ClearBridge Investments

Appreciation Strategy

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Key Takeaways

- U.S. investors are abandoning the notion of open-ended central bank intervention with U.S. interest rates permanently pegged at zero.
- Goods inflation is here and real, though the service sector accounts for 80% of the U.S. employment base and service inflation is moderating.
- We began shifting the portfolio to a modestly more cyclical stance in mid-2020, methodically tilting to underweight technology stocks while allocating incremental capital to the more cyclical areas of materials and financials, which we believe positions us well for the remainder of 2021.

Market Overview

After stumbling out of the gate, the S&P 500 Index added 6.2% in the first quarter, increasing more than 5% for the fourth consecutive quarter. But, make no mistake, underneath the surface the quarter was anything but uneventful.

Like the mindset of a freshly COVID-19 vaccinated adult, the psychology of the U.S. equity market shifted markedly in the first quarter. As we exit the abyss of seemingly endless days homebound in sweatpants, U.S. investors are similarly abandoning the notion of open-ended central bank intervention with U.S. interest rates permanently pegged at zero.

Mass vaccinations and improved mobility are only part of the evolving investment landscape. In January we inaugurated a new president whose policies on taxation, stimulus, climate change and government expenditures represent a material shift from those of his predecessor. Investors also dealt with two high-profile potential black swan events with Melvin Capital/GME and Archegos Capital; an unprecedented assault on Capitol Hill; and the continued epidemic of race-based hate crimes. Indeed, fiduciaries have more to consider today than ever before, extending well beyond beating a benchmark. Today's institutional investors must consider how our capital allocations impact society and the environment.

Investor repositioning toward economic recovery beneficiaries continued in the quarter. Both energy and financials — which lagged significantly at COVID-19's outset — posted a second

consecutive quarter of outperformance, at a magnitude not seen since exiting the global financial crisis (GFC) in 2009. Energy's first-quarter relative performance was its best since at least 1999 and the sector has now posted two consecutive quarters of 15%+ relative outperformance, a feat accomplished by any sector only one other time since 1999 (the real estate sector did it in 2009, exiting the GFC). Financials also posted two consecutive quarters of nearly 10% relative outperformance, results not seen by the sector since exiting the GFC in mid-2009.

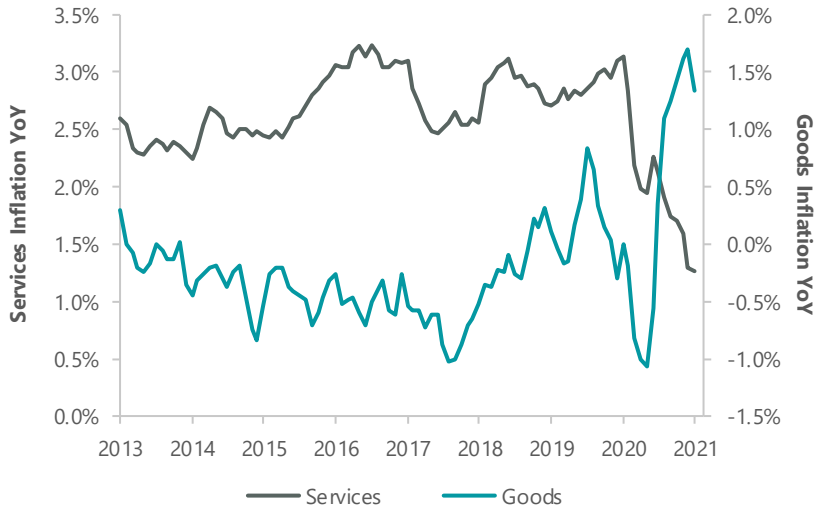
There remains significant labor force slack, which we believe will act as an impediment to labor cost inflation.

On the flip side, after seven consecutive quarters of relative outperformance (all of 2019 and three quarters of 2020), information technology (IT) lagged for a second straight quarter. Of note, IT has not underperformed the S&P 500 for three consecutive quarters since the second quarter of 2013.

On a similar theme, consumer discretionary stocks have now lagged for two quarters, weighed down by the large and technology-centric Tesla and Amazon.com. Finally, consumer staples were the S&P 500's largest laggard as investors repositioned for recovery and away from household product stocks.

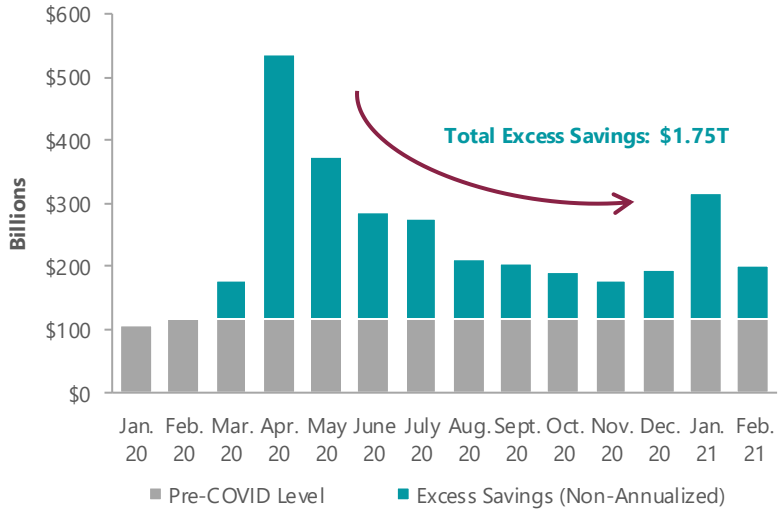
At the heart of evolving sector leadership is the debate about the future path of inflation and interest rates. No doubt, goods inflation is here and real (Exhibit 1). Commodity prices — both hard and soft — are up materially, which will inevitably be passed to consumers. As an example, with oil at about $60/barrel we're paying nearly $3/gallon at the pump, up 50% year over year. Lumber prices are up nearly 300% year over year, which is a direct passthrough to homebuyers from homebuilders. Although not as stark, soft commodities such as sugar, corn and soybeans have all rallied significantly, implying higher prices at the grocery store. When considering a consumer that has never been more liquid on unprecedented stimulus-driven savings (Exhibit 2); additional stimulus en route to consumer bank accounts; and supply chains of all kind stressed with lean inventories and extended lead times, we expect goods inflation will remain with us for the majority of 2021.

Exhibit 1: Goods Inflation Does Not Mean Services Inflation



As of Feb. 28, 2021. Source: Bureau of Labor and Statistics, Bloomberg Finance.

Exhibit 2: Consumer Balance Sheets are Flush



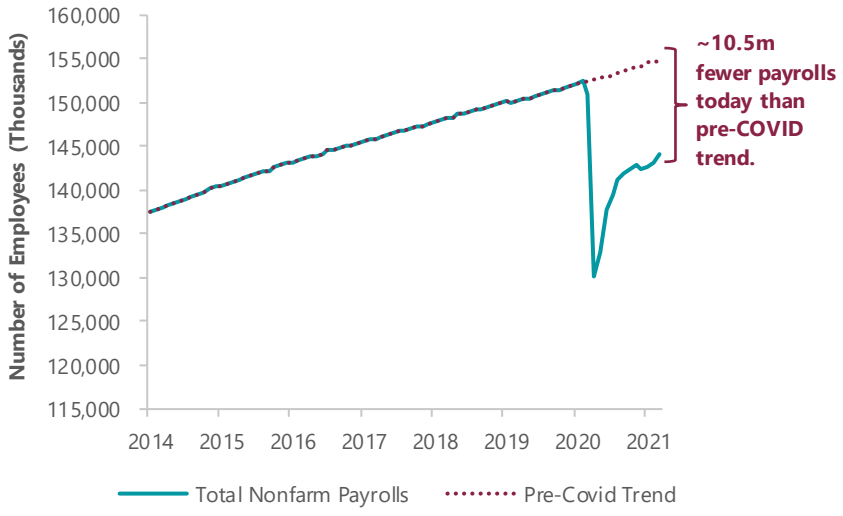
Data as of Feb. 28, 2021. Source: Bureau of Economic Analysis, ClearBridge Investments.

Is goods inflation a sustainable driver of higher inflation that would force the Fed to raise rates? We don't believe so. For the Fed to consider raising rates we believe the linchpin is labor costs and services inflation. The service sector accounts for 80% of the U.S. employment base. Today service inflation is moderating.

With unemployment hovering around 6%, underemployment still double digits and an estimated 10.5 million more jobs necessary to return to pre-COVID-19 levels, there remains significant labor force slack, which we believe will act as an impediment to labor cost inflation (Exhibit 3). That said, with input cost inflation real and no way to prove the labor cost argument until we are well into a "normal" economic environment, we believe it is prudent to

maintain a balanced approach. Although our daily lives seem poised to return to "normal" in 2021, the investment landscape looks anything but normal.

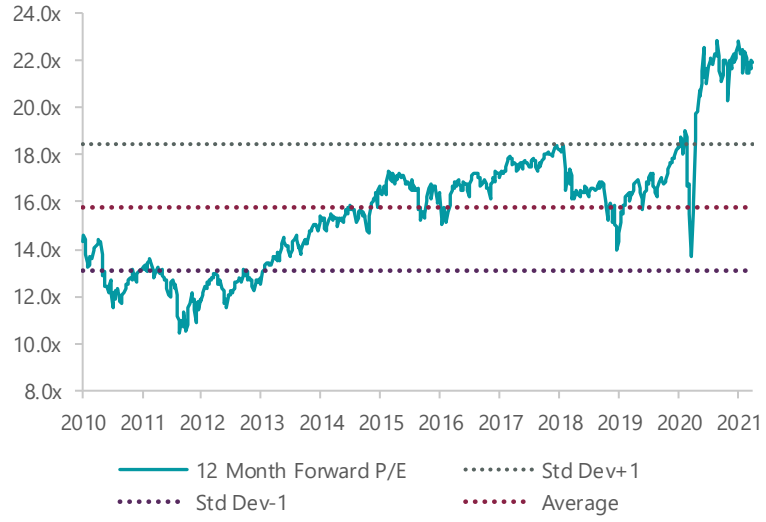
Exhibit 3: Jobs Market Contains Considerable Slack



As of Feb. 28, 2021. Source: Bureau of Labor Statistics, ClearBridge Investments.

While powerful near-term economic growth and the likelihood of a long economic expansion ahead of us make us comfortable with intermediate-term stock market returns, we believe the path to future market gains will encounter increased volatility and greater risk of a 10%+ market correction. With the reopening economic expansion upon us, we are concerned that it seems nobody is talking about the possibility of a correction (Exhibit 4). The specter of higher inflation is a headwind to near-record valuation multiples, especially for the heady multiples of hyper-growth and thematic stocks (clean energy/renewables, electric vehicles). In addition, the market excesses discussed in our last letter are still brewing and we're mindful of the black swan flybys of the first quarter. We began shifting the portfolio to a modestly more cyclical stance in mid-2020, consciously and methodically tilting our portfolio to underweight technology stocks while allocating incremental capital to the more cyclical areas of materials and financials, which we believe positions us well for the remainder of 2021.

Exhibit 4: Valuation Multiples Near Records



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

Despite these concerns we still see attractive areas to invest in. The U.S. has underspent on rails and bridges for decades and a Democratic Congress is likely to have success passing a significant infrastructure bill. We continue to believe housing is at the start of a powerful cycle ignited by migration from the cities to the suburbs plus pent-up demand from over a decade of below-trend household formation. We also believe the rotation out of growth has left some idiosyncratic opportunities for stocks with bright fundamentals and more reasonable valuations.

Outlook

The outbreak of COVID-19 in the U.S. introduced short-term volatility and amplified pre-existing market conditions, benefiting companies perceived to have open-ended growth opportunities while cyclicals and rate-sensitive stocks lagged. For risk-averse, valuation-conscious investors who believe a diversified portfolio will outperform through the cycle, a valuation-agnostic market with a narrow set of winners — like the one that existed up until the fourth quarter — tends to be a challenge for us. But the portfolio looks well positioned for the conditions that appear to be playing out in 2021.

We are constructive on the outlook for economic growth and believe businesses levered to improved economic activity have better risk/reward than the mega cap secular growth companies, on average. As a result, we have methodically and prudently tilted our portfolio slightly more toward investments that reflect this view. This is done within the context of our rigorous focus on high-quality stocks that seek to protect investor downside. We believe the Appreciation Strategy's conservative approach to investing and portfolio of high-quality earnings compounders

with quality balance sheets and durable competitive advantages is well-positioned for a powerful economic recovery but an expensive stock market.

Portfolio Highlights

The ClearBridge Appreciation Strategy underperformed the benchmark in the first quarter. On an absolute basis, the Strategy had gains in 10 of 11 sectors. The main contributors to performance were the financials, communication services and energy sectors. The consumer staples sector was the only absolute detractor from performance.

In relative terms, sector allocation was positive for performance, while stock selection detracted. In particular, stock selection in the industrials, materials, consumer staples and IT sectors weighed on relative returns, while stock selection in the consumer discretionary sector contributed positively.

On an individual stock basis, the biggest contributors to absolute performance during the quarter were JPMorgan Chase, Alphabet, Microsoft, Home Depot and Bank of America. The biggest detractors were Apple, Amazon.com, Adobe, Walmart and Merck.

During the quarter we initiated positions in Teledyne Technologies in the industrials sector and Chubb in the financials sector. We closed positions in Viatris in the health care sector and AT&T in the communication services sector.