ClearBridge Investments

Select Strategy

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Key Takeaways

- In a narrow market concentrated in mega cap stocks, the Strategy managed to outperform with diversified contributions from small to large cap companies across nine sectors.
- We continued to seed the portfolio with 12 new investments in the quarter, one third being initial public offerings.
- We trimmed positions in some of our best performers in the disruptors group, shifting proceeds into more cyclically sensitive and attractively valued investments in the stable compounders and evolving opportunities areas.

Market Overview and Outlook: Gaining Upside from All Corners

A September correction for widely held momentum stocks did little to slow down the post-pandemic surge for equities. 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 Index gained 9.2% for the quarter, with growth stocks in the index (+12.9%) outperforming value stocks by over 740 basis points, continuing the leadership of companies aligned with business trends accelerated by the COVID-19 pandemic.

The consumer discretionary sector (+19.0%) was the best performer in the benchmark by a wide margin while materials (+11.9%), industrials (+11.9%), information technology (IT; +11.8%) and consumer staples (+10.2%) also outperformed. Energy (-18.8%) was the worst performer for the quarter as limited travel kept oil demand in check, while the income-oriented real estate (+1.3%) and financials (+3.4%) sectors as well as health care (+6.2%) also trailed.

In a narrow market that remains concentrated in mega caps, the Select Strategy managed to outperform through contributions from a diversified portfolio of small, mid and large cap companies across nine of 11 sectors. Our fundamental research approach, which encompasses analysis of both public and private companies, often leads us to opportunities not recognized by investors more broadly while steering us away from those with deteriorating outlooks.

The Strategy's health care holdings are a good example of this differentiated approach. We gained shares of Livongo Health through its initial public offering in 2019. Livongo provides a technology platform and communication services to assist patients with chronic physical and mental health conditions including diabetes and high blood pressure. The shares rerated during the quarter on the announcement of the company's merger with Teladoc Health, which will form one of the leading providers of telemedicine in the U.S. The merger is expected to leverage Livongo's technologies across a much wider pool of general practitioners at a time when COVID-19 has sharply increased remote office visits. Surgery Partners, a long-time portfolio holding, was hurt early in the pandemic when lockdowns curtailed elective surgeries. We increased our position during the depths of the market selloff in early spring. The stock has rebounded as non-emergency procedures have resumed and the company's standalone surgery centers become a safer and more cost-effective option for future surgeries compared to large hospitals.

Our health care exposure is targeted toward companies like these disrupting traditional methods of delivering medical care or supporting the adoption of new treatments and services. We are less optimistic about the outlook for large pharmaceutical companies that must spend billions in R&D or acquisitions to keep churning out new drugs in competitive treatment areas. Within biopharmaceuticals, we have instead pinpointed companies like BioMarin Pharmaceutical developing compounds to treat rare diseases, an area expected to face less pricing competition and regulation, and firms like Ultragenyx Pharmaceutical harnessing genomics to serve unmet needs. BioMarin sold off in the quarter after the FDA failed to green light its gene therapy treatment for hemophilia, requesting more clinical trial data, but we expect the approval will come in time and added to our position post the stock's decline.

Portfolio Positioning

The success of growth stocks has given rise to record IPO issuance in 2020. The Strategy participated in four IPOs during the quarter, two in the IT sector: Unity Software, whose platform allows video game developers to quickly create new games and monetize them on a multitude of operating systems and hardware; and JFrog, a software-as-a-service company providing critical workflow solutions to software developers.

The third IPO, Dragoneer Growth Opportunities, is in a category that has gained popularity this year, the special purpose acquisition company or SPAC. SPACs raise cash to acquire private companies and the Strategy has recently invested in several including Vertiv (spun out of a SPAC) and Goldman Sachs Acquisition Holdings II. Dragoneer is run by Marc Stad, a successful, innovation-focused investor in venture capital and public markets, including a number of companies where we have also been investors such as top 10 portfolio holding MercadoLibre. Dragoneer has deep ties with major strategic partners in the software and Internet space. We expect it to acquire an asset at an attractive valuation where it can fuel revenue growth and improve economic returns using the thoughtful and creative tactics for which the firm is known.

ESG considerations have always been a core part of public equity analysis at ClearBridge and are now factoring into the business plans of companies hoping to go public. Vital Farms, the largest distributor of free-range eggs, enjoyed a strong third quarter debut as investors and consumers gravitate to more sustainable food choices. The company has established a dominant 80% share of the free-range market by partnering with local farmers with the land to raise chickens in this way and offers a truly unique product.

In addition to tapping the new issue market, we made eight additional purchases during the quarter spanning the four different types of investments we target in the Strategy. Purple Innovation fits neatly in the disruptors group of companies with a unique solution that is challenging legacy consumer business models. The mattress maker operates a direct-to-consumer business that has taken off due to its superior marketing technology and the quality of its internally manufactured, unique, purple-colored "hyper-elastic polymer" products.

New buy American Eagle Outfitters falls into the evolving opportunities group of stocks where changing dynamics and improving economics should lead to better performance. With mall traffic in decline, the teen retailer is reducing its real estate footprint, which should produce significant cost savings. The company should also benefit from unlocking the value of its rapidly growing and innovative Aerie athleisure division.

The Strategy can also invest in non-equity alternatives such as convertible securities. We recently purchased convertible shares of Bloom Energy, which manufactures solid oxide fuel cells that provide an environmentally friendly standalone electricity source for businesses. Bloom's addressable market could be much bigger than first anticipated as its products have both land and marine applications. We believe owning the convertibles provides a good risk-adjusted way to participate in the upside of the stock while earning a modest income stream along the way.

De-risking is a crucial part of our process, steering us away from companies running into operational or financial issues, overpromising or underdelivering on their growth forecasts or losing share due to product or service obsolescence. This step is just as important in ramping markets like the current one as in declining markets. We continuously de-risk existing portfolio holdings as well, checking that the thesis for owning each company remains intact. This discipline caused us to sell out of four investments in the third quarter — ZoomInfo, SelectQuote, RealReal and CrowdStrike Holdings — where we saw better risk/reward elsewhere.

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In a market strongly favoring innovative companies, positive sentiment has lifted valuations to extended levels in some areas. We trimmed positions in some of our best performers, including e-commerce disruptors Carvana and Shopify, shifting cash into more cyclical and attractively valued names like stable compounders First Republic Bank and Truist Financial, both new positions, as well as evolving opportunities Performance Food Group and Expedia.

The options market is implying a choppy end to the year, with volatility expected to increase right after the election. We are preparing for a wide range of outcomes because, as we learned in the 2016 presidential race and in the initial rebound from bear market lows in the spring, things don't always play out in the stock market the way forecasters expect. Risks are starting to build up again, with a rise in COVID-19 cases and the uncertainty of further stimulus. With the extra volatility, we want to be ready to take advantage of favorable prices. The economic backdrop is unlikely to change much, with interest rates remaining very low, keeping equities attractive relative to the alternatives.

Portfolio Highlights

The ClearBridge Select Strategy outperformed its Russell 3000 Index benchmark for the third quarter. 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). The IT and consumer discretionary sectors were the primary contributors to performance while the health care and industrials sectors also had positive impacts.

In relative terms, the Strategy outperformed its benchmark due primarily to stock selection, with sector allocation also beneficial. Specifically, stock selection in the health care and consumer discretionary sectors were the primary drivers of results. Stock selection in the financials, industrials, consumer staples and IT sectors, overweights to IT and consumer discretionary and underweights to the energy and financials sectors also contributed to relative performance. Conversely, stock selection in the materials and communication services sectors detracted slightly from results.

On an individual stock basis, the largest contributors to absolute returns during the third quarter were Carvana, Livongo Health, DocuSign, Surgery Partners and Apple. Positions in BioMarin Pharmaceutical, Fortinet, New Relic, Syneos Health and Pioneer Natural Resources were the greatest individual detractors from absolute returns.

In addition to the transactions mentioned earlier, the Strategy initiated positions in Pinterest in the communication services sector as well as Cloudflare and Alteryx in the IT sector.