ClearBridge Investments

Mid Cap Growth Strategy

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Key Takeaways

- A coterie of companies with products and services either advantaged or accelerated by the COVID-19 shutdowns and likely long-term evolutions of work-from-home policies were stellar performers for the Strategy.
- We made four new investments during the quarter in companies with strong industry leadership positions while closing out of several others where business improvements are taking longer than expected.
- Progress on medical treatments for COVID-19, as well as the upcoming presidential election, are swing factors that could impact the markets and the economy over the remainder of the year.

Market Overview and Outlook

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.

Energy (+40.7%) 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 (+39.9%), communication services (+37.5%) and information technology (IT, +33.8%) sectors also outperformed. More defensive real estate (+14.4%) and consumer staples

(+15.5%) as well as materials (+14.8%) lagged the index in an environment of abundant liquidity most conducive to long-duration growth assets.

While the overall market rose sharply, dispersion widened considerably across growth and value styles.

On the simple differentiation between growth and value, growth stocks outperformed by about 10 percentage points as measured by the Russell Midcap 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.

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 20% of the Mid Cap Growth Strategy's assets fall into this category. Examples include technology providers Atlassian and DocuSign, e-commerce platforms Carvana and MercadoLibre and trucking and freight distributor XPO Logistics.

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.

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.

Portfolio Positioning

We made four new investments during the second quarter across IT, consumer staples and industrials. 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. Entegris is a consumables-based leader in chemicals and materials for semiconductor production. The secular trend of more chips being produced as the Internet of Things proliferates and additional materials going into chips as Moore's Law – the maxim that

processing power increases regularly – breaks down hasten the need for the company's products. We also added to our cyclical exposure through the purchase of W.W. Grainger, a high-quality industrial distributor taking market share from smaller competitors. Grainger should be a direct beneficiary as the industrial economy rebounds and offers some downside protection from outsized growth in sales of safety equipment and masks.

We added food service supplier Performance Food Group in place of US Foods as we believe it has the technology to cater to changing restaurant customer preferences and the balance sheet to fund acquisitions or take share from weaker local players. The restaurant distribution business is likely to see fewer customer in the near term as more dining establishments close, however we believe the frequency of dining will come back in 12-18 months.

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, and Alexion Pharmaceuticals, where competitive pressures in the treatment of rare diseases it targets may take longer to resolve than initially estimated.

Outlook

We persist in a market concerned with top-down drivers, with investors awaiting clarity on C-19 treatments and a vaccine. If we don't get that good news, equities could sell off indiscriminately. A presidential election five months away poses additional uncertainty as we don't believe the market has priced in risks like much higher tax rates. Yet if we get better news on virus treatments and continued progress on a vaccine, workers will start being brought back off furlough and the economy should recover nicely. That has implications beyond the consumer as the valuation of the market does not look stretched if we see a strong recovery.

In the meantime, we are excited to own companies with positive outlooks for their businesses and strong balance sheets trading at reasonable valuations. The portfolio has rebounded nicely from the headwinds of the pandemic and we expect that improvement to continue.

Portfolio Highlights

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

In relative terms, stock selection contributed to performance. Specifically, stock selection in the consumer discretionary, industrials and IT sectors was the primary driver of results. Conversely, stock selection in the communication services, real estate and materials sectors and an overweight to real estate detracted from relative performance.

The leading contributors to absolute returns during the second quarter included MercadoLibre, Splunk, Carvana, Datadog and Fortinet. Positions in Live Nation Entertainment, Performance Food Group and Black Knight were the lone detractors from absolute returns.

In addition to the transactions mentioned above, we closed a position in Universal Health Services in the health care sector.