ClearBridge Investments

Large Cap Growth ESG Strategy

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Key Takeaways

- We continued to focus on improving the Strategy's up capture by increasing exposure to the select bucket of growth companies through additions to our software and Internet holdings as well as managing our largest positions.
- We feel very good about the consumer and, with the return of more normal economic activity, we believe the Strategy is well-positioned to participate.
- In a hot housing market, many companies held across ClearBridge portfolios are helping make the homes of the future — back deck included — more environmentally responsible spaces.

Market Overview

Equities grinded higher to start 2021, boosted by supportive economic policy, improving fundamentals and a widening COVID-19 vaccine rollout. The S&P 500 Index gained 6.2% on rising optimism over a reopening of the economy that enabled cyclical and value stocks to lead for the second-straight quarter. The Russell 1000 Value Index advanced 11.3% in the first quarter, outperforming the 0.9% return of the benchmark Russell 1000 Growth Index. The market action since last fall has closed most of the historic advantage enjoyed by growth and momentum names, with growth stocks up 62.7% over the last year and value stocks ahead by 56.1%.

Greater risk taking by investors, especially in a handful of heavily shorted stocks bid up by individual investor message boards as well as in SPACs and cryptocurrencies, also drove lower-quality areas of the market higher while causing several spikes in volatility as hedge funds were forced to unwind positions that went against them. In addition, a surge in bond yields, with the U.S. 10-Year Treasury rising 83 basis points to finish the quarter at 1.74%, pressured higher-multiple growth stocks whose profits are discounted farther into the future.

From a sector standpoint, energy (+19.6%) was the best performer in the benchmark as crude oil prices rose 21%, followed by communication services (+8.5%), real estate (+7.1%), industrials (+3.4%) and financials (+2.7%). The consumer discretionary (-1.0%) and information technology (IT, -0.7%) sectors, prime beneficiaries of the work-from-home and e-

commerce boom during the pandemic, underperformed, as did consumer staples (-0.7%), another lockdown stalwart.

Against this backdrop, the ClearBridge Large Cap Growth ESG Strategy underperformed the benchmark. Relative performance improved through the second half of the quarter as the passage of a new $1.9 trillion fiscal stimulus package turned what had been a broadening of leadership into a full-fledged value rotation. Weakness in a handful of the portfolio's software names, as well as our limited positioning in cyclicals, were headwinds as the broader stock market rallied in anticipation of the strongest GDP growth in years.

Portfolio Positioning

We continued to keep our learnings from 2020 in mind during the quarter as we sought to increase the up capture of the portfolio. That effort ramped up in the second half of last year with the addition of enterprise software names Workday and Atlassian, which fall into our select bucket of above-average growers with rapidly expanding end markets.

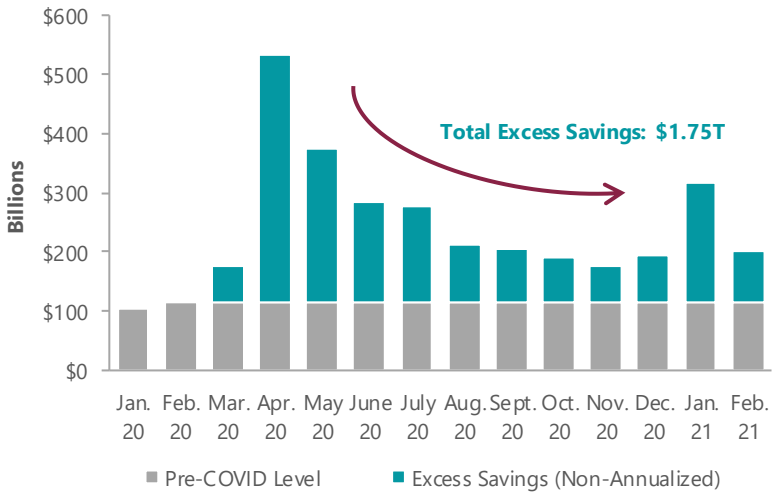
We also made adjustments to the portfolio's top 10 holdings to increase the participation of select stocks, including Facebook, while trimming our weighting to stable names. The FAANGs and Microsoft delivered mixed results during the quarter and we continue to be mindful of our weighting to these mega cap growth stocks to ensure they are not limiting our ability to add diversity through new ideas. Our repositioning has been encouraging so far with the portfolio performing better on up days in the market while maintaining good down capture during more turbulent sessions.

Within IT, we have also increased exposure to a cyclical semiconductor industry currently working through a severe supply shortage due to several years of capacity reductions, COVID-19 shutdowns and one-off production delays as well as demand resilience in areas like autos and smartphones. Two recent additions, specialty semiconductor maker NXP Semiconductors and semiconductor capital equipment firm ASML were among the portfolio's leading contributors in the first quarter. NXP rose as auto production ramped up and electric vehicle sales continued to expand. ASML, which operates in a virtual monopoly for high-end chipmaking equipment, began to exert pricing power as it works through an order backlog that has stretched to over a year. Both are Dutch-based companies and out-of-benchmark names that provide access to different growth profiles than are available in the U.S. Analog chipmaker Texas Instruments, meanwhile, benefited from better inventory management than peers. The main risk for semiconductors is short-term revenue pressure until capacity catches up with

demand, which hurt wireless chipmaker Qualcomm. Looking past current constraints, we expect the industry to see a strong second half and solid growth in 2022.

We also anticipate a strong 2021 for consumer spending as the U.S. and global economies reopen. With the ability to spend on high-ticket items like dining and travel curtailed by COVID-19 restrictions, U.S. consumers amassed over $1.4 trillion in excess savings in the last 12 months (Exhibit 1). Most Americans received another $1,400 stimulus check in March and the Federal Reserve's commitment to keeping interest rates low longer into the recovery has kept liquidity abundant. Recent housing turnover, spurred by historically low mortgage rates, has also led to more home-related spending.

Exhibit 1: Consumer Balance Sheets are Flush



Data as of Feb. 28. 2020, latest available as of March 31, 2021. Source: Bureau of Economic Analysis.

As the market continues to broaden with the return of more normal economic activity, we believe the portfolio is well-positioned to participate. We added to our consumer holdings in the first quarter, including Home Depot, and also added a new position in Tractor Supply, which is indexed to residential and rural home purchases and improvements. We also have direct exposure to a reopening through names such as Visa, Fidelity National Information Services, Disney and Uber.

Tractor Supply, a destination-based rural retailer of supplies for farmers, has a number of attractive retail attributes as it targets the do-it-yourself concept and verticals less likely to be disintermediated by e-commerce competitors. With about 2,000 stores, the company is also well-positioned to benefit from the trends in housing sparked by COVID-19 such as movement to more suburban and rural areas and increasing pet ownership. A new CEO who came from Home Depot has put in place several initiatives to improve store productivity that we believe could add

100–150 bps to same-store sales growth over the next several years while a loyal and growing customer base provides stability.

To take a more discretionary stance in retailing and make room for our additional purchases where we see better opportunities, we closed our position in Costco Wholesale. Costco was a big winner during the most restrictive periods of the COVID-19 lockdowns with its focus on staples, larger basket size, necessities and bulk items, and it remains an exceptional retailer in its category, with a sticky subscription base and non-U.S. growth ahead. However, the company is facing very tough comparisons as well as margin pressure in its core business and we believe its valuation has become stretched.

We also sold biotechnology holding Alexion Pharmaceuticals ahead of its acquisition by AstraZeneca but expect to redouble our efforts in health care through the rest of the year. We see good growth potential in the sector and after full due diligence, have been busy populating our wish list with new names we would like to own.

Outlook

With all the liquidity being pumped into the economy, we have been keeping a close eye on inflation and what it could mean for the equity market and the companies we own. As mentioned above, the semiconductor industry is positioned to exert pricing power amid a severe supply disruption while select holdings in the industrials sector such as W.W. Grainger are also positioned to pass along price increases. Consumer discretionary companies reliant on raw materials could see margin pressure but appear to be managing the higher costs effectively. Labor costs this year and next will be of particular interest given they are the largest component to broad inflation gauges.

Despite a meaningful rotation out of IT after a terrific 2020, we remain committed to the sector as one of the best places to participate in above-average long-term growth. We view last year's acceleration in enterprise capex as panic spending to support the work-from-home environment. This year, we are seeing enterprise IT budgets starting to loosen up with the focus shifting to digital transformation. Our software-as-a-service holdings are seeing pull-forward spending on digital initiatives and expect IT spending to remain healthy going forward.

While the Strategy tends to do best in more moderate growth environments than are forecast for this year, we believe the market's appreciation in 2020 was reflective of expected future GDP growth. This discounting gives us optimism that we can deliver solid performance as the expansion picks up steam. The last several years of relative performance headwinds have been in large part a function of our commitment to diversification and

maintaining strong down capture. That down capture comes at a cost in strong up markets like we saw in 2019 and 2020 but we are encouraged with our exposures in what we expect will be a more moderate market for growth stock appreciation in 2021.

Our base case is that we have pulled forward a tremendous amount of retail sales, given the massive support of government transfer payments. We remain constructive, but also feel a level of conservatism is warranted. We have delayed an economic recession, but not completely avoided one. The U.S. government is responsible for 27% of personal income today, an unrealistic level going forward. In addition, ambitious spending plans from the Biden Administration will result in higher taxes across the board. It is too early to tell how corporations and individuals will react to these increases in spending patterns. Lastly, equity valuations have had a huge tailwind of P/E multiple expansion with the Federal Reserve pegging rates near zero. In our view it will be very difficult to control rates (without distorting the yield curve) if we see reasonable economic growth and inflation, which naturally occur coming out of recessions. Higher rates could have a disproportional negative effect on the most expensive pockets within the market.

Our limited positioning in cyclicals was a headwind as the broader stock market rallied in anticipation of the strongest GDP growth in years.

Portfolio Highlights

The ClearBridge Large Cap Growth ESG Strategy underperformed its Russell 1000 Growth Index benchmark during the first quarter. On an absolute basis, the Strategy had gains across four of the eight sectors in which it was invested (out of 11 sectors total). The leading contributors to performance were the communication services, health care and industrials sectors while the primary detractor was the IT sector.

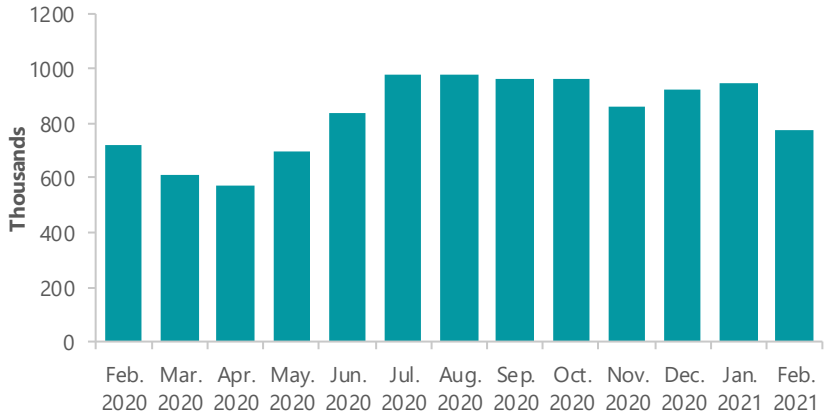
On a relative basis, overall stock selection and sector allocation detracted from performance. Specifically, stock selection in the IT, communication services and real estate sectors and an underweight to communication services had negative impacts on results. On the positive side, stock selection in the consumer discretionary and health care sectors and an overweight to industrials contributed the most to relative performance.

On an individual stock basis, leading contributors to absolute returns in the first quarter included positions in Facebook, NXP Semiconductors, Home Depot, Microsoft and ASML. Amazon.com, Apple, Splunk, Qualcomm and Palo Alto Networks were the worst detractors on an absolute basis.

ESG Outlook

We are in the midst of a booming real estate market: prices for many houses are growing the fastest in over a decade thanks to millennial household formation which was increasing before the pandemic, a pandemic-driven acceleration of the exodus from urban centers and a healthier banking system after the global financial crisis. New home sales are elevated even given the winter's typical seasonal lull (Exhibit 2). Despite a recent pickup in long-term bond rates, 30-year fixed mortgage rates are near historic lows, suggesting the growth could continue. Stimulus money and lifestyle changes engendered by people spending substantially more time at home during the pandemic have also meant more home remodeling.

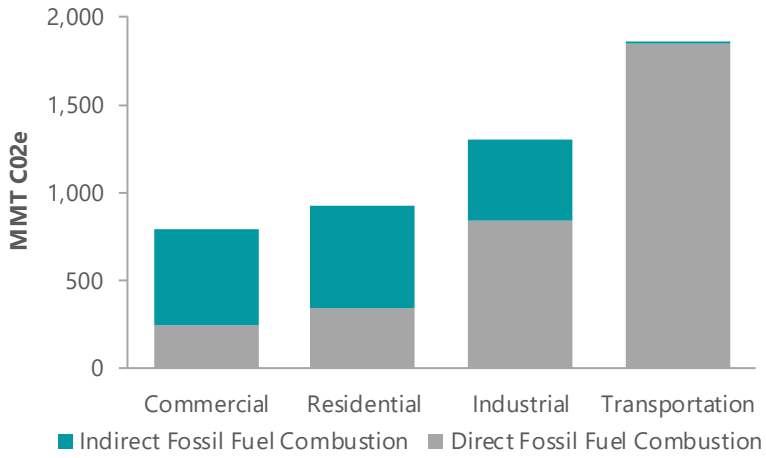
Exhibit 2: New Privately-Owned Houses Sold



Source: U.S. Census Bureau and U.S. Department of Housing and Urban Development, New Residential Sales, March 23, 2021.

As many people move into new single-family houses or apartment homes, or refresh the existing housing supply, now is a good time to reflect on how green the building and renovation processes can be, as the residential sector contributes a meaningful amount to national carbon emissions (Exhibit 3). A wide range of ClearBridge portfolio companies are working to improve the sustainability profile of tomorrow's homes, which should help reduce costs over the long term as well. Homebuilders, residential REITs, roofers and insulators, smart home enablers and others across ClearBridge portfolios, are helping make the homes of the future — back deck included — more environmentally responsible spaces.

Exhibit 3: End-Use Sector Emissions of CO^2 from Fossil Fuel Combustion (2019)



Source: U.S. Environmental Protection Agency.

Homebuilders are beginning to take steps toward building more environmentally friendly homes and disclosing the impact of their own operations. In many cases, the price sensitivity of new home buyers discourages the incorporation of green building in new homes. Homebuilder Lennar, for example, included solar panels in every home it built in California for several years prior to the California Energy Commission making solar standard as part of new construction, although this has not been without consumer pushback.

ClearBridge holding Century Communities, which makes single and attached homes, recognizes homebuilders can be a laggard industry in sustainability disclosures. The company finds that consumers in the past have not been willing to pay a price premium for green features on homes and apartments, even though they say they want them. This has led the industry to generally build to the lowest common regulatory standard, as additional green building practices were dilutive to returns.

Driven by top-down recognition of the strategic importance of green building as well as by demographic changes in home buyers (younger buyers value green features more than older buyers do), Century Communities is taking steps to be a leader in green building by publishing its first ESG report. Disclosing the company's Scope 1, 2 and 3 carbon emissions for the first time, the report represents a strategic commitment to increased disclosure and better sustainability practices with the ultimate goal of Century Communities becoming an ESG leader in the homebuilding space. We applaud this step toward clear, tangible results.

While homebuilders face some structural challenges in improving green building (with some exceptions), residential REITs, which take on longer-term responsibilities in owning and

operating the properties, are in this way more incentivized to make sustainability gains.

ClearBridge holding American Homes 4 Rent builds, acquires and leases more than 52,000 single-family rental homes across 22 states. The company designs homes with resource-efficient fixtures and appliances. To help residents conserve water, it installs high-efficiency toilets and plumbing fixtures in all development properties and in renovations of existing homes. In arid states such as Arizona and Nevada, it installs smart, water-efficient irrigation features in its landscape design.

Historically, green building practices were dilutive to returns, though they are now being recognized to be of strategic importance.

There's More Than Just Bricks in the Wall

Roofer and insulator Owens Corning, also a ClearBridge holding, is helping make the building sector more sustainable. The company operates across 33 countries and has positive environmental impact primarily through its insulation business. In the EU, for example, buildings are responsible for 40% of energy consumption and 36% of GHG emissions. New buildings consume only half of the energy of those built over 20 years ago, according to the company. But as 85% of the buildings in the EU are older than 20 years, and 85%–95% of them are expected to still be standing in 2050, there is need for a massive renovation. Roughly 35 million buildings in the EU will need to be renovated by 2030, according to the company.

Properly insulated homes lower energy intensity and thus the overall carbon footprint of a home. According to Owens Corning, insulation intensity of new homes is on the rise, driven in part by state and municipal rules requiring certain levels of insulation, but also by consumer preference for reducing energy consumption and being greener in the home. The company is helping meet this demand with insulation products that are lighter weight yet deliver stronger performance than higher-weight/higher-density products. The insight that greater density does not necessarily mean better performance has allowed the company to reduce shipping weight and fuel.

Owens Corning's roofing business also features shingles that use a highly reflective granule technology to reflect the sun, keep roofs cooler and lower air conditioning energy demand. Its composites business also counts wind turbines as a major end use, another positive for sustainability goals.

As part of its 2030 Sustainability Goals, Owens Corning is also looking to grow a circular economy model in which virgin raw materials, waste, energy and emissions are minimized through intelligent design, renewable and recycled input and energy-efficient production.

Smart thermostat maker and ClearBridge holding Resideo Technologies is also helping homes become more sustainable

through behind-the-wall innovation. Resideo makes behind-the-wall components and front-facing controls for homes whose purpose is to drive water and energy conservation or improve air quality. Resideo's smart thermostats help provide the right temperature using the lowest energy consumption; its components and controls for boilers, furnaces and heat pumps help energy conservation; and its leak and freeze detectors aid in water conservation. Currently, of Resideo's 150 million home installed base, only 6 million are conservation-advantaged "connected homes." The company's goal is to grow this mix, while also launching predictive tools for its professional installer customer (a plumber might get an alert once a pipe starts leaking, rather than waiting for the call once a basement is flooded) and working closer with utilities to make the grid smarter and more efficient. Resideo's smart thermostat, meanwhile, is built into homebuilder Lennar's new line of Connected Homes.

Home Expansion Offering Green Opportunities

Just as the new home market has been hopping amid low interest rates and the greater need for space, the market for home improvement has also been robust for similar reasons. Decks have been perfect places for safe social gatherings during the pandemic, and ClearBridge portfolio holding Trex has been meeting demand with its composite decking made from recycled wood fibers and plastic waste.

Trex's high-performance decking portfolio is made using more than 95% recycled content. Trex uses locally sourced reclaimed wood that would otherwise end up in landfills and so avoids cutting down trees to make its products. The recycled plastic film it uses comes from a variety of sources, including industrial shrink wrap, agricultural plastic sheeting and household plastic such as grocery and shopping bags. With the average 500-square foot composite Trex deck containing 140,000 recycled plastic bags, Trex is one of the largest plastic bag recyclers in the U.S. The company has also innovated ways of recycling dirtier plastics more likely to end up in landfills.

Trex has seen already strong demand get stronger during the pandemic; the company was sold out during much of 2020 and began expanding capacity across the U.S. to meet heightened demand. With lumber prices soaring amid the strong housing market, Trex's composite decks are increasingly gaining share, especially in price-sensitive areas of the market, which bodes well for both the environment and shareholders.

Sustainability Is Growing in Prominence in the Building Sector

We are encouraged by the increasing number of companies working to build the home of tomorrow more sustainably, which will typically provide an improved return on investment. In addition, the sustainably built home covers expansive geographies and diverse demographics. This is particularly important in the context of climate change, as homes that use water and energy efficiently can also prove more resilient amid volatile energy and water availability and prices. As the EPA notes, homes that maintain habitable conditions in extreme heat, power outages and strong storms are crucial to protecting their inhabitants. If they can be built using sustainable resources by companies actively looking to reduce carbon emissions, all the better.