ClearBridge Investments

Appreciation ESG Strategy

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Key Takeaways

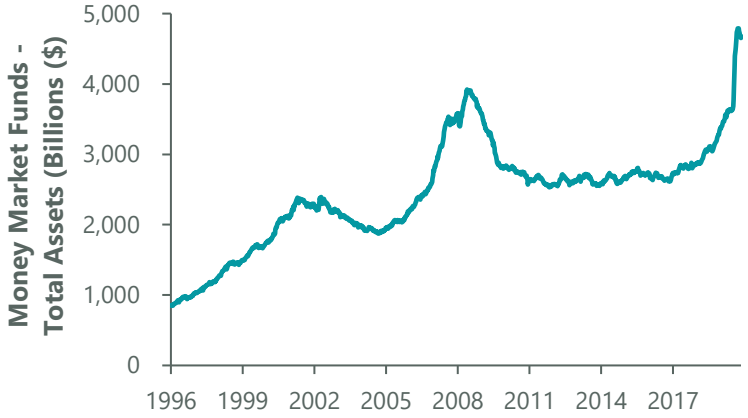
- Given aggressive monetary and fiscal easing, we are not surprised by the resilience of financial asset values in the second quarter, although we were surprised by the power of the market rally.
- We are risk-averse investors, and a key risk we see emerging is market concentration in a very few large technology stocks, reminiscent of what we saw in the late 1990s.
- There is a clear business case for diversity, and companies with recruitment, pay equity and executive compensation practices conducive to growing diversity can help build a more just society as well as achieve better financial performance.

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**	**40.0**

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.

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.

The valuation disparities caused by market volatility create stock-picking opportunities.

Portfolio Highlights

The ClearBridge Appreciation ESG Strategy had a positive return during the second quarter of 2020, underperforming the Strategy's benchmark.

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 information technology (IT), communication services, consumer discretionary and health care sectors. The utilities, energy, real estate and financials sectors were the main laggards.

In relative terms, the Strategy underperformed its benchmark due to stock selection and sector allocation. In particular, stock selection in the financials, IT and health care sectors, an overweight to the consumer staples sector and an underweight to the consumer discretionary sector detracted the most from relative performance. Conversely, an underweight to the utilities sector and an overweight to the materials sector 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 Berkshire Hathaway, American Express, CME Group, American International Group and NextEra Energy.

During the quarter we initiated new positions in Amgen in the health care sector, Canadian Pacific Railway in the industrials sector, American International Group in the financials sector and ArcelorMittal in the materials sector. We closed a position in American Express in the financials sector.

ESG Highlights

ClearBridge's ESG mission for over 30 years has been to continually improve the integration of our ESG analysis into fundamental research and portfolio construction, as well as use engagements with companies and proxy voting to drive positive change and reduce risks. That change includes the promotion of social equality and the economic equality that supports social equality, as well as responsible environmental and governance practices.

Stay-at-home orders have not reduced our contact with portfolio companies in 2020 — in fact, we have increased our engagements. Given there is currently very little disclosure by most companies on racial diversity, to scope out innovative practices our analysts have been reaching out to companies in our coverage that we consider best-in-class in sustainability and asking them how they are thinking of diversity as a key component of a strong human capital pipeline. Our approach has focused on gathering information in the service of three main goals: 1) spurring managements to think about racial diversity; 2) motivating companies to track diversity by candidly assessing their company's workforce profile and to be transparent about it externally; and 3) sharing insights, such as the value of informal networks within a company, in which mentorships or other internal structures increase visibility, experience and opportunity for minority groups.

In renewing our discussions with managements on solutions that public companies can offer to disparities of social, and in particular racial, inequality, we have been encouraged by a universal acknowledgment of the problem. And in general, leaders are aware there is more to be done: according to a recent survey by PricewaterhouseCoopers, only 16% of directors scored their companies as "excellent" in recruiting a diverse workforce, 15% believed they were excellent at developing diverse executive talent and over 80% thought their companies should be doing more to promote gender and racial diversity. Common hurdles cited for increasing diverse representation include difficulty sourcing talent up the pipeline and unconscious bias, while experts contend that more networking opportunities would help alleviate these issues. Our outreach has offered insight into a mosaic of challenges in addressing racial inequality, and it has also offered solutions we believe range from good starts to exemplary.

Lack of Diversity Data Is a Challenge

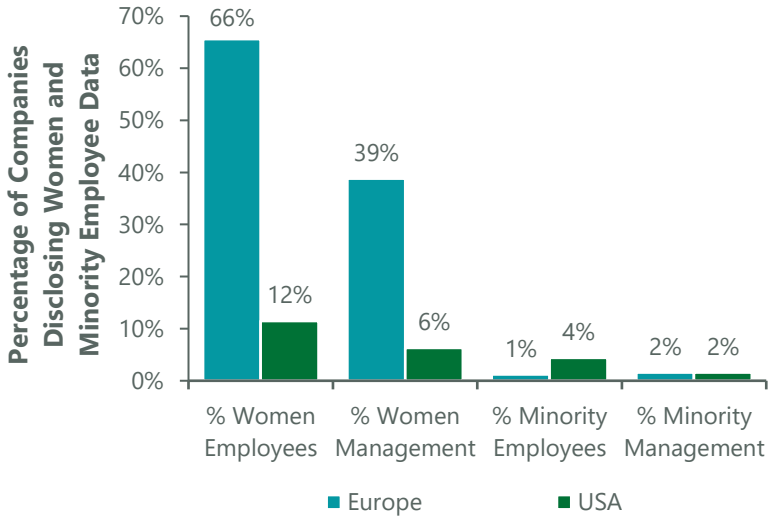
While diversity is a frequent focus of our engagements, we tend not to ask questions specifically on any one group of employees; rather, our focus is on all employees being treated fairly. We look for benefits, policies and practices that support an inclusive culture for training and advancement opportunities for all employees as a key stakeholder group. We ask about racial and gender representation in management, boards of directors and C-suite executives and about what diversity policies are in place. But overall disclosure of racial data remains a challenge, especially in the United States, with only 4.4% of companies in the S&P 500 reporting racial diversity data (Exhibit 3).

Companies with global operations may face difficulties tracking data around ethnicity in certain countries due to local rules and permissions to ask for such disclosure for privacy reasons to avoid discrimination. Ethnic statistics are often forbidden in France, for

example, and are the subject of intense sociological debate. Companies that are unionized tend to be color blind on racial lines: union members get treated equally.

Nevertheless, we are happy to see many companies we engage with not only thinking about diversity in a meaningful way, but also tracking and disclosing diversity metrics. This is encouraging because while U.S. Equal Employment Opportunity laws have for decades required disclosure of diversity data, voluntary detailed disclosure to shareholders has been hard to come by.

Exhibit 3: Disclosure of Minority Employee Data Remains Low



As of June 12, 2020. Source: J.P. Morgan, Bloomberg / Europe: BBG Europe 500 firms; USA: S&P 500 firms. Courtesy J.P. Morgan Chase & Co., J.P. Morgan's ESG Wire, Copyright 2020.

The Business Case for Diversity

There is a strong and growing business case for gender, ethnic and cultural diversity in corporate leadership as shown by a recent McKinsey analysis, "Diversity Wins: How Inclusion Matters." In terms of profitability, the most diverse companies are now more likely than ever to outperform less diverse peers. In 2019, top-quartile companies outperformed peers in the bottom quartile by 36% in profitability, up from 33% in 2017 and 35% in 2014. As McKinsey has found before, the likelihood of outperformance continues to be higher for diversity in ethnicity than for gender.

Companies with diverse management teams have almost 10% higher operating margins than those with below-average diversity, according to a Harvard Business Review study. Boston Consulting Group found that diverse management teams were more innovative than less diverse ones, judging by revenue from products and services launched within the past three years (a proxy for innovation). The study found this innovation advantage meant better overall financial performance.

It can be both good business and social policy to adapt stores to minority community needs, tailoring staff to reflect the community.

Finding and Sharing Leading Recruitment and Pay Equity Practices

Recruitment and pay equity practices are key parts of human capital management and a frequent topic of discussion with our portfolio companies. We have, for example, discussed with ClearBridge holding Intel its establishment of the "Rooney Rule": in the program, hiring managers are required to interview at least one person of color for a job as a way to get talented people in front of managers that may otherwise have been overlooked for systemic or discriminatory reasons. The company noted this was a way of bypassing more subjective (and thus discriminatory) promotions and forced accountability on managers that systematically bypass qualified minority employees.

Intel has also created a hotline that allows underrepresented minorities to call with questions or concerns about their immediate managers or just to get help with career choices/decisions. Intel had data that showed people that used the hotline had lower churn than employees that didn't as it provided them a way to discuss more passive forms of discrimination from their immediate management and also provided a more centralized form of mentorship (as the company pointed out, one of the issues with career advancement was that underrepresented minorities tend to have fewer informal mentorship opportunities and networks than others).

Intel also tracks cohort data to ensure that underrepresented minorities continue to proceed through the organization. Some companies explain lack of diversity in management by pointing to efforts in their infancy and noting the time it takes for them to become effective, but that ignores the fact that while entry level hiring decisions may increase diversity/inclusion, career progression tends to be more limited. By tracking and providing cohort data, it highlights progress in real time, rather than just pointing to an indefinite point in the future for progress to be more evident to shareholders.

Linking Executive Compensation to Inclusion Metrics

Linking executive compensation to inclusion metrics can go a long way to incentivizing leadership to think about and track diversity initiatives. Intel, for example, has linked a portion of executive and employee compensation to corporate responsibility factors, including operational goals such as advancing women in senior leadership and building an inclusive culture. In 2020, its operational goals were redesigned to include metrics related to diversity and inclusion, as well as employee experience, climate change and water stewardship.

Diversity Programs Can Take Many Forms

First Republic Bank (FRC), a large regional bank focused on high net worth clients and a ClearBridge holding, has some of the better disclosures regarding female and minority representation within the financials sector. In our conversations with FRC, we have also discussed diversity programs it has found valuable. In addition to establishing a Diversity Equity Inclusion Council, FRC has participated in internship programs like INROADS (places talented, underserved youth in business) and supported diversity-focused foundations such as Posse (recruiting/networking events for undergraduate students) and 10,000 Degrees, which makes scholarship funds available to students from low-income backgrounds. FRC has also created a Culture Carrier Roundtable, which is a program to reveal how diverse perspectives underpin the company's culture and shape its growth. The program has grown to over 1,100 participants, or 25% of the company's workforce, since its 2010 inception.

CVS Health, another ClearBridge portfolio company, approaches racial equality both internally, as it pertains to employees, and externally in the targeted work CVS does for communities that are underrepresented in terms of health access. CVS has, for example, developed Colleague Resource Groups, groups of employees with shared interests or affinities with goals that help the organization. Groups include the Black Colleague Resource Group, which promotes inclusion, networking, community outreach and mentorship, Juntos, a multicultural organization of members of Latin ethnicities, Pride+, focused on inclusion for LGBT employees, as well as groups focused on recognizing American Indians and Alaska Natives, environmental awareness, women's leadership development, fitness, faith and more.

CVS illustrates the opportunity and obligation of health care companies to enhance health at a societal level. CVS has also undertaken large-scale efforts to improve the health of underserved communities. Its hallmark program, "Project Health," offers in-store health screening to large numbers of people, largely ethnic minorities, in underserved communities, then helps connect those people with primary care providers and clinics. CVS works with local health clinics and government-sponsored community health centers to enhance local access to quality care. CVS also supports local food banks to address nutritional insecurity, which can have significant health implications. During the COVID-19 pandemic, CVS is making a concerted effort to set up testing sites in underserved communities.

In addition, in what is both good business and social policy, CVS adapts stores to minority community needs, tailoring its store assortment and staff to the ethnic makeup of local communities. The company emphasizes hiring store managers, pharmacists and pharmacist technicians to align with local demographics and languages spoken, particularly Spanish.

Conclusion

Supporting the advancement of everyone's right to live in a safe, respectful and just society is a key element in the long-term sustainability of a business. Many high-quality companies such as those ClearBridge seeks out, for example, have diversity recruiting and inclusion practices as well as policies to allocate contracts to minority-owned businesses. Many of these companies are further focusing these efforts, while others are still in the early stages of developing them.

Engaging on company efforts that we believe promote social and economic equality, both internally and in the communities in which they operate, has always been an integral part of ClearBridge's ESG efforts. Whether it is discussing and sharing best practices on community investment and job creation, financial inclusion and access, human capital management (including recruitment, retention, diversity and inclusion), or supply chain labor management, we will continue to factor these considerations into our analysis as we look to enhance the long-term sustainability of our portfolio companies and help build a more just society.