ClearBridge Investments

Appreciation ESG Strategy

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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.
- Developing the energy grid of the future will require an ecosystem of renewable energy innovators and adopters, and several ClearBridge holdings are playing a role.

Market Overview: Shift in Market Leadership May Be Underway

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.

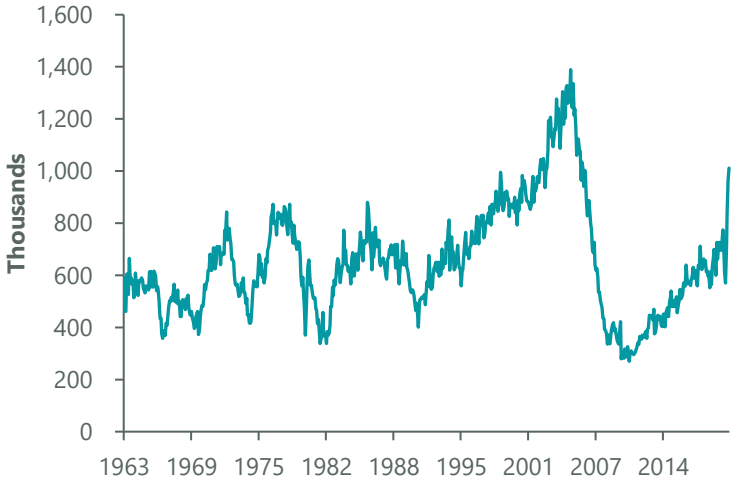
The consumer appears in excellent shape despite elevated unemployment. Helped by massive stimulus packages, consumer savings as a percent of personal income is at all-time highs, while consumer debt remains stable. At the same time, applications to refinance mortgages have spiked (Exhibit 1) as many 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.

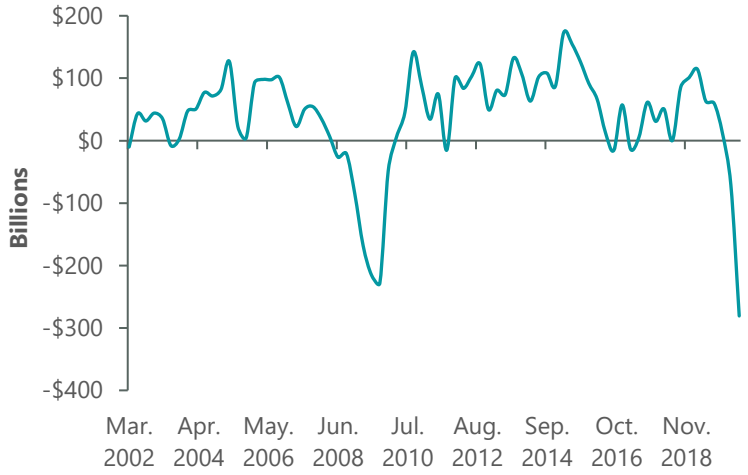
Exhibit 2: New Home Sales Are Surging



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 ClearBridge Appreciation ESG Strategy had a positive return during the third quarter of 2020, outperforming the Strategy's benchmark.

On an absolute basis, the Strategy had gains in nine of 11 sectors in which it was invested during the quarter. The main contributors to the Strategy's performance were the IT, communication services, consumer staples and health care sectors. The energy and real estate sectors were the sole detractors.

In relative terms, the Strategy outperformed its benchmark due to stock selection and sector allocation. In particular, stock selection in the communication services, industrials, consumer staples and health care sectors and an underweight to the energy sector contributed the most to relative performance. Conversely, stock selection in the IT sector detracted.

On an individual stock basis, the biggest contributors to absolute returns during the quarter included positions in Apple, Costco, United Parcel Service, Amazon.com and Berkshire Hathaway. The greatest detractors from absolute returns were positions in American Tower, Kinder Morgan, Automatic Data Processing, CVS Health and Ciena.

During the quarter we initiated new 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.

ESG Highlights: An Ecosystem of Renewable Energy Is Thriving

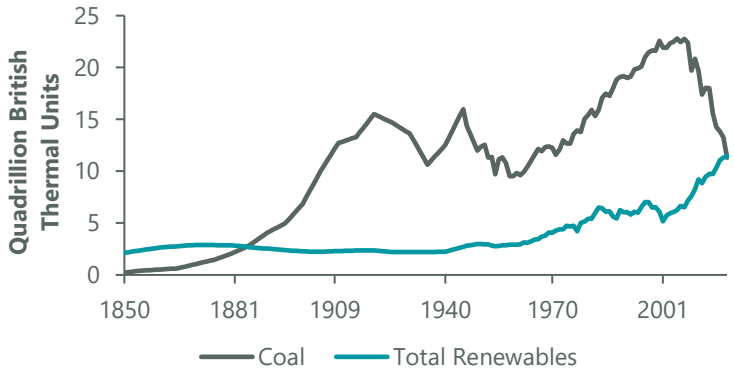
Recent developments in the energy and power sector suggest 2020 might be a watershed year for renewable energy and efforts to reduce carbon emissions. Forecasts for global oil demand have declined; the cost of wind and solar have fallen to levels nearly on par with fossil fuel energy sources; and investors

have fled the traditional energy sector while boosting stocks tied to renewable energy.

Governments around the world also continue to raise their ambitions for carbon reduction. For example, the EU is now looking at 55% reductions by 2030 (versus 40% previously), and China set a new goal to achieve net-zero carbon emissions by 2060. Renewable energy consumption recently surpassed coal for the first time since the 19th century (Exhibit 4).

It is too early to tell if this pace of change will continue, but we expect to see a steady tide of renewable energy sourcing from several quarters. As an active owner of companies across the renewable energy ecosystem, ClearBridge is finding economic opportunity in an array of innovators and adopters that are enabling this surge and helping the world transition to a less carbon-intensive future, maybe sooner than we think.

Exhibit 4: U.S. Renewable Energy Consumption Surpasses Coal



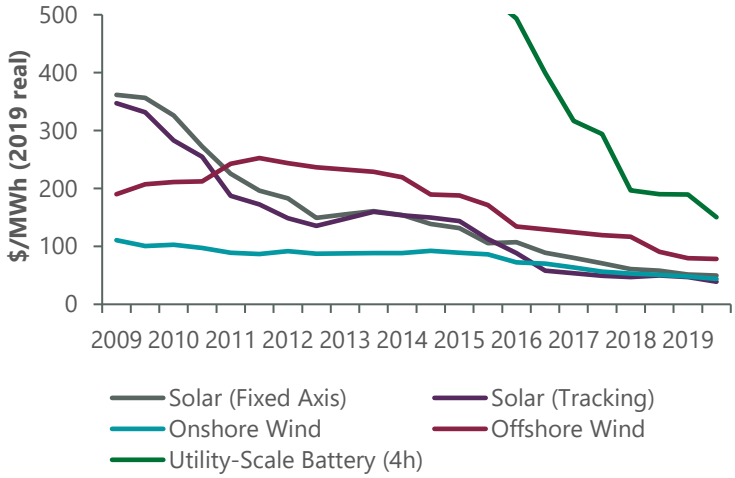
As of May 28, 2020. Source: U.S. Energy Information Administration. Renewables prior to 1890 from wood and biomass; hydroelectric added in 1890, geothermal in 1960, biofuels in 1981, wind in 1983 and solar in 1984.

Corporate Demand for Renewables Only Getting Stronger

Many companies held across ClearBridge portfolios have set aggressive targets for lowering emissions through use of renewable energy. Earlier this year, Amazon.com announced it is on track to run on 100% renewable energy by 2025, five years ahead of schedule, while Microsoft announced it expects to be carbon negative and beginning to remove the carbon it has emitted since its founding, by 2030. The ambition of these measures is made possible by falling costs of renewable energy (Exhibit 5).

Demand for renewable energy has continued to grow even through the pandemic, according to ClearBridge holding Brookfield Renewable. Brookfield Renewable's globally diversified, multi-technology renewables business, including a large hydro fleet, is well-positioned to help companies achieve decarbonization goals and makes Brookfield an attractive partner as more business and governments seek to lower their emissions.

Exhibit 5: Falling Costs of Renewable Energy Enable More Ambitious Initiatives



As of May 20, 2020. Source: Bloomberg New Energy Finance.

Commitments by large companies to increase renewable energy sourcing are felt through their supply chains, providing a competitive advantage to environmental forerunners and encouraging others to catch up. Data center provider and ClearBridge holding Equinix, for example, is a leader in renewable energy sourcing. In a recent engagement with Equinix, we discussed how several large customers that have announced their own targets around renewables and lowering carbon emissions were in some cases prioritizing Equinix data centers over competitors as it allowed them to get closer to their goals. Accordingly, we believe Equinix's goal of reaching 100% of energy sourced by renewables will be a positive for business.

Favorable Economics and Innovation Driving Solar Adoption

Brookfield Renewable has also been adding utility-scale solar in its energy mix. Solar costs have dropped in the past five years from $4 per watt to install to less than $1 per watt, according to the company, which believes solar could account for most of the its production capacity in 10 years' time (it is less than 20% today).

On the residential side, innovation by ClearBridge holdings SolarEdge Technologies and Enphase Energy, along with cheaper panels, is enabling more adoption by homeowners. SolarEdge makes solar inverters and optimizers for residential and commercial solar photovoltaic (PV) systems. SolarEdge's system combines power optimizers on the back of each solar panel on the roof (known as "module-level power electronics," or MLPE) with a string inverter on the side of the building (which converts the direct current power produced by the solar modules to usable alternating current).

Enphase was the first company to commercialize microinverters for residential and small commercial solar PV systems. A microinverter, a type of MLPE, is a small inverter placed directly on the back of each solar module, as opposed to the traditional system of one string inverter on the side of the building.

MLPEs improve the efficient energy capture of a solar PV system by performing maximum power point tracking at the module level, rather than at the array level (all modules combined). They also allow greater flexibility in how modules are installed, in terms of angle, type and number, so houses with multiple roofs at different angles can use more surface area and capture more energy from it.

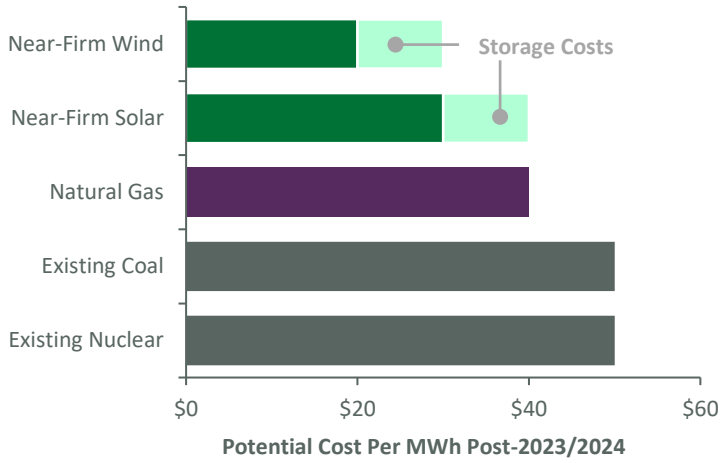
Storage Next Big Question for Renewables

While good for the planet, renewable power has two main shortcomings: an inability to "match" power consumption peaks and variability of renewable power production driven by weather dependency. California rolling blackouts in August amid record-high summer temperatures, low winds and lower imports of power from neighboring states underscore these drawbacks of renewables and highlight the importance of storage/battery capacity for a reliable power grid.

Renewable energy paired with storage is an increasingly attractive option, and one which utility companies have begun to offer. While most battery technologies today offer only a few hours of power storage, the "near-firm" renewable power resources (solar or wind plus battery that can provide power that is nearly firm, or nearly around the clock) could help alleviate some of the impacts from grid outages, especially urgent in regions currently facing generation shortages. Solar and storage is now cheap enough that it is replacing inefficient peaking units — power plants that run only when there is a high demand for electricity, in order to balance the grid.

Storage remains a focus for several ClearBridge utility holdings, such as NextEra Energy, whose unregulated NextEra Energy Resources segment has the largest battery storage capacity in the world. NextEra Energy believes near-firm renewables will be competitive with all the traditional generation technologies as of 2023–2024 (Exhibit 6). The company's project pipeline has 2.2GW in battery storage under development and battery storage investments in 2021 are expected to exceed $1 billion. It expects the continued innovation by the automotive industry, improvements in converters and enclosures, and lower balance of system costs to drive down the cost of energy storage by ~16% CAGR between 2020 and 2023.

Exhibit 6: Even with Addition of Storage, Renewables Are Cost Competitive



As of Sept. 2020. Source: NextEra Energy. Represents projected cost per MWh for new build wind, solar, and natural gas; excludes production tax credit for wind and assumes 10% investment tax credit for solar; projected per MWh operating cost including fuel for existing nuclear and coal; based on NextEra Energy internal estimates.

Yet overall renewables remain intermittent, and while storage improves availability of renewable assets, the combination cannot beat high 90% availability of baseload gas or nuclear plants, at least in the near term. The grid of the future should have a much higher presence of renewables, although a full elimination of the traditional sources of power will likely require some major breakthroughs in storage technology.

Many Businesses Can Thrive in Transition to Renewable Energy

As efforts to combat climate change become more urgent, it is encouraging to see the increasing scale of commitments by corporations as well as state and city governments. Developing the energy grid of the future, which will have to support more cars, trucks and buses transitioning to electric motors, will require an ecosystem of renewable energy innovators and adopters. ClearBridge will continue to seek out and engage with leading companies that can thrive as we progress toward a net-zero future.