ClearBridge Investments

Sustainability Leaders Strategy

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Key Takeaways

- Vaccine announcements broadened market gains for the quarter and year while the Strategy continued to excel, driven by a diverse set of sustainability-focused names.
- A quarter of political and public health shifts was also an active one for portfolio positioning, as we added seven new names from six different sectors.
- Companies held by ClearBridge across the market are playing a significant role in the vaccine rollout, striking a delicate balance between supporting stakeholders and delivering to shareholders.

Market Overview and Outlook: Climate-Focused Names Drive Performance

U.S. equities made strong gains in the fourth quarter, with the announcement of two vaccines for COVID-19 overshadowing a period of volatility heading into the U.S. elections as well as rising COVID-19 infection rates. The benchmark Russell 3000 Index rose 14.7%. Market 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, while the momentum trade that has lifted markets for the last several years showed signs of fatigue. Value stocks outperformed growth stocks for the first time since the fourth quarter of 2018, even while growth stocks trounced value in annual performance.

Stocks benefited from two catalysts in the quarter. Joe Biden won the race for president and will likely govern with a small majority in Congress. The lack of an overwhelming Democratic mandate could likely remove the near-term risk of structurally higher taxes and more stringent regulation. Meanwhile, more fiscal stimulus along with positive COVID-19 vaccine trial results from Pfizer/BioNTech and Moderna increased optimism about an eventual return to normal economic activity. Subsequent FDA approval and initial distribution of the vaccines in December further bolstered the upswing.

Spikes in cases of COVID-19 resulted in a retrenchment of mobility restrictions in some areas of the U.S. and Europe, putting a damper on economic data. In the U.S., nonfarm payrolls returned to negative territory in December with the cutting of 140,000 jobs and initial jobless claims remained elevated, even while manufacturing PMIs continued to expand.

The strongest contributions to performance for the quarter came from our information technology (IT) holdings. Two major themes in the portfolio related to combating climate change — electric vehicles (EV) and renewable energy — had a very strong 2020 and got a further boost with Biden's win in November and the Democratic control of Congress. The Biden administration is expected to accelerate the shift to EVs in the U.S., which is positive for TE Connectivity and Aptiv, two names added to the portfolio in the second quarter of 2020. TE Connectivity makes connectors for a wide range of uses, including automobiles, data centers and medical devices, while Aptiv is an electronic connector manufacturing company, primarily for automotive components. Both are major beneficiaries of the growth of EVs, which require increasing connectivity.

Enablers of the renewable energy transition likewise jumped on the prospect of a more renewables-friendly administration. Readers of recent editions of this commentary will be very familiar with Enphase, which designs and manufactures microinverters for residential and small commercial solar PV systems, and SolarEdge Technologies, a solar energy company making power inverters and optimizers for solar installations, both of which were again top contributors. Danish wind turbine producer Vestas Wind Systems also had a strong quarter amid a seemingly synchronized global push for green energy, with the EU agreeing to more aggressive cuts in greenhouse gas emissions over the next decade as it aims to be the first climate-neutral continent.

Robust gains for equities and an improved outlook for 2021 helped Treasury yields rise over the quarter, from 0.68% to 0.92% by quarter end for the 10-year Treasury note. The rising yield curve helped financials in the portfolio such as Charles Schwab, First Republic Bank and Bank of America make strong contributions, while a strong pricing cycle and favorable workers' compensation trends were beneficial for Hartford Financial.

Increased investor risk appetite and modestly higher interest rates were a headwind for consumer staples holdings such as new position Vital Farms. The company is a leader in the fast-growing niche of pasture-raised eggs. Vital is a Certified B Corporation —a business that balances profit and purpose to meet the highest verified standards of social and environmental performance, public transparency and legal accountability — and is focused on sustainable agriculture. Given the growing appetite by U.S. consumers for traceable, sustainable and humanely treated food, Vital Farms is in a unique position as the largest producer of pasture-raised eggs (76% market share) and butter. Vital Farms maintains a high level of supply chain responsibility and is committed to conscious capitalism: business decisions consider the impact on all stakeholders, in contrast with the factory farming model, which principally

emphasizes cost reduction at the expense of animals, farmers, consumers, employees, communities and the environment.

Other leaders for the quarter included Lam Research, one of a very few global leaders in semi cap equipment, feeding the ever-growing demand for semiconductors, and Walt Disney, which gave higher than expected long-term streaming subscriber guidance, particularly for its Disney+ streaming service. Disney has also demonstrated strong cost control across its other businesses including the parks division, to limit losses while demand remains negatively impacted due to COVID-19.

We deepened the portfolio's bet on products that improve resource management, whether through use of renewable energy or through higher energy efficiency.

In a strong quarter for cyclicals, holdings in the more defensive health care and real estate sectors lagged, with Gilead Sciences, CVS Health and Amgen detracting among health care names. Amgen was hurt by disappointing Phase III data for its omecamtiv treatment for heart failure. The company followed up with positive Phase III data for tezepelumab in asthma and our positive thesis is unchanged as we are bullish on tezepelumab. Our one real estate holding, Equinix, was lower as positive coronavirus vaccine trials pointed the way to a business environment less reliant on video conferencing and working from home, which Equinix's data centers serve.

Portfolio Positioning

A quarter of political and public health shifts was also an active quarter for portfolio positioning, as we added six new names from five different sectors and exited five names. Array Technologies and Resideo Technologies, in the industrials sector, deepen the portfolio's bet on products that improve resource management, whether through use of renewable energy or through higher energy efficiency. Array Technologies is an equipment manufacturer that makes trackers and associated software for ground-mounted solar projects. Trackers align the panels with the sun throughout the day. Resideo Technologies is a home electronics company spun off from Honeywell that focuses on mostly residential comfort, thermal and security solutions and maintains an installed base of over 150 million homes. While historic operations have resulted in a $140 million a year environmental reimbursement obligation, most of Resideo's products enable energy and water conservation and should see growth as homeowners seek more sustainability in the home.

We also added hospitality company Marriott International. The travel industry has come under tremendous pressure during the pandemic with occupancy and revenue down substantially; however, due to a capital-light business model and royalty/fee-based revenue streams, the company remains financially healthy and stands to benefit as demand returns. The company is also making progress on carbon and water intensity reduction goals.

In health care we bought CVS Health, which has a unique set of assets consisting of 10,000 retail pharmacies, 90 million lives covered by the Caremark PBM and over 22 million Aetna health plan members. CVS has long been a leader among health care services peers with respect to its consideration of and commitment to social issues. CVS is also playing a large roll in mobilizing the COVID-19 vaccines, which we discuss below.

We also bought software-as-a-service (SaaS) and cloud company Workday, whose next-generation SaaS-based enterprise resource planning suite should continue to take share of this large market indefinitely, with the rising tide of digital transformation as a key driver. We funded the position with the sale of Automatic Data Processing, which had accomplished many of the self-help initiatives needed to improve its margins and returns, and we thought it was fairly valued.

Two other names exited at what we considered fair value were mountain resort company Vail Resorts, which rose handily with vaccine announcements, and industrial automation technology company Rockwell Automation. We also sold our shares of Alphabet; the formal launch of a Department of Justice investigation, as well as different state lawsuits, created an overhang on the stock that we think will serve to limit capital appreciation.

Outlook

While the results from the election appear to be market friendly and vaccines make clearer a timetable for the effective end of the pandemic, the health of the economy remains a concern for many. The strength of the portfolio thus far through a volatile period is consistent with our experience that a diversified set of companies with strong balance sheets, high returns, sustainable cash flows and leading ESG profiles should perform well in periods of market turbulence. We believe this will be true in a market of broader upside participation, as the fourth quarter of 2020 has begun to demonstrate. Uncertainties surrounding the COVID-19 pandemic notwithstanding, we see plenty of positive drivers for high-quality companies with leading sustainability characteristics.

Portfolio Highlights

The ClearBridge Sustainability Leaders Strategy outperformed its Russell 3000 Index benchmark during the fourth quarter. On an absolute basis, the Strategy had gains in nine of 10 sectors in which it was invested (out of 11 sectors total). The main contributors were the IT, financials, industrials and communication services sectors. The real estate and consumer staples sectors were detractors.

On a relative basis, overall stock selection contributed positively to performance. Stock selection in the IT, industrials, utilities, communication services and financials sectors made the strongest contributions, while stock selection in the health care, consumer staples, real estate and materials sectors detracted.

The vaccine technology could also be valuable for other infectious diseases as well as oncology.

On an individual stock basis, Array Technologies, Enphase Energy, Lam Research, Apple and Walt Disney were the largest contributors to absolute performance in the quarter. The main detractors from absolute returns were positions in Vital Farms, Amgen, CVS Health, Gilead Sciences and Home Depot.

During the fourth quarter, besides portfolio activity discussed above, we initiated a position in Morgan Stanley in the financials sector and closed a position in Ormat Technologies in the utilities sector. We also exited our holdings in C-corp shares of Brookfield Renewables, preferring to hold units of Brookfield Renewable Partners LP.

Public Companies Taking Lead in Vaccine Rollout

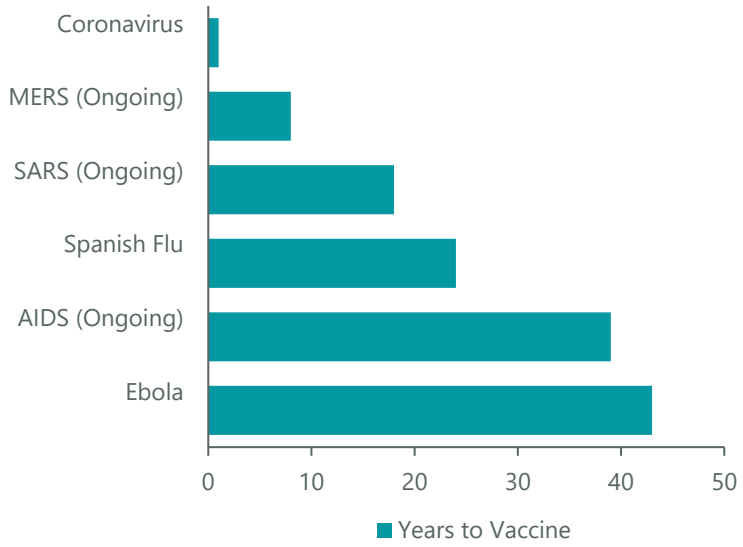
The COVID-19 pandemic has forced companies large and small to adapt in order to safely serve customers, care for employees and in some cases, just stay afloat. Businesses have also been central to another key development, as the online maps millions used to check the spread of the virus in the spring 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 1). Going forward, the technology could also be valuable for other infectious diseases as well as oncology.

Exhibit 1: 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 long-time ClearBridge 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. ClearBridge 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.

Health care equipment companies are also stepping up to ensure a successful vaccine rollout. ClearBridge holding Becton Dickinson, for example, has estimated the opportunity for needles for vaccination to be $100–$150 million, although at below-corporate-average margins. The company is working with the U.S. government, as well as investing on its own, to expand domestic needle manufacturing capacity so that there is additional capacity in the U.S. for both business growth and future surges.

All Will Benefit

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.