to SPX Return (bps) | Contribution to SPX Return (%)* |
|---|---|---|---|---|
| AAPL | 5.3 | 43.8 | 208 | 10.1 |
| MSFT | 5.7 | 29.4 | 160 | 7.8 |
| AMZN | 4.1 | 41.5 | 153 | 7.4 |
| FB | 2.1 | 36.1 | 67 | 3.3 |
| PYPL | 0.7 | 82.0 | 42 | 2.0 |
| GOOG | 3.3 | 22.0 | 71 | 3.5 |
| HD | 1.0 | 35.0 | 33 | 1.6 |
| NVDA | 0.8 | 44.2 | 32 | 1.6 |
| V | 1.3 | 20.1 | 26 | 1.3 |
| ADBE | 0.7 | 36.8 | 25 | 1.2 |
| **Total** | **25.0** | | **817** | **40** |

As of June 30, 2020. *S&P 500 return: 20.5%. Source: ClearBridge Investments, FactSet.

The high concentration of the market creates a dilemma for us as portfolio managers. The mega cap technology companies have attractive business models that are faring well during COVID-19. But they are very expensive stocks. Owning even market weights in them creates a portfolio that begins to lose the benefits of diversification. And we deeply believe in the long-term benefit of diversification. We have begun judiciously trimming our positions in the big technology stocks.

The valuation disparities caused by market volatility create stock-picking opportunities. COVID-19 accelerated the shift from traditional retail to online. The obvious beneficiaries have performed well this year and are now very expensive. Many smaller retailers will struggle or go bankrupt, but the off-price retailers have great balance sheets and offer a shopping experience you cannot get online. The payment processors are another way to play this theme that have lagged the market. After years of being very expensive, selected utility stocks are starting to look interesting. In an environment of near-zero interest rates they offer 3.5% dividend yields and defensive business models. The homebuilding industry looks set up for a strong cycle. COVID-19 and working from home seem likely to renew migration from center cities to the suburbs. The introduction of the 5G wireless standard continues to create interesting investment opportunities. Meanwhile, interest rates are likely to be close to zero for several years, impairing the earnings outlook for banks and life insurers.

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## Outlook

With the uncertain global economic outlook, we believe diversification and a balanced approach to stock selection, industry allocation and factor exposure are prudent. Also, given the potential for elevated unemployment and long-term economic slack, we believe our philosophy of investing in high-quality stocks with strong balance sheets and sustainable growth is of greater value today than any time in recent memory.

## Portfolio Highlights

The Appreciation Strategy underperformed the benchmark in the second quarter. On an absolute basis, the Strategy had gains in all 11 sectors in which it was invested during the quarter. The main contributors to the Strategy's performance were the IT, communication services and consumer discretionary sectors. The utilities, real estate and financials sectors were the main laggards.

In relative terms, stock selection detracted from performance. In particular, stock selection in the financials, IT, health care and industrials sectors detracted from relative results. An underweight to the consumer discretionary sector was also detrimental. Conversely, an underweight in utilities and an overweight in materials were beneficial.

On an individual stock basis, the biggest contributors to absolute returns during the quarter included positions in Microsoft, Apple, Amazon.com, Adobe and Home Depot. The greatest detractors from absolute returns were positions in Raytheon Company, American Express, Berkshire Hathaway, Wells Fargo and CME Group.

During the quarter we initiated positions in Amgen in the health care sector, Canadian Pacific Railway in the industrials sector, ArcelorMittal in the materials sector and American International Group in the financials sector. We closed positions in Wells Fargo and American Express in the financials sector. We received and retained shares of Raytheon Technologies and Otis upon the merger of United Technologies with portfolio holding Raytheon Company. We also received but did not retain shares of Carrier from the same corporate action.