ClearBridge Investments

All Cap Value Strategy

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Key Takeaways

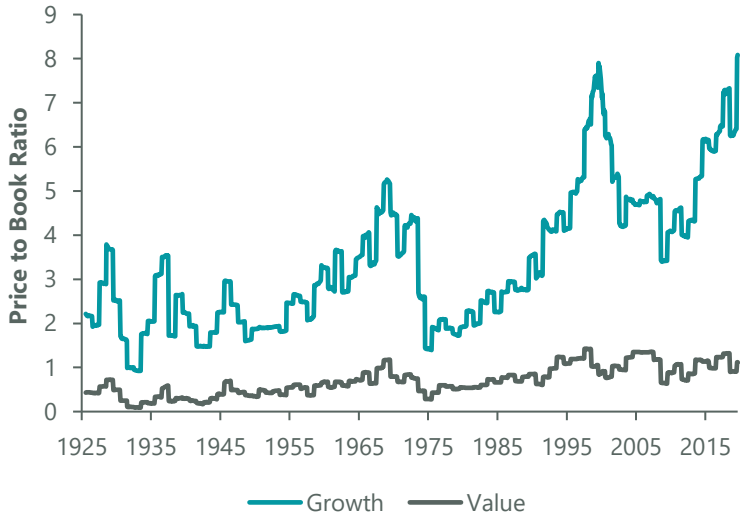
- The investing world has never expected less of U.S. value stocks relative to U.S. growth stocks, but the value tail of the distribution may be where the real opportunity lies, and it is where fewer and fewer investors are looking.
- Value isn't a homogenous basket of dead zombie companies; there are many value stocks earning solid returns on capital, generating ample earnings and free cash flow and paying down debt.
- As another layer of portfolio diversification and robustness, we are balancing the continued negative price momentum in deep value sectors, primarily in energy and financials, with value names that are starting to rebound powerfully.

Market Overview and Outlook: Wide Expectation Gaps Suggest a Shift in Market Narrative

Looking back several decades, the investing world has never expected less of U.S. value stocks relative to U.S. growth stocks. This ignominious record has come after value stocks have underperformed growth stocks by over 50% during this market cycle, with value quarantined at its lowest relative valuation in our respective careers.

To most market observers the shock of this value implosion has worn off, as the underlying drivers are widely accepted. After all, the digital era is mean-repelling, as growth stocks enjoy digital monopolies from network effects that have created some of the best business models investors have ever witnessed. The result is a winner-take-all dynamic that is destroying lesser businesses at an increasing rate. This has allowed growth stocks to scale the heights of Mount Olympus while value stocks have been banished to the depths of Hades. Every market cycle has its dominant narratives that are well-supported by observed reality, and the digitally powered dominance of growth is the narrative of this cycle.

Exhibit 1: Growth and Value Stocks Are at Historic Extremes



As of Sept. 30, 2020. Source: ClearBridge Investments, Kenneth R. French Data Library.

The risk, however, is that cycle truths eventually get taken too far, with expectations rising to excess levels on a tidal wave of liquidity and consensus-driven capital flows. As has been attributed to Mark Twain, "It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so." Eventually the unexpected happens and market truths get challenged. In the last market cycle, the two big known truths that dominated investor behavior and capital flows were that U.S. home prices could never decline in aggregate and that commodity supply would never catch up to the insatiable demand from emerging market growth. This gave the previous cycle a growth narrative with a value twist, and it also enjoyed its very own acronym of BRIC (Brazil, Russia, India and China). Remember that?

The key then is to ask what could challenge the current accepted market truth of growth dominance? Growth stocks get all the attention when trying to tackle this question, with investors noisily debating the bubble question. However, we think the more interesting answer comes from focusing the question on the inverted bubble in value stocks: what if value stocks do what they have always done and start to revert to the mean? This historic extreme in the value tail of the distribution may be where the real opportunity lies, and like many great opportunities, it is where fewer and fewer investors are looking.

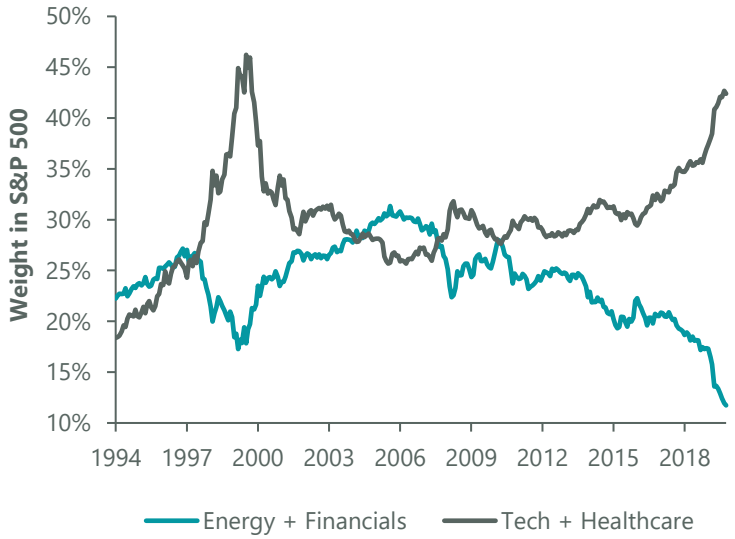
It will help to break this potential value opportunity into three scenarios: the absurdity of zero bound, no mean reversion, and historic norms.

First, the absurdity of zero bound. Unlike U.S. interest rates that may defy 5,000 years of history and dive below zero, value stocks cannot go to zero relative to growth stocks. A persistent decline

in the price of value stocks where the underlying businesses are generating positive fundamental value must make these attractive enough to own at some point above zero.

Having a zero bound for value stocks is as absurd as the embedded return expectations in the mega-cap growth stocks, which suggest their market capitalizations will grow bigger than the U.S. economy over the next decade. Today tech is dominant, but there are limits to its dominance, as tech cannot be 100% of the market and the economy. Absurd math happens late in cycles as investor exuberance around a powerful narrative starts to outrun practical reality.

Exhibit 2: Health Care and Tech at Historic Odds with Energy and Financials



As of Sept. 30, 2020.f Source: ClearBridge Investments, Bloomberg Finance, FactSet.

The other argument against zero is that many value stocks are indeed creating value, and these companies are also critical customers for all-things tech. Value isn't a homogenous basket of dead zombie companies; there are many value stocks earning solid returns on capital, generating ample earnings and free cash flow and paying down debt. This is true even in the most maligned sectors of energy and financials. In energy we are investing in exploration and production companies that are generating positive free cash flow at currently depressed prices and maintaining a very valuable option on higher oil prices in the future. In financials, we are investing in banks and insurance companies that are generating earnings and cash flow despite the intense headwinds from a COVID-19-impaired economy, which is allowing them to build book value and pay dividends. Yet both sectors have arguably never been more depressed.

Second: no mean reversion. That is, what if the relative valuation of value just stabilizes? Relative performance would obviously stop deteriorating. But this in itself would be a massive improvement as the deepest relative value hole would quit getting deeper, and the structural excess return value it tends to earn due to its higher cost of capital would cease to be overpowered and obscured by the valuation compression. A higher absolute return for many value stocks, with their higher current dividend yields than the market, might start to garner some investor attention in a world that is madly chasing returns and yield in pretty much every asset class besides value stocks. Which is to say any stabilization would lead to a mean reversion.

If history is any guide, however, when value stocks do reverse course — our third scenario — it will likely be in a relative explosion higher. Reversion is what value does, especially from extreme levels like we're observing currently. In an excellent recent paper, "Reports of Value's Death May Be Greatly Exaggerated," researchers dove into what reversion from these relative depths would mean for value relative to growth performance.[1] According to the paper, a revaluation of value to median levels (from 100th to 50th percentile) would entail a relative outperformance by value of more than 75%. But even a much smaller reversion, to the 95th percentile — to all but 5% of historic observations — would result in greater than 35% relative performance.

Exhibit 3: Stakes Are Potentially Very High in a Revaluation of Value

Scenario End Point: Percentile of Relative Cheapness of Value; (100 = Cheapest Ever, 50 = Median)	Relative Return of Value Vs. Growth (%)
Stay at 100th Percentile	4.5
Move to 95th Percentile	37.1
Move to 90th Percentile	45.8
Move to 75th Percentile	64.8
Move to 50th Percentile	76.8

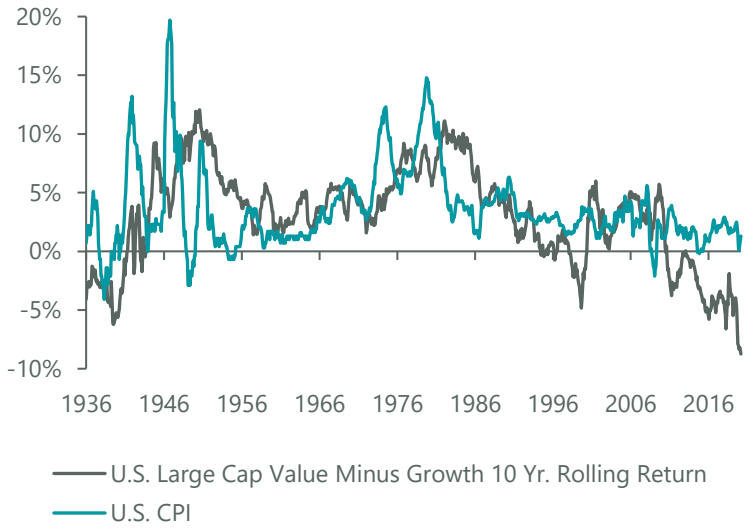
As of Aug. 23, 2020. Source: Arnott, Robert D. and Harvey, Campbell R. and Kalesnik, Vitali and Linnainmaa, Juhani T., "Reports of Value's Death May Be Greatly Exaggerated." Table offers forward-looking expected returns according to scenario analysis, conditional on revaluation, if they occurred in a single year.

Timing the exact start of a reversion process is impossible, but we think any move higher in interest rates would catalyze a big bang for value. With interest rates at 5,000-year lows and close to zero, the dreams of continued glory for growth stocks have been pulled into the present, as have the expected future

[1] Arnott, Robert D. and Harvey, Campbell R. and Kalesnik, Vitali and Linnainmaa, Juhani T., Reports of Value's Death May Be Greatly Exaggerated (August 23, 2020). Available at SSRN: https://ssrn.com/abstract=3488748 or http://dx.doi.org/10.2139/ssrn.3488748

demise of value stocks. Low rates have effectively weaponized the value and growth multiple divergence, and any expansion in rates would logically trigger the reverse.

Exhibit 4: Inflation and Value Have Historically Moved Together



As of Sept. 30, 2020. Source: ClearBridge Investments, Kenneth R. French Data Library.

Not surprisingly, markets continue to reflect a macroeconomic certainty of low rates forever, making the upward journey of growth and downward journey of value look dependent on this. However, we think that over the next few quarters as the noise of the upcoming election fades away, more fiscal expansion will follow, and it will be combined with a good probability of success on the COVID-19 vaccine front. This combination could finally light the fuse on the record amount of monetary fuel that has been pumped into the global economy, and dramatically shift current market narratives.

With value at such historically depressed levels we are finding attractive new investments, and our portfolio activity remains modestly elevated as we try to make the most of what may prove to be one of the best opportunities for value in our careers. An added benefit of value being treated as a dead investment strategy is that the opportunity set is not only deep, but also diverse. Accordingly, we added four new names to the portfolio during the quarter from four different sectors: consumer staples, energy, industrials and materials. As another layer of portfolio diversification and robustness, we are balancing the continued negative price momentum in deep value sectors, primarily in energy and financials, with value names that are starting to rebound powerfully.

In this latter group we added Vulcan Materials, which sells mundane construction materials: aggregates, asphalt, concrete and cement. The materials may not be very fancy, but Vulcan enjoys a regional monopoly in cities where it operates a quarry, as the high cost to ship aggregates and zoning restrictions greatly limit local substitutes. The result is long-term pricing power and low capital spending that generate very attractive long-term business economics. Vulcan stock has started to rebound as the ongoing housing boom is driving strong construction material demand. There are also two very valuable long-term options embedded in Vulcan stock: the potential for a major increase in infrastructure spending as fiscal policy ramps up after the election, and the ability to drive prices above inflation in the event inflation is reborn from the marriage of fiscal and monetary policy over the next several years.

Low rates have effectively weaponized the value and growth divergence, and any expansion in rates would logically trigger the reverse.

A major benefit of having very little expected of value is that we don't need to know much about the future. We just need to stay focused on companies that continue to create business value in the present and have the staying power to endure value's perceived death until the market narrative shifts. History is never an exact guide to the future, but as Mark Twain also famously said, "History doesn't repeat itself, but it often rhymes."

Portfolio Highlights

The ClearBridge All Cap Value Strategy had a positive return during the third quarter, underperforming the Strategy's benchmark Russell 3000 Value Index.

On an absolute basis, the Strategy had gains in 10 of 11 sectors in which it was invested during the quarter. The primary contributors to the Strategy's performance were the industrials, health care, communication services and financials sectors. The energy sector was the sole detractor.

In relative terms, the Strategy underperformed its benchmark due to sector allocation and stock selection decisions during the quarter. An overweight to the energy sector and stock selection in the consumer staples, consumer discretionary and health care sectors detracted the most. Conversely, stock selection in the energy, real estate and utilities sectors proved beneficial.

On an individual stock basis, the greatest contributors to absolute returns during the quarter were positions in OneMain Holdings, Synchrony Financial, AES, Unilever and Covetrus. Citigroup, Suncor Energy, Kinder Morgan, Sprouts Farmers Markets and Reynolds were the largest detractors from absolute performance.

Besides portfolio activity mentioned above, during the quarter we initiated positions in Total in the energy sector, TreeHouse Foods in the consumer staples sector and Curtiss-Wright in the industrials sector. We closed a position in Service Corporation in the consumer discretionary sector.