ClearBridge Investments

Multi Cap Growth Strategy

Evan Bauman
Managing Director, Portfolio Manager

Richard Freeman
Managing Director, Portfolio Manager

Key Takeaways

- Overall market breadth began to expand beyond mega cap technology, leading to solid absolute and relative performance for the Strategy.
- The Strategy's media holdings continued to show signs of improvement, buoyed by an improving advertising market and optimism around new streaming services.
- Continued innovation in therapeutics, testing and diagnostics should ultimately reverse historically depressed health care valuations and cause the sector to regain a leadership position.

Market Overview: Media Returning to Normalcy

A broadening of leadership, sparked by positive developments for COVID-19 vaccines and resolution of the U.S. election, led to a strong period of performance for both the market and the ClearBridge Multi Cap Growth Strategy. The S&P 500 Index gained 12.2% in the fourth quarter to end 2020 up 18.4% while the Russell 3000 Index rose 14.7% for the quarter and 20.9% for the year.

The mega cap and momentum trades that have lifted markets for the last several years and presented relative headwinds for the Strategy showed signs of fatigue, with value stocks outperforming growth stocks for the first time since the fourth quarter of 2018. The Russell 3000 Value Index gained 17.2% compared to 12.4% for the benchmark Russell 3000 Growth Index. Despite this reversal, growth outperformed value by over 35 percentage points for the year.

Stocks benefited from two catalysts in the quarter. Joe Biden won the race for president and will govern with a small majority in Congress. The lack of an overwhelming Democratic mandate could likely remove the near-term risk of structurally higher taxes and more stringent regulation. Meanwhile, more fiscal stimulus along with 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.

With the market at all-time highs, certain sectors are structurally overvalued while others remain underappreciated.

The Strategy experienced one of its best-ever quarters of performance on both an absolute and relative basis and we are encouraged it occurred in a solidly positive market. Information technology (IT) led Strategy results, with seven of the top 10 individual contributors for the quarter coming from the sector. In fact, our high active share approach, which causes the portfolio to look very different from the benchmark and other growth strategies, was evident in the 32.2% gain for our IT holdings in the quarter compared to a return of 13.2% for the IT sector in the Russell 3000 Growth Index.

The performance of our tech holdings also speaks to how the portfolio is well-exposed to key emerging growth areas. These include electric vehicles (Cree), automotive connectivity (TE Connectivity), AI-driven speech recognition (Nuance Communications and Cerence), 5G communications applications (Broadcom) and cybersecurity (FireEye). Seagate Technology and Western Digital, meanwhile, are filling the growing need for digital storage to support the accelerating adoption of cloud computing.

A quickening comeback in advertising with the return of live events and sports globally supported a strong snapback in shares of many of the Strategy's media holdings. Twitter was higher on a firming advertising market and the return of live sports while programmers AMC Networks and Discovery experienced significant rebounds on better than expected free cash flow generation. AMC, home to the Walking Dead franchise, saw robust subscriber growth in its streaming service while Discovery was supported by optimism around the January debut of its own streaming offering. Comcast was also among the better performers for the period as consistent growth in broadband subscribers was augmented by advertising growth at its NBCUniversal and Sky divisions. Fear of dramatic increases in regulation due to a blue wave election result weighed on the company's multiple; however, the tight Senate outcome along with the positive vaccine news raised optimism around Comcast's more economically sensitive businesses like theme parks, which led to recent strength.

The Strategy outperformed despite stubborn weakness in our health care positions, particularly those in the therapeutics area. Biogen and Vertex Pharmaceuticals, the portfolio's two largest biotechnology holdings, both traded down on disappointing clinical news. A negative opinion from an FDA review panel on Biogen's aducanumab treatment for Alzheimer's disease and its potential impact on FDA approval remained a cloud over the stock. We maintain our belief that Alzheimer's is an enormous global unmet need for which the FDA is motivated to find a way to move the compound forward. Vertex, whose cystic fibrosis franchise had caused the stock to outperform the overall market for most of the year, traded sharply lower after a key pipeline product was

discontinued due to negative Phase 2 trials. The Vertex reaction speaks to the ongoing negative sentiment toward large cap biopharmaceutical companies even in the wake of the industry's extraordinary clinical response to the COVID-19 crisis. We believe Vertex's current cystic fibrosis franchise plus cash provide strong valuation support at these levels and its promising pipeline in four other therapeutic areas is underappreciated by investors.

Overall, we expect continued innovation in therapeutics as well as testing and diagnostics from such companies as Guardant Health to ultimately reverse historically depressed valuations and cause the sector to regain a leadership position.

Outlook

The outperformance of the more reasonably valued parts of the market in the fourth quarter followed a September correction for mega cap IT and Internet stocks. Even so, this narrow group of momentum names remains well ahead of the structurally undervalued names we own in the Strategy over longer time periods. For the year, the tech-heavy Nasdaq Composite rose 44% while the consumer discretionary and IT sectors of the Russell 3000 Growth benchmark advanced 61.3% and 52.7%, respectively. These results suggest a broadening of participation rather than a rotation out of what has worked for the last several years. Nevertheless, the market action of the last four months is encouraging and affirms many of the trends we have been discussing in past commentaries. We are confident this is the beginning of a more durable rotation toward quality, undervalued growth companies and has significantly more room to run.

The close of 2020 demonstrated that companies in subsectors of IT like semiconductors and communications components, as well as other less appreciated and under owned sectors, can do well alongside the giant software, e-commerce and cloud names that dominate growth benchmarks. We were surprised how fast the market rallied back from March lows and do not expect multiple expansion can continue to drive the overall indexes much higher. Instead, it's becoming even more important to find companies that can grow earnings and cash flows organically in what is still an uncertain macro environment. COVID-19 will continue to suppress normal business and economic activity in the near term, even with the introduction of vaccines.

If 2020 was the year of work-from-home, 2021 and beyond will see many behaviors adjusted or permanently altered due to the crisis that we have endured. The return of live events and easier advertising comparisons should be a boon to media companies, highlighted by the NFL featuring an expanded playoff schedule, the NBA and NHL starting a new season and both the Summer and Winter Olympics slated to take place over the next 12 months.

With the U.S. market closing the year at all-time highs, certain sectors are structurally overvalued while others remain underappreciated and under owned. As market breadth continues to improve, and volatility returns, the portfolio could also see some broadening of exposures beyond the three core sectors where we are now focused.

Portfolio Highlights

The ClearBridge Multi Cap Growth Strategy outperformed its Russell 3000 Growth Index benchmark in the fourth quarter. On an absolute basis, the Strategy generated gains across the seven sectors in which it was invested (out of 11 sectors total). The primary contributors to performance were the IT and communication services sectors.

Relative to the benchmark, overall stock selection and sector allocation contributed to performance. In particular, stock selection in the IT, materials and communication services sectors drove results. Conversely, stock selection in the health care sector detracted from relative performance.

On an individual stock basis, positions in Autodesk, Cree, Broadcom, Freeport-McMoRan and UnitedHealth Group were the leading contributors to absolute returns during the period. The lone detractors were Vertex Pharmaceuticals, Biogen and Citrix Systems.