ClearBridge Investments

Select Strategy

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Key Takeaways

- A sharp market rotation tied to economic reopening caused low multiple stocks and laggards during the most restrictive stages of the COVID-19 pandemic to assume leadership from companies with the highest growth rates.
- The Strategy's broad and balanced mandate allowed it to keep pace with the market, with contributions coming from a combination of reopening plays, cyclical stocks and COVID beneficiaries.
- We remained very active during the quarter, participating in a select number of SPAC IPOs as well as using volatility to establish new positions in attractively valued disruptors and companies indexed to a normalizing economy.

Market Overview

Optimism that improving conditions and supportive policy will jumpstart a robust reopening of the U.S. economy further amplified a shift to value and cyclical stocks in the first quarter. The S&P 500 Index rose 6.2% while the benchmark Russell 3000 Index advanced 6.4%. Growth stocks were caught in the crosshairs of the rotation, with greatest divergence in performance occurring among smaller cap companies. While the Russell 3000 Growth Index lagged its value counterpart by 1070 basis points, the Russell 2500 Growth Index, comprised of mid and small cap stocks, underperformed its value equivalent by 1434 bps.

From a sector standpoint, cyclicals crushed everything else in the first three months of the year. Energy (+31.5%), financials (+16.4%), industrials (+11.4%) and materials (+10.4%) were the strongest performers while information technology (IT, +1.4%), consumer staples (+2.1%), health care (+2.4%) and consumer discretionary (+5.2%) lagged.

Investors' new obsession with rates and inflation, as well as big policy changes in the White House, have created a challenging investment environment. Low multiple stocks and those that suffered the steepest losses through the most restrictive stages of the COVID-19 pandemic have taken over leadership from companies with the highest growth rates and best returns on assets. Amidst this transition, we continue to apply our approach of complementing disruptive growth companies with evolving

opportunities and stable compounders whose growth potential is underappreciated by the market.

This broad and balanced mandate allowed the ClearBridge Select Strategy to mostly keep pace with the benchmark in the first quarter. Portfolio contributions came from a combination of reopening plays including Expedia and Trex; cyclical stocks such as Summit Materials, an evolving opportunity under a new management team that should benefit from greater infrastructure spending, and Pioneer Natural Resources, a best-in-class oil and gas exploration & production company running its business to optimize cash flow as a stable compounder; as well as COVID beneficiaries that continue to execute well including marketing software maker Sprout Social and information security provider Fortinet.

We made more use of options; writing calls on some existing positions where we felt valuations were starting to get stretched.

Current market dynamics make it a confusing time for fundamental investors like us. We continue to target good growth stories with the business models to go after underserved markets, like Latin American e-commerce platform MercadoLibre and e-commerce enablement provider Shopify, but many are underperforming for no other reason than macroeconomic conditions. At the same time, individual investor obsession with GameStop and other "meme" stocks as well as SPACs speak to the speculative forces building in a market being supported by generous fiscal and monetary stimulus.

The first quarter was the busiest in U.S. history for stock offerings, which includes initial public offerings, follow-ons and convertible offerings. The 92 traditional IPOs were the most since the first quarter of 2000, raising $40 billion, while a record 296 SPACs also went public, raising $95 billion. The activity was front-end loaded with market participants starting to pull away from deals by the end of February with IPO price ranges being cut and many not trading well after their debuts. We see this as a "digestion" period for the more speculative areas of the market which is having a tangential impact on higher growth stocks.

Portfolio Positioning

We have been selective buyers of SPACs for the last 18 months as they provide an avenue to new ideas and proven experience of managers we know and respect. Many of the SPACs that went public recently are not attractive in our view, either due to the asset quality of the companies they are acquiring or the price, which has caused us to stay away from buying in aftermarket. The four SPACs we added in the first quarter were all bought at the IPO and still in the money at quarter end.

Only one of the SPACs we own has announced a deal. Dragoneer Growth Opportunities plans to acquire CCC Information Services, a developer of cloud software for processing auto insurance claims and repairs. CCC is the market share leader, well represented in auto

body shop networks and growing nicely. The company is extremely profitable with high margins and we believe Dragoneer paid a reasonable multiple to acquire it. In addition to our SPAC exposure, the cooling off of the IPO market could lead to attractive opportunities and we are actively researching companies in this area.

In addition to the new issue market, we have been tactically adding growth exposure. Our largest new position was Match Group, the global leader in the online dating space that was spun off by Interactive Corp. in 2020. Singles have put their life plans on hold during the pandemic but continue to want to meet people. Match was negative impacted by COVID, especially in markets like India, but the business is very profitable with high margins and is driving growth through international expansion, increasing users and better monetization and engagement. In the same vertical, we also took a starter position in Bumble, which runs a popular social media dating app. We took advantage of the selloff in disruptors that comprise a large portion of the portfolio to initiate a position in enterprise software maker Workday and added to existing names ServiceNow and DocuSign.

MSC Industrial Direct was another significant addition during the quarter. Management moves to improve margins and cash flow had the distributor of industrials parts and equipment poised for better performance leading into COVID, but the company was severely impacted by the closing of the economy. In a fragmented market, MSC has the ability to flex its supply chain to win market share as the business cycle picks up.

To make room for these new names with more attractive outlooks related to the reopening, we sold out of companies where the thesis is not playing out at the pace we expected including BioMarin Pharmaceutical, Visa, BJ's Wholesale Club and Splunk.

We also made use of options during the quarter, writing calls on some existing positions where we felt valuations were starting to get stretched. We also entered bullish options strategies to gain exposure to some new companies we have been researching for years with the growth selloff and increased volatility providing an attractive entry.

Outlook

We are encouraged that the active repositioning we have undertaken over the last year has provided enough balance for the Strategy to perform well in both the higher growth of 2020 as well as the cyclical-oriented market we are experiencing today. Some of our best contributors in the latest quarter were companies we bought or materially added to from the middle of the second quarter through the third quarter such as Performance Food Group and Willscot Mobile Mini.

Going forward, we will continue to focus on buying a select few remarkable businesses at the right valuation. As we move through the rest of the year, we will be paying close attention to the speed of vaccine dissemination and the spread of variants; fiscal and monetary policy changes in Washington and how they impact economic growth, interest rates and inflation; as well as regulatory and incentive structures and their influence on large cap technology and clean tech providers. As the economy transitions from restrictions to reopening, we are analyzing which new behaviors are likely to stick and which are more ephemeral as well as seeking out opportunities generated by the frictions of reopening, such as capacity constraints in semiconductor production for the auto industry and rehiring and training challenges in the service economy.

Portfolio Highlights

The ClearBridge Select Strategy slightly underperformed its Russell 3000 Index benchmark in the first quarter. On an absolute basis, the Strategy had gains across nine of the 10 sectors in which it was invested during the quarter (out of 11 sectors total). The consumer discretionary and industrials sectors were the primary contributors to performance.

In relative terms, overall stock selection contributed to performance but was offset by negative sector allocation effects. Specifically, stock selection in the consumer discretionary, health care and consumer staples sectors and an overweight to industrials were the primary drivers of results. Conversely, stock selection in the financials, industrials and IT sectors and underweights to financials and energy detracted from results.

On an individual stock basis, the largest contributors to absolute returns during the first quarter were Surgery Partners, American Eagle Outfitters, Pioneer Natural Resources, Expedia Group and Summit Materials. ServiceNow, MercadoLibre, Copart, DocuSign and Apple were the greatest individual detractors from absolute returns.

In addition to the transactions mentioned earlier, the Strategy initiated positions in Shoals Technologies Group in the industrials sector, ON Semiconductor in the IT sector and Horizon Therapeutics in the health care sector as well as participating in a private placement for Brain Corp. in the IT sector. We also closed positions in Agora and Cardtronics in the IT sector, Clarivate in the industrials sector and a convertible position in Newpark Resources in the energy sector.