ClearBridge Investments

Dividend Strategy

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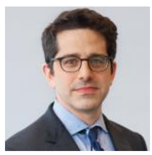

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Key Takeaways

- Capital markets recovered substantially during the second quarter, driven by tremendous monetary and fiscal stimulus, although recent COVID-19 surges question the durability of the rally.
- We have added utilities and health care stocks because both industries are fundamentally defensive, and the selloff provided us with attractive opportunities in great companies in these areas.
- More than ever, we believe it is critical to focus on businesses with recurring, predictable revenues and limited economic sensitivity. Despite all of the turmoil, our dividends have generally held up well and, indeed, have grown.

Market Overview

In a confluence of events few would have predicted three months ago, capital markets recovered substantially during the second quarter despite a disastrous surge in COVID-19 cases in the U.S. The primary drivers of the markets, in our view, have been the accommodative moves from the Federal Reserve and the tremendous fiscal stimulus provided by the Federal government.

While we could quibble with the particulars of the programs, we believe these moves were critical to preventing a financial collapse and we applaud the fast action. There will be long-term consequences (bigger deficits and the distortive effect of near zero interest rates), but inaction would have led to a more dire situation, or even a depression.

Loose monetary policy and generous fiscal transfers explain why the market has bounced but they are not enough to sustain this trend indefinitely. For this recovery to have legs, and for the market to avoid a meaningful correction, employment and confidence will have to recover substantially and securely.

As states began to reopen in May and June, economic indicators bounced back sharply. Investors cheered each positive economic release as confirmation of the much hoped for V-shaped recovery. Given the time it takes for the disease to spread and people to get tested, there were a blissful few weeks where the positive economic numbers were not yet tainted by the specter of rising infections. Now, though, the costs of reopening too soon are clear. Those states that opened hastily have seen surges in the disease and many have had to hit pause and/or retrace their steps. As they do, economic activity will slow again.

Like everyone else, we are uncertain of how the pandemic will unfold. In our investment process, we seek to embrace this uncertainty through humility. We are not making calls on the timing of a vaccine or the speed with which unemployment and the economy will recover. Rather, we stick to high-quality companies that will endure the tempest and should do reasonably well under most scenarios.

We have exited positions in Sysco and McDonalds. They are terrific companies, but they are completely dependent on people dining out. We have trimmed Disney because 40% of its profits are derived from theme parks; but we have — thus far — maintained a position in it because life will eventually return to normal and the other 60% of the company continues to generate substantial cash flow. We have added utilities and health care stocks because both industries are fundamentally defensive, and the selloff provided us with attractive opportunities in great companies in these areas. Public Service Enterprise, for example, is a diversified electric and natural gas utility with earnings underpinned by a solid regulated utility business which should post attractive growth over the next several years. In health care, earlier this year we bought Becton Dickinson, a global medical technology company with steady, mid-single-digit top-line growth and low-double-digit EPS growth as well as a growing track record internationally.

Our focus on such Steady Eddie companies is not new: it is the hallmark of our approach. We emphasize high-quality companies with recurring cash flows and limited economic sensitivity. We select companies with strong balance sheets, attractive current dividend yields and the potential to compound those dividends over time. This approach has served us well and generally positioned the portfolio to outperform in down markets. Indeed, we have outperformed in eight of the last 10 periods where markets have declined over the past 11 years.

> We are grateful that markets have recovered as they have, but skeptical that this momentum can continue.

Unfortunately, we have underperformed the market thus far in 2020. Yet while about 15% of the S&P 500 Index has cut or suspended their dividends, just 2% of our portfolio companies have reduced their dividends. Nevertheless, our stocks have underperformed the S&P 500. The big winners this year have been technology companies in three sectors: communication services (Alphabet, Facebook, Netflix), consumer discretionary (Amazon.com) and information technology. These sectors acted defensively during the downturn in the first quarter and rebounded strongly with the recovery in the second quarter. Today, these three sectors constitute almost 50% of the S&P 500. Many of the largest companies in these sectors do not pay dividends and therefore are not suitable candidates for our investment approach (Alphabet, Amazon, Facebook and Netflix to name a few).

It is unusual, though not necessarily illogical, that the sectors that prove most defensive in a downturn also perform best in a recovery. The large tech companies have fabulous balance sheets, strong growth and excellent profitability and return characteristics. Further, while most industries have been negatively impacted by shutdowns and people working from home, many of the tech juggernauts benefit from these trends. So, while we might not have predicted these companies would perform best in both the downturn and the recovery, we cannot necessarily argue with it.

What is striking, however, is that many of the sectors that have traditionally outperformed in tough times have lagged in the first half of 2020. Consumer staples enjoyed their best sales in years as everyone hunkered down and loaded up on groceries and cleaning supplies. Nevertheless, staples are down 6% this year and have underperformed the S&P 500. Similarly, utilities, which are often referred to as bond proxies, are down 11% even as interest rates have declined by 120 basis points (bps) to all-time low levels of around 70 bps. In aggregate, the economy is far worse than it was six months ago. One would think, therefore, that companies whose fundamentals have held up (utilities) or improved (staples) would outperform. But when technology companies constitute almost half the S&P 500 and technology outperforms, everything else must necessarily underperform.

The year so far has been humbling for investors. First, the market was overwhelmed by the magnitude of the pandemic. Then, investors were caught off guard by the strength of the rebound. With so many unanswered questions about the pandemic, the economy and the election, the second half of the year is likely to be as “interesting” as the first half of the year.

Thus far, the U.S. has failed in its efforts to address the health crisis but has succeeded in triaging the economy and the markets. There is hope (and cause) for further stimulus, but even the government's coffers are not bottomless. Future programs will be smaller than previous ones and each new initiative further exacerbates the country's long-term financial imbalances.

Outlook

We are grateful that markets have recovered as they have, but skeptical that this momentum can continue. We are concerned that the failure to stem the pandemic will cause reopenings to go in fits and starts, weighing on the recovery of consumer and business confidence. We also worry that policy fatigue will set in and that both politicians and taxpayers will tire of writing trillion-dollar checks before the medical community finds a vaccine.

More than ever, we believe it is critical to focus on businesses with recurring, predictable revenues and limited economic sensitivity. This has always been our focus, but it is even more important today. Despite all of the turmoil, our dividends have generally held up well and, indeed, have grown. Regardless of what unfolds, we expect this salutary trend to continue.

Portfolio Highlights

The ClearBridge Dividend Strategy underperformed its S&P 500 Index benchmark during the second quarter. On an absolute basis, the Strategy had gains in 10 of 11 sectors in which it was invested for the quarter. The main contributors to Strategy performance were the information technology (IT), financials, materials and industrials sectors. Utilities, meanwhile, was the sole detractor from absolute results.

On a relative basis, sector allocation and stock selection detracted from performance for the quarter. In particular, underweights to the consumer discretionary and IT sectors and overweights to the consumer staples and utilities sectors were detrimental. Stock selection in the energy, health care, communication services and materials sectors were also a drag on relative performance. Conversely, stock selection in the financials sector and overweights to the energy and materials sectors were beneficial.

On an individual stock basis, the main positive contributors were Apple, Microsoft, Apollo Global Management, Home Depot and Williams Companies. Positions in Raytheon (RTN), Wells Fargo, Boston Properties, NextEra Energy and Public Service Enterprise Group were the main detractors from absolute returns in the quarter.

Besides portfolio activity discussed above, during the quarter we closed a position Wells Fargo in the financials sector. We received and retained shares of Raytheon Technologies (RTX) upon the merger of portfolio holdings United Technologies and Raytheon Company. We also received shares of Otis and Carrier from the same corporate action and retained them in the portfolio.