Large Cap Growth Strategy

Peter Bourbeau
Managing Director, Portfolio Manager

Margaret Vitrano
Managing Director, Portfolio Manager

Key Takeaways

- Extreme concentration of the largest stocks in the benchmark continues to be a performance headwind for the Strategy and other active large cap growth managers running diversified portfolios.
- Industrial names supporting e-commerce and communication services companies enabling the digital economy drove Strategy performance during the quarter.
- We know how the momentum trade will end, but not the timing, and have positioned the portfolio to effectively manage this transition by maintaining exposure to a wide range of growth companies and increasing our weighting among more economically sensitive businesses.

Market Overview: Overcoming Challenges of a Concentrated Growth Market

Information technology (IT) and related momentum stocks endured their first correction since the onset of the COVID-19 pandemic yet still delivered strong gains for the third quarter as the economy continued to mend. The S&P 500 Index marched 8.9% higher over the past three months, capping its best six-month run since 2009, and is up 5.6% year to date as ample liquidity, improving economic data and a lack of attractive investment alternatives supported equities. Despite a sharp selloff among mega cap IT and Internet names to start September, growth stocks maintained their leadership with the benchmark Russell 1000 Growth Index gaining 13.2% for the quarter, outperforming the Russell 1000 Value Index by over 760 basis points. That advantage for growth has now expanded to nearly 3,600 bps year to date, one of the widest margins in market history.

Consumer discretionary (+20.5%) was the best-performing sector for the quarter, boosted by resilient retail spending and continued e-commerce growth, while IT (+15.0%) and the cyclical materials (+15.0%), and industrials (13.4%) sectors also outperformed. Utilities (-4.0%) and energy (-4.0%), which have minimal weightings in the benchmark, were the worst performers, while real estate (+1.0%), health care (+5.7%) and financials (+6.4%) also lagged.

The Russell 1000 Growth Index remains concentrated with the largest stocks in the benchmark exerting an outsized influence on returns, creating challenges for diversified active managers. During the third quarter, six stocks (Apple, Amazon.com, Tesla, Nvidia, Facebook and Microsoft) accounted for half of the benchmark's return. And as of September 30, three of those companies — Apple (11.3%), Microsoft (9.5%) and Amazon (8.1%) — accounted for 29% of the benchmark's value. The mutual fund vehicle is one of several ways investors can access the ClearBridge Large Cap Growth Strategy. For a mutual fund to be considered diversified under the SEC's Investment Company Act of 1940, 75% of its assets must be held in individual stocks accounting for no more than 5% of total fund assets. The remaining 25% of a fund portfolio can comprise larger stock positions but holding just Microsoft, Apple and Amazon at market weight would exceed this limit. As a result, most diversified funds tracked by Goldman Sachs in a September report were underweight the FAAMG stocks — Facebook, Apple, Amazon, Microsoft and Google (now Alphabet) — as shown in Exhibit 1.

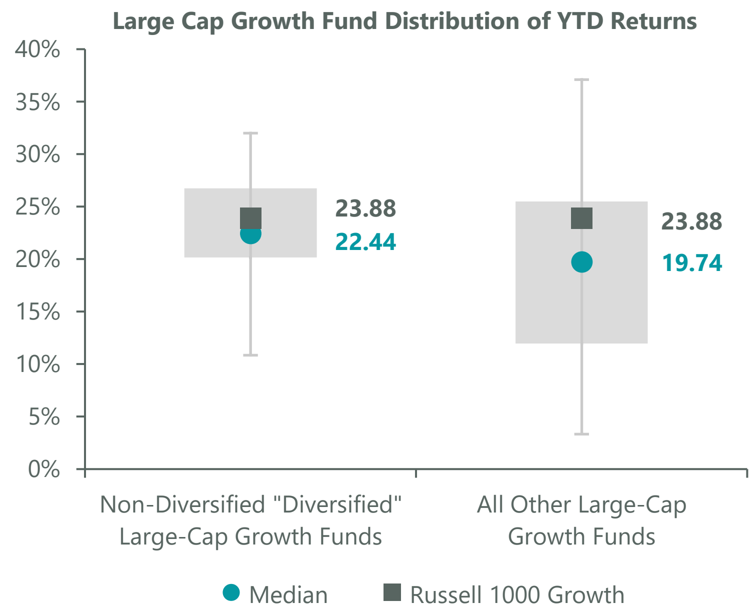
Exhibit 1: Large Cap Growth Fund Universe Positioning

Ticker	Average Fund Weight (%)	Weight in R1000 Growth (%)	Overweight/ (Underweight) (bps)
GOOGL	4.41	4.48	(7)
FB	2.93	3.73	(80)
AMZN	6.37	8.00	(163)
MSFT	6.25	10.42	(417)
AAPL	4.64	10.21	(557)
FAAMG	**24.7%**	**36.9%**	**(1224) bps**

Data as of June 30, 2020. Source: Goldman Sachs Global Investment Research.

Passive and index and exchange-traded funds that track the Russell 1000 Growth Index are not subject to these diversification requirements. Nor are non-diversified mutual funds, many of which have become so by choosing to maintain close to market weight exposure to the FAAMGs. As Goldman Sachs noted, such concentration has led to a performance advantage for these active large cap growth funds (Exhibit 2) and resulted in less than a third of all active large cap growth funds beating the benchmark for the year-to-date period through September 8.

Exhibit 2: Non-diversified Strategies have Generally Delivered Higher Returns



Data as of September 8, 2020. Source: Goldman Sachs Global Investment Research.

The ClearBridge Large Cap Growth Strategy is underweight the FAAMGs in aggregate, with active overweights to Amazon and Facebook and underweights to Apple and Microsoft. We have no exposure to Alphabet after completing the sale of our Class C shares in the third quarter, which followed the sale of Class A holdings in the second quarter. As we have written in previous commentaries and elsewhere at ClearBridge, the largest capitalization technology and Internet stocks have continued to grow through the disruptions of the COVID-19 pandemic, but we believe the growth prospects of many of these stocks are already reflected in current valuations.

While different vehicles give us more latitude to take concentrated positions, we choose to maintain consistent portfolio construction across all vehicles as we have always believed that a portfolio of companies with a diverse set of growth drivers offers the best opportunity to outperform over a full market cycle. We have managed through periods where one investment style has been a dominant performer for several quarters or even longer, such as momentum is currently. Over the last six to 12 months, the market has underappreciated the zero cost of capital made possible by low interest rates, which has translated into very high price/sales multiples for growth stocks. This cannot continue indefinitely as inflation and higher bond yields will eventually remove the justification for high valuations. As interest rates and inflation normalize with better economic growth, the sector performance with the highest momentum will end, as a rotation to economically sensitive sectors will become more in favor. We want to be positioned to effectively manage that transition.

As growth investors, we see nuances in leadership and performance every calendar year. The companies we own don't manage for yearly results and we maintain a similar longer-term view. The accelerated recovery of the stock market makes it easy to forget that we are in the early stages of recovery from a historically deep, albeit short recession and as a result we are still managing the portfolio for a low-growth environment. Nothing suggests we are entering a new renaissance of economic growth, as many sectors remain on life support. What has been different in 2020, however, is how parts of IT have played both offense and defense, a historical oddity.

Our focus on managing a diversified portfolio leads us to seek long-term growth opportunities not only in above-average earnings and revenue growers like chipmaker Nvidia and business software provider Salesforce.com, companies that fall into our select bucket of growth companies and were strong performers in the quarter as leaders in areas around gaming and work from home, but also in established franchises who are market leaders and generators of healthy free cash flows. Microsoft, data center operator Equinix and warehouse retailer Costco are examples of the stable growth companies that constitute the largest weighting in the portfolio.

Our third area of focus is cyclical growth companies that operate in more economically sensitive areas of the market or are undergoing a business transformation that should boost earnings growth. These include industrials holdings United Parcel Service (UPS) and C.H. Robinson Worldwide, which were strong contributors in the quarter as key providers of the transportation infrastructure necessary to handle this year's surge in e-commerce. UPS has positioned itself as more valuable today, as capacity has come out of the system due to COVID-19. As a result, UPS will demonstrate pricing power in the next cycle, as consumers are willing to pay for the privilege of receiving their purchases as quickly as possible. Trucking broker C.H. Robinson, meanwhile, connects shippers with available drivers and has benefited from sharply higher prices for its services while operating without the overhead of physical assets.

Portfolio Positioning

Another mega trend we are witnessing in real time is the explosive transition to battery electric vehicles as well as greater sophistication of automotive technologies. We initially gained exposure to these new technologies through the purchase of high-end components maker Aptiv in March and increased our participation in the third quarter through a new position in NXP Semiconductors. NXP develops analog and microcontroller chips for a wide range of communications and sensor applications across the automotive, wireless and industrial markets. NXP supplies the brains that make electronic content in vehicles function properly and should benefit from overall auto production and demand normalizing. The Dutch company also has strong positions in industrial "Internet of Things" applications, near-field communications tools and ultrawide band chips for mobile phones, which we believe offer additional growth opportunities.

A mega trend we are witnessing is the explosive transition to battery electric vehicles as well as greater sophistication of automotive technologies.

Other significant moves included adding to our new position in Alcon, a leader in surgical correction of cataracts and contact lenses. Alcon has major positive product cycles in both of its core businesses that will accelerate revenue and earnings. Additionally, Alcon has a significant opportunity to expand margins by investing in new manufacturing and leveraging its commercial investment. The company had traded expensively since its separation from Novartis, but surgical disruption due to COVID-19 created a unique buying opportunity.

In general, we see parts of health care as offering attractive growth rates at more reasonable multiples than IT and related Internet names. Companies like Thermo Fisher Scientific are seeing a strong uptake from its COVID-19 tests, which augment a diversified lineup of in-demand research supplies and analytics services. Managed care provider UnitedHealth Group is also well-positioned, regardless of who wins the White House, as it maintains a leadership position in keeping overall health care system costs in check. We are a bit more cautious on the biopharmaceutical space as prescription drug pricing will likely remain a bipartisan target of lawmakers. BioMarin Pharmaceutical, which is less susceptible to pricing pressures due to the rare diseases it treats, was a leading detractor in the quarter as the company received a surprise rejection from the FDA for its "valrox" Hemophilia A gene therapy, and the agency is now requiring more data from the pivotal trial prior to approval. We think the stock move is an overreaction and remain confident the product will ultimately be approved.

Beyond health care, we are conducting due diligence in a number of areas, including the financials and consumer discretionary sectors, which could lead to new positions over time. This work is geared toward identifying secular growth stories with sound fundamentals that can balance our exposure to the growth leaders of the moment.

Outlook

As mentioned above, overall economic growth is constrained and could remain so in the near to medium term. Plenty of risks linger on the horizon, including the outcome of the presidential election and whether consumers and businesses will receive more stimulus to keep demand healthy and workers employed. The primary inflection point we are monitoring is the development of a COVID-19 vaccine. When that medical breakthrough occurs, we expect a movement out of IT and communication services names that have been viewed as a safety trade and into more economically-sensitive areas of the market like retail, hospitality and transportation. As "real world" economic growth picks up, rates would also move commensurately, leading to a shift in investor risk tolerance and potentially bolstering a move in market leadership from digital to physical businesses.

Although the banking sector is well capitalized, we still worry about what a credit cycle will look like over the next 12-18 months as unemployment naturally normalizes at a much higher rate. The global economy was at stall speed before COVID, it's hard to think that conditions will be improving to the extent that stimulus acts as an accelerant from here. There is no question that the Fed, Treasury (and hopefully Congress) will be acting in good faith for the American worker, but there will be limits to what is possible from a partisan perspective.

Our long-term orientation gives us the latitude to be patient as this transition in the market plays out. The volatility we experienced in early September is expected to continue for at least the next several quarters. We can use this turbulence to our advantage because of the fundamental work we have already done on companies and continue to do. Going forward, we will be ready to make opportunistic purchases when prices are favorable. What is clear is that leadership companies are demonstrating their ability to pivot and cut cost at an alarmingly fast pace, limiting financial damage through this crisis. That said, recessions have consequences, and it might be too early to tell what the damage will end up looking like for many quarters to come.

Portfolio Highlights

The ClearBridge Large Cap Growth Strategy underperformed its Russell 1000 Growth Index benchmark during the third quarter. On an absolute basis, the Strategy had gains across eight of the nine sectors in which it was invested (out of 11 sectors total). The leading contributors to performance were the IT and consumer discretionary sectors.

On a relative basis, overall stock selection detracted from performance. Specifically, stock selection in the consumer discretionary, IT and materials sectors had the most significant negative impacts on results. On the positive side, stock selection in the industrials and communication services sectors and an overweight to consumer discretionary contributed the most to relative performance.

On an individual stock basis, leading contributors to absolute returns in the third quarter included positions in Amazon.com, Apple, United Parcel Service, Nvidia and Facebook. BioMarin Pharmaceutical, VMware, Raytheon Technologies, Splunk and Nutanix were the worst detractors on an absolute basis.