ClearBridge Investments

Select Strategy

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Key Takeaways

- The Strategy gravitates to disruptive and innovative companies and was well positioned to participate in secular growth trends accelerated by the COVID-19 pandemic.
- Private market research and heightened volatility enabled us to expand exposure to alternative investments, with several private placements and options helping improve overall risk/reward.
- Activity during the quarter was geared to rebalancing the portfolio as we trimmed some of the biggest winners in the disruptors group and added to evolving opportunities and value names.

Market Overview and Outlook

Equities staged a historic rally in the second quarter, boosted by tremendous stimulus from the Federal Reserve that provided abundant liquidity to financial markets and a flattening of COVID-19 cases. Growth stocks dominated performance with the Russell 3000 Growth Index gaining 28% for the quarter. Those returns compare to a 22% gain for the benchmark Russell 3000 Index.

The consumer discretionary sector (+37.5%), home to many e-commerce stocks that have seen increased demand as consumers were forced to shelter in place to curb the spread of the virus, was the strongest performer in the benchmark. Energy (+32.3%) and information technology (IT, +31.6%), especially software and services companies, also outperformed while more cyclical stocks in communication services (+21.0%) and industrials (+18.6%) joined in the broad market's forceful snapback. The more defensive utilities (+2.4%), consumer staples (+8.9%) and real estate (+13.5%) sectors lagged the broader market in the vigorous bounce off the March lows.

The outperformance of smaller stocks during the second quarter reflects a greater confidence among investors that the worst could be behind us in terms of business impacts from COVID-19. Consecutive months of record employment gains following an April crash in the job market and a robust May rebound in retail sales are encouraging signs, but a spike in virus cases in areas of the U.S. that escaped the first wave of infections reminds us that the economy could be in for an uneven recovery. What has

changed are consumers' buying and lifestyle patterns as well as the way many workers now conduct business away from physical offices. The Strategy gravitates to companies disrupting the status quo and was well positioned to participate in secular growth trends accelerated by the pandemic. Such exposures contributed to very strong absolute results and relative outperformance during the second quarter.

Portfolio Positioning

We remained active both during the market selloff and the subsequent rally, taking advantage of higher volatility and dispersion as not all stocks rebounded in line with the broad market. Portfolio performance and positioning changes covered four main areas.

Stocks that are direct beneficiaries of changes necessitated by measures to combat COVID-19, such as those enabling e-commerce (Shopify, Wix.com, Carvana and MercadoLibre) and work-from-home (WFH) capabilities (DocuSign, ServiceNow and Datadog) were among the portfolio's leading contributors, with several gaining over 100% in the quarter. Many of these companies operate recurring revenue businesses with high returns on invested capital and are realizing revenues faster from onboarding customers more quickly. Livongo Health shares these qualities with exposure to the rising uptake for telemedicine. Trex is a less obvious beneficiary of the pandemic lockdowns but the manufacturer of decking made from recycled materials continues to take market share as stay-at-home consumers are putting more money into home renovation.

We added to this group of companies with several new purchases. The high velocity of markets is creating more volume for the securities and commodities exchanges owned and operated by Intercontinental Exchange (ICE), including the New York Stock Exchange. ICE also generates earnings from selling high-margin trading data and information services to financial customers. New additions ZoomInfo Technologies and Chewy, meanwhile, are leaders in WFH collaboration and online delivery of pet supplies.

The portfolio also saw solid results from overlooked recipients of the changing environment where there were concerns of slowing growth due to COVID-19. This has not been the case for such companies as casual footwear maker Crocs, which has pivoted to e-commerce channels over the last several years, warehouse retailer BJ's Wholesale Club, which benefited from consumers stocking up on essential supplies during the lockdowns, and home improvement chain Lowe's, which saw the investment

in online infrastructure pay off in its curbside pickup sales. These companies are what we consider evolving opportunities due to positive fundamental and operational developments in each company's business.

The outperformance of smaller stocks reflects investor confidence the worst business impacts from COVID-19 could be behind us.

Vertiv, a stock we acquired through an earlier investment in a special purpose acquisition company or SPAC run by the former CEO of Honeywell, also falls in the evolving opportunity group and illustrates how our research leads to overlooked investment ideas. Vertiv is the former HVAC business of Emerson Electric that provides cooling systems for servers, surge protectors and similar support functions to data centers. The business had been mismanaged and starved of R&D before being sold to the SPAC and taken public in February. It is now positioned to be a direct beneficiary of cloud buildout while expanding operating margins and paying down debt. We added to the position during the March selloff and the stock has since come back strongly as cloud migration becomes a higher priority for enterprises.

The four sales during the quarter occurred among evolving opportunities names. When the thesis for improvement among these companies is not playing out at the pace and or magnitude we had anticipated, we are disciplined in selling and moving on to better ideas. This was true of FireEye in cybersecurity, where poor sales execution and levels of innovation that were falling behind peers led us to exit the stock. The margin turnaround story at Advance Auto Parts was taking too long while at Outfront Media, the severe drop in commuting hurt the company's advertising in metro markets and on mass transit. We also sold out of World Wrestling Entertainment after issues surfaced around the company's governance practices.

The third area of focus was among companies suffering the worst hits from COVID-19, resulting in substantial declines in volume or revenue. We have targeted stocks dealing with what we view as temporary issues whereas their share prices were discounting a much longer recovery. New buy Performance Food Group has a national presence in food distribution to restaurants, a fragmented business that is likely to see fewer customers in the near term as more dining establishments close. We believe the frequency of dining will come back in 12-18 months, however, with Performance positioned to take share from weaker local competitors, leverage its technology advantages to adapt to changing customer preferences and use a strong balance sheet to fund acquisitions.

Other holdings overshadowed by negative COVID-19 sentiment have also rallied. XPO Logistics, a provider of last mile delivery, is a vital part of the solution as companies sort out disjointed supply chains that we added to in the second quarter. Expedia, a position we built up in the heart of the storm roiling the travel industry, is being relied upon by hotel operators to clear excess inventory

through their suite of online travel websites. Surgery Partners, meanwhile, has survived a pause in elective surgeries as the health care system doubled down on virus cases, and operates surgery centers that will be preferable to hospitals from both a safety and cost standpoint as patients resume deferred procedures. The stock remained volatile through the second quarter and we continued to add to the position on weakness.

The Select Strategy also has the ability to invest in alternatives, which has recently presented a number of opportunities. We have been very active in engaging private companies preparing for initial public offerings or seeking to raise more capital. During the second quarter, we made a private placement investment in Insurance Acquisition Corp., a SPAC raising funds to buy Shift Automotive, a West Coast-based competitor to online used car platforms Carvana and Vroom that targets the low end of the market in more dense regions. Shift further differentiates itself by focusing on the full lifecycle of a used car by offering servicing to owners and buying vehicles back when those customers are ready to trade up. We also participated in a private placement at Brain Corp., which has developed deep expertise in advanced machine learning and computer vision systems for autonomous mobile robots. Brain's first commercial applications are in the floor care/cleaning market that includes hospitals, airports and malls and the company's solutions are already being trialed for other autonomous use cases. The adoption of Brain's solutions significantly reduces human labor and has a high return on investment for customers.

Also within alternatives, we have been increasing our use of options. Higher volatility builds in premiums on put and call options for stocks where we have long positions in the portfolio. Selling put and call options generates additional income and creates a better risk/reward than just participating in the common stock. Options also serve as a risk mitigator by enabling us to hedge some positions and control position sizes. In sum, options open up a lot more angles for each company we own in the portfolio.

All of our activity during the quarter helped rebalance the portfolio to best participate in the opportunities ahead. We trimmed back some of our biggest winners in the disruptors group and added more to evolving opportunities and value names with the goal of bringing overall risk/reward back to equilibrium.

The near-term outlook for stocks and the economy remains murky due to elevated levels of unemployment, an uneven reopening of the U.S. economy as well as a technology and trade war heating up again with China. All this comes against the backdrop of an upcoming presidential election with the potential to significantly alter regulatory and corporate tax policies. Our best way to manage risk in this period of extended uncertainty is to stick with

our highest conviction ideas. We continue to favor more disruptive companies with faster growth rates as well as those with more company-specific levers to pull on to improve returns. Our research and attention to risk also causes us to steer away from more cyclically-exposed businesses that are more dependent on a rapid economic recovery to be successful.

Portfolio Highlights

The ClearBridge Select Strategy outperformed its Russell 3000 Index benchmark by over 2,000 basis points for the second quarter. On an absolute basis, the Strategy had gains across all 10 sectors in which it was invested during the quarter (out of 11 sectors total). The IT sector was the primary contributor to performance while the consumer discretionary and health care sectors also had positive impacts.

In relative terms, the Strategy outperformed its benchmark due primarily to stock selection with sector allocation also contributing. Specifically, stock selection in the IT, health care, consumer discretionary, industrials and consumer staples sectors, overweights to IT and consumer discretionary and an underweight to the financials sector contributed to relative performance. Conversely, stock selection in the real estate sector detracted from results.

On an individual stock basis, the largest contributors to absolute returns during the second quarter were Shopify, Wix.com, DocuSign, Carvana and MercadoLibre. Positions in Agora, Outfront Media, Advance Auto Parts, Chewy and SelectQuote were the greatest individual stock detractors from absolute returns.

In addition to the transactions mentioned earlier, the Strategy initiated positions in Agora and CrowdStrike in the IT sector as well as GS Acquisition Holdings and SelectQuote in the financials sector.