ClearBridge Investments

Aggressive Growth Strategy

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Key Takeaways

- While overall market breadth remains narrow, the Strategy's performance during the technology correction in the last month of the quarter is encouraging.
- The Strategy's media holdings showed signs of improvement, buoyed by the return of live sports and robust demand for broadband.
- A clinical breakthrough on a COVID vaccine could be the catalyst that spurs a rotation out of momentum into the types of fundamentally strong, attractively valued companies we own.

Market Overview: Media Finds its Footing

A September correction for mega cap information technology (IT) and Internet stocks was not enough to derail the momentum trade in another strong quarter for equities in general and growth companies in particular. The S&P 500 Index advanced 8.9% in the third quarter, capping its best six-month run since 2009, while the tech-heavy NASDAQ Composite rose 11% to complete its best two-quarter performance since 2000. The benchmark Russell 3000 Growth Index gained 12.9% for the quarter, outperforming the Russell 3000 Value Index by over 740 basis points. Growth stocks have now beaten their value counterparts by an unprecedented 41 percentage points (4,100 bps) over the last 12 months.

While overall market breadth, highlighted by the historically concentrated nature of the benchmark, remains unfavorable to our valuation sensitive, high active share approach, the Aggressive Growth Strategy's performance over the last month is particularly encouraging. Our portfolio of companies trade at a steep discount to the benchmark and held up better during the selloff in high multiple names where we have minimal exposure.

Media has been one of the biggest detractors for our portfolios but also represents one of the more undervalued segments of the market in 2020 and showed signs of improvement during the recent quarter. While the communication services sector (+10.1%) trailed the return of the benchmark, the majority of our holdings in the sector performed better than the index. Companies like Comcast and Twitter had been hurt in the early lockdown period of the pandemic by advertising budget cuts due to a lack of live events. Engagement and ratings remained at record levels,

however, and when live sports returned in the third quarter with the resumption of the NBA season as well as the start of Major League Baseball and NFL seasons, advertising and viewership also picked up strongly, benefiting those two companies.

Broadband has also seen strong uptake in the work from home environment, increasing the demand for the higher connection speeds provided by Comcast and Liberty Broadband. Comcast reported the biggest growth in broadband subscribers in over a decade. Programmers AMC Networks and Discovery posted strong cash flow numbers in their most recent quarterly reports but have yet to see as strong a rebound as more diversified and distribution-focused holdings. Given their attractive valuations, high quality content and a supportive financing backdrop, we expect M&A could help return these assets to fair value.

Given stubbornly poor sentiment toward health care, it could take M&A activity or a blockbuster breakthrough to properly monetize these companies.

Consumer discretionary (+20.3%) was the best-performing sector in the benchmark for the quarter, boosted by resilient retail spending and continued e-commerce growth. The Strategy has limited exposure to consumer discretionary stocks, which was a meaningful relative headwind in the third quarter and has been for the last several quarters. IT (+14.6%) and the cyclical industrials (+13.7%) and materials (+13.6%) sectors also outperformed. Energy (-4.3%), which has a minimal weighting in the benchmark and the Strategy, was the worst performing sector. Health care (+5.5%) and financials (+6.2%) also lagged. The weaker relative performance of health care, which represents the Strategy's second largest overweight, also negatively impacted results.

The Strategy's health care exposure is centered in the areas of innovative biopharmaceuticals, managed care and diagnostics where the threat of pricing controls on prescription drugs and an overhaul of the health care system have weighed on sentiment in a contentious election year. Despite growing concern about a potential democratic sweep of both houses of Congress and the presidency, we believe the policy outcome is likely to be more benign than current expectations suggest. Accelerating advances in testing, and therapeutic and vaccine development in response to the COVID-19 pandemic, could be a boon for the sector moving forward. Investment in early detection and prevention of future crises will be crucial to the economy.

Clinical readouts of compounds being developed by our biopharmaceutical holdings and competitive pressures have also led to a volatile year for share prices. We have written previously about the patent challenges to one of Biogen's key drugs, while in the third quarter Vertex Pharmaceuticals and small cap holdings Ionis Pharmaceuticals and Agios Pharmaceuticals were pressured despite all delivering results that topped earnings expectations. Investors are taking commercial products for granted for these companies and now casting a skeptical eye on pipeline developments that we believe hold a great deal of promise. Vertex

was down for the quarter despite receiving FDA approval for an expanded use of its cystic fibrosis treatment Kalydeco in infants and has shown consistent top and bottom-line growth and advancement of its pipeline. We continue to believe the biopharmaceutical companies we own are on the leading edge of innovation and scientific breakthroughs and are developing must own, must use products to treat unmet needs. Several, like Vertex, Ultragenyx Pharmaceutical and Voyager Therapeutics, are involved in finding personalized treatments based on genomics and a genetic code to target specific therapies to specific patients. But given the stubbornly poor sentiment toward the group, we again are looking at M&A activity or a blockbuster breakthrough, such as FDA approval of Biogen's potential Alzheimer's treatment, to properly monetize these companies.

The largest detractor for the quarter was IT, an area where we look most different from the benchmark. The Strategy earned positive contributions from companies developing solutions in speech recognition (Nuance Communications), automotive/electric vehicle connectivity (TE Connectivity) and 5G and related communications applications (Broadcom) but was hurt in other areas such as digital storage (Western Digital) and computing (Intel). Western Digital, and to a lesser extent Seagate Technology, are being hurt in the near term by a weak memory pricing environment and the slow ramp up of new hard drive products. However, we see a strong long-term need for storage as cloud usage continues to grow exponentially.

Outlook

The Strategy was again impacted by lack of ownership in the handful of high-multiple momentum names that have generated the majority of benchmark performance in 2020. While those stocks underperformed in the early September correction, they are still well ahead year to date and in today's slow growth recovery from COVID, continue to be viewed as a safety trade. The FAANGs have been great companies and today's performance of the NASDAQ is not the bubble of 2000, but we do see similarities in terms of heavy retail participation in the markets. It's the first time we can remember since the dot-com meltdown where you have significant overvaluation in certain areas along with pockets of overwhelmingly positive sentiment. This suggests parts of the market are reaching a level of speculation that cannot continue indefinitely.

A clinical breakthrough on a COVID vaccine could be the catalyst that spurs a rotation out of momentum back into the types of fundamentally strong, attractively valued companies we seek to own in the Strategy. An approved vaccine would spark a return to normalcy in the U.S. economy and the equity markets. We could see one of the most dramatic shifts ever for the names we own in broadcasting and cable, for example. Longer term, we expect that

many of our holdings coming off trough valuations are well positioned to deliver sustainable growth in their businesses and share prices.

While the past several years have been disappointing from a relative performance standpoint, we have remained committed to a consistent investment process that seeks to deliver non-correlated performance. The Strategy would add little value if we were to mimic the benchmark. Instead we manage a portfolio with an active share above 95 and strive to produce alpha by targeting profitable growth companies throwing off healthy levels of free cash flow and that are leaders in industries with high barriers to entry.

Portfolio Highlights

The Aggressive Growth Strategy underperformed its Russell 3000 Growth Index benchmark in the third quarter. On an absolute basis, the Strategy generated gains across six of the eight sectors in which it was invested (out of 11 sectors total). The primary contributors to performance were the communication services and IT sectors.

Relative to the benchmark, overall stock selection and sector allocation detracted from performance. In particular, stock selection in the IT and health care sectors, an underweight to the consumer discretionary sector and an overweight to health care detracted the most from results. On the positive side, stock selection in the communication services sector contributed to relative performance.

On an individual stock basis, positions in Comcast, Twitter, Nuance Communications, TE Connectivity and Broadcom were the leading contributors to absolute returns during the period. The primary detractors were Vertex Pharmaceuticals, Ionis Pharmaceuticals, Intel, Western Digital and Agios Pharmaceuticals.