ClearBridge Investments

Appreciation Strategy

Scott Glasser
Managing Director, Co-Chief Investment Officer, Portfolio Manager

Michael Kagan
Managing Director, Portfolio Manager

Key Takeaways

- We believe September ushered in a period of healthy market consolidation as markets grapple with several near-term concerns.
- The obvious COVID-19 beneficiaries have performed well but we believe we are nearing the point where market leadership will shift to companies who will benefit from the recovery from the pandemic.
- We remain optimistic the bull market that began in March will continue as we see both consumer and commercial tailwinds supporting continued economic expansion.

Market Overview: Strength of Cyclicals Projects a 2021 Recovery

Although the liquidity-driven rally that began in late March continued through the third quarter, with the S&P 500 adding 8.9%, momentum stalled in September as the market declined -3.8%. We believe September ushered in a period of healthy market consolidation as markets grapple with several near-term concerns. COVID-19 is still wreaking havoc on mobility (with the U.S. potentially entering a "second wave" of infections); the November U.S. presidential election is — to put it politely — contentious; our politicians are at a stalemate over additional economic support; and Federal Reserve messaging is seemingly out of sync. Looking past the presidential election and into 2021, we remain optimistic the bull market that began in March will continue as we see both consumer and commercial tailwinds supporting continued economic expansion.

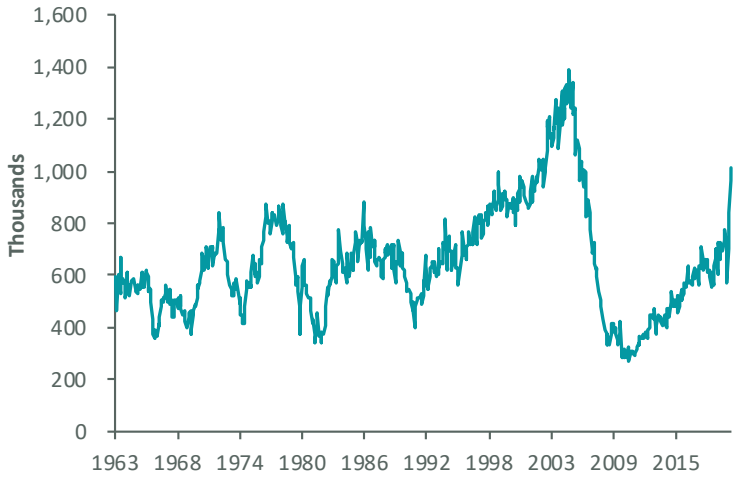
The consumer appears in excellent shape despite elevated unemployment. Helped by massive stimulus packages, consumer savings as a percent of personal income is at all-time highs, while consumer debt remains stable. At the same time, applications to refinance mortgages have spiked (Exhibit 1) as many consumers capitalize on the low rate environment to reduce their debt burden. As unemployment mends — Automatic Data Processing estimates we have already regained nearly half of the roughly 20 million jobs lost in March and April — we believe further improvement in consumer spending (which represents two thirds of U.S. GDP) is likely. The consumer's strength has helped a surge in new home sales (Exhibit 2). Houses sold today support future residential construction spending and should sustain momentum

in durable goods consumption well into 2021, in our view. Finally, we are encouraged by a generally improving trend in personal consumption, which is nearly flat year over year, while retail and food service sales are growing year over year despite the health and economic headwinds.

Exhibit 1: Mortgage Refinancing Applications Remain Elevated

As of Sept. 25, 2020. Source: ClearBridge Investments, Mortgage Bankers Association, Bloomberg Finance.

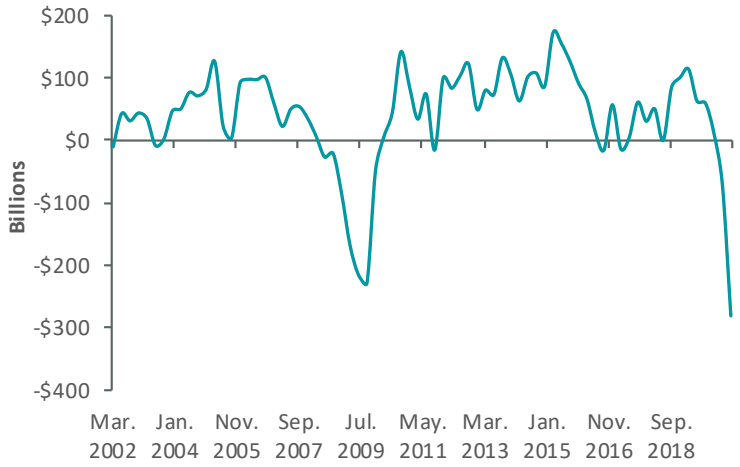
Exhibit 2: New Home Sales Are Surging



As of Aug. 31, 2020. Source: ClearBridge Investments, Bloomberg Finance.

On the commercial side, the unprecedented decline in business inventories (Exhibit 3) created more than a 2% drag on U.S. GDP growth over the past two quarters. We believe it is only a matter of time before stable and improving consumption trends require companies to replenish inventories, boosting GDP next year.

Exhibit 3: Decline in Business Inventories Poised to Rebound



As of June 30, 2020. Source: ClearBridge Investments, Bureau of Economic Analysis, Bloomberg Finance.

During the third quarter, market performance broadened a bit from the narrow, mega-cap-dominated market performance in the second quarter. Information technology (IT) outperformed for the seventh consecutive quarter but gave up ground in September. The strongest performance came in consumer discretionary, industrials and materials sectors. Energy fell sharply, hurt by weak oil prices and concern that electric vehicles and renewable energy will secularly diminish oil and gas demand starting this decade. Real estate and financials appreciated only slightly. On a day-by-day basis, bad news on COVID-19 generally drove outperformance from IT stocks while good news encouraged strength in cyclicals. The broadening of performance into cyclicals during the quarter indicates that the market is looking ahead to recovery from COVID-19 in 2021.

The obvious COVID-19 beneficiaries have performed well but we believe we are nearing the point where market leadership will shift to companies who will benefit from the recovery from the pandemic. We feel the high valuation and concentrated ownership of mega-cap IT stocks makes them risky despite their resilient business models. The opportunities in this market lie elsewhere. Technological disruption is nascent in mortgages and automobiles while stock valuations are modest. We believe the COVID-19-induced population movement out of center cities into the suburbs will be a multiyear trend, creating opportunities in homebuilders. Some cyclical industries are at the beginning of multiyear upcycles, most notably steel producers. Logistics companies are benefiting from a firmer stance on getting paid fairly for the service they provide. On the flip side, we expect interest rates to remain near zero for several years and continue to be cautious on banks and life insurers.

Outlook

We remain risk averse investors who believe diversification and a balanced approach to stock selection, industry allocation and factor exposure are prudent. We are constructive on the outlook for economic growth and believe businesses levered to improved economic activity have better risk/reward than the mega-cap secular growth companies. As a result, we have methodically and prudently tilted our portfolio slightly more toward investments that reflect this view. As ever, we focus on owning high-quality stocks and protecting investor downside.

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Portfolio Highlights

The Appreciation Strategy outperformed the benchmark in the third quarter. On an absolute basis, the Strategy had gains in nine of 11 sectors. The main contributors to performance were IT and communication services. Energy and real estate were the only two sectors with negative absolute contributions to performance.

In relative terms, stock selection accounted for all of Appreciation's outperformance in the quarter. Stock selection in the communication services and health care sectors contributed the most to relative outperformance while stock selection in the IT, real estate, and consumer discretionary sectors detracted the most. Sector allocation was a small detractor to relative performance as an underweight in consumer discretionary and overweight in energy more than offset the benefit of an overweight in materials.

On an individual stock basis, the biggest contributors to absolute outperformance during the quarter were Apple, United Parcel Service, Berkshire Hathaway, Amazon.com and Comcast. The biggest detractors were Chevron, Exxon Mobil, Raytheon Technologies, American Tower and Kinder Morgan.

During the quarter we initiated positions in Toll Brothers and General Motors in the consumer discretionary sector, Abbvie in the health care sector and Intercontinental Exchange in the financials sector. We closed positions in American International Group in the financials sector and Cisco in the IT sector. We received rights for shares in T-Mobile, which we converted into equity to hold in the portfolio.