ClearBridge Investments

All Cap Value Strategy

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Key Takeaways

- A historic shift in fiscal policy could collide with recovering GDP growth to create inflation well above expectations.
- Rising growth in 2021 will allow for much broader market participation and a continued rotation into value and recovery plays as they bounce off the historically depressed levels reached in 2020.
- During the quarter we added nine new names, capping off a very active year with diverse opportunities while sticking to our valuation discipline.

Market Overview and Outlook: Nominal Growth Could Come Back Big, Further Boosting Value Stocks

There is an unquenchable desire to know what drives financial markets. At an almost primal level, investors struggle to reconcile how great news doesn't always translate to strong markets and vice versa. In fact, as this is being written protesters are storming the Capitol and the pandemic is still raging, while the market takes out all-time highs. How can the market be so divorced from reality?

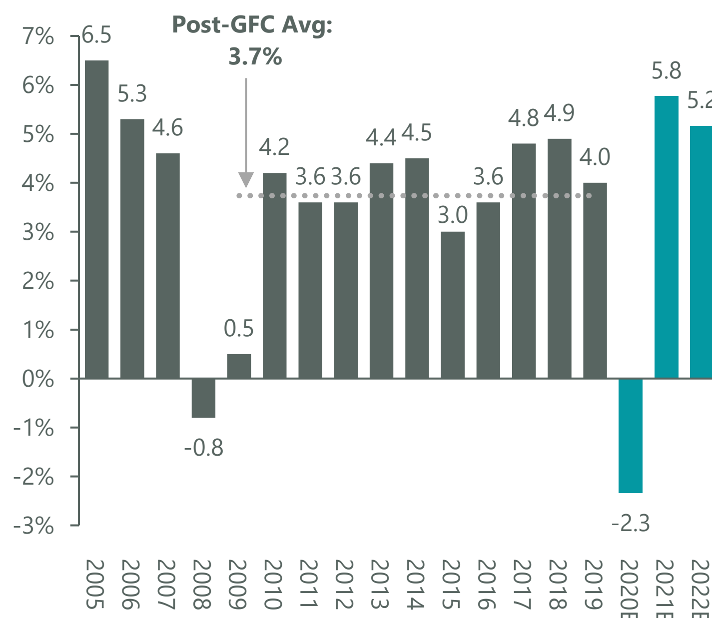
This causal thinking almost always leads to an intense focus on the broad economy, and specifically forecasting economic growth. Certainly, economic growth and the market are complementary dance partners? Nope. As Exhibit 1 shows, the correlation between GDP growth and market performance is essentially zero (rather than forming a pattern, the dots in the chart are scattered widely).

Exhibit 1: No Correlation Between GDP Growth and Market Performance

As of Dec 31, 2020. Source: BEA, S&P and Bloomberg Finance. Annual S&P 500 Index returns and Nominal GDP growth since 1950.

The temperature of economic waters over this past cycle has been decidedly "new normal" cool (Exhibit 2). Nominal growth has averaged a paltry 3.7% over this cycle despite every effort of central banks to reach escape velocity. Yet rather than holding back the markets, this slow nominal growth created a perfect elixir for inflating asset prices, especially in companies that enjoyed secular growth that was untethered from the anemic cycle. Unfortunately, like tropical fish trying to survive in an unheated tank, the slow nominal growth led to the worst relative performance for value stocks by many measures.

Exhibit 2: GDP Expectations Strongest in 15 Years



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

In 2020, however, while nominal GDP growth was -2.3%, from an absolute performance level, the stock market enjoyed a record rally off the bottom and a surprisingly solid year. If you had followed that negative nominal growth in making investment decisions, you would have gotten the market outcome very wrong.

Fiscal Spending Boosted 2020 Returns, and Could Continue

What led markets in the opposite direction of nominal GDP growth in this case was the historic shift in fiscal policy (a record low discount rate certainly helped). We have not seen fiscal stimulus at 2020 levels since World War II, and as a result we have not seen U.S. consumer balance sheet strength at comparable levels since the end of World War II. Likewise, the U.S. banking system grew capital during this downturn, with loan-to-deposit ratios also plummeting to multi-decade lows. This has created a tremendous amount of buying and lending potential, and the question becomes: will the vaccine-driven recovery in 2021 and

beyond light the fuse on a powder keg of pent-up demand? Exhibit 2 shows consensus growth expectations for 2021 and 2022 that decidedly break above the new normal slump. However, we think the consensus will prove much too low and that nominal growth will accelerate to 20-year highs.

The main thing that gives us so much upside conviction in nominal growth is that fiscal policy will be further unleashed — beyond the current COVID-19-related pivot — to attack two major policy goals: wealth disparity and climate change. The modern policy mandate appears to be a Green Society plan that is being pursued by governments simultaneously across the globe. The result will be trillions of dollars in capital spending on labor- and resource-intensive green investments. It is already being estimated that the combined spending will surpass the demand for commodities from emerging markets during the BRIC-driven commodity cycle.

At the very least, this fiscal spending will start to warm up the economic waters that investors must swim through in 2021. Especially with the Federal Reserve signaling it will be throwing no monetary ice in the tank to cool things until the temperature gets back to tropical levels. This warming will be a tremendous boost to many stocks, especially value and cyclical stocks that suffered so much from low nominal economic growth.

Broader Market Participation Still Calls for Constant Adaptation

With inflation expectations rising and interest rates starting to climb, the big question is: when will things get too hot? The honest answer is that no one knows, but we will be observing key metrics very carefully in 2021 — especially any acceleration in bank loan growth, as faster monetary velocity is a critical driver for inflation and higher rates. For now, we think the warming trend in 2021 will simply allow for much broader market participation and a continued rotation into value and recovery plays as they bounce off the historically depressed levels reached in 2020.

The real value of a forecast, however, is that it gives you something against which to falsify and update your beliefs. A real strength of our team is that we make a continual market in cognitive diversity by debating different potential events and what they might mean for financial markets: the macro-to-micro translation is especially challenging in a complex adaptive system like markets, as evidenced by the zero correlation between economic growth and markets.

- **Water Could Get too Hot**: Some on our team believe things could get hot in a non-linear way in late 2021 as the economy roars back and inflation expectations increase toward 3%. Narratives are truly powerful as they influence behavior and

reflexively feed on themselves. High inflation expectations were the narrative that Volcker had to crush in 1982, and today's Fed seems equally convinced it needs to crush deflationary expectations. At what level of inflation expectations could they start to feed on themselves, with people starting to shun deflating cash for hard assets? If this critical point is reached, the correlation between growth and markets could get very negative, with historically high asset valuations compressing materially. In this scenario, we would expect value stocks, especially interest-rate-sensitive financial stocks and commodity stocks, to do extremely well, while growth would likely suffer dramatically. Our general plan would be to stick with current portfolio positioning.

- **Water Could Cool Sooner than Expected**: Conversely, some on our team, and most investors we speak with, think deflationary pressures are structurally entrenched by the ongoing digital transformation in the economy, demographics and deeply embedded expectations around structural deflation. If so, real rates could stay negative despite faster growth, and the value rotation will run out of steam as easy 2020 comps and faster nominal growth recedes as we look beyond 2021. In this scenario, growth would regain its leadership, and defensive stocks would enjoy a much more favorable macro environment. Within our value mandate, we would look to adjust our portfolio accordingly.

Unlike TV pundits whose mostly wrong forecasts are simply buried in our noisy world, our two variant views and base case of modestly warming waters in 2021 will be constantly updated and reacted to, if appropriate, in the portfolio. Beyond the debates of the direct portfolio team, we leverage the depth and diversity of the ClearBridge research platform to have different stocks ready to go as the world shifts and our views are strengthened or falsified by what we observe. As Eisenhower so perfectly put it, reflecting on his great military career: "In preparing for battle I have always found that plans are useless, but planning is indispensable." This is the spirit that drives our active decisions around the portfolio, with the only constraint being the valuation discipline that defines our investment process. Constant adaption is essential, but so is sticking to stocks that trade well below our assessment of business value.

As a concrete example of our inductive portfolio management process, the majority of last quarter's portfolio turnover happened after the Pfizer COVID-19 vaccine announcement was made on November 9. We had already discussed a plan of action if the vaccine disappointed or exceeded expectations. When the efficacy was much better than expectations, we pivoted to stocks that would benefit materially from a vaccinated world in 2021 at prices still well below the increase in business value from the

positive shock of the vaccine news. By planning conditional actions before we observe big events, it helps offset the classic behavioral error of anchoring and the biases that reflect our human nature as individuals. The process and the collective team are clearly essential, and we are always refining the process to make judgement even better.

Portfolio Positioning

> For now, we think the warming trend in 2021 will allow for much broader market participation.

During the quarter we added nine new names, capping off an active year as market and economic conditions varied more violently than any in our 30 years of experience. The vast majority were recovery names trading well below business value against an expected economic recovery starting in 2021, primarily from the consumer discretionary and industrial sectors. Given the massive benefits of the fiscal response to COVID-19 for the consumer, our biggest pivot on November 9 was in travel-related and leisure stocks like Carnival, Sunstone Hotel and Spirit AeroSystems.

Beyond recovery plays we continue to add to companies that will benefit from the Green Society plan that will accelerate electric vehicle (EV) and renewable energy adoption. As an example, Eaton, which specializes in electricity power management, will be a major beneficiary of EV adoption and investments in an enhanced electrical grid. Finally, we also added to the global leader in personal cyber security, NortonLifeLock. Norton has the valuable attributes of being a beneficiary of the accelerated transition to work-from-home due to COVID-19, but with a recurring revenue model that will generate higher cash flows well into the future. Unfortunately, cybersecurity is also going to be an area of intense focus and a priority after widely publicized attacks that pose a material risk to an ever-increasing digital world. We are always looking for good businesses with structural tailwinds that come in value stock wrappers and Norton checks all those boxes.

We think this diverse list of stocks with material upside to business value reflect the depth of our team in finding new ideas, and the broad opportunities to be active in a passive investment world.

We feel the portfolio is very well-positioned for warmer economic waters and the likelihood of nominal GDP accelerating well above current consensus in 2021 to multi-decade highs. The resulting rotation into value has been a welcome tailwind to our valuation-driven strategy, and we will make the most of it as value has the potential to recover much more fully as the economic temperature rises. Beyond this current outlook and positioning, our decision-making process embraces a world that will continue to surprise us well after the shock of COVID-19 and recovery wear off. After all, these surprises are often what create the biggest opportunities for active, valuation-driven investors like us.

Portfolio Highlights

The ClearBridge All Cap Value Strategy had a positive return during the fourth quarter, outperforming the Strategy's benchmark Russell 3000 Value Index.

On an absolute basis, the Strategy had gains in all 11 sectors in which it was invested during the quarter. The primary contributors to the Strategy's performance were the financials, information technology (IT), industrials and health care sectors. The consumer staples sector was the sole detractor.

In relative terms, the Strategy outperformed its benchmark due to sector allocation and stock selection decisions during the quarter. Stock selection in the financials, IT, utilities and health care sectors and overweights to the financials and energy sectors drove most of the positive results, while stock selection in the energy, consumer staples, communication services and materials sectors were detrimental.

On an individual stock basis, the greatest contributors to absolute returns during the quarter were positions in OneMain Holdings, Synchrony Financial, Citigroup, American International Group and AES. The largest detractors from absolute performance were Wheaton Precious Metals, Unilever, Sprouts Farmers Markets, Reynolds and EQT.

Besides portfolio activity mentioned above, during the quarter we initiated positions in Medtronic in the health care sector, Lithia Motors in the consumer discretionary sector, Kimco Realty in the real estate sector and Oshkosh in the industrials sector. We closed positions in Foot Locker in the consumer discretionary sector, Conagra Brands in the consumer staples sector and Bristol-Myers Squibb in the health care sector.

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