ClearBridge Investments

Large Cap Growth ESG Strategy

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Key Takeaways

- Large cap value stocks outperformed growth for the first time in two years, boosted by positive COVID-19 vaccine news that discounted a return to normal economic activity.
- Companies held by ClearBridge across sectors are playing a significant role in the vaccine rollout, striking a delicate balance between supporting stakeholders and delivering to shareholders.
- The Strategy continues to hold a balance of secular winners in areas that have accelerated during the pandemic along with healthy exposure to a reopening of the economy.

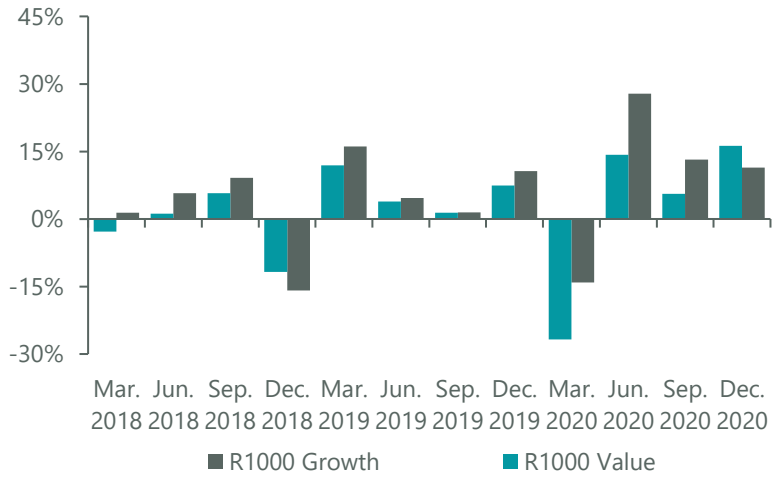
Market Overview: Public Companies Balance Priorities in Vaccine Response

The lessening of political and COVID-19 uncertainties sparked equities to a strong finish in a year like no other for the global economy. The S&P 500 Index gained 12.2% in the fourth quarter to end 2020 up 18.4% while the large cap Russell 1000 Index rose 13.7% for the quarter and 21% for the year. The momentum trade that has lifted markets for the last several years showed signs of fatigue in the final three months of 2020, with value stocks outperforming growth stocks for the first time since the fourth quarter of 2018. The Russell 1000 Value Index gained 16.3% compared to 11.4% for the benchmark Russell 1000 Growth Index. Despite this reversal, growth outperformed value by over 35 percentage points for the year.

Stocks benefited from three catalysts over the last quarter. Joe Biden won the presidency and will govern with a narrow majority in Congress. Investors cheered the outcome as the lack of an overwhelming Democratic mandate removed the risks of higher taxes and more stringent regulation in the near future. Meanwhile, positive COVID-19 vaccine trial results from Pfizer/BioNTech and Moderna increased optimism about an eventual return to normal economic activity, sparking a rally in cyclical areas of the market. Subsequent FDA approval and initial distribution of the vaccines in December further bolstered the upswing. Finally, a very dovish Federal Reserve continued to promise an accommodative stance as it relates to managing monetary policy.

The catch-up trade for value and cyclical shares began in August but we view the latest market action as a broadening of leadership rather than a rotation out of growth stocks (Exhibit 1). Not all value stocks are up as financials (+5.8%) have not moved much while mid cap information technology (IT) stocks have outperformed larger names. While energy (+28.8%) was the best-performing sector for the quarter, IT (+12.6%), consumer discretionary (+12.9%) and communication services (+13.8%) also continued to outperform. These areas of the market were led by the small segment of companies most benefiting from shifts to work from home, e-commerce, cloud computing and security that continue to deliver strong results and that have been rewarded handsomely with huge price/sales ratios. While the pandemic may have pulled forward several years of growth and pushed up valuations, we still want to maintain meaningful exposure to these companies and the secular growth trends they are leading.

Exhibit 1: Growth Has Led for Most of the Last Three Year



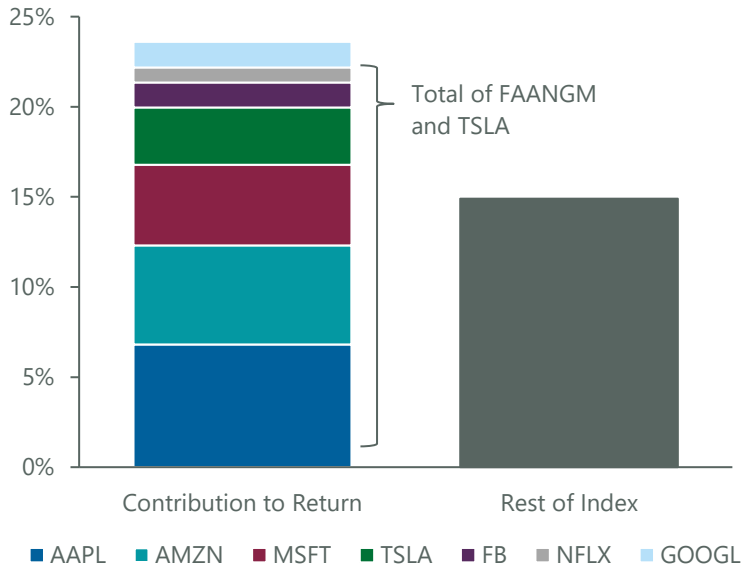
Source: FactSet.

The ClearBridge Large Cap Growth ESG Strategy is constructed to thrive through a full market cycle and deliver strong down capture during turbulent periods while focusing on companies with strong ESG characteristics or an awareness of the importance of improving their sustainability practices. Any year where our very concentrated benchmark is up 38% will likely be a difficult one due to our focus on diversification across three buckets of growth companies. The Strategy underperformed during the fourth quarter and trails the benchmark over an extended period of momentum leadership. Our base case remains that we are still in an unprecedented period of economic stress, with significant government assistance needed just to “keep the lights on.” We do not subscribe to the notion that huge U.S. Treasury transfer payments and zero bounds on the risk-free interest rate have been stimulative; rather, these have been necessary to avert widespread economic collapse.

Looking back on the year, we were too conservative in repositioning the portfolio during the volatility of the first and second quarters. While adding five names and exiting eight others in that span, we weren't active enough in an IT sector that acted much more defensively than expected. Valuation concerns have thus far been ignored in the most expensive areas within tech and communications. We continue to hold a balance of secular winners along with healthy exposure to reopening of the economy, post vaccine success.

As discussed in last quarter's commentary, the desire to promote diversification also prevented us from maintaining a benchmark weight in Apple, which accounts for 11.6% of the Russell 1000 Growth Index and was up over 80% for the year. Choosing not to own electric vehicle (EV) maker Tesla (for valuation, corporate governance, fundamental and volatility reasons) was also a significant headwind to relative results as the stock skyrocketed more than 700%. In fact, the FAANG stocks (Facebook, Apple, Amazon.com, Netflix and Google/Alphabet) plus Microsoft and Tesla accounted for close to two thirds of the benchmark's 38.5% return in 2020 (Exhibit 2). Without those stocks, the index would have gained 14.9%.

Exhibit 2: A Select Few Stocks Dominated Growth Performance



Source: FactSet.

That said, stock selection across the portfolio was solid, with companies like Uber and Disney rebounding in the fourth quarter on improving results and optimism about the economy reopening, while Aptiv and NXP benefited from rising production of EVs, along with the increasing electrification of internal combustion autos. Chipmaker Qualcomm was an outsized performer as well, playing into the theme of 5G globally.

We believe inflation and the slope of the yield curve will be key determinants of whether growth stocks outperform in 2021.

Merger & acquisition activity during the quarter produced mixed results. Three portfolio companies announced deals, but in another example of how unusual a year 2020 has been, two drew only lukewarm reactions. Biotech Alexion Pharmaceuticals jumped on an acquisition offer from British pharmaceutical maker AstraZeneca, which will gain a steady source of cash flow from the developer of treatments for rare diseases. IHS Markit initially rose sharply on news of a bid by business information rival S&P Global but has since trended lower. Long term, we see a significant amount of revenue synergies from the deal, which will diversify S&P from its reliance on fixed income issuance. Shares of salesforce.com have also fallen since its surprise offer for messaging software developer Slack. Collaboration and communications software has grown in importance during the pandemic, likely pressuring salesforce.com to do a deal to compete with Microsoft's successful Teams application.

Portfolio Positioning

The Strategy's IT underweight has been detrimental to performance over the past several years (but less so in the fourth quarter) and we remain cognizant of the benchmark and changes to its composition. The challenge in the sector today is that most stocks have already factored in a decade of similar revenue trajectory, making it tougher to find companies where extreme optimism is not already priced in. We took advantage of volatility in the quarter to increase our IT exposure through three purchases where we felt valuation was more reasonable.

Atlassian is a pure play in the collaboration space, allowing engineers and related groups to work effectively across the enterprise. The company's JIRA project and issue-tracking tool constitutes a near-monopoly in the industry and is at the heart of its portfolio of products. Recent moves to accelerate its cloud transition are positive for the business model and customer adoption. In tandem, price hikes for on-premise server deployments and large cloud customers will serve as incremental drivers. With less than 50% of revenues from cloud today, this represents a long-term catalyst.

Cloud delivery of software is another accelerating trend where Workday maintains a leadership position in an $88 billion market for human capital management (HCM) and finance solutions. The company sells primarily through subscriptions, a model which, at scale, is highly profitable and generates significant recurring cash flow. We believe that Workday's financials solutions are poised to accelerate in the quarters ahead, fueling a second growth vertical for the company.

We also increased our participation in the buildout of more advanced computing and communications components with the purchase of semiconductor equipment maker ASML. The Dutch company maintains a monopoly on deep ultraviolet and extreme ultraviolet lithography technologies critical to all semiconductor manufacturing and is exercising its pricing power. The end of Moore's Law has changed the requirements within advanced computing. In addition, ASML has been boosted by work-from-home trends that have supported demand for personal computing and data center chips and could lead to an upside in orders from multiple customers into next year. Supply and demand trends in the DRAM chip market are also expected to drive increases in orders for ASML manufacturing tools.

We are constantly weighing the outlook for our portfolio companies, seeking to focus on the names that offer the best balance of risk and reward over the next three to five years and longer. As part of this process, we culled two companies in the quarter where recent improvements have quickly been priced in and future growth looks less compelling. C.H. Robinson Worldwide, a provider of logistics and trucking brokerage services, has seen its net revenue stabilize as the company has traded price for volume, where it had lost share over the last few years. But with the possibility of spot pricing coming under pressure as capacity eases up in 2021 and with sizable capex ahead, we exited the position. American Express is heavily indexed to high-end leisure and corporate travel, along with small and medium-size businesses, all of which have seen dramatic cutbacks due to COVID-19. The shares rallied strongly on optimism about an economic recovery, approaching our estimate of fair value well ahead of an earnings comeback. We believe Amex can get back to peak earnings, but with corporate travel probably never returning to pre-COVID-19 levels, other parts of the business will need to accelerate from here, namely lending and small business, both of which will require additional time.

The sale of Amex technically eliminates the Strategy's financials exposure, yet we continue to own and have recently added to Visa and Fidelity National Information Services, which are classified in the IT sector and are direct beneficiaries of a rapid migration to digital payments. From a cyclical standpoint, we see better upside as the economy reopens in consumer names like Ulta Beauty, Monster Beverage and Comcast.

Outlook

For some time, the Strategy has been positioned for an environment of low economic growth. That was certainly the case for much of 2020 as the economy suffered through a sharp but brief recession. As we enter the new year, the economy is still down 10 million jobs from its pre-COVID-19 peak and a recent

surge in infections has caused jobless claims to move higher again. What's uncertain is whether the economy is hitting a rough patch or headed for a double dip recession. We think the former scenario is more likely as the successful distribution of COVID-19 vaccines, combined with new fiscal stimulus, continued monetary accommodation and a Wall Street–friendly divided Congress, could lead to reasonable GDP growth in 2021.

GDP growth and inflation have historically been correlated so inflation is a factor we've been examining closely. We believe the level of inflation and the slope of the yield curve will be key determinants of whether growth stocks outperform in 2021. We're not seeing it yet, but when inflation picks up and the yield curve steepens, that should cause a further broadening out in the market and less of a premium on the very narrow universe of growth stocks that have performed so well the last several years. The recent moves we have made give us confidence that our companies can do well in a variety of outcomes. We continue to participate broadly in secular growth trends that accelerated during the pandemic, more nascent industries like electric vehicle production as well as cyclically oriented areas such as omnichannel retail.

Portfolio Highlights

The ClearBridge Large Cap Growth ESG Strategy underperformed its Russell 1000 Growth Index benchmark during the fourth quarter. On an absolute basis, the Strategy had gains across eight of the nine sectors in which it was invested (out of 11 sectors total). The leading contributor to performance was the IT sector.

On a relative basis, overall stock selection and sector allocation detracted from performance. Specifically, stock selection in the IT and consumer discretionary sectors had the most significant negative impact on results. On the positive side, stock selection in the industrials, health care, financials and consumer staples sectors contributed the most to relative performance.

On an individual stock basis, leading contributors to absolute returns in the fourth quarter included positions in Walt Disney, Qualcomm, Apple, Palo Alto Networks and Uber Technologies. Salesforce.com, Amgen, Splunk, Akamai Technologies and Fidelity National Information Services were the worst detractors on an absolute basis.

ESG Outlook: Public Companies Taking Lead in Vaccine Rollout

The COVID-19 pandemic has forced companies large and small to adapt in order to safely serve customers, care for employees and in some cases, just stay afloat. Businesses have also been central to

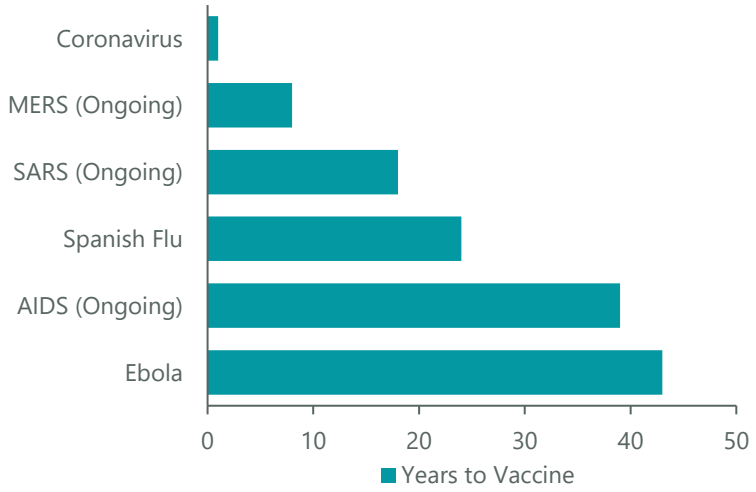
another key development, as the online maps millions used to check the spread of the virus in the spring of 2020 now show the rollout of vaccines. Innovation and adaptation by public companies spanning several industries are bringing vaccines to a world in need through a real-time mobilization for which there is no easy comparison.

Companies held by ClearBridge across sectors are playing a significant role in the vaccine rollout, striking a delicate balance between supporting stakeholders and delivering to shareholders. In some cases, the ability to effectively distribute the vaccines has been made possible by improved business models. For others facilitating vaccinations is simply the right thing to do, as solving the pandemic is the best way for all companies, as well as their employees and customers, to thrive.

Vaccines a Reminder of Innovation in Health Care

The swiftness of development and the efficacy of the two initial vaccines, by Pfizer/BioNTech and Moderna, reflect how the health care industry's drive to innovate treatments and cures has made meaningful advances not only for rare and genetic diseases, but also for infectious diseases. BioNTech and Moderna effectively developed a brand-new platform from first infection to market in under a year, an achievement that stands out among vaccine efforts in other pandemics (Exhibit 3). Going forward, the technology could also be valuable for other infectious diseases as well as oncology.

Exhibit 3: COVID-19 Vaccines Represent Remarkable Achievement



Source: ClearBridge Investments. (Ebola: 1976–2019; AIDS: 1981–present; Spanish flu: 1918–1942; SARS: 2002–present; MERS: 2012–present).

More broadly, the vaccines, as well as the life-saving advances in treatment for symptoms of the virus, serve as a poignant reminder that the health care industry has the capability and the responsibility to use its resources to improve the welfare of society at large.

While governments have rightly supported the development of vaccines, companies with the financial resources have also taken substantial economic risk on their own. Pfizer, for example, has invested several billion dollars in its partnership with BioNTech, including manufacturing its vaccine before being certain it would work.

Distribution Is a Logistical Challenge

Vaccine mobilization also requires a vast and efficiently operating delivery network. Logistics companies such as FedEx and portfolio holding United Parcel Service (UPS) have been working very closely with health care companies and health agencies on coordinating the distribution of vaccines. Shipping vaccines entails GPS tracking, special labels and first-loaded status on planes and trucks, as well as ensuring precise temperature conditions. While parcel delivery capacity has been extremely tight in 2020 with significant shifts by consumers towards online shopping, FedEx and UPS have prioritized the national health effort by reserving meaningful capacity for distribution of the vaccine. UPS has gone so far as to publicly state it prioritized vaccine distribution ahead of holiday shipments, a typically critical set of volume for the company.

UPS is also focused on serving small and medium-size businesses (SMB), which have been especially challenged by the pandemic in 2020. These efforts include increasing speed of delivery service, which helps make SMBs more competitive, creating 1,500 more UPS Access Point locations — partnerships with independent retailers such as hardware and grocery stores that drive traffic for smaller businesses and expand service to underserved areas — and adding visibility and tracking solutions designed for SMBs.

Health Care Providers Reaching the Masses

The enormous task of getting a vaccine into the arms of millions — globally, billions — of people requires a major mobilization through health care providers. Portfolio holding CVS Health has been on the front lines in testing, performing six million COVID-19 tests so far and expecting to continue at 70,000 or more per day. It will also be pivotal in delivering the vaccines, initially through its contract to administer vaccines to nursing home patients, and as part of a broader national campaign. CVS has infrastructure in place to distribute and administer vaccines that require regular or ultra-low temperatures.

In addition to helping end the pandemic, being central to distributing the vaccine should be a positive for business and represents a key moment in CVS's growth as a company. While the monetary incentive for distributing the vaccine is modest, roughly as profitable as a regular prescription, the company's ability to do so reflects a changing mindset in the health care services sector.

In our conversations with CVS over the years, ClearBridge has been an advocate for a repositioning of its business model from a dispensary model to a service model, and CVS has begun the transition down this path. Its recent naming of Karen Lynch as its next CEO — Lynch comes from the ranks of its recently acquired Aetna business, rather than the retail or pharmacy benefits manager businesses — is indicative of this shift. ClearBridge has long supported the business case for this shift, largely because of the overall societal benefit we believe it would involve, as the company's retail assets, directly connected to patients, could help get health care out of more expensive settings. A CVS store-based service model offers patients better convenience, encouraging better health care compliance and ultimately lower costs.

CVS sees its efficiently performing COVID-19 tests as an important proof point that Americans will seek health care services at its retail locations. Its role in the vaccine distribution further demonstrates the benefits of a customer-focused business model. With roughly 10,000 locations in the U.S., the company is in a unique position to quickly bring the vaccine to the population. CVS also has the infrastructure in place to track recipients and provide reporting to health authorities. Both Pfizer/BioNTech and Moderna vaccines require a critical second dose for much of their effectiveness, and CVS's systems can help execute these crucial follow-up immunizations.

Testing Has Also Been a Triumph

COVID-19 testing has been a crucial component in controlling the virus. Becton Dickinson has also been a large supplier of COVID-19 diagnostic tests, both PCR and rapid antigen tests. Diagnostics firms such as portfolio holding Thermo Scientific as well as Danaher and Hologic, companies owned across different ClearBridge portfolios, have also demonstrated their value by putting the right instruments and equipment in place in labs, as testing was key especially in early stages of the pandemic. Investments in testing equipment, instruments and consumables (such as the reagents used to perform tests) may also yield longer-term benefits even after COVID-19 has been contained, increasing preparedness for other threats down the road. Although the magnitude and benefits of this for diagnostics firms is unclear, it is likely there will be a higher baseline testing level for infectious diseases going forward, a tailwind for diagnostics companies and a positive for the public.

As the vaccine rollout develops, we are optimistic for a reduction in infection and death rates, but also reductions in unemployment as pandemic-related restrictions can be rolled back. The breadth of the dimensions involved for vaccine distribution, reopenings and implementation oversight will mean it will take some time. But the effect of public companies prioritizing stakeholders by helping the vaccines reach all corners of the country will be a tangible improvement in societal well-being, and even those who are not owners of these equities will greatly benefit.