ClearBridge Investments

Select Strategy

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Key Takeaways

- Results were driven by continued strength in longstanding ownership in disruptive Internet-related businesses as well as contributions from newly acquired companies tied to the reopening of the economy.
- Active repositioning throughout the year has created a more balanced portfolio with a wide array of exposures across public and private equity and alternative investments that we believe will be important as market breadth improves.
- Some of the major changes in business and consumer behavior during COVID-19 will have durability, not only in work-from-home, e-commerce and cloud computing but also on the health care side with the growth in telemedicine.

Market Overview and Outlook: Blurring of Public/Private Markets Uncovers Opportunity

A volatile quarter and year ended strongly with greater clarity on the U.S. political landscape and the trajectory of several COVID-19 vaccines providing a boost to equities. The S&P 500 Index gained 12.2% in the fourth quarter to end 2020 up 18.4% while the benchmark Russell 3000 Index rose 14.7% for the quarter and 20.9% for the year. The momentum trade that has lifted markets for the last several years briefly gave way to cyclicals as the Russell 3000 Value Index gained 17.2% for the quarter compared to 12.4% for the Russell 3000 Growth Index. Despite this reversal, growth outperformed value by over 35 percentage points for the year.

The ClearBridge Select Strategy started strong ahead of the presidential election but lost ground after the utter euphoria in markets on November 9 when Pfizer/BioNTech first announced positive results for their COVID-19 vaccine. The brief period saw huge moves in airlines, cruise lines, banks and retailers as well as more cyclical areas of REITs, areas where the Strategy has limited exposure. For these stocks to keep working, the fundamentals of their businesses need to improve and the spike in COVID-19 cases into the end of the year was a reminder that such improvement could take time. This near-term uncertainty related to the virus, as well as a delay in the passage of additional stimulus, caused growth areas of the market deemed more defensive and with greater visibility to come back as the quarter closed.

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The Strategy gained ground in this span to outperform the benchmark for the quarter and maintain its advantage for the year. Fourth-quarter results were boosted by continued contributions from a group of Internet stocks that we consider disruptors, including Pinterest and Chewy. We have owned most of these innovative, hyper growth disruptors like e-commerce enablement platforms Shopify and MercadoLibre, for several years and they were consistent drivers of alpha throughout 2020.

Performance was complemented from the second half of the third quarter through the end of the year by more recent additions tied to the reopening of the economy. Stocks like freight and logistics provider XPO, youth retailer American Eagle and banks First Republic and Truist fall into our evolving opportunities group of companies enjoying secular tailwinds that saw cyclical headwinds related to the pandemic overpower them in the first half of the year. As the economy began to stabilize in the second half, most of these names reported better earnings and their multiples came back. We want to own these more economically sensitive companies as they have levers to improve efficiencies in their business operations, adding additional operating leverage on top of strong cyclical revenue growth.

Portfolio Positioning

After a year of active repositioning, the portfolio has more balance than ever before. We have established a wider array of exposures across public and private equity and alternative investments because we believe there will be more breadth in the market going forward. That stands in contrast to early 2020 and prior years when the market was fairly concentrated in high-multiple, secular growth names. The broadening of the portfolio started in the second quarter as pandemic-related volatility spiked and has been achieved through opportunistic buying of evolving opportunities and mispriced steady compounders like Performance Food Group and Expedia. We partially funded these additions through select profit taking in disruptors that have seen huge moves. In the fourth quarter, this involved the purchase of WillScot Mobile Mini and American Equity Investment Life and the sale of recent IPO Unity Software after a very strong debut.

Willscot Mobile Mini, which provides modular offices and portable storage space, is a classic evolving opportunity. The company had started to transform its business prior to COVID-19 but was hurt by the disruption of activity. We expect the cost and selling synergies achieved from the merger of WillScot and Mobile Mini that was announced in March, as well as a shift to value-added products with higher margins, such as selling telecom, lighting and shelving for their modular offices, will create an amplifier effect as the economy accelerates in 2021.

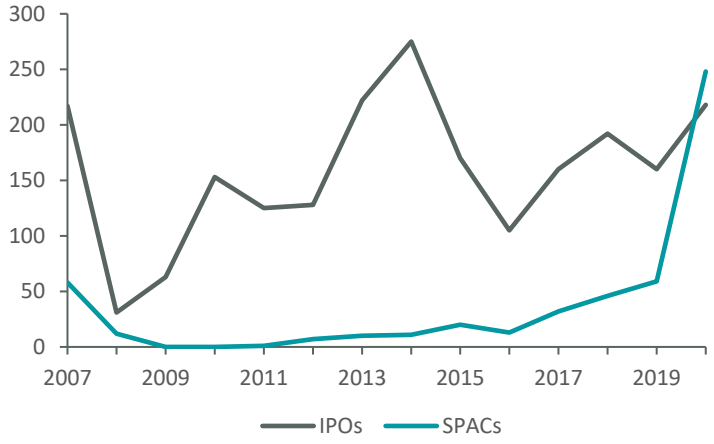
American Equity Investment Life is a company we owned in another ClearBridge portfolio that was significantly undervalued and lacking catalysts until a new CEO arrived in 2020. The annuity provider operates in a consolidating industry dominated by private equity and hedge fund owners. The stock sold off after rejecting a merger offer from a larger competitor but the new CEO's multi-pillar strategy to drive returns and growth while unlocking capital led to a partnership with Brookfield Asset Management that leaves it well positioned to carry out its plan.

Our approach to out of favor companies is not simply motivated by valuation; instead, we need to gain confidence that a business has the balance sheet and management to follow through on its roadmap for improvement. Uber and Pinterest, for example, continued to invest in their businesses earlier this year as competitors were hampered.

We are finding more opportunities in more areas across capital markets. During the fourth quarter alone, we put on more than 10 options positions, invested in three private placements and participated in four IPOs. The private investments, Paycor in payroll and human capital software, Caris in health care technology and genetic testing as well as DataRobot, which develops software to power AI, allow us access to innovative businesses earlier in a company's life cycle and provide insights into the future trajectory of many industries.

In the IPO market, SPACs have figured prominently this year and accounted for more than half of all new issues for the year (Exhibit 1). We have looked at a number of SPACs but participated in just a few where we knew the managers very well and expect them to target alluring disruptive businesses. New SPACs we added in the fourth quarter were Altimeter Growth, led by technology investor Brad Gerstner, and a second offering from Dragoneer, run by a management team we discussed in an earlier commentary.

Exhibit 1: SPAC Issuance Surpassed Traditional IPOs in 2020



Source: Renaissance Capital.

Two traditional IPOs of note in the quarter were food delivery company DoorDash and solar power provider Array Technologies. DoorDash is the No. 1 player in U.S. food delivery where penetration levels are still low. We believe the company, which we originally vetted in 2016 while still private, can maintain and potentially grow share in a rapidly expanding end market and has figured out how to do it in a profitable manner. Array Technologies makes mechanical tracking systems platforms for industrial grade solar installations that pivot as the direction of the sun changes to capture the most solar exposure. The company, run by a team with a keen sense of where to offer software around its physical platform, has seen mostly U.S. market share gains thus far and will begin to ramp up its international business in 2021.

Outlook

The global economy appears on a trajectory of improvement with vaccine distribution continuing to ramp up. But as we learned last year, it's the unknowns that can present the most risk. The ClearBridge Select Strategy remains flexible and nimble, ready to adjust as new uncertainties arise. We continually assess and reassess the theses for the companies we own to maintain confidence in our exposures as this is the best way to be prepared for exogenous events like COVID-19.

We have been spending a lot of time lately analyzing what the new normal will look like coming out of the pandemic. Some of the major changes in business and consumer behavior during COVID-19 will have durability, not only in work-from-home, e-commerce and cloud computing but also in other areas of our economy such as health care with the increased adoption of telemedicine. We are evaluating what the sustainable trajectory is of some of our businesses given these enduring trends.

2020 witnessed a total blurring of lines between private and public companies. After a period of private companies taking longer to go public, we saw a switch in 2020 where companies went to the public markets earlier — even some with no revenue! We used to only see those in biotech but are now seeing it in areas such as alternative energy, battery technologies and health care technology where younger companies are earning significant valuations. This presents opportunity and risk and speaks to the importance of not only understanding companies with a limited business history but also being very selective in the ones we choose to own.

Portfolio Highlights

The ClearBridge Select Strategy outperformed its Russell 3000 Index benchmark for the fourth 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 consumer discretionary, information technology (IT) and industrials sectors were the primary contributors to performance.

In relative terms, the Strategy outperformed its benchmark due primarily to stock selection. Specifically, stock selection in the consumer discretionary, industrials and health care sectors were the primary drivers of results. Conversely, stock selection in the real estate and financials sectors and an underweight to financials detracted from results.

On an individual stock basis, the largest contributors to absolute returns during the fourth quarter were MercadoLibre, XPO Logistics, Crocs, Performance Food Group and Chewy. Positions in SBA Communications, Vital Farms, Alibaba, JFrog and BJ's Wholesale Club were the greatest individual detractors from absolute returns.

In addition to the transactions mentioned earlier, the Strategy initiated positions in Vroom in the consumer discretionary sector, Clarivate and Regal Beloit in the industrials sector, Charles River Laboratories and Teladoc Health in the health care sector, Lamar Advertising in the real estate sector and Universal Display in the IT sector. We also closed positions in Intercontinental Exchange in the financials sector, Comscore in the communication services sector, PPD in the health care sector as well as Cloudflare, Alteryx and Qualys in the IT sector.