ClearBridge Investments

Large Cap Value Strategy

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Key Takeaways

- A broad-based rally driven by a rotation to cyclical areas helped value stocks outperform growth for the first time in two years.
- Positive portfolio performance was driven by financials, industrials and stocks leveraged to long-term trends of connectivity and digitalization.
- We are heartened by the arrival of vaccines and are cautiously optimistic about economic growth in 2021, although the long-term effects of unprecedented stimulus remain unclear.

Market Overview and Outlook: Vaccines Pave Way for Value Rotation

The announcement of two effective vaccines for the coronavirus and their subsequent approvals for emergency use contributed to a strong fourth quarter for U.S. equities. Additionally, a closer than anticipated national election was well-received by the markets. The combination helped stocks overcome pre-election uncertainties, rising COVID-19 infections and a return to lockdown conditions in some areas of the U.S. and Europe.

The benchmark Russell 1000 Value Index rose 16.3% during the quarter, with large cap value stocks outperforming growth for the first time in two years. While the Russell 1000 Growth Index and the broader S&P 500 Index lagged during the period with returns of 11.4% and 12.2%, respectively, growth stocks finished the year well ahead, driven by robust performance of technology stocks favored by stay-at-home conditions. The rally was broad-based, with eight of 11 sectors within the Russell 1000 Value Index up double digits.

Gains were skewed toward the cyclical areas hit hardest at the start of the pandemic, which are expected to see gradually normalizing conditions starting in 2021. The benchmark index was led by energy, financials and industrials sectors, while defensive utilities and consumer staples sectors lagged.

In the portfolio, high-quality financials such as JPMorgan Chase and Bank of America were top contributors as the timeline for lifting the cloud of the pandemic became clearer and optimism grew that government support of the economy averted the worst of the economic strain of the pandemic. Both banks were able to remain profitable despite building massive loan loss reserves in

2020, demonstrating the benefits achieved from a decade of enhanced risk controls, strict underwriting and greater capital discipline following the Global Financial Crisis.

We increased our financials exposure by adding to American Express, which continued to invest in growth through the pandemic and should be a major beneficiary of the eventual return of travel. We also initiated a position in Capital One Financial, a largely domestic diversified financial services company with a primary focus on credit cards that also operates a leading auto lending business. Its consumer finance concentration is balanced with a traditional commercial bank. The bank has a long history of profitably managing the credit risk inherent in its consumer finance portfolio. We expect the business to benefit from broad economic recovery in 2021 and beyond.

Strong contributions from TE Connectivity and Lam Research reflect the portfolio's emphasis on competitively advantaged franchises with defensible business models operating in stable to growing end markets. Both companies should continue to benefit from digitalization and connectivity. This is a secular story that we think will play out in the growing electronification of cars, for which TE Connectivity provides essential components, and which got a boost from the nascent recovery of the global auto cycle. The insatiable appetite for more memory, storage and processing power creates ever-growing demand for semiconductors, which feeds the need for semi cap equipment, benefiting Lam Research, one of a very few global leaders in this space. While operating in cyclical industries, we think both companies should be secular winners over the coming years, benefiting from and enabling all things digital.

A new position in Qualcomm also reflects our interest in digitization and connectivity. Qualcomm is a truly differentiated, high-IP company with good visibility for several years given its exceptionally strong positioning for 5G; it has roughly 50% more content in 5G devices than 4G devices. We funded the position by trimming Microsoft and Apple after their strong runups.

The fourth-quarter vaccine news resulted in a rally driven by cyclical and to some extent consumer discretionary parts of the market where the Strategy has less exposure. While the Strategy participated with the rising market, some of our industrials, communication services and materials holdings lagged more cyclical vaccine beneficiaries in the fourth quarter. These companies performed well earlier in the year and should continue to generate solid results over time.

Industrials holdings Honeywell and Raytheon Technologies, whose commercial aerospace businesses reacted positively to vaccine announcements, saw robust gains while UPS and Vertiv lagged after excellent performance during preceding quarters. In communication services, our large active position in Charter was a

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small drag on relative performance as it rose only modestly in the quarter following a multiyear period of strong returns. While maintaining large absolute and relative exposure to Charter, we trimmed our position in the quarter.

American Tower, also a long-term strong performer, has seen domestic leasing trends skew lower recently as a result of a temporary slowdown in T-Mobile spending and expected decommissioning of the Sprint network over the next few years following the T-Mobile/Sprint merger. We trimmed our American Tower position during the quarter. Air Products and Chemicals was lower on delays in large projects in Saudi Arabia and China, which we are monitoring with keen interest. We added to our position on the pullback. Amgen's omecamtiv heart failure data underwhelmed as the trial reached statistical significance, weighing on the stock. The drug was fairly high risk and not central to our thesis on Amgen, which continues to execute well and has a strong pipeline.

In terms of portfolio positioning, in addition to increasing financials exposure as described above, we lowered our health care exposure through two sales. We sold Pfizer, a lower-conviction name we owned largely for its pipeline, which failed to materialize. We also exited our modest position in CVS Health, where we felt less comfortable with its business model transition while managing overall portfolio exposure to health care services in an environment of heightened political risk.

With the support of continuing economic stimulus and the introduction of effective vaccines, we are cautiously optimistic about the prospects for economic growth in the short and intermediate terms. However, the unprecedented stimulus has resulted in a very large national debt, and it is unclear how this will affect market conditions over time. We also know the vaccines will take some time to reach the population, and until they do, high infection rates and restricted economic activity will lead to pockets of market volatility. We continue to maintain our disciplined investment approach, focusing on competitively advantaged companies with strong franchise characteristics that we believe are capable of generating superior returns across cycles.

Portfolio Highlights

The ClearBridge Large Cap Value Strategy underperformed its Russell 1000 Value 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 strongest contributions came from the financials, industrials and information technology (IT) sectors. The real estate and consumer discretionary sectors were the sole detractors.

On a relative basis, overall stock selection detracted from performance, while sector allocation was a positive. In particular, stock selection in the industrials, communication services, real estate and financials sectors and an underweight to energy detracted from relative returns. Conversely, stock selection in the IT and utilities sectors and underweights to the consumer staples and health care sectors proved beneficial.

On an individual stock basis, the largest contributors were JPMorgan Chase, Bank of America, Honeywell, Lam Research and TE Connectivity. Positions in American Tower, Amgen, Air Products and Chemicals, Home Depot and Suncor Energy were the main detractors from absolute returns in the quarter.