ClearBridge Investments

Small Cap Strategy

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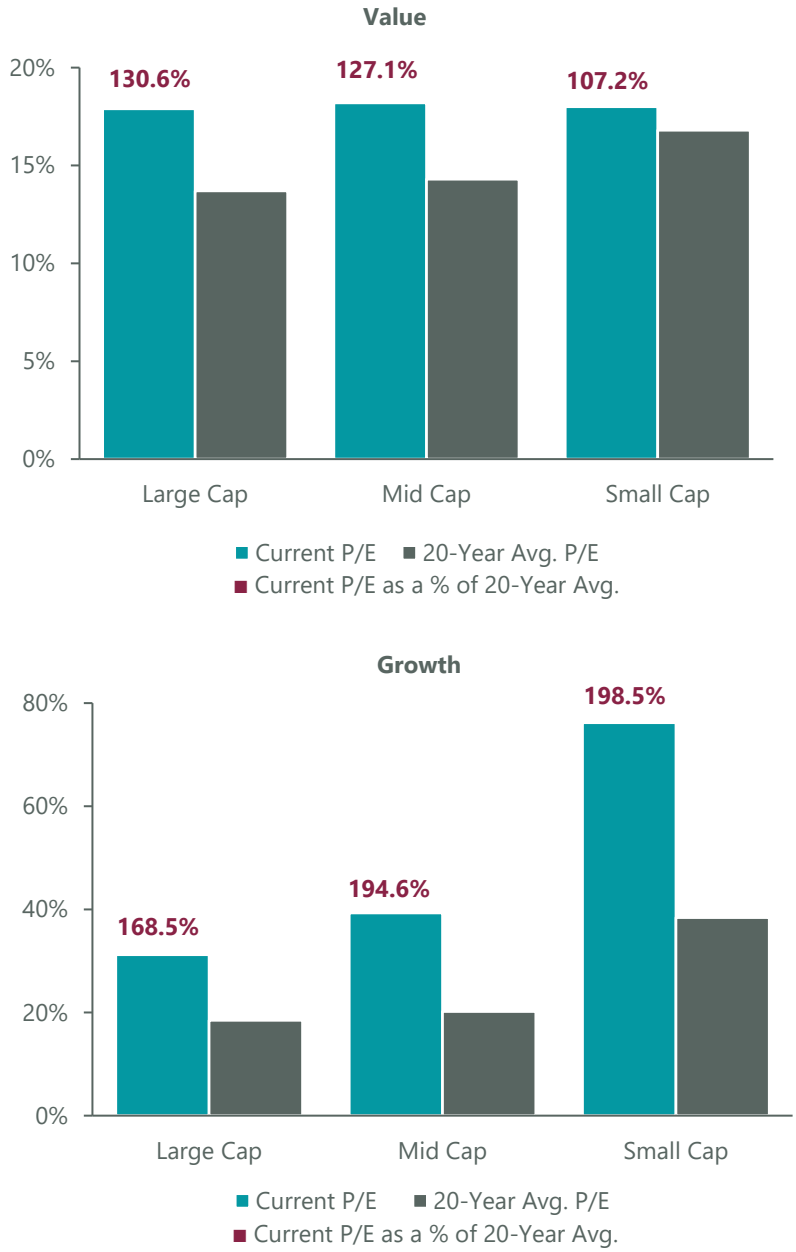
Key Takeaways

- The ClearBridge Small Cap strategy kept up as the market soared to new highs in the fourth quarter, lagging slightly due primarily to cash drag.
- 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: Growth is a Component of Value, Not its Opposite

The Russell 2000 Index closed 2020 strong, gaining 31.4% to finish the year up 20.0%. The ClearBridge Small Cap Strategy lagged slightly in the fourth quarter due primarily to cash drag, as the market soared to new highs. For the year, the Strategy struggled badly across multiple sectors. Although the Russell 2000 Value Index reversed a long drought of underperformance against the Russell 2000 Growth Index in the fourth quarter, the difference was negligible, with both indexes up about 30%. 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, JP Morgan 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.

Being diversified was a headwind in 2020. The rotation within recovery stocks or themes (work-from-home, fuel cell, casino stocks recently) and velocity of moves without much incremental data was also a headwind for long-term-oriented managers who think probabilistically. Our performance deficit for 2020 was mainly driven by first-quarter results, where we entered the year underweight software, given its strong multiyear run, and biotech. We also had larger exposure to leisure stocks that we believe were less correlated in any scenario outside a global shutdown. Our Strategy had a much stronger second half of the year: we

outperformed the market in the third quarter despite negative clinical news on two of our key health care holdings and kept up in a very strong market in the fourth quarter.

In 2018 and 2019, health care was among our best-performing sectors. In 2020, with negative legal developments for Amarin and negative data from Akebia Therapeutics (a name we have since sold), along with a lack of exposure to digital medicine and direct plays on any COVID-19 vaccines, our health care holdings did not do as well as in past years. We have historically been more exposed to biotech companies with existing commercial products and/or near-term opportunities, but in 2020 long duration companies have seen more upside partly due to lower cost of capital.

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.

To understand valuation, we want to consider the profits a company needs to earn over its entire competitive advantage period.

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.

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 top contributor 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 Strategy underperformed the Russell 2000 Index, the Strategy's 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 the Strategy's performance were the financials, information technology (IT), health care and industrials sectors. The consumer staples and energy sectors were the main laggards.

On a relative basis, the Strategy underperformed its benchmark due primarily to stock selection. Stock selection in the industrials, energy, consumer staples and materials sectors detracted the most. Conversely, stock selection in the financials and health care sectors proved beneficial.

On an individual stock basis, Luminar Technologies, Acadia Healthcare, Visteon, MP Materials and R1 RCM were the largest contributors to absolute performance. Stride, Healthcare Merger Corp, Sprouts Farmers Markets, Encore Capital and Lantheus were the greatest detractors from absolute returns.

We initiated several new positions in the quarter, including, besides names discussed above, Avient in the materials sector, INSU Acquisition and Deerfield Healthcare Technology Acquisitions in the financials sector and Curtiss-Wright and EnerSys in the industrials sector. More significant positions sold during the quarter included EVERTEC in the IT sector, Sanderson Farms in the consumer staples sector, Cubic in the industrials sector, Texas Roadhouse in the consumer discretionary sector and PNM Resources in the utilities sector.