ClearBridge Investments

Small Cap Strategy

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Key Takeaways

- The Strategy performed well in the third quarter in an environment where stocks with at least one indicator of earnings quality — high returns on equity — outperformed.
- Overall the characteristics of the outperformers during the quarter were very similar to the last several quarters: growth continues to crush value.
- If at some point factors such as slower economic growth, spiking debt costs or inflation begin to be discounted in asset values, the narrative will quickly change.

Market Overview and Outlook: Earnings Quality Suddenly Matters Again

The Small Cap Strategy outperformed the Russell 2000 Index for the quarter ended September 30, 2020. During the quarter stock selection was the main driver of performance, partially offset by sector allocation. Some cyclical areas of the market that the Strategy is underweight, notably consumer durables and some portions of industrials, outperformed during the period. We continue to look for opportunities in those sectors. We also lost significant ground from stock selection in health care, which remains a challenge to outperform, given the boom-or-bust nature of small cap stocks in the sector. Our two biggest detractors for the quarter were Akebia Therapeutics and Amarin, but, on the other side of the ledger, R1 RCM was our biggest contributor.

Overall the characteristics of the outperformers during the quarter were very similar to the last several quarters: growth continues to crush value. The Russell 2000 Growth Index outperformed the Russell 2000 Value Index by another 460 basis points (bps) in the quarter for a year-to-date lead of 2,542 bps. Based on data from Jefferies, growth stocks are now at the widest spread relative to value stocks since March of 2000. One change was that stocks with at least one indicator of earnings quality — high returns on equity (ROE) — outperformed during the quarter. While it may suggest the market is starting to favor higher-quality companies, it is also worth noting that the bottom two quintiles of ROE also outperformed the Russell 2000. The market continues to favor growth at any price.

Humans tend to form narratives that help explain what is going on in the world around them. One example was a Bloomberg article on October 5 seeking to justify the stock market's move on

that day.[1] The narrative offered was that a bigger lead in the polls by Mr. Biden would result in a clear, uncontested election win and therefore "the market" was starting to price in more certainty. While it may be true that the market "likes" certainty, trying to assign cause and effect to a complex adaptive system like the stock market is a fool's errand. If the market had been down that day, we may have read the argument that a Biden presidency would lead to higher taxes, which in turn would be bad for the market. Or maybe the market was up because higher taxes and higher government spending on productive investments would actually be good for the economy?

Over time and with the benefit of hindsight, the reason the market trended up or down may become clearer, but we believe it is extremely difficult to succeed in investing through such simplistic predictions of the future. First, one must predict the event correctly. Next, one must gauge properly what effect that event will have on the market. Finally, one must position one's portfolio to take advantage of it. If those steps sound easy, consider this: If you knew on March 1 that an economic lockdown was coming, that GDP would fall dramatically, that the unemployment rate would more than double from 3.5% in February to 7.9% in September, would you sell your total market fund? Whoops, bad call — the Russell 3000 Index was up close to 15% with dividends reinvested from March 1 to September 30.

Right now, the "winning" narrative in the stock market appears to be that the combination of low interest rates for an extended period of time and monetary and fiscal stimulus, will result in better economic outcomes than what is discounted in the prices of stocks. If so, the sectors and industries that have been leading may continue to do so, despite their very lofty valuations. There are several possibilities, however, such as slower economic growth, spiking debt costs, inflation and myriad other things that we may not even know about now. If at some point those factors begin to be discounted in asset values, the narrative will quickly change. We believe we will achieve better long-term returns by staying focused on finding companies with solid competitive strategies and maintaining our valuation discipline and portfolio diversification, rather than by pursuing themes or narratives. It is difficult to do so when cognitive diversity breaks down to the point it has in this market, but we are sticking to our process.

Portfolio Activity

Special purpose acquisition corporations (SPACs) have been around for decades, but 2020 has seen a surge in SPAC launches as well as private companies going public through SPAC conversion. SPACs are shell companies, usually with a well-known

[1] A Clear-Cut Biden Win Is Emerging as a Bull Case for Stocks," Bloomberg.com, October 5, 2020.

management team, that raise money in an IPO to make acquisitions of unspecified targets, generally in an industry of management's expertise. Investors in SPACs usually receive warrants in addition to shares at face value, providing an incentive to invest early. Unlike private equity, SPACs usually buy companies with cash only, which they have on hand from their IPOs and may raise in a private investment in public equity (PIPE) at the time of the deal announcement. The owners of the target company may take cash out and/or roll their stake into shares of the public entity after conversion.

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A company might prefer to sell to a SPAC for a number of reasons, including the ability to raise a large amount of cash for deleveraging; gaining access to the management expertise of the SPAC founders; and converting to a public company more quickly than through the traditional IPO route. For example, the SPAC Collier Creek was founded by Roger Deromedi and others, who had run Pinnacle Foods for many years and sold to ConAgra. Collier Creek acquired family-run Utz Brands, a snack-food company, with its $453 million in cash. Given the enterprise value of the company (~$1.6 billion) and its high level of existing debt, it would have been very difficult and taken many months for Utz to raise that much cash in a public IPO. Utz owners took $60 million of cash and received 50% ownership in the public company, now called Utz Brands (UTZ). The company was able to pay down $375 million in debt, giving it more ammunition to make acquisitions in the snack-food market, and it added as chair of the board SPAC founder Roger Deromedi, who has decades of experience in the packaged foods industry and as an acquisition integrator at a public company.

We assess SPAC deals in the same way we evaluate IPOs and other public company deals. We examine the financials, competitive strategy, management team and valuation. We have participated in these deals this year in several ways: we invested in a newly formed SPAC (energy-focused East Resources); we bought PIPEs in SPAC conversions prior to deal announcement, giving us an advantaged deal price (Conyers Park, whose Advantage Solutions offers sales and marketing services to consumer goods manufacturers and retailers, and Healthcare Merger, which combined with acute care telemedicine provider SOC Telemed); and we have purchased shares in the public market of a SPAC following its deal announcement (Utz). Each case has a different investment angle and a different reason why a SPAC was the preferred method, rather than an IPO or other route to liquidity, but our analysis was the same. We believe each was an attractive vehicle for shareholder value creation.

Whether the current spate of SPACs is a bull market phenomenon or a new secularly growing financing vehicle (like private equity, hedge funds and venture funds in the past two decades) is

unclear. Like all financial structures it has its advantages and its drawbacks. In the final analysis, we try to determine if the present value of future cash flows to shareholders will exceed the cost of the investment, whatever the financing structure is.

Portfolio Highlights

The ClearBridge Small Cap Strategy outperformed the Russell 2000 Index, the Strategy's benchmark, during the third quarter.

On an absolute basis, the Strategy had gains in eight of 11 sectors in which it was invested for the quarter. The primary contributors to the Strategy's performance were the consumer discretionary, industrials, information technology (IT) and communication services sectors. The energy and financials sectors lagged the most.

On a relative basis, the Strategy outperformed its benchmark due to stock selection, partially offset by sector allocation. Stock selection in the industrials, communication services, utilities and consumer discretionary sectors contributed the most. Conversely, stock selection in the health care and energy sectors and an underweight to the consumer discretionary sector detracted from relative results.

On an individual stock basis, R1 RCM, Lithia Motors, K12, QuinStreet and Textainer were the largest contributors to absolute performance. Akebia Therapeutics, Amarin, Quotient, Washington Federal and Sprouts Farmers Markets were the greatest detractors from absolute returns.

We initiated several new positions in the quarter, including, besides names discussed above, Omnicell in the health care sector, frontdoor and Century Communities in the consumer discretionary sector and Vertex and Sumo Logic in the IT sector. During the quarter we sold positions in Akebia Therapeutics in the health care sector, Helen of Troy and Oxford Industries in the consumer discretionary sector, MGP Ingredients in the consumer staples sector and MRC Global in the industrials sector.