ClearBridge Investments

Sustainability Leaders Strategy

Mary Jane McQuillen
Managing Director, Head of ESG Investment, Portfolio Manager

Derek Deutsch, CFA
Managing Director, Portfolio Manager

Key Takeaways

- A large injection of liquidity into financial markets as well as the largest U.S. fiscal stimulus package ever helped equity markets rebound from lows in March.
- Our technology holdings, where we are focused on large platform companies and those addressing climate change by developing cleaner energy sources, were a main driver of portfolio returns.
- 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 and Outlook

Massive liquidity injected into the financial system by the Federal Reserve, glimmers of improving economic data and signs of initial progress slowing the spread of COVID-19 combined to produce a strong recovery for equities in the second quarter. The benchmark Russell 3000 Index rose 22.0%.

As initial jobless claims soared, the Coronavirus Aid, Relief and Economic Security (CARES) Act in March delivered nearly $2 trillion in stimulus to the U.S. economy, the largest such package ever. The Federal Reserve meanwhile expanded its balance sheet to historic levels with loans and asset purchases.

The U.S. economy showed signs of improvement in the quarter. A surprisingly upbeat jobs report that saw 2.5 million jobs added in May was accompanied by positive consumer spending news: personal consumption rose 8.2% and retail sales rose 17.7%. The economy then added another 4.8 million jobs in June, while the unemployment rate fell to 11.1% from 13.3% in May. Similarly, manufacturing activity picked up, with the ISM Manufacturing PMI for the U.S. rising from 41.5 in April to 43.1 in May and into expansionary territory in June with a 52.6 reading. At the same time, surges in the number of COVID-19 infection cases, both abroad and in parts of the U.S., continue to loom over economic reopening.

In the benchmark index, several cyclical sectors outperformed more defensive sectors. An improving economic outlook along with OPEC production constraints pushed oil prices higher, boosting energy stocks during the period, although they remain well below levels achieved earlier in the year and are not represented in the portfolio. Consumer discretionary spending benefited as the economy started to gradually open and people began to cautiously venture outside of their residences where they have been cooped up for months. Meanwhile, financials underperformed other cyclical sectors as fears of credit losses and the prospect of lower for longer interest rates limited investor enthusiasm. Information technology (IT), often perceived to be somewhat cyclical, continues to perform well as workers remain connected remotely. Defensive, income-oriented utilities and consumer staples underperformed in the period.

Technology companies in the portfolio were the main drivers of returns in the quarter, led by Apple and Microsoft, which are benefiting from increased reliance on their platforms as workers plug in from home. Apple maintains a strong service business and is being bought up ahead of the expected release this fall of its next iPhone, which is expected to include 5G connectivity. Microsoft continues to execute well; the developer of Windows and Office as well as the Azure cloud platform is a key beneficiary of accelerating cloud adoption.

Other strong IT performers in the portfolio are not household names. Two of these are companies addressing climate change by developing cleaner energy sources. Enphase Energy, a first-quarter addition to the portfolio, designs and manufactures microinverters for residential and small commercial solar PV systems. Enphase is executing well and maintaining solid margins as it evolves from a solar inverter maker into a “home energy management” company that can act as the brains for the home’s energy system, including microinverters for solar, as well as storage and energy management software. SolarEdge Technologies, a solar energy company making power inverters and optimizers for solar installations, is one of the best-positioned component suppliers to a fast-growing solar industry with a differentiated product, strong balance sheet and continuing market share gains.

Other IT holdings rose amid a nascent recovery of the semiconductor cycle that proved resilient amid pandemic-induced shutdowns. These included recent addition Synopsys, a leading provider of electronic design automation software and services to the semiconductor industry, a very attractive niche market. Synopsys plays a pivotal role in innovation by helping shrink chip sizes and increasing computing power. Lam Research, which makes capital equipment used in the semiconductor manufacturing process, was also a strong contributor. Lam’s technologies are crucial to the miniaturization of semiconductor technology, which reduces device size and energy consumption for chips.

As investors looked past COVID-19-induced shutdowns and rather optimistically positioned for a V-shaped recovery, utilities holdings such as geothermal energy leader Ormat Technologies were challenged. Ormat is also facing pressure as costs fall for other renewable energy sources such as solar and wind, although Ormat's recent results show it has made headway in improving profitability after two disappointing quarters.

Electronic content per vehicle is growing and is especially high in electric vehicles, where electronic connectors are in high demand.

Border closures and drastically reduced travel activity were large headwinds for Booking, an online travel agency and new position initiated this quarter. While travel stocks have been hurt in 2020 due to COVID-19-induced travel restrictions, Booking's solid growth prospects, good margins and defensible moats are attractive characteristics looking past near-term disruption in travel trends.

Portfolio Positioning

During the quarter we added two names with strong exposure to the secular growth of electric vehicles (EVs), which will have a large impact over time reducing reliance on fossil fuels. Aptiv is an electronic connector manufacturing company, primarily for automotive components, that benefits from growing trends of vehicle electrification as its connectors support emissions control or hybrid electrification content in EVs. Aptiv's products enable hybrid and EV automakers' efforts to meet increasingly stringent emission standards. The company also has numerous environmental initiatives in place to manage greenhouse gas emissions (which are down 11% over 2013–16) and lower water consumption and waste disposal per employee (down 17% and 23%, respectively, over 2013–16).

TE Connectivity (TEL) makes connectors for a wide range of uses, including automobiles, data centers and medical devices. TEL's transportation/automotive segment revenue is outgrowing light vehicle production as electronic content per vehicle continues to grow, and TEL is a major beneficiary of the secular trend of vehicle electrification, enjoying double the per-vehicle content for EVs compared to traditional internal combustion engine vehicles.

TEL has best-in-class environmental policies that complement its impact as it supports the broad growth of EVs. The company has reduced its energy use intensity by 30% and its greenhouse gas intensity by 38% over the past decade. The manufacturing process for connectors is also very water intensive, but the company has been able to reduce its water usage by 30% over the past decade as well. The company has been working to improve its commitment to responsible sourcing and has been working to find alternatives to problematic materials such as cobalt for enablement of EVs, despite the fact that cobalt is not a directly sourced material for TEL itself.

Global health care company Merck delivered mixed clinical results for its leading cancer immunology drug, Keytruda, in a Phase III trial treating small-cell lung cancer. The stock was a modest detractor. Keytruda was central to our thesis on Merck, based on earlier exceptional Phase III data, especially in lung cancer. Lacking this catalyst, we felt there was better opportunity elsewhere in the market and exited.

We also sold U.S. Bancorp, a super-regional bank based in the U.S. Midwest and West, for whose earnings lower-for-longer interest rates will be a significant headwind.

Outlook

Looking ahead, we think the outlook for the U.S. equity market is very difficult to discern given the unprecedented nature of the pandemic-induced recession and the massive amount of fiscal and monetary stimulus being applied across the globe. We are monitoring evolving economic data and the infection rates of COVID-19 as we believe subsequent waves of the virus will challenge the narrative of a V-shaped recovery. We are also cognizant of risks posed in a U.S. election year. That said, we spend most of our time and effort researching individual stocks and de-emphasize macro factors when constructing our portfolio. We maintain a quality orientation toward companies with strong balance sheets, high returns on invested capital, sustainable cash flows and leading ESG profiles. There is no change in our thesis that companies with these characteristics are attractive long-term investments and can have a positive impact on the world we live in.

Portfolio Highlights

The ClearBridge Sustainability Leaders Strategy underperformed its Russell 3000 Index benchmark during the second quarter. On an absolute basis, the Strategy had gains in all 10 sectors in which it was invested (out of 11 sectors total). The main contributors were the IT, health care and industrials sectors. The utilities and real estate sectors were the main laggards.

On a relative basis, overall sector allocation and stock selection detracted from performance. Overweights to the utilities and consumer staples sectors weighed on relative results and a lack of energy holdings detracted in a quarter that saw oil prices and energy stocks recover off lows. Stock selection in the consumer discretionary and materials sectors also detracted. Conversely, stock selection in the IT and industrials sectors proved beneficial.

On an individual stock basis, Apple, Microsoft, SolarEdge Technologies, Trex and BioMarin Pharmaceutical were the largest contributors to absolute performance in the quarter. The main detractors from absolute returns were positions in Booking, U.S. Bancorp, Ormat Technologies, Xylem and T-Mobile.

Besides portfolio activity discussed above, during the quarter we initiated new positions in Amgen in the health care sector and T-Mobile in the communication services sector. We closed out positions in Xylem in the industrials sector, Colgate-Palmolive in the consumer staples sector and Starbucks in the consumer discretionary sector.

Despite EEO laws, voluntary detailed diversity disclosure to shareholders has been hard to come by.

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.

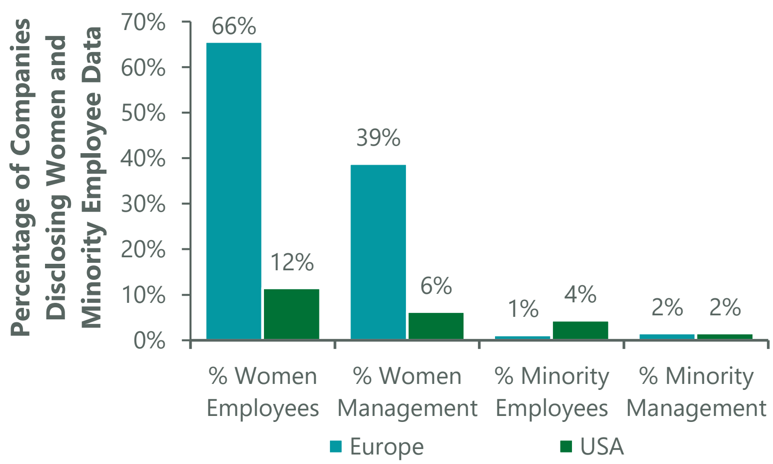
Lack of Diversity Data Is a Challenge

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 1).

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 1: 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.

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

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.

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 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 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.