ClearBridge Investments

Dividend Strategy

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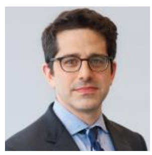

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Key Takeaways

- Markets have recovered because of extraordinary policy interventions without which we believe they would be down, yet we continue to be cautious.
- The Strategy rose nicely in the third quarter and outperformed during September's volatility, but lagged the broader market at quarter end as the handful of stocks powering the averages higher coincidentally do not pay dividends.
- Our underweight in technology has hurt us this year. Looking forward, however, we suspect this headwind may soon become a tailwind.

Market Overview

The S&P 500 rose 8.9% in the third quarter to put the index back in the black and up 5.6% for the year. We continue to be astounded. In hindsight we can rationalize the performance, but we never expected such gains in a year where both human beings and economies have suffered so much.

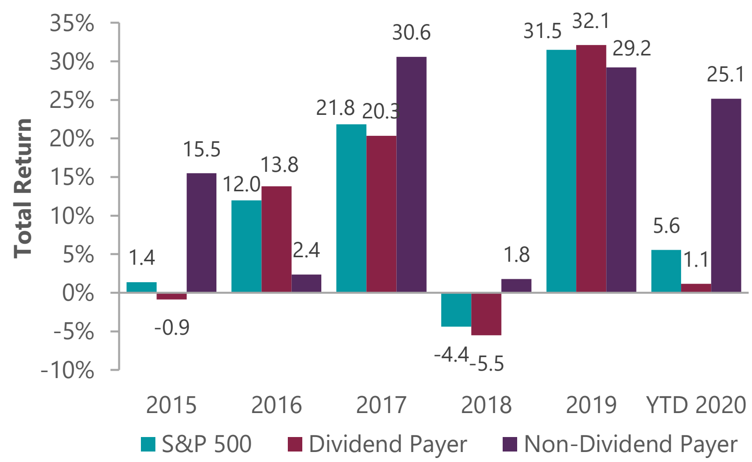
Markets have recovered because of extraordinary policy interventions. Multi-trillion-dollar fiscal stimulus offset the impact from shutdowns, while the Fed slashed interest rates to liquify markets and spur activity. As societies have reopened, economies have partly recovered. Investors have piled in as negligible interest rates leave them devoid of alternatives.

Without these interventions, we believe financial markets would still be down. Instead, investor statement balances have been resurrected. While we understand this narrative and consider it in forming our worldview, we are careful to not let it dominate our investment process. We continue to be cautious.

The Dividend Strategy rose nicely in the third quarter and outperformed during September's volatility, but still lagged the broader market at quarter end. Companies that benefit from work-from-home or stay-at-home (mostly technology) continued to soar, while the rest of the market underperformed. In a world of near-zero interest rates, one might expect dividend payers to perform well — but that has not been the case.

Non-dividend payers in the S&P 500 are up north of 25% year to date, while dividend payers are up just 1%. Even this pittance comes from just two stocks. If we strip Apple and Microsoft from the analysis, ALL other dividend stocks are collectively down on the year!

Exhibit 1: S&P 500 Returns: Dividend Breakdown



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

The decline in dividend-paying stocks outside of Apple and Microsoft does not reflect investor aversion to equity income. Rather, the handful of stocks powering the averages higher coincidentally do not pay dividends.

This dynamic presents a structural headwind for dividend investors in the current environment. Many of today's best stocks — primarily in technology — do not pay dividends. Yet they make up an ever-increasing portion of the market. In fact, non-dividend payers constituted over 22% of the S&P 500 market capitalization at quarter end, compared with just over 16% in 2015. Technology, at 21% of the portfolio, is our largest exposure. Yet, given its preponderance in the index (28%), it also represents our second-biggest underweight, next to consumer discretionary. Throw in the "shadow tech" sectors of communication services and consumer discretionary (Amazon) and the disparity becomes even more pronounced. These three sectors represent 51% of the S&P 500, compared to 30% of Dividend Strategy.

The seeds of this underweight are rooted in happenstance; many highfliers do not pay dividends. With the surge in these stocks, however, this positioning has become somewhat deliberate. Trees do not grow to the sky. Even stocks like Alphabet, Amazon and Facebook (to name a few) will ultimately suffer pullbacks and corrections. Years ago, these stocks' valuations did not reflect their many fabulous attributes — today they do.

The rise in tech stocks has made the market more concentrated and less diversified. Today, technology (broadly defined) represents approximately half the market. Diversification is a core principle of the ClearBridge Dividend Strategy and something we work assiduously to maintain. There is much we like about technology, but we would not put half of our portfolio in it. Our underweight in technology has hurt us this year. Looking forward, however, we suspect this headwind may soon become a tailwind.

The valuations of many assets these days seem defensible only in the context of ultra-low rates.

Outlook

As we contemplate the next few months and look out into 2021, the outlook seems both complicated and challenging. We must wrestle with the disease, the economy and politics. Each of these factors is independently significant. The interplay between them creates a volatile and turbulent dynamic.

Ironically, the disease seems like the easiest factor to forecast. Summer is over. Cases are trending higher in areas that previously seemed to be under control (Europe, New York, etc.). Winter will be tougher across the northern hemisphere as backyard visits cease and indoor exposures rise. On the positive side, however, promising new therapies have emerged, and experts seem highly confident that at least one of the vaccine candidates under development will be successful. The main question regarding the vaccine seems to be one of timing. Will it be widely distributed in the next few months or will we have to wait longer? Our take, unfortunately, is that it will likely be the second half of 2021 before the world can collectively take off its mask.

With COVID-19 with us for another year, many of the current economic dynamics will persist. Office workers will still operate remotely, schools will remain hybrid, and travel and leisure businesses will suffer. Some companies will benefit from this (Zoom, Amazon), but the economy overall will languish, given the large number of people who work in restaurants and travel.

The first round of stimulus staved off a depression, but without more funding the economy will roll over. The market will end up like Wile E. Coyote running off the cliff — initially carried by momentum until people look down and realize there is nothing below. We are hopeful the government will enact more stimulus, but given current partisanship it is far from guaranteed. We keep our fingers crossed.

Of course, fiscal stimulus is not the only lifeline that has kept markets afloat. The lowest interest rates of all time have also buoyed markets and animal spirits. The Fed has promised to keep rates low for several years and thereby encouraged investors to bid up asset prices. Consensus says inflation is not a risk and we agree it is unlikely in the very near term.

Looking beyond a few months, however, one can imagine how the situation might change. A vaccine will catalyze an unprecedented recovery in activity as the same fiscal stimulus (hopefully) is being pumped into the economy. The two could work together to turbocharge the economy, quickly powering the world out of a downturn and into a robust recovery. Overnight, the outlook for growth, employment and inflation could change, taking with it the assumption of low rates forever. We are not calling for this scenario, mind you; we are merely pointing out its possibility.

So long as one's investments do not require absurdly low interest rates to justify their valuation, rising rates are no cause for concern. But the valuations of many assets these days seem defensible only in the context of ultra-low rates. Should rates rise, bonds would get hit harder than stocks. All else being equal, high-multiple stocks have more downside risk than low-multiple ones.

In Dividend Strategy we take a balanced approach to investing. We focus on best-in-class companies with big moats, low risk of secular disintermediation and the ability to compound dividends over time. We own some terrific growth stocks like Apple, Mastercard, Microsoft and Visa. We also own some less flashy — though still terrific — companies like PPG, Waste Management and Wisconsin Electric (WEC).

In the upside-down world we find ourselves in today, we think our approach is a sound one. Our group of dividend payers offers attractive current yield, the potential for growth over time and a history of strong downside protection. Despite the economy, the pandemic and the election, we think we are well-positioned for whatever lies ahead.

Portfolio Highlights

The ClearBridge Dividend Strategy underperformed its S&P 500 Index 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 main contributors to Strategy performance were the information technology (IT), industrials and consumer staples sectors. The financials, energy and real estate sectors, meanwhile, detracted from absolute results.

On a relative basis, sector allocation detracted from performance for the quarter, while stock selection was a positive. In particular, underweights to the consumer discretionary and IT sectors and an overweight to the energy sector were detrimental. Stock selection in the financials and real estate sectors were also a drag on relative performance. Conversely, stock selection in the energy, communication services, consumer staples and health care sectors and an overweight to the materials sector were beneficial.

On an individual stock basis, the main positive contributors were Apple, United Parcel Service, Comcast, Procter & Gamble and Mastercard. Positions in Kinder Morgan, Blackstone Group, Raytheon Technologies, Apollo Global Management and American Tower were the main detractors from absolute returns in the quarter.

During the quarter we initiated positions in Oracle in the IT sector and Sempra Energy in the utilities sector. We closed positions in Exxon Mobil in the energy sector and Carrier in the industrials sector.