ClearBridge Investments

Large Cap Growth Strategy

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Key Takeaways

- Large cap value stocks outperformed growth for the first time in two years, boosted by positive COVID-19 vaccine news that discounted a return to normal economic activity.
- While an underweight to information technology hurt results, we took advantage of volatility to increase our exposure to the sector through three purchases where we felt valuations were reasonable.
- The Strategy continues to hold a balance of secular winners in areas that have accelerated during the pandemic along with healthy exposure to a reopening of the economy.

Market Overview: Building for a Broadening Market

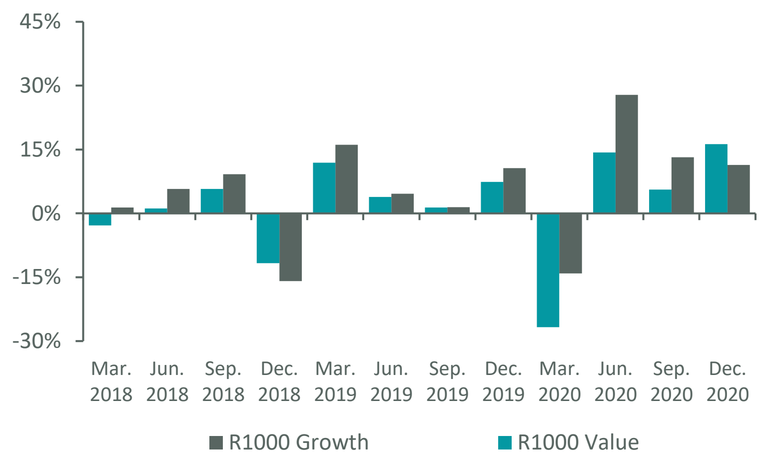
The lessening of political and COVID-19 uncertainties sparked equities to a strong finish in a year like no other for the global economy. The S&P 500 Index gained 12.2% in the fourth quarter to end 2020 up 18.4% while the large cap Russell 1000 Index rose 13.7% for the quarter and 21% for the year. The momentum trade that has lifted markets for the last several years showed signs of fatigue in the final three months of 2020, with value stocks outperforming growth stocks for the first time since the fourth quarter of 2018. The Russell 1000 Value Index gained 16.3% compared to 11.4% for the benchmark Russell 1000 Growth Index. Despite this reversal, growth outperformed value by over 35 percentage points for the year.

Stocks benefited from three catalysts over the last quarter. Joe Biden won the presidency and will govern with a narrow majority in Congress. Investors cheered the outcome as the lack of an overwhelming Democratic mandate removed the risks of higher taxes and more stringent regulation in the near future. Meanwhile, positive COVID-19 vaccine trial results from Pfizer/BioNTech and Moderna increased optimism about an eventual return to normal economic activity, sparking a rally in cyclical areas of the market. Subsequent FDA approval and initial distribution of the vaccines in December further bolstered the upswing. Finally, a very dovish Federal Reserve continued to promise an accommodative stance as it relates to managing monetary policy.

The catch-up trade for value and cyclical shares began in August but we view the latest market action as a broadening of leadership rather than a rotation out of growth stocks (Exhibit 1).

Not all value stocks are up as financials (+5.8%) have not moved much while mid cap information technology (IT) stocks have outperformed larger names. While energy (+28.8%) was the best-performing sector for the quarter, IT (+12.6%), consumer discretionary (+12.9%) and communication services (+13.8%) also continued to outperform. These areas of the market were led by the small segment of companies most benefiting from shifts to work from home, e-commerce, cloud computing and security that continue to deliver strong results and that have been rewarded handsomely with huge price/sales ratios. While the pandemic may have pulled forward several years of growth and pushed up valuations, we still want to maintain meaningful exposure to these companies and the secular growth trends they are leading.

Exhibit 1: Growth Has Led for Most of the Last Three Year



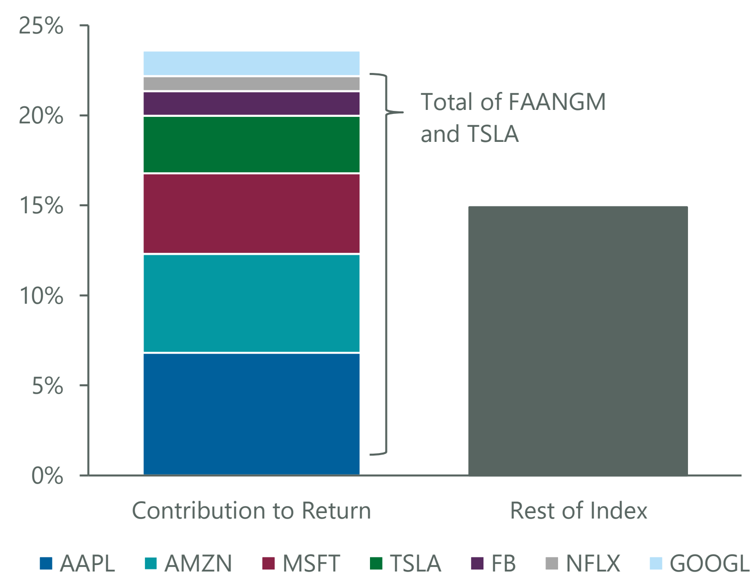
Source: FactSet.

The ClearBridge Large Cap Growth Strategy is constructed to thrive through a full market cycle and deliver strong down capture during turbulent periods. Any year where our very concentrated benchmark is up 38% will likely be a difficult one due to our focus on diversification across three buckets of growth companies. The Strategy underperformed during the fourth quarter and trails the benchmark over an extended period of momentum leadership. Our base case remains that we are still in an unprecedented period of economic stress, with significant government assistance needed just to "keep the lights on." We do not subscribe to the notion that huge U.S. Treasury transfer payments and zero bounds on the risk-free interest rate have been stimulative; rather, these have been necessary to avert widespread economic collapse.

Looking back on the year, we were too conservative in repositioning the portfolio during the volatility of the first and second quarters. While adding six names and exiting eight others in that span, we weren't active enough in an IT sector that acted much more defensively than expected. Valuation concerns have thus far been ignored in the most expensive areas within tech and communications. We continue to hold a balance of secular winners along with healthy exposure to reopening of the economy, post vaccine success.

As discussed in last quarter's commentary, the desire to promote diversification also prevented us from maintaining a benchmark weight in Apple, which accounts for 11.6% of the Russell 1000 Growth Index and was up over 80% for the year. Choosing not to own electric vehicle (EV) maker Tesla (for valuation, corporate governance, fundamental and volatility reasons) was also a significant headwind to relative results as the stock skyrocketed more than 700%. In fact, the FAANG stocks (Facebook, Apple, Amazon.com, Netflix and Google/Alphabet) plus Microsoft and Tesla accounted for close to two thirds of the benchmark's 38.5% return in 2020 (Exhibit 2). Without those stocks, the index would have gained 26.1%.

Exhibit 2: A Select Few Stocks Dominated Growth Performance



Source: FactSet.

That said, stock selection across the portfolio was solid, with companies like Uber and Disney rebounding in the fourth quarter on improving results and optimism about the economy reopening, while Aptiv and NXP benefited from rising production of EVs, along with the increasing electrification of internal combustion autos. Chipmaker Qualcomm was an outsized performer as well, playing into the theme of 5G globally.

Merger & acquisition activity during the quarter produced mixed results. Three portfolio companies announced deals, but in another example of how unusual a year 2020 has been, two drew only lukewarm reactions. Biotech Alexion Pharmaceuticals jumped on an acquisition offer from British pharmaceutical maker AstraZeneca, which will gain a steady source of cash flow from the developer of treatments for rare diseases. IHS Markit initially rose sharply on news of a bid by business information rival S&P Global but has since trended lower. Long term, we see a significant amount of revenue synergies from the deal, which will diversify S&P from its reliance on fixed income issuance. Shares of salesforce.com have also fallen since its surprise offer for messaging software developer Slack. Collaboration and communications software has grown in importance during the pandemic, likely pressuring salesforce.com to do a deal to compete with Microsoft's successful Teams application.

We believe inflation and the slope of the yield curve will be key determinants of whether growth stocks outperform in 2021.

Portfolio Positioning

The Strategy's IT underweight has been detrimental to performance over the past several years (but less so in the fourth quarter) and we remain cognizant of the benchmark and changes to its composition. The challenge in the sector today is that most stocks have already factored in a decade of similar revenue trajectory, making it tougher to find companies where extreme optimism is not already priced in. We took advantage of volatility in the quarter to increase our IT exposure through three purchases where we felt valuation was more reasonable.

Atlassian is a pure play in the collaboration space, allowing engineers and related groups to work effectively across the enterprise. The company's JIRA project and issue-tracking tool constitutes a near-monopoly in the industry and is at the heart of its portfolio of products. Recent moves to accelerate its cloud transition are positive for the business model and customer adoption. In tandem, price hikes for on-premise server deployments and large cloud customers will serve as incremental drivers. With less than 50% of revenues from cloud today, this represents a long-term catalyst.

Cloud delivery of software is another accelerating trend where Workday maintains a leadership position in an $88 billion market for human capital management (HCM) and finance solutions. The company sells primarily through subscriptions, a model which, at scale, is highly profitable and generates significant recurring cash flow. We believe that Workday's financials solutions are poised to accelerate in the quarters ahead, fueling a second growth vertical for the company.

We also increased our participation in the buildout of more advanced computing and communications components with the purchase of semiconductor equipment maker ASML. The Dutch company maintains a monopoly on deep ultraviolet and extreme ultraviolet lithography technologies critical to all semiconductor manufacturing and is exercising its pricing power. The end of Moore's Law has changed the requirements within advanced computing. In addition, ASML has been boosted by work-from-home trends that have supported demand for personal computing and data center chips and could lead to an upside in orders from multiple customers into next year. Supply and demand trends in the DRAM chip market are also expected to drive increases in orders for ASML manufacturing tools.

We are constantly weighing the outlook for our portfolio companies, seeking to focus on the names that offer the best balance of risk and reward over the next three to five years and longer. As part of this process, we culled two companies in the quarter where recent improvements have quickly been priced in and future growth looks less compelling. C.H. Robinson Worldwide, a provider of logistics and trucking brokerage services, has seen its net revenue stabilize as the company has traded price for volume, where it had lost share over the last few years. But with the possibility of spot pricing coming under pressure as capacity eases up in 2021 and with sizable capex ahead, we exited the position. American Express is heavily indexed to high-end leisure and corporate travel, along with small and medium-size businesses, all of which have seen dramatic cutbacks due to COVID-19. The shares rallied strongly on optimism about an economic recovery, approaching our estimate of fair value well ahead of an earnings comeback. We believe Amex can get back to peak earnings, but with corporate travel probably never returning to pre-COVID-19 levels, other parts of the business will need to accelerate from here, namely lending and small business, both of which will require additional time.

The sale of Amex technically eliminates the Strategy's financials exposure, yet we continue to own and have recently added to Visa and Fidelity National Information Services, which are classified in the IT sector and are direct beneficiaries of a rapid migration to digital payments. From a cyclical standpoint, we see better upside as the economy reopens in consumer names like Ulta Beauty, Monster Beverage and Comcast.

Outlook

For some time, the Strategy has been positioned for an environment of low economic growth. That was certainly the case for much of 2020 as the economy suffered through a sharp but brief recession. As we enter the new year, the economy is still down 10 million jobs from its pre-COVID-19 peak and a recent surge in infections has caused jobless claims to move higher again. What's uncertain is whether the economy is hitting a rough patch or headed for a double dip recession. We think the former scenario is more likely as the successful distribution of COVID-19 vaccines, combined with new fiscal stimulus, continued monetary accommodation and a Wall Street–friendly divided Congress, could lead to reasonable GDP growth in 2021.

GDP growth and inflation have historically been correlated so inflation is a factor we've been examining closely. We believe the level of inflation and the slope of the yield curve will be key determinants of whether growth stocks outperform in 2021. We're not seeing it yet, but when inflation picks up and the yield curve steepens, that should cause a further broadening out in the market and less of a premium on the very narrow universe of growth stocks that have performed so well the last several years. The recent moves we have made give us confidence that our companies can do well in a variety of outcomes. We continue to participate broadly in secular growth trends that accelerated during the pandemic, more nascent industries like electric vehicle production as well as cyclically oriented areas such as omnichannel retail.

Portfolio Highlights

The ClearBridge Large Cap Growth Strategy underperformed its Russell 1000 Growth Index benchmark during the fourth 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 contributor to performance was the IT sector.

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

On an individual stock basis, leading contributors to absolute returns in the fourth quarter included positions in Qualcomm, Apple, Walt Disney, Palo Alto Networks and Uber Technologies. Alibaba, salesforce.com, Amgen, Splunk and Akamai Technologies were the worst detractors on an absolute basis.