ClearBridge Investments

Mid Cap Growth Strategy

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Key Takeaways

- Mid cap growth stocks endured a disconcerting year of profound instability for society and the U.S. economy to follow up a very strong 2019 with even better performance in 2020.
- Performance was driven by the portfolio's holdings in consumer sectors, which tend to be leaders in growth trends that accelerated during the pandemic or are directly tied to the economy's reopening.
- We remained active in the fourth quarter, trimming and selling stocks that have worked and reinvesting in four new companies where we see strong secular growth ahead.

Market Overview and Outlook: Picking Our Spots in an Ebullient Market

Last year we advised investors, "don't succumb to vertigo" as the mid cap growth equity market reached record highs after a 35.5% increase during 2019.

At that time, no one could have foreseen the coming events of the year just past including: 1) a lethal and virulent pandemic, 2) wrenching nationwide social justice protests, 3) a resolved though still-contested national election, and 4) manic levels of capital raising by U.S. corporations. And yet, quite implausibly, mid cap growth stocks, as measured by the benchmark Russell Midcap Growth Index, repeated its robust performance with a 35.6% return in 2020.

Merrill Lynch's market legend Bob Farrell once quipped, "The market usually does whatever makes the most people most uncomfortable." Morgan Stanley's Barton Biggs's similar and more colorful expression of that sentiment was "We forget that Mr. Market is an ingenious sadist, and that he delights in torturing us in different ways."

As we've remarked in these commentaries and in conversations, the ClearBridge Mid Cap Growth Strategy is not guided by our views of "the market." The portfolio is populated with a high active share, concentrated accent on companies with innovative products and services, capital adequacy and focused leadership. During 2020, company managements have had to lead through some of the most trying circumstances of our investment careers.

This year's Strategy performance was marked by three phases:

- **Phase 1:** A euphoric overall market march to highs in February followed by a rapid and nauseating plunge of equities, hitting bottom in late March, during which the Strategy held serve versus the benchmark.
- **Phase 2:** The recovery from late March until "Vaccine Monday" (November 9) when the efficacy of Pfizer/BioNTech's vaccine was joyously revealed. The Strategy handily outperformed during this period as the opportunities and operating dynamics for a number of portfolio companies were accelerated materially.
- **Phase 3:** Vaccine Monday through year end, when the Strategy underperformed as an investor rotation toward value/cyclical/reopening/biotech/the smallest of the small investments combined with a rapid market ascent pared Phase 2's outperformance.

Overall, this has been an investment year with rewarding returns during a disconcerting year of profound instability (political, social, economic, health, climate). We are mindful of our extraordinary good fortune and are ever-thankful for those who have ministered to the afflicted and needy during these times which presented great challenges to many.

After multiple years of dominance by mega cap stocks, the market environment has become more supportive of small and mid cap companies. We believe mid caps in particular have benefited from appealing valuations relative to mega cap stocks and stand to gain, to a greater degree, from an accelerating economy. The yield on the 10-Year Treasury climbed 24 bps during the quarter to finish at 0.92%, potentially signaling rising expectations for growth and inflation as the economy recovers. Due in part to the massive liquidity provided by the U.S. Federal Reserve, conditions were not as dire for many companies in cyclical sectors as their stock prices indicated.

The ClearBridge Mid Cap Growth Strategy's consumer holdings drove performance in the fourth quarter, led by Latin America e-commerce portal MercadoLibre (MELI) and online pet food and supplies merchant Chewy.com. MELI is seeing greater e-commerce spending due to pandemic restrictions while Chewy is benefiting from new customers spending more money on pet food delivered to the home, and on services such as telehealth for pets, which should lead to recurring business long after the pandemic subsides. High-end auto components maker Aptiv is thriving in its role as a key supplier to the growing electric and autonomous vehicle market. Off-price retailer Burlington Stores and online travel agency Expedia, meanwhile, moved higher on reopening optimism.

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We were encouraged as well by the results from several of our health care companies, which validate the crucial role biopharmaceutical companies have played in developing testing and treatments for COVID-19. Shares of Syneos Health moved higher as clinical research organizations that conduct lab testing for biopharmaceutical clients bounced back. Idexx Labs delivered continued strong performance, benefiting from increasing pet ownership and accompanying higher expenditures on veterinary care. We added to our health care exposure in the quarter with the purchase of Avantor, a vertical supplier and distributor of laboratory, biopharma production, and research products serving a variety of healthy growing markets. The company is a beneficiary of increasing biotech funding, R&D spend, and the launch of new biologic drugs.

The Strategy's information technology (IT) and industrials holdings delivered mostly positive results but failed to keep pace with the lower-quality, more leveraged companies that experienced a vigorous rally after "Vaccine Monday." Monitoring and security software provider Splunk fell sharply after lowering guidance due to several large contracts being delayed while several other high-quality software companies failed to keep up with the market rally. Citrix Systems declined on concerns about whether the company can transition its business toward SaaS-based subscriptions and upcoming first-quarter 2021 earnings comparison following the big surge in "temporary licenses" with which Citrix enabled customers during the sudden shift to remote work earlier this year.

Portfolio Positioning

The year did not turn out like it was supposed to, but we stuck to our investment process and focused all our attention on individual stocks. As the pandemic broke out in the first quarter and business activity was curtailed, the Mid Cap Growth team stepped up our due diligence, vetting all pre-existing facts about our portfolio holdings to make sure everything we owned was going to be able to cope with the pandemic, regardless of how long it lasted. We stayed nimble through the height of the selloff and early recovery, operating with greater turnover than in prior years by quickly moving on from business models with uncertain visibility and into new opportunities created by the pandemic.

The mid cap growth market has gained over 90% from March lows and we have been cognizant of valuations for companies that have rallied the most. We funded our four purchases during the quarter by trimming several winners as valuations grew fuller, including Carvana and Chewy, and taking profits on recent IPO Unity Software.

Some of the market leaders through the pandemic gave back gains post-Vaccine Monday and we used the opportunity to establish a position in Wix.com, a provider of web-based tools to create and manage desktop and mobile websites. Small and medium size businesses recognize the need for a web presence, with registered users accelerating in recent months with good conversion to paid subscriber as well as increasing accelerating transactions on Wix's payment platform.

Azek, another new addition, is the No. 2 composite decking material company benefiting from increasing penetration of composites as a percentage of total decking market and the majority of lumber decks nearing end of life. This transition was accelerating pre-pandemic and has strengthened as people have invested in their homes. We are familiar with the strong demand and ESG case for decking made from recycled materials from our long-term ownership of market leader Trex in other ClearBridge portfolios and believe Azek can close its margin gap with Trex as recycling content improves.

We also participated in the IPO of DoorDash, 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.

Outlook

Looking ahead to the new year, we anticipate volatility will remain high. Economic forecasts are improving but we still see a number of uncertainties that need to be resolved before macro growth can return to a normal pace. We are encouraged by the initial distribution of vaccines as a key driver that should ease restrictions and spur the resumption of consumer and business activity, perhaps as early as mid-2021.

Amid this transition, we continue to drive returns in the portfolio from stock selection. Our objective is to find growth companies that can invest at higher returns and compound them for years to come.

Portfolio Highlights

During the fourth quarter, the ClearBridge Mid Cap Growth Strategy outperformed the benchmark Russell Midcap Growth Index. 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), with the consumer discretionary and IT sectors the leading contributors.

In relative terms, outperformance was primarily driven by stock selection. Specifically, stock selection in the consumer discretionary sector was the primary driver of results while selection in the industrials, health care and consumer staples sectors also helped. Conversely, stock selection in IT and real estate, an overweight to consumer discretionary and an underweight to IT detracted from relative performance.

The leading contributors to absolute returns during the fourth quarter included Pinterest, MercadoLibre, Chewy, Aptiv and Atlassian. Positions in SBA Communications, Splunk, PPD, Datadog and Citrix Systems were the greatest detractors from absolute returns.

In addition to the portfolio activity mentioned above, we closed positions in GoHealth in the financials sector, Rockwell Automation in the industrials sector and IPG Photonics in the IT sector.

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