ClearBridge Investments

Mid Cap Growth Strategy

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Key Takeaways

- While mean reversion led to a September rally for value stocks across U.S. equity markets broadly, growth outperformance persisted among mid caps.
- We remained active in seeding the Strategy with new growth names across five sectors, positioning for a variety of post-pandemic outcomes.
- Stock market multiples are high by absolute standards. Yet compared with paltry fixed income yields, there is still good value to be captured in mid cap growth stocks.

Market Overview and Outlook: Growth Resilient Among Mid Caps

What a nine months we've experienced, with manifold uncertainties clearly in sight:

- The COVID-19 (C-19) pandemic (over 208,000 known domestic casualties)
- Economic shutdowns in the U.S. and elsewhere
- A flash recession that exceeded the Great Depression in speed and severity
- Speedy, coordinated fiscal and monetary policy response which led to a brisk, if incomplete, recovery with roughly half the jobs lost at the depth recovered
- High velocity capital-raising by corporates given the uncertainty of the C-19 disease progression
- Police shootings and high-level social protest causing America to re-examine its diversity and inclusion efforts
- Political dissension about the outcome of the looming November national elections as well as the composition and size of the U.S. Supreme Court
- A C-19 super-spreader event in the Rose Garden leading to the hospitalization of the President
- The acceleration of a variety of secular trends relating to digital experience (telemedicine, work-from-home, cloud adoption)

If we were focused solely on these macro factors, our heads would assuredly be spinning. That's why we concentrate on companies and their opportunities as well as capable management execution throughout the many abnormal challenges.

Despite a sharp selloff among information technology (IT) and Internet names to start September, growth stocks maintained their leadership in the third quarter with the benchmark Russell Midcap Growth Index gaining 9.4% for the quarter, outperforming the Russell Midcap Value Index by about 300 basis points.

Many strategists and investors question the durability of that trend and we're the first to admit mean reversion could happen any time, as we've experienced some sharp daily reversals. Indeed, during September, the Russell 3000 Value Index outperformed the Russell 3000 Growth Index; but at least in the mid cap universe, growth outperformance persisted.

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Growth stocks continued to lead despite earnings during the second quarter declining by roughly one third. While earnings will still be lower year over year for the next two quarters, the gradient is positive and underwritten by GDP, which may increase as much as 30% or more sequentially versus the second quarter.

Communication services (+16.7%) and consumer discretionary (+14.8%) were the best-performing sectors in the benchmark, as e-commerce has accelerated through the pandemic. The cyclically oriented industrials (+12.1%) and materials (+11.6%) sectors also outperformed as parts of the economy began to anticipate a recovery in business activity. Utilities (-4.8%) and energy (-4.0%) were the worst-performing sectors, while real estate (+2.8%) and financials (+2.1%) also lagged.

Overall, companies have adapted rapidly to 1) protect their employee's safety, 2) serve their clients, 3) be thoughtful about their community responsibilities, and 4) ensure their capital adequacy.

Portfolio Positioning

With the macroeconomic backdrop highly uncertain, our activity level remained high during the third quarter as we seek to position the Mid Cap Growth Strategy for a post-COVID-19 environment. We added six positions across five sectors, led by the following:

- In IT, the Strategy established a new position in RealPage, a maker of software to help real estate companies manage their properties and improve efficiency. We also participated in the initial public offering of Unity Software, whose platform allows video game developers to quickly create new games and monetize them on a multitude of operating systems and hardware.
- Charles River Laboratories, a new position in the health care sector, is the leading provider of outsourced preclinical services for biopharmaceutical research and development. Charles River is benefiting from the biotechnology funding environment and the increased usage of outsourcing for clinical work by drug companies.

- WillScot Mobile Mini, in the industrials sector, is a leader in modular office space with 40% market share. The company just acquired Mobile Mini, which offers good cross-selling opportunities while its internal pricing actions and value-added services should drive revenue growth regardless of non-residential construction uncertainty.
- In the consumer discretionary sector, we purchased shares of Chipotle Mexican Grill. Digital sales and a strong brand supported positive same store sales for the burrito chain through the pandemic and Chipotle has several initiatives in place to drive future sales. A strong balance sheet allows them to keep expanding their footprint compared to the vast majority of other fast casual restaurants that are pulling back.

The Strategy's four exits during the quarter were a combination of profit taking and eliminating exposure to uncertain areas of the mid cap market. We sold into strength both Varian Medical Systems, ahead of its acquisition by Siemens and Advanced Micro Devices, whose strong stock performance caused it to move out of our market cap range. The sale of commercial real estate broker and operator Jones Lang LaSalle reflected headwinds in the office market as companies balance work-from-home with future office space needs. We exited water heater manufacturer A.O. Smith to concentrate on better opportunities elsewhere.

Outlook

With so little visibility in markets and the economy, we see resolution of COVID-19 and the election as the two biggest unknowns in the near term. Yet we manage the portfolio without conscious or explicit macro tilts. Instead, our investment process is grounded by de-risking individual investments; returns are from a concentrated portfolio that embeds a variety of growth rates.

Stock market multiples are high by absolute standards. Yet compared with paltry fixed income yields and a sub-1% 10-year Treasury yield, there is still good value to be captured in stocks. U.S. unemployment is receding, forward inflation expectations appear quiescent and fixed income and equity capital availability is ample.

Ongoing risk management remains of paramount importance, assessing how exogenous events and factors can affect specific investments in the Strategy. Our attention to sustainable business dynamics, backed up by robust capital discipline, is an elemental ClearBridge philosophy that we will continue to apply to the existing portfolio and new growth opportunities that we foster.

Portfolio Highlights

During the third quarter, the ClearBridge Mid Cap Growth Strategy outperformed the benchmark Russell Midcap Growth Index. On an absolute basis, the Strategy had gains across nine of the 10 sectors in which it was invested during the quarter (out of 11 sectors total), with the consumer discretionary and IT sectors the leading contributors.

In relative terms, outperformance was primarily driven by stock selection. Specifically, stock selection in the consumer discretionary, communication services and industrials sectors was the primary driver of results. Conversely, an overweight to the real estate sector detracted from relative performance.

The leading contributors to absolute returns during the third quarter included Carvana, Pinterest, Mettler-Toledo, PPD and Varian Medical Systems. Positions in BioMarin Pharmaceutical, Fortinet, Jack Henry & Associates, Splunk and Syneos Health were the greatest detractors from absolute returns.