Multi Cap Growth Investing in a Momentum Market

Key Takeaways

- In navigating many different equity environments over the last four decades, including crashes and bubbles, we have sought to deliver a consistent process that has provided non-correlated performance compared to the overall market.
- Paying high multiples for stocks with no underlying profits provides investors no floor when the market environment shifts. We would rather own a portfolio of companies throwing off a lot of cash flow as we have learned that long-term cash flows win over short-term speculation.
- We continue to invest in innovative and disruptive businesses, including health care companies making scientific breakthroughs to treat unmet needs and technology companies supporting the growth of electric vehicles and the buildout of 5G.

U.S. equity markets and the economy have been acting in unprecedented ways since the onset of the COVID-19 pandemic in the first quarter. The swiftness of the recovery from the shortest bear market in history, supported by never before seen levels of monetary and fiscal stimulus, has been powerful, yet one thing that has not changed is the ongoing market leadership of mega cap growth and momentum stocks. Until a reversal in early September, valuations had become important in a counterintuitive way, with investors expressing a preference for the most expensive companies in the market. Passive buying, and the pressure felt by some active managers to keep up with their benchmarks, has further strengthened the momentum trade and left the disparity between growth and value stocks — as well as market concentration of the five largest index constituents (Exhibit 1) — at generational wide gaps.

Richie Freeman and Evan Bauman have experienced such extreme conditions several times during their tenure as portfolio managers of the ClearBridge Aggressive Growth and Multi Cap Growth Strategies. They recently shared their perspectives on how the current environment compares with the past and why they maintain conviction in the positioning of both portfolios.

Exhibit 1: Russell 3000 Growth Index Concentrated in Top Names

Data as of 8/31/20. Source: FactSet.

How does the current market environment, where some are concerned about a bubble in certain growth sectors, compare with past market cycles?

Richie Freeman (RF): This is not the bubble of 2000, but there are similarities in terms of rising speculation and heavy retail participation in certain areas of the markets. This is the first time I can remember since the financial crisis where you have had optimism, even euphoria, among some retail investors. Obviously some of the very expensive names in the market have driven the market higher. When you look at the index returns back in March of 2000, the NASDAQ was dominating the returns, the Dow and the S&P 500 were flat to down. And everybody, in hindsight, remembers that as an obvious bubble but we and some of the other managers who had been through different market cycles at ClearBridge were amongst the few that were speaking to the risks back then.

Evan Bauman (EB): The environment we're in right now is unprecedented in a lot of ways. We try to be consistent in how we manage through difficult times. We're very bottom up in our strategy. We're really looking at the businesses themselves as opposed to managing to an index. One of the tenets Richie and I have always believed is that you want to own companies that can survive, and even thrive when there's significant disruption, either economically speaking or in the capital markets. That means companies that have the ability to grow and gain share, even when the economy is volatile, compounding earnings and free cash flow particularly where you're not overpaying for that growth.

We've navigated many different market conditions since the eighties, including crashes and bubbles. What we've tried to deliver is a consistent message and process. We're not traders, even though we watch the market every second of every day, but we're long-term investors in businesses. We've always tried to invest in profitable growth companies. We've always really been focused on the fundamentals, balance sheets and management teams that are going to grow a business over a long period of time. What we've always provided is non-correlated performance.

Are there risks that investors are overlooking in this market?

EB: If we're buying undervalued, well-capitalized free cash flow and growth stories, then they should be monetized on the other end. If you're paying 30 to 50 times sales with no underlying profits and no underlying cash flow for certain companies that are going up every day, as has been the case since late March, ultimately there's no floor for companies like that when the market environment shifts. I don't think you have the same bubble that you had in 2000, but you do obviously have a lot of speculation in some areas of the market and expectations for a sharp economic recovery embedded in the valuations of some parts of the market right now.

What are some lessons to share from enduring those past periods of narrow, expensive markets?

RF: The key is not to have a portfolio that's dramatically loaded with what you consider overpriced stocks, where you're worried that things have to be perfect for the portfolio not to go down. That's a sure sign of risk. I'd rather own a portfolio of companies throwing off a lot of cash flow. I've learned cash flow over the long term wins over short-term speculation (Exhibit 2).

You run into periods like this, where it appears things have permanently changed. The market is going to come back to where cash flow is going to win for some of our names. It hasn't helped us recently, but I can't tell you how excited I am right now in owning what we own. We've been doing this for a heck of a long time. If we think that we should be doing anything differently, you would be seeing our approach changing. One mistake is missing some on the way up, but the biggest mistake is compounding the error by capitulating at the wrong time. And that's something we're not going to do.

EB: Today, the portfolios almost look like value products in terms of the metrics on a valuation basis for a lot of the companies that we own (Exhibit 3). Yet, we are still looking for growth, especially long-tailed growth companies that can compound over multi-decade time periods. In today's environment where the market has recovered but the economic backdrop remains incredibly choppy, it's very important to own companies that have the durability characteristics, the intellectual property and the ability to grow during difficult periods

The name Aggressive Growth suggests investing in emerging, disruptive growth companies, is that still true of the Strategy today?

EB: Absolutely. When we talk about innovation and exclusivity and durability of growth, we've looked at health care companies that are really unique, with must own, must use products treating unmet needs. A lot of our companies are involved in finding personalized treatments based on genomics and a genetic code to actually target specific therapies to specific patients. In addition to cystic fibrosis, Vertex Pharmaceuticals is involved in this for a number of different underlying therapeutic areas like kidney disease, liver disease, lung disease, and blood disorders. Biogen could soon become the first company with a disease altering agent for Alzheimer's disease. As shown during the COVID crisis, the speed which with the industry has come together to find treatments speaks to the scientific breakthroughs the sector can achieve. It is still a very underappreciated area, especially when you look at health care valuations relative to other areas of the market and we think the sector could be a leader coming out of this latest period of mega cap and momentum dominance.

In technology, the lack of ownership of the big names has hurt. Yet the tech stocks we do own run disruptive unique businesses that are profitably growing, companies like Broadcom and Citrix Systems. We've got exposure to electric vehicles through a number of holdings, the growth of 5G infrastructure, and obviously other enabling technologies like the cloud and speech recognition. We believe the valuations and the risk/reward we own right now are significantly outsized versus a lot of other sectors of the market.

Exhibit 2: Aggressive Growth Strategy Historical Performance Patterns

Data as of August 31, 2020. Source: FactSet.

Exhibit 3: Strategies Look Very Different from Benchmark

Characteristics	Aggressive Growth	Multi Cap Growth	Russell 3000 Growth Index
P/E Ratio (forward 12 mos.)	15.8	17.9	31.6
Price/Book	4.9	4.7	12.9
EPS Growth Next 3-5 Years (%)	8.4	18.8	17.7
Weighted Median Market Cap ($ bn)	36.6	36.6	191.9
Weighted Average Market Cap ($ bn)	74.9	74.0	524.7
Dividend Yield	1.3	1.5	0.9
Free Cash Flow Yield	6.0	5.2	3.0
Debt/Equity Ratio	0.8	0.9	2.2
Active Share	94.8	95.8	-
Turnover (Trailing 12 mos.)	1.8	1.6	-

Three-Year Risk Statistics	Aggressive Growth	Multi Cap Growth	Russell 3000 Growth Index
Standard Deviation (%)	18.62	17.74	17.91
Sharpe Ratio	0.30	0.40	0.93
Tracking Error (%)	6.56	5.92	-
R^2	0.88	0.89	-
Alpha (%)	-10.20	-8.15	-
Beta	0.97	0.94	-

Source: FactSet. Risk statistics source: Internal. Benchmark source: Russell Investments. P/E ratios are weighted harmonic average. Price/Book is weighted average. Data as of June 30, 2020.

What catalysts could lead to the type of market shift or leadership change that has marked past periods of outperformance for the Strategies?

RF: The one thing that would probably upset the leadership of what's happening in the market and leadership of companies that have benefited from stay at home is a proven vaccine for the virus. If we hear of a breakthrough scientists are comfortable with, that means we've turned the corner and will allow people to live normal lives. I think you'll probably see one of the most dramatic, maybe short term, but one of the most dramatic shifts that we've seen for the names we own in broadcasting and cable, where they've seen record ratings and engagement and are throwing off massive cash flows, even in a tough advertising environment. For many of the companies that have been hurt, we will have not just the knee jerk reaction, but it could be much more sustainable because they're coming off of their trough market valuations.

The Strategies had some very strong years even without the index participating. So, I don't know the day it will happen, but I certainly believe in owning growth-oriented businesses at good values and intrinsically undervalued companies that are both under owned and underappreciated.

About the Authors

Evan Bauman
Managing Director, Portfolio Manager

- 24 years of investment industry experience
- Joined predecessor in 1996
- BS in Mathematics from Duke University

Richard Freeman
Managing Director, Portfolio Manager

- 44 years of investment industry experience
- Joined predecessor in 1983
- MBA in Finance from New York University's Leonard N. Stern School of Business
- BS in Accounting from Brooklyn College

ClearBridge Investments
620 Eighth Avenue, New York, NY 10018 | 800 691 6960
ClearBridge.com

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