ClearBridge Investments

Dividend Strategy

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Key Takeaways

- Beneath the surface of the fourth-quarter rally, dynamics evolved from previous quarters as cyclical and value stocks modestly outperformed growth.
- While the pandemic environment earlier in 2020 favored technology companies that often do not pay dividends, our dividend payers have begun to participate in market upside and, importantly, our dividend growth has proved very resilient.
- As the world returns to face-to-face life and relies a little less on Zoom, some of the tailwinds that have propelled tech stocks may become headwinds as the companies lap tough comparisons.

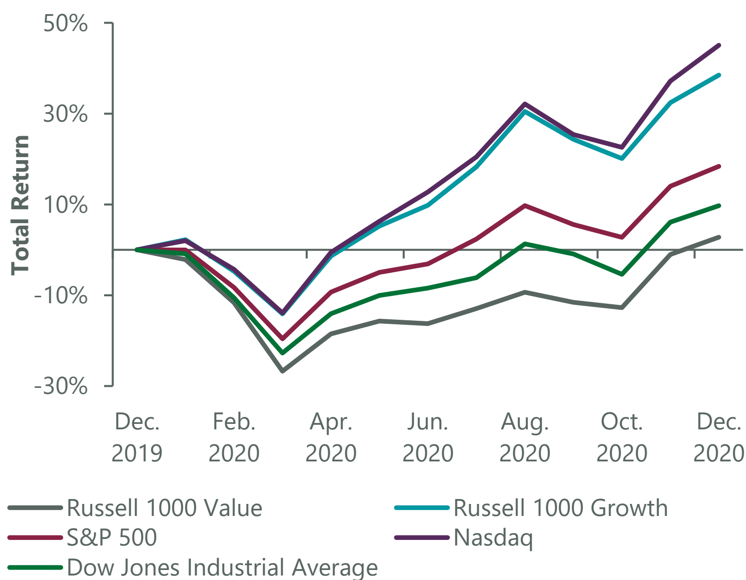
Market Overview and Outlook: Dividend Growth Being Recognized Again

The fourth quarter marked an extraordinary end to a unique and historic year. The second wave of the pandemic hit hard and both cases and deaths reached staggering levels. Yet the markets posted broad-based, double-digit gains as the effectiveness of the COVID-19 vaccine surpassed even the highest expectations. The election outcome — while dramatic and noisy — proved benign. President-Elect Biden is a centrist Democrat and Congress will be reasonably balanced, regardless of the outcome in Georgia's runoff election.

Superficially, the fourth quarter seemed a continuation of the trend in place since the spring. Despite an unprecedented humanitarian and economic disaster, markets have rallied and proven resilient. Beneath the surface, however, dynamics in the fourth quarter differed from previous quarters as cyclical and value stocks modestly outperformed growth.

Throughout the spring and summer, the bounce in stocks was concentrated in a relatively narrow segment of the market. Growth trounced value and the tech-heavy Nasdaq massively outperformed other popular averages (Exhibit 1). Internet and technology businesses benefited from lockdowns and work-from-home, while more traditional companies and industries (particularly travel and energy) suffered.

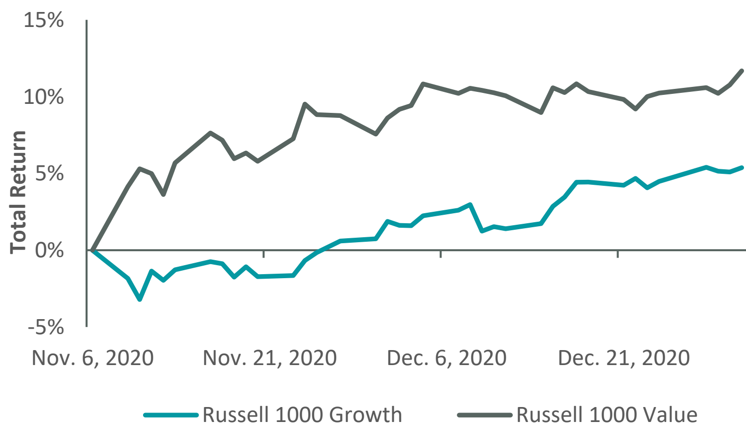
Exhibit 1: Growth and Tech Stocks Led in 2020



As of Dec. 31, 2020. Source: ClearBridge Investments, Bloomberg Finance.

Indeed, in the first nine months of the year, growth outperformed value by over 3,500 basis points — one of the starkest such disparities of all time. This divergence began to reverse on November 9, however, when Pfizer published its initial vaccine data showing that a highly effective vaccine should definitively end the pandemic in 2021. Since then, market strength has broadened out meaningfully and value has outperformed growth/tech (Exhibit 2).

Exhibit 2: Vaccines Sparked a Value Rotation



As of Dec. 31, 2020. Source: ClearBridge Investments, Bloomberg Finance.

It remains to be seen whether this change in market dynamics (value outperforming growth) will endure, but it is worth considering. The tech/growth trade has been the dominant factor within equity markets over the last four years. Over the very long term, growth and value have performed similarly, but over shorter

time frames (like the current one) we see huge cyclical oscillations where one style outperforms the other. Since 2017, growth has compounded at close to 25% per year whereas value has only grown at 8% — a staggering difference. If we have reached an inflection point where value begins to outperform growth, it will have meaningful implications for investors moving forward.

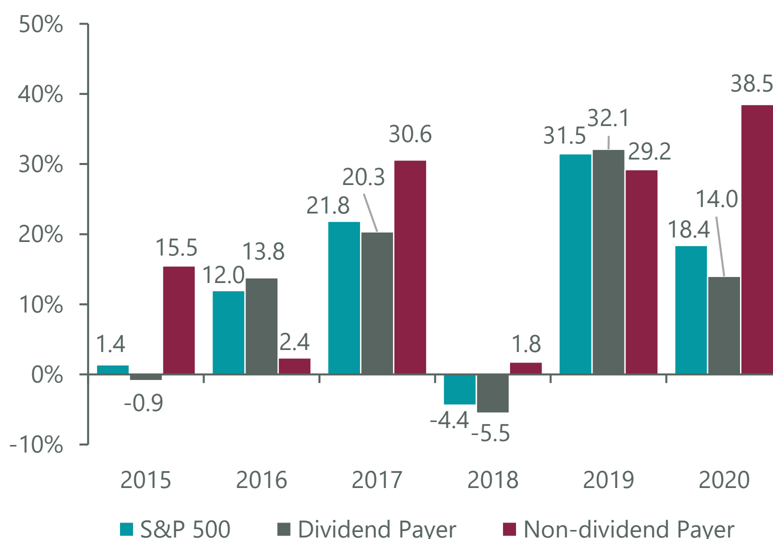
A surging economy could call into question the assumption of the persistence of low interest rates.

The ClearBridge Dividend Strategy portfolio is neither a value nor growth style portfolio. Rather, we endeavor to build a diversified portfolio of dividend payers that offer: 1) attractive upfront yields, 2) robust compounding of dividends and 3) strong downside protection. We focus on companies with big moats, recurring revenues, strong balance sheets, low risk of secular disintermediation and the ability to compound dividends over time. Markets have begun to reward these types of stocks recently, with the portfolio showing much more upside participation in the fourth quarter. Our financials holdings in particular all made strong contributions; we opportunistically added to core holding Travelers, as property and casualty stocks lagged despite the industry enjoying the best pricing cycle we've seen in a long time.

We own many fantastic growth stocks like Apple, Mastercard, Microsoft and Visa. Yet, because so many of the big growth companies do not pay dividends (Alphabet, Amazon.com, Facebook, Netflix and Tesla to name a few), we are a bit hamstrung in markets like the current one. With the tremendous rise in tech stocks over the last few years, tech and shadow tech have become almost 40% of the total stock market. We find ourselves in the paradoxical position where information technology (IT) is both our single largest exposure and our second-largest underweight (or largest, were Amazon categorized as tech).

While the S&P 500 rose 18.4% this year, there was a stark difference in the performance of dividend-paying stocks (77% of the market's capitalization) versus non-dividend payers (23% of total market cap). Non-dividend-paying constituents in the index rose 39%, while the dividend payers rose 14% (Exhibit 3). Each group — despite the considerable 3x size differential — contributed about one half of the market's return. Within the dividend cohort, about 70% of the returns came from just two stocks: Apple and Microsoft. Thus, 85% of the market return in 2020 was generated by non-dividend payers plus Apple and Microsoft — that's a tough backdrop for diversified dividend investors!

Exhibit 3: A Dividend Breakdown of S&P 500 Returns



As of Dec. 31, 2020. Source: ClearBridge Investments.

We believe two factors explain the disparate performance between dividend payers and non-dividend payers in 2020. First, the non-dividend payers tend to consist largely of technology companies whose businesses benefited from lockdowns. As life returns to normal, some of the tailwinds they experienced in 2020 will diminish. Second, and somewhat related, the significant decline in interest rates has caused investors to bid up the multiples for growth stocks, many of which, again, do not pay dividends.

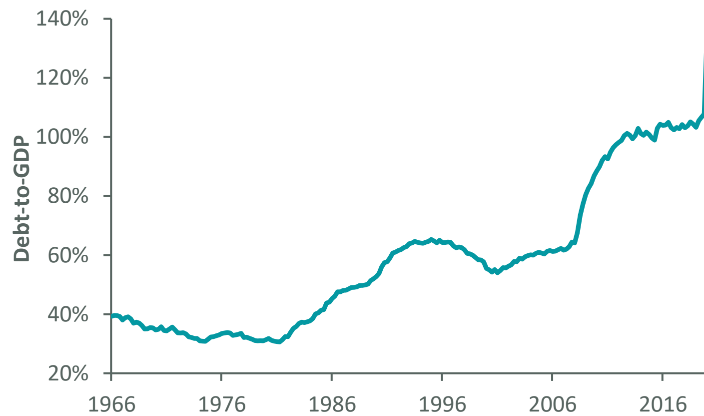
Looking back on the year, it is staggering to think that the markets performed so well when humanity and the economy suffered so much. The S&P 500 rose 18.4% despite a 23% decline in earnings. This divergence between corporate profitability and stock performance is due, in part, to the market's ability to look through the temporary impact of the pandemic and toward a more normal future. But the overwhelming driver of this year's unexpected market strength was the lightning-fast implementation of unprecedented fiscal and monetary stimulus.

From the beginning, we have applauded these moves. Desperate times call for desperate measures, and this year was as challenging as any in several generations. But medicine sometimes has side effects, and the full impacts of the disease and its treatment may not be known for some time. The government and the Fed appropriately acted swiftly to cushion the blow to the economy and markets. These actions sustained the economy during 2020 and positioned it to recover sharply post the vaccine. But the bills for these expenditures will eventually come due.

Deficits around the world have soared and debt-to-GDP in the U.S. is at its highest level in decades (Exhibit 4). With interest rates near zero the costs of these deficits are manageable, but what if interest rates ever rise? The exploding deficit becomes

just one more phenomenon (housing prices in coastal cities, P/E multiples, etc.) that makes sense only through the lens of absurdly low interest rates.

Exhibit 4: Soaring Debt-to-GDP in the U.S.



As of Dec. 31, 2020. Source: ClearBridge Investments, Bloomberg Finance.

While we are not calling for a rise in rates, it gives us pause that the primary driver of global asset prices is a belief in the persistence of near-zero interest rates. We could envision a scenario in 2021 where the economy roars but the stock market whimpers. Indeed, GDP growth in 2021 is expected to be 3.9%, the best since 2000. It is not obvious to us, however, that such strength will translate into robust equity markets.

The market's moves in 2020 already discount a return to more normal activity; investors have largely "looked through" 2020. While a return to "normal" economic activity will benefit many sectors, it will also negatively impact others. As the world returns to face-to-face life and relies a little less on Zoom, some of the tailwinds that have propelled tech stocks may become headwinds as these companies lap tough comparisons. With tech and shadow tech constituting almost 40% of the stock market, this matters. More profoundly, a surging economy could call into question the assumption of the persistence of low interest rates. With unemployment still elevated, inflation tame and a Fed committed to low rates, higher rates currently seem like a low-probability event. The impact of rising rates, should they occur, however, is sufficiently large that we must constantly bear them in mind even if the probability seems low.

As we turn the page on 2020, we believe our portfolio is well-positioned for 2021. Despite a tremendous economic contraction, many of our portfolio companies continued to pay and grow their dividends. While the S&P 500 saw 15% of its dividend payers cut their dividend in 2020, our portfolio saw only one dividend suspension — that of Disney, whose theme parks were closed. And in a year where earnings for the S&P 500 were down

23%, our dividends grew on average 7%. Our companies are well-positioned for an economic recovery and their valuations screen favorably compared to many other asset classes and sectors. Amid a world so full of uncertainty, we continue to believe in the soundness of investing in high-quality dividend growers.

Portfolio Highlights

The ClearBridge Dividend Strategy underperformed its S&P 500 Index benchmark during the fourth quarter. On an absolute basis, the Strategy had gains in nine of 11 sectors in which it was invested for the quarter. The main contributors to Strategy performance were the financials, IT, materials and communication services sectors. The consumer discretionary sector, meanwhile, detracted from absolute results.

On a relative basis, stock selection detracted from performance for the quarter, while sector allocation was a positive. In particular, stock selection in the energy, industrials and consumer staples sectors and an overweight to consumer staples detracted from relative returns. Conversely, stock selection in the financials, communication services and utilities sectors and overweights to financials and energy proved beneficial.

On an individual stock basis, the main positive contributors were Apple, Walt Disney, Blackstone Group, Raytheon Technologies and Travelers. Positions in American Tower, Home Depot, Intel, Nestle and WEC Energy Group were the main detractors from absolute returns in the quarter.

During the quarter we initiated a position in Northrop Grumman in the industrials sector and closed positions in Intel in the IT sector and International Paper in the materials sector.

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