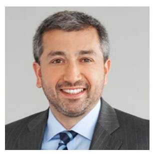
ClearBridge Investments

Large Cap Value Strategy

Robert Feitler
Managing Director, Portfolio Manager



Dmitry Khaykin
Managing Director, Portfolio Manager

Key Takeaways

- Markets ebbed and flowed with infection rates in the U.S., while multinational companies noted substantial recoveries in their China-based manufacturing operations, an encouraging sign for global economic activity.
- A broadening of performance into cyclical stocks helped industrial holdings in the portfolio, while cable companies continued to benefit from their competitively advantaged high-speed internet access, an essential service in the work-from-home and remote learning environment.
- Amid many uncertainties, we are planting the seeds by investing in high-quality businesses, taking advantage of opportunities created by volatility throughout the year, while taking money off the table in cases where stock valuations appear to be more demanding.

Market Overview: In Year of Tech, Industrials Begin to Shine

U.S. equities delivered another strong quarter despite rising coronavirus infections, a slowing economic recovery and a broad-based late-quarter selloff that included market-leading technology stocks. Strong market returns came as the Federal Reserve increased its accommodative stance supporting asset prices, while massive fiscal stimulus buoyed personal income and consumer spending. The Russell 1000 Value Index increased 5.6%. Despite a slight rotation toward cyclicals in September, mega-cap growth stocks continued to lead the market higher, benefiting from work-from-home (WFH) amid a partially locked-down economy.

After dropping precipitously in May and June, virus infection rates in the U.S. ticked up during July and August, forcing some states to roll back reopening measures. Markets ebbed and flowed, reacting to infection rates as well as the news flow related to additional fiscal stimulus negotiations between Congress and the White House.

Economic data showed signs of a slowing recovery. Unemployment has dropped as employers have brought back roughly half of the 22 million jobs lost at the beginning of the pandemic, though the pace of hiring has decelerated. Initial jobless claims remained over 800,000 for a fifth straight week as of September 26, and surveys are showing that the manufacturing expansion has slowed. The EU region seems to be on a similar recovery trajectory, while China appears to have snapped back to pre-pandemic levels with robust manufacturing activity supporting fragile global recovery.

The resilient U.S. consumer, buoyed by government stimulus, saw household income fall sharply in August as the supplemental unemployment benefits provided by the CARES Act expired. The $600 weekly supplemental unemployment checks were subsequently replaced with a temporary program paying a substantial, albeit reduced, $300 in weekly benefits. In addition to propping up retail-related sectors of the economy, the support programs have been impactful for financial services companies, which have continued to report pristine consumer credit statistics despite the economic downturn, affording banks time to build substantial loan loss reserves. The massive government stimulus generated a record $3.1 trillion deficit in fiscal 2020, which at 16% of GDP is the largest U.S. deficit since 1945. The path from an economy supported by deficit spending to self-sustaining growth remains uncertain.

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Despite a pullback in September, technology and communication services stocks that have benefited from the WFH environment remained strong contributors during the quarter. Apple continued to perform well, driven by strong demand for iMacs, iPads and wearables, while software and services continue to grow at a healthy clip. The introduction of the newest 5G-capable iPhone is expected in mid-October and should be well-received. Long-term portfolio holding Charter Communications and 2018 addition Comcast continue to dominate the residential high-speed internet access business, benefiting from millions of people working and studying from home.

TE Connectivity makes connectors for a wide range of applications including automobiles, data centers and medical devices. With over 40% of its business exposed to the automotive industry, the company continues to benefit from the secular trend of growing content through the electronification of vehicles and more recently from the cyclical recovery in global automobile production.

A broadening of performance into cyclical stocks helped industrial companies in the portfolio such as United Parcel Service (UPS) and Deere. UPS has benefited from a surge in e-commerce related to COVID-19 and new management's laser focus on profitability, resulting in the company increasingly flexing its pricing power. This strategy has been well-received by investors and closely followed by peers. Deere continues to benefit from tightly managed dealer inventory levels, better than expected demand and solid pricing for its core agricultural equipment. The company continues to lead in precision agriculture, the adoption of which has been picking up pace in core geographies. By deploying sophisticated technology and integrating AI algorithms across its fleet of combines, sprayers and planters, Deere enables farmers to improve yields while reducing use of water and harmful chemicals.

The quarter saw a shift in Federal Reserve regime as the Fed announced it would no longer pre-emptively raise interest rates to ward off inflation and would instead tolerate periods of inflation above its 2% target. A pledge for lower-for-longer interest rates kept a lid on long-term bond yields, negatively impacting rate-sensitive financial services stocks while in theory benefiting bond-proxies such as REITs, consumer staples and utilities. However, some portfolio holdings in these sectors detracted from performance during the quarter. These included American Tower (REIT) and Reynolds (consumer staples). American Tower has been a strong performer over the years. During the quarter, the stock came under pressure on the heels of its recently executed 15-year contract with T-Mobile. Investors became concerned about the contract economics, as well as the implied churn related to Sprint cell site decommissioning. While Sprint churn is a factor depressing top-line growth over the next few years and is not to be minimized, the certainty provided by the historically long 15-year contract and ever-growing wireless data consumption globally position the company well in the long term.

Reynolds produces food storage products, trash bags, cooking products and tableware and continues to benefit from elevated demand as more people have cooked at home amid the pandemic. While the company reported robust sales and profits during its second-quarter earnings call, investor expectations were even more optimistic. Additionally, in order to meet elevated demand, the company announced incremental production capacity investments, temporarily depressing free cash flow. Reynolds has otherwise been a strong performer, up roughly 20% since we purchased it at its initial public offering in January.

In the consumer discretionary sector, long-time holding Home Depot continued to do well, although our underweight to the sector, the best performing in the index, was a headwind. The sector includes industries such as retail, travel and leisure, fast food and auto, many of which experienced partial recoveries following the shutdowns in the earlier months of the pandemic. Home Depot continues to perform well operationally while being vigilant regarding the safety and well-being of its associates and customers. Cooped up at home and unable to travel, consumers are spending heavily on home improvements, benefiting Home Depot’s sales and profits.

During the quarter we initiated a position in Vertiv, a market leader in critical digital infrastructure including cooling and power systems for data centers and broad commercial and industrial applications. Secularly driven by migration to the cloud, data centers are an attractive growth market where Vertiv sells sticky and differentiated products into a large and fragmented customer base, allowing it to leverage pricing and bundle new products and services.

After their spectacular performance, we meaningfully reduced exposure to Apple and Microsoft while adding to utility holdings Sempra Energy and Edison International. Both companies are largely based in California, a market that offers strong growth opportunities driven by the state-mandated shift to renewable energy. This regulatory framework provides years of highly visible investment opportunities at attractive regulated returns. Notwithstanding short-term uncertainty due to the California wildfires, which compressed valuations for both stocks, Edison especially, we are confident in the long-term prospects for both companies.

Outlook

We are going through an extraordinary period marked by the ongoing effects of a global pandemic on one hand and extraordinary stimulus on the other. COVID-19 uncertainty remains high, as does the effectiveness and availability of a vaccine. In addition, the U.S. election is likely to impact individual stocks and sectors in unpredictable ways. Stimulus has mitigated some of the near-term impact of COVID-19 and we expect it to continue regardless of the outcome of the election. Similarly, we expect the Fed to maintain its accommodating monetary policies.

While near-term uncertainty is unavoidable, we continue to plant seeds by identifying and investing in high-quality franchises with attractive long-term potential trading at reasonable valuations. While opportunistically taking advantage of a volatile market, we are also being disciplined with valuation of existing holdings, taking money off the table in cases where valuations appear to be more demanding. We continue to believe that high-quality companies will generate superior performance over the medium and long term.

Portfolio Highlights

The ClearBridge Large Cap Value Strategy outperformed its Russell 1000 Value Index benchmark during the third quarter. On an absolute basis, the Strategy had gains in seven of 11 sectors in which it was invested for the quarter. The strongest contributions came from the industrials, IT and communication services sectors. The energy, real estate and consumer staples sectors were the main laggards.

On a relative basis, overall stock selection contributed to outperformance, partially offset by sector allocation. In particular, stock selection in the IT, industrials, materials and financials sectors added to relative returns. Conversely, stock selection in the consumer staples, health care, utilities and real estate sectors and an underweight to the consumer discretionary sector detracted.

On an individual stock basis, the largest contributors were UPS, Deere, Charter, Apple and Comcast. Positions in Dish Network, Chevron, Suncor, ConocoPhillips and American Tower were the main detractors from absolute returns in the quarter.

Besides portfolio activity discussed above, during the quarter we closed a position in Exxon Mobil. Historically perceived to be the best-run integrated energy company with low cost resource base and a strong balance sheet, Exxon Mobil has faced growing challenges in the low commodity price environment. With the company's balance sheet stretched at current oil prices and its dividend coverage now legitimately in question, we exited our position.

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