ClearBridge Investments

Small Cap Strategy

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Key Takeaways

- The rebound in stock prices has not been uniform across sectors or industries, which is normal given the differences in changes in expectations for each sector.
- We have observed apparent inconsistencies in what may be discounted in different areas of the market, such as consumer durables and direct consumer lenders.
- On balance, we are finding attractively valued investment opportunities across most sectors and are seeking to exploit the dramatic swings in the market to create long-term value for shareholders.

Market Overview and Outlook

After the sharp move in the market since mid-March (from the March 18 close to the end of the second quarter the Russell 2000 was up 49.2%) the Russell 2000 is back to forward P/E multiples on 2021 estimates that rival the 1999 peak. The market appears to be looking past the 2020 impact on some sectors of the recession started by the COVID-19 pandemic. That outlook may turn out to be correct, but such optimism seems to include very modest, if any, consideration for the lingering impact of high unemployment rates, the long-term implication of record levels of government debt and rising social unrest across the country.

The rebound in stock prices has not been uniform across sectors or industries, which is normal given the differences in changes in expectations for each sector. We have observed, however, apparent inconsistencies in what may be discounted in different areas of the market. For example, consumer durables companies are largely discounting a sharp rebound in demand, strong margins and an extended period of growth. Conversely, the companies that offer the financing that most consumers rely on to make such purchases (such as direct consumer lenders and regional banks) seem to be discounting an environment of considerable credit losses and low returns on equity in the future.

Discount rates are another important determinant of value, so the continued decline in interest rates helps explain the outperformance of long-duration growth assets. The combination of lower rates and the general perception that growth will be limited to some "winning" sectors in the economy have resulted in sustained outperformance of the Russell 2000 Growth over the Russell 2000

Value (+2,044 basis points year to date, +1,168 basis points in the second quarter). The potential for rates to stay low for an extended period does exist but it is not a guarantee, as fiscal stimulus could spur inflation or bring new investments that may result in lower returns on future capital deployed than currently discounted.

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Prior to the 2008 Great Financial Crisis (GFC), the Federal Reserve relied mostly on changes in interest rates to spur or slow economic activity. However, the success of unprecedented fiscal and monetary policies during the GFC may have created a level of expectation that U.S. government and the Fed have found the "magic formula" to avoid (or at least limit the duration or severity) recessions without any "payback" for higher government debt. That may well prove to be true over time, but there are a lot of risks involved in the alchemy of ever-increasing debt with no consequences. In addition, social unrest has accompanied both the GFC and the current recession, leading to increased risk that fiscal policies benefiting corporate and investor interests, such as the 2017 Tax Cuts and Jobs Act, may face repeal under future administrations.

These are observations on market conditions, not attempts to predict the future. You will not see them reflected in our holdings in a top-down manner. We remain committed to balancing the risks and opportunities when considering individual investment candidates as well as the entire portfolio. Our goal is to consider a wide range of possibilities, understand the impact each may have in the value of individual companies, and invest when we conclude that the risk we take is appropriate. However, for some time it has not paid to consider the downside of expectations. We find it increasingly difficult to find attractive investment opportunities in the "winning" sectors of the market, where already very high expectations have become exceedingly high, while opportunities in "losing" sectors abound. On balance we are finding attractively valued investment opportunities across most sectors. We are seeking to exploit the dramatic swings in the market to create long-term value for shareholders. The ride may continue to be bumpy, but we believe the portfolio is on the right track.

Portfolio Highlights

The ClearBridge Small Cap Strategy underperformed the Russell 2000 Index, the Strategy's 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 primary contributors to the Strategy's performance were the health care, information technology (IT), consumer discretionary and industrials sectors. The energy, utilities, real estate and materials sectors lagged the most.

On a relative basis, the Strategy underperformed its benchmark primarily due to sector allocation. In particular, an underweight to the health care sector and the Strategy's cash position weighed on relative results. Stock selection in the consumer discretionary,

energy and industrials sectors were also detrimental. Conversely, an overweight to the consumer discretionary sector and stock selection in the health care, financials and communication services sectors proved beneficial.

On an individual stock basis, Covetrus, Quotient, Aaron's, Sprouts Farmers Markets and K12 were the largest contributors to absolute performance. International Seaways, ProAssurance, Great Western Bancorp, Black Hills and WesBanco were the greatest detractors from absolute returns.

We initiated several new positions in the quarter, the most significant of which were in Collier Creek and BRP Group in the financials sector, Texas Roadhouse and Helen of Troy in the consumer discretionary sector and Cubic in the industrials sector. More significant positions sold included ProAssurance and Great Western Bancorp in the financials sector, Service Corporation and Monro in the consumer discretionary sector and Summit Hotel Properties in the real estate sector.