ClearBridge Investments

Dividend Strategy

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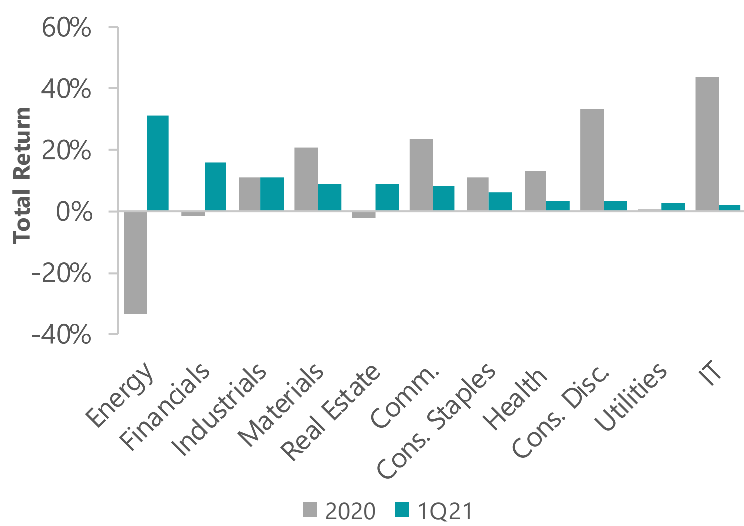
Key Takeaways

- The market's upward trend marked a continuation of last year's gains, but the underlying dynamics were starkly different, with reopening plays gaining at the expense of technology and growth stocks.
- From a macroeconomic perspective, the potential for a sharp rise in rates makes high-multiple stocks look vulnerable.
- We are looking to add companies with solid outlooks but historically normal earnings multiples and have been finding names leveraged to the major trends in technology, such as the cloud, digital transformation and electric vehicles.

Market Overview

The stock market and the ClearBridge Dividend Strategy both rose nicely in the first quarter. The market's upward trend marked a continuation of last year's gains, but the underlying dynamics were starkly different. Investors bought reopening/recovery plays (led by energy, financial services and industrials) and moved away from many of the technology and growth stocks that were last year's winners. Interest rates rose sharply and, for the first time in ages, investors began to worry about inflation.

Exhibit 1: Reversing Underlying Market Dynamics in the S&P 500



As of March 31, 2021. Source: ClearBridge Investments, FactSet.

In the coming quarters we expect an exceptional economic recovery and one of the strongest business environments we have seen in decades. This should drive robust sales and earnings growth and lay the foundation for solid dividend increases.

Shortly before the pandemic our average portfolio holding compounded dividends north of 9%. Due to the pandemic, in 2020 that fell to below 7%, though in 2021 we expect dividend growth to accelerate and the portfolio's holdings will return to their long-term historical average.

At the most basic level, investment analysis tries to answer two questions: 1) how much cash flow will an investment throw off and 2) how much will investors pay for that stream of cash flows? While it is easy to forecast that corporate profits will soar coming out of the pandemic, it is difficult to know the multiple the market will settle at — the S&P 500 Index is currently a full 20x estimated 2022 profits! The difficulty in forecasting the market's multiple is rooted in the very thing that makes forecasting the corporate earnings outlook so easy: the stimulus wild card.

This economic recovery will be robust because of actions taken by the federal government and the Federal Reserve. The relief/stimulus programs and loose monetary policy enacted over the last year offset the impact of shutdowns and all but ensure a high escape velocity during the recovery. But the scale of these programs (over $5 trillion in federal spending so far!) imperil the fiscal sustainability of the U.S. and risk stoking inflation.

While interest rates are still extremely low by historical standards, they increased sharply during the first quarter. This, in part, represents a normalization. Investors who flocked to bonds early in the pandemic are re-risking their portfolios and moving out onto other parts of the risk spectrum. This is healthy and to be expected. At the same time, rising rates reflect investor concern over the U.S. government's fiscal health and fear that inflation — nonexistent for years — could become a headwind.

Exhibit 2: Longer-Term Interest Rates Have Risen Markedly, but From Low Levels

As of March 31, 2021. Source: ClearBridge Investments, Bloomberg Finance.

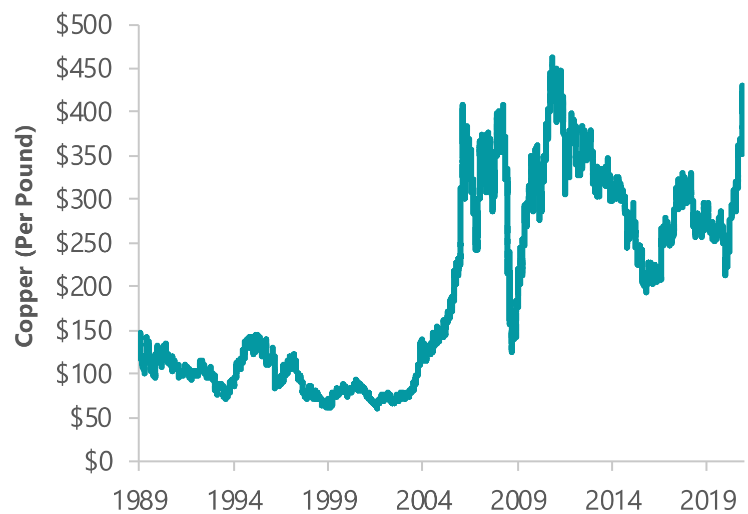
While it may seem counterintuitive to worry about inflation during a pandemic (when unemployment is high and economic activity is weak), there is the potential for an inflationary surge as the world recovers. The economic contraction in 2020 forced many businesses to shutter or reduce capacity — meaningfully tightening the supply side of the global economy. Federal programs like the Paycheck Protection Program cushioned the blows of the pandemic and position consumers to spend strongly as the economy reopens. As the vaccinated millions emerge from their homes, robust demand will bump up against restrained supply and prices may rise.

Energy prices provide a clear example. OPEC slashed production to match reduced demand, but the market has tightened, demand is recovering and prices are back at pre-pandemic levels. Copper, an industrial bellwether, is near all-time highs.

Exhibit 3: Oil Prices Back at Pre-Pandemic Levels

As of March 31, 2021. Source: ClearBridge Investments, Bloomberg Finance.

Exhibit 4: Copper Prices Near All-Time Highs



As of March 31, 2021. Source: ClearBridge Investments, Bloomberg Finance.

Outlook

Increases in interest rates and commodities have propelled financial and energy stocks and reversed most of the losses suffered in 2020. Tech/growth stocks, meanwhile, underperformed in the quarter due to both fundamental and macroeconomic factors. While their outlooks remain robust, a return to the office and in-person life will mean fewer Zoom calls and less online shopping. From a macroeconomic perspective, the potential for a sharp rise in rates makes high-multiple stocks look vulnerable.

The $1.9 trillion American Rescue Plan passed in March provides a needed boost, but its size could cause the economy to overheat and spark inflation. Further federal programs contemplated by the Biden administration address real needs in the economy and the world but, again, their sheer magnitude stokes concern that they could lead to inflation and drive interest rates much higher.

We are not global macro investors. We characterize ourselves as bottom-up, fundamental managers focused on best-in-class companies with strong franchises, durable moats, healthy growth outlooks, high returns and the ability to compound earnings and dividends at solid rates over time. Our portfolio is diversified and well-positioned to benefit as the economy reopens and accelerates.

While there is no certainty that interest rates will rise, the potential consequences of rising rates for high-multiple stocks requires vigilance. While many terrific high-multiple growth companies will undoubtedly enrich their shareholders, rising rates increase the burden of proof on high valuations.

Portfolio Positioning

We are looking to add companies with solid outlooks but historically normal earnings multiples. Within technology we recently added Oracle (in late 2020), Cognizant Technologies and NXP Semiconductors. These companies are positioned to leverage major trends in technology, such as the cloud, digital transformation and electric vehicles, respectively, but sport modest valuations.

Over the past several quarters we have increased our overweights to consumer staples and utilities, and are being patient as these trades play out. Frustratingly, despite these companies performing defensively during the pandemic, work-from-home technology stocks proved to be last year’s safety trade. This year these defensive sectors have lagged again, as investors look for leverage to the economic recovery. We remain positive on these investments. We like our staples’ strength in pricing power; our utilities should see above-trend, long-term growth from the energy transition and are protected from potential inflation by their regulatory recovery mechanisms.

While we continue to like Blackstone Group, we have taken some gains in the name as we believe the next leg up in financials is more likely to come from traditional areas like banks and insurance.

As oil prices have risen, we have remixed our energy holdings to benefit more directly from rising commodity prices. We exited our investment in pipeline company Kinder Morgan and initiated a position in oil producer Pioneer Natural Resources.

We are very bullish on the economy, corporate earnings and a return to better days, but we have big questions regarding macroeconomic policy and its implications. While we maintain our focus on company-specific analysis, we have a keener eye than usual on the macroeconomic backdrop.

Portfolio Highlights

The ClearBridge Dividend Strategy underperformed its S&P 500 Index benchmark during the first quarter. On an absolute basis, the Strategy had gains in 10 of 11 sectors in which it was invested for the quarter. The main contributors to Strategy performance were the financials, energy and industrials sectors. The consumer staples and health care sectors, meanwhile, detracted from absolute results.

On a relative basis, stock selection detracted from performance for the quarter, while sector allocation was a positive. In particular, stock selection in the industrials, consumer staples and communication services sectors and an overweight to consumer staples detracted from relative returns. Conversely, stock selection in the consumer discretionary sector, overweights to financials and energy and underweights to consumer discretionary and information technology (IT) proved beneficial.

On an individual stock basis, the main positive contributors were MetLife, Bank of America, Blackstone, Williams Companies and Microsoft. Positions in Apple, Walmart, Nestle, Merck and Edison International were the main detractors from absolute returns in the quarter.