ClearBridge Investments

Small Cap Value Strategy

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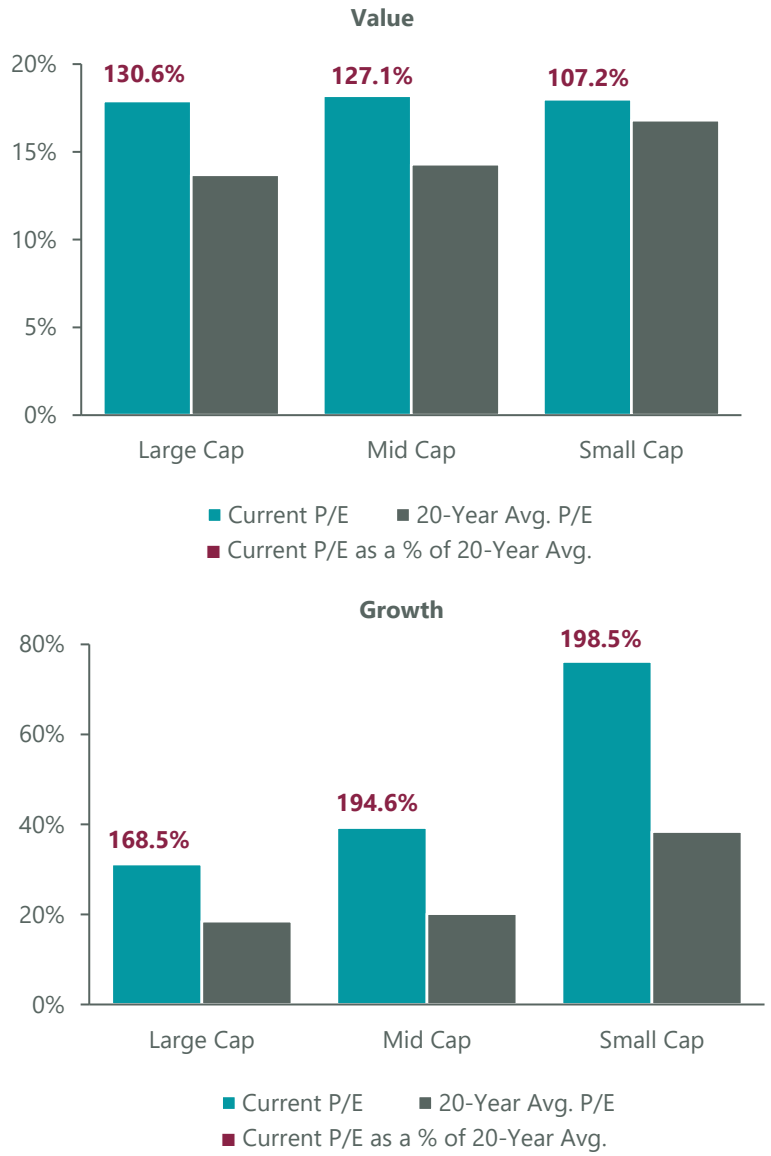
Key Takeaways

- The ClearBridge Small Cap Value strategy participated meaningfully as the market soared to new highs in the fourth quarter.
- We enter 2021 with very high expectations embedded in the market generally, but that does not mean the market is overvalued.
- There are many opportunities to invest in companies that can benefit from big, structural changes in how we live our daily lives, although valuations for some require quite unlikely outcomes.

Market Overview and Outlook: High Expectations Still Define Market

The ClearBridge Small Cap Value Strategy captured gains of 30%+ in the fourth quarter but lagged as the market soared to new highs. Although the Russell 2000 Value Index reversed a long drought of underperformance against the Russell 2000 Growth Index in the quarter, the difference was negligible. The growth index outperformed the value index by 30 percentage points over the full course of 2020 and by more than 70 percentage points since 2016. As of year end, JPMorgan estimated that the growth portion of the small cap market was trading at about double its historical multiple (Exhibit 1).

Exhibit 1: Growth Multiples Soaring vs. Historic Averages



As of Dec. 31, 2020. Source: FactSet, Russell Investment Group, Standard & Poors, J.P. Morgan Asset Management.

We enter 2021 with very high expectations embedded in the market generally, but that does not mean the market is overvalued. There are still many good values to be found, both in the value sector of the market and in the growth sector, where expectations may be high but not high enough. We have always believed that value comes not just from a low multiple or asset value, but also from high growth and excess returns on incremental capital. Growth is a component of value, not the opposite side of the coin. We determine what we think is an attractive valuation not by multiples alone but by first decomposing the market price into future expectations for growth and returns, then comparing those expectations to what we think is a likely outcome.

Let's run through an example from today's market. As of January 12, 2021, the largest component of the Russell 2000 by far was Plug Power (PLUG). Plug carried a $33 billion market cap at $66/share on roughly 500 million shares currently registered, which does not include at least 100 million in options, convertible debt, and warrants outstanding at very low strike prices. The true equity valuation was likely over $40 billion. The stock has performed spectacularly from excitement about the potential for hydrogen fuel cells to reduce carbon emissions in many applications, from automobile engines to commercial power systems. Fuel cell technology has been around for centuries but has been hamstrung by the cost to produce at scale and the lack of an affordable source of hydrogen broadly available in the country. Plug has been a public company since 1999, when excitement about the potential for fuel cells reached a previous fever pitch. In the ensuing two decades, Plug has primarily made power systems for forklifts only and hasn't generated a single dollar of operating income. But that is the past. Our primary concern for purposes of valuations is the future.

What does a $40 billion enterprise value tell us about expectations for Plug Power? Plug believes it can quadruple sales to $1.2 billion by 2024 and earn $200 million in operating income, so it is currently trading over 30x 2024 sales and 200x operating profit. Those multiples don't tell us much, as it would be silly to assert that Plug ought to be trading at 40x sales four years out rather than 30x. Why not 20x or 50x? Instead, we want to consider the profits Plug needs to earn over its entire competitive advantage period, since it's clear that near-term profits will not even begin to explain valuation. We need a long-term, discounted cash flow model to understand valuation.

Discounted cash flow models provide the value of an investment given growth rates, investment needs, and incremental returns on capital for a company over a certain time horizon, discounted at the company's cost of capital. For the sake of argument, let's say that Plug can earn excess returns from its technology for 20 years, its cost of capital is 8%, and it will incur a 25% tax rate after exhausting losses. To be worth $40 billion, Plug would need to increase sales over 30% annually — to reach $70 billion in 2040, above Caterpillar (CAT) and engine-maker Cummins (CMI) combined in 2020 — and 20% operating margins, which would generate an astonishing incremental return on invested capital above 100% continuously over the next 20 years. There are, of course, other ways to solve for the current price using other inputs, but that calculation gives us a rough idea of performance assumptions needed for the company to be worth what it's trading for. Looked at another way, Plug needs to average a present value of about $3.2 billion annually in the future to be worth $40 billion. Compare that to its expectation of pre-tax income of $200 million four years from now.

As stock pickers, we require good reasons to believe that future results are likely to be better than expectations.

These are extremely high expectations. Sales growth in excess of 30% over 20 years is exceedingly rare in any industry and even more so for an industrial company. It's also uncommon to have operating margins as high as 20% for an industrial company. Cummins, which makes diesel and natural gas engines, has $20 billion in sales but has never exceeded 12% operating margin in any year, after decades of single-digit operating margins. Yet Plug must achieve those levels just to be valued fairly, not even to provide an excess return. As stock pickers, we require good reasons to believe that future results are likely to be even better than those expectations to make the stock worth buying. There may be certain scenarios where Plug will exceed expectations, but it needs to be probable to justify investment. That's an awfully steep hill to climb.

There are many opportunities to invest in companies that can benefit from big, structural changes in how we live our daily lives. Many do not require nearly the mental gymnastics that Plug does. A new portfolio position and among the top contributors in the fourth quarter, MP Materials, for example, is the only U.S.-based rare-earth mining company, whose product is essential for electric motors, no matter what the power source is for the motor. Whatever electric vehicle manufacturer ends up leading the market, whether it's Tesla, Lordstown, Canoo, Nikola, or any of the dozen others that are in the market today, MP Materials should benefit. Valued around $5 billion, about 20x its 2023 operating income, it is much easier to construct scenarios in which it would be worth more than that.

Portfolio Highlights

The ClearBridge Small Cap Value Strategy underperformed its Russell 2000 Value Index benchmark during the fourth quarter. On an absolute basis, the Strategy had gains in all 11 sectors in which it was invested for the quarter. The primary contributors to performance were the financials, industrials, information technology (IT), real estate and materials sectors. Consumer staples, communication services and energy sectors were the main laggards.

On a relative basis, the Strategy underperformed its benchmark due primarily to stock selection decisions. Stock selection in the consumer discretionary, consumer staples, energy, financials, IT and materials sectors detracted the most, while stock selection in the real estate and health care sectors proved beneficial.

On an individual stock basis, Western Alliance Bancorp, Wintrust Financial, Acadia Healthcare, Bank OZK and Tronox were the largest contributors to absolute performance in the quarter. The greatest detractors included positions in Stride, Triton International, Encore Capital, Sprouts Farmers Markets and Silgan.

During the quarter, besides positions discussed above, larger positions initiated included Curtiss-Wright, EnerSys and Primoris in the industrials sector, Advantage Solutions in the communication services sector and Lantheus in the health care sector. Larger positions closed included Physicians Realty Trust and STAG Industrial in the real estate sector, PNM Resources and IDACORP in the utilities sector and First Interstate BancSystem in the financials sector.