ClearBridge Investments

Appreciation ESG Strategy

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Key Takeaways

- Powerful U.S. economic performance and a 95% decline in U.S. COVID-19 cases drove strong market gains, while under the surface the market is wrestling with post-pandemic uncertainties.
- We are constructive on the outlook for economic growth and believe businesses levered to improved economic activity have on average a better risk/reward than the mega cap secular growth companies. This is especially true if inflationary pressures linger longer than investors expect.
- ClearBridge holdings are proactively developing forward-thinking solutions that foster stronger hiring and retention cultures, helping to ensure the businesses remain competitive for years to come.

Market Overview

Powerful U.S. economic performance and a 95% decline in U.S. COVID-19 cases drove an 8.6% gain in the S&P 500 Index during the second quarter of 2021. The U.S. market increased in each of the last five quarters for a cumulative increase of 69.7%, the strongest gain in 75 years. Underneath the surface however, the second quarter's market performance was a tale of two halves illustrative of a market wrestling with an uncertain post-COVID-19 economic landscape.

Economic recovery plays such as financials and energy led during the first half of the quarter, continuing the trend that began in late 2020 when the COVID-19 vaccine rollout became tangible to U.S. investors. Secular growers, especially the big technology stocks, took over at mid quarter. Tech's leadership accelerated post the mid-June FOMC meeting where the Federal Reserve discussed tapering monetary policy accommodation. The yield curve, which flattened steadily during the quarter (a common warning sign for equity investors), accelerated its compression after the meeting, reflecting fears Fed actions to quell inflation could derail the nascent U.S. economic recovery (Exhibit 1).

Exhibit 1: 10-Year Treasury Minus 2-Year Treasury Yields

As of June 29, 2021. Source: ClearBridge, Bloomberg Finance.

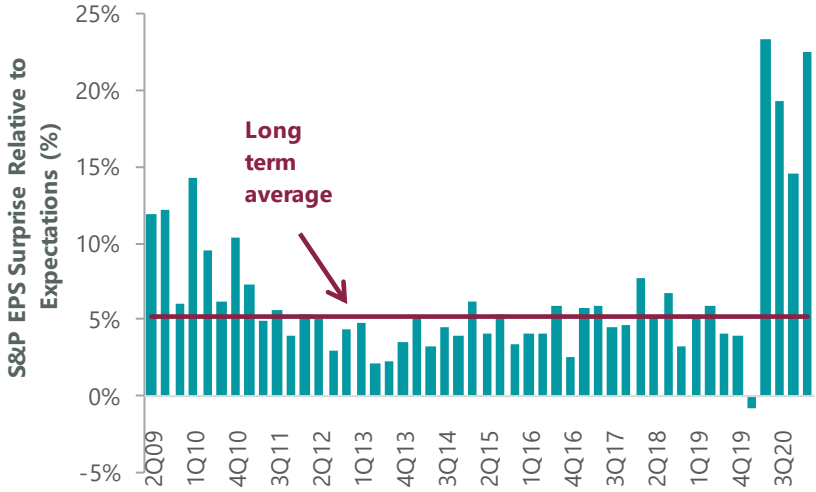
The strongest sectors during the quarter were technology, real estate, energy and communication services, while the weakest were utilities and consumer staples. This mixture reflects the change in leadership during the quarter in a heady market that favored high-beta stocks.

As investors we are wrestling with several issues. First, how can a stock market that is nearly two standard deviations above its historical average price/earnings ratio and 20% above its previous peak valuation on the Buffett ratio continue to rise? Second, given the enormous strength in the U.S. economy and commodity price pressures, why has the 10-year Treasury yield stalled out and even fallen below 1.5% — a real interest rate of -0.75% — when the historical average real interest rate is +0.25%? Either the economic strength is real, and yields should rise, or market valuations are at risk.

Positive earnings revisions explain the market surge. The S&P 500's 2021 consensus EPS forecast rose +16.9% since July 2020 versus the average historical estimate revision of -3.9%, and 2022 EPS estimates are +13.2% over this same timeframe. Normally consensus tends to overestimate future earnings requiring negative revision as time passes, but since mid-2020 earnings estimates have been dramatically underestimated. Importantly, the largest percent changes to EPS expectations have come in the energy, materials, and financials sectors, supporting a hand-off of leadership — from secular growth to cyclical recovery — and buoying a market regularly notching all-time highs. The breadth (percentage of companies reporting an EPS beat) and depth (percentage of difference versus consensus expectations) of earnings surprises are at the highest levels since before the Global Financial Crisis (GFC).

Earnings topped consensus expectations by a whopping +21.4% in the first quarter of 2021 (Exhibit 2), the second-largest upside surprise in any earnings season since the GFC (the second quarter of 2020 EPS beat expectations by +23.2%). Earnings surpassed consensus expectations by more than 15% in each of the last four quarters, compared to the average surprise of +5.7%. Finally, 87% of companies in the S&P 500 exceeded consensus expectations in the first quarter, the best performance since the GFC and well above the 68% long-term average. In sum, corporate execution versus market expectations over the past year was nearly as unprecedented as the environment corporations operated in.

Exhibit 2: Historic Earnings Surprises



As of June 30, 2021. Source: ClearBridge, FactSet.

If fundamentals are so powerful, why has the U.S. 10-year Treasury yield fallen below 1.5%? The past month the BAA spread, the difference between junk bond yields and investment grade, has been the lowest this century, suggesting that the bond market is indeed comfortable with the U.S. economic outlook. Clearly, the Fed's commentary from the June FOMC meeting created fear that the Fed could act precipitously, hurting growth next year. Coming into the FOMC meeting there was a strong consensus that interest rates would rise. Some investors might have been too aggressively positioned and were forced to cover by the Fed comments. It is likely that international money flows, a flight to safety, are a partial cause for the Treasury yield declines. While U.S. COVID-19 cases have plummeted and growth has soared, total cases in the world are near peak and global economic recovery is trailing that of the U.S. China's crackdown on its business's autonomy and on cryptocurrencies is driving money flows into U.S. Treasurys.

Our economic view remains largely unchanged from our first-quarter outlook except for a slight wrinkle. We continue to believe the economic rebound is on solid footing as evidenced by

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plentiful job openings, robust corporate capital spending plans, and a still-liquid consumer. The one wrinkle is — although we still believe inflation pressures will prove transitory — we expect inflationary forces to linger well into 2022, longer than our prior expectation. This is because despite robust job openings, positions remain hard to fill, likely requiring higher wages (despite the economy having 6.7 million fewer jobs than before COVID-19); supply chain disruptions are mending slower than expected; and demand appears to be absorbing incremental manufacturing capacity.

A market and valuations at all-time highs make it challenging for us to find stocks to buy. 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. Several large cap pharmaceutical companies and biotechs offer visible growth and good dividend yields and sell at modest valuations. We remain positive on railroads as volumes will benefit from a robust U.S. economy. The industry has done a remarkable job the past two decades reducing its capital intensity and increasing its operating margins — but we see room for even more improvement.

Outlook

Investors are at a crossroads, uncertain whether low rates and peaking growth will drive a narrow market led by secular growth-oriented stocks; whether economic momentum will drive further outperformance from cyclical and interest-rate-sensitive stocks; or whether Fed policy will truncate the expansion, ushering in a bear market. As risk-averse, valuation-conscious investors who believe a diversified portfolio will outperform through the cycle, we are well-positioned in the latter two scenarios. The former environment — a narrow, tech-driven market — would be more challenging for our Strategy.

We are constructive on the outlook for economic growth and believe businesses levered to improved economic activity have on average a better risk/reward than the mega cap secular growth companies. This is especially true if inflationary pressures linger longer than investors expect. Although the growth selloff in April and May did present us with opportunities in technology, our portfolio remains methodically and prudently tilted slightly more toward investments that reflect our view. This is done within the context of our rigorous focus on high-quality stocks that protect investor downside. We believe the ClearBridge Appreciation ESG Strategy's conservative approach to investing in a portfolio of high-quality earnings compounders with quality balance sheets and durable competitive advantages is well-positioned for a powerful economic recovery and an expensive stock market.

Portfolio Highlights

The ClearBridge Appreciation ESG Strategy had a positive return during the second quarter of 2021, underperforming the Strategy's benchmark.

On an absolute basis, the Strategy had gains in 10 of 11 sectors in which it was invested during the quarter. The main contributors to the Strategy's performance were the information technology (IT), communication services and health care sectors. The utilities, energy and real estate sectors were the main laggards.

In relative terms, the Strategy underperformed its benchmark due to sector allocation, while stock selection contributed positively. In particular, stock selection in the consumer staples, industrials and IT sectors and an underweight to the utilities sector were the most positive contributors to relative performance. Conversely, stock selection in the financials sector proved detrimental.

On an individual stock basis, the biggest contributors to absolute returns during the quarter included positions in Microsoft, Alphabet, Apple, Costco and Facebook. The greatest detractors from absolute returns were positions in Walt Disney, Cognizant Technology, Ecolab, Verizon and Ball.

During the quarter we initiated new positions in Hartford Financial Services in the financials sector and Enphase Energy in the IT sector and closed positions in Chubb in the financials sector and Cognizant Technology in the IT sector.

ESG Highlights: Cultivating Human Capital for Long-Term Success

Cost pressures in a reopening U.S. economy are coming from a variety of sources: shutdown-related supply shortages, a Suez Canal blockage rippling across global shipping, a semiconductor plant fire in Japan, and, not least, a tight labor market as demand for goods and services outpaces labor supply.

Managing human capital — a mixture of employee skills, wellness, productivity and innovative ability — through a pandemic and recovery is requiring approaches focused on the long-term success of both employees and the bottom line. Among these, wage inflation is conducive to reducing economic inequality in many industries.

As the pandemic wanes and the labor market tightens, ClearBridge holdings in essential retail, rideshare and logistics businesses are balancing labor and shareholder interests by proactively developing forward-thinking solutions that foster stronger hiring and retention cultures, helping to ensure the businesses remain competitive for years to come.

Essential Retailers Prioritize Retention

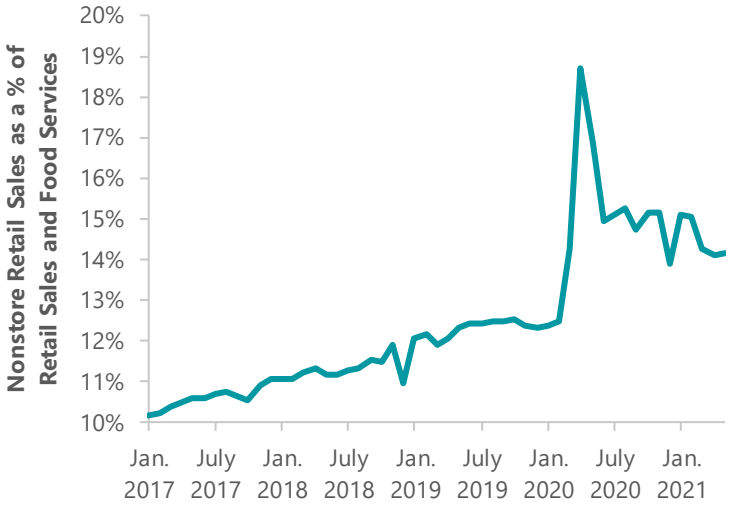
The pandemic has created challenges for businesses large and small; one major challenge for large essential retailers such as ClearBridge holdings Home Depot, Walmart and Costco has been ensuring adequate staffing to meet demand under trying conditions. All three instituted enhanced pay practices during the pandemic, with raises, unplanned bonuses and other benefits helping compensate employees for their efforts in a difficult environment. Over the course of the pandemic, for example, Home Depot has invested $2 billion in expanded benefits for employees. These have included extra weeks of paid time off that employees could use either as vacation time or supplementary pay, paid time off for employees contracting COVID-19 or requiring to be quarantined, and relaxed time off policies.

While some of the compensation measures are temporary, some have transitioned into permanent wage hikes. At Home Depot, expanded benefits include $1 billion a year in permanent raises for hourly workers. In September 2020 Walmart raised wages for 165,000 employees, including a number of entry positions to $15 an hour. It followed this in February with a raise for 425,000 workers that moved its average pay above $15 an hour. In February 2021 Costco, which we have long acknowledged as a leader in workplace practices, raised its starting wage to $16 an hour; its average wage at the time was $24 an hour.

The expanded benefits have meant a hit to margins for these companies, even while the essential services nature of their businesses has meant large influxes in sales that could offset these outlays, but we view the moves as forward-thinking human capital management.

There is a strategic benefit in raising wages and benefits to keep these businesses competitive. For one, being earlier rather than later in enhancing employee compensation also sends a strong positive message to workers that builds good will and trust. Proactively supporting employees through enhanced compensation measures also better positions these companies amid a scramble for talented workers in a new e-commerce-driven retail paradigm the pandemic has helped cement (Exhibit 3).

Exhibit 3: A New Plateau of E-commerce



As of May 31, 2021. Source: Census Bureau.

One benefit of proactively raising worker compensation as these companies compete in a growing e-commerce paradigm is better employee retention, a key competitive advantage as higher retention saves costly onboarding and training efforts and keeps institutional knowledge strong. In terms of ensuring access to sufficient labor, Home Depot shared with ClearBridge that there has been no reduction in the number of applications for temporary workers it has been receiving, an indication its human capital policies are ensuring it is still able to attract talent even amid higher competition.

The pandemic has accelerated the move to e-commerce and put forces into play that should result in higher wages both for workers in large retail supporting e-commerce and adjacent industries such as restaurants. Anecdotally, we have seen some spillover effects from wage increases from large essential retail employers (Walmart employs 1.5 million; Home Depot 500,000; Costco 273,000) in that industries competing for this labor pool, such as restaurants, are now seeing worker scarcity as candidates prefer higher-paying distribution center jobs or jobs at grocery stores that are steadier and not reliant on tips.

There is some confirmation of this in the latest job data, which show average hourly wages for retail workers rose 8.6% in June from February 2020, while restaurant and hospitality workers' wages rose 7.9%, both above the overall wage growth of 6.6%. The average hourly wage in the hospitality sector was $18.23 an hour in June, and $21.92 in the retail sector.

While there are prices for the expanded compensation in terms of adjacent businesses, there is also potentially a modest downside for customers in the form of broader inflation as businesses pass on the expenses through price increases, ultimately weakening

purchasing power for those enjoying higher wages. This does not seem to be the case at present, however. Companies may also be reducing sale promotions as a way to mitigate labor cost increases. At the same time, many companies will try to offset higher labor costs with technological innovation that will seek to boost efficiencies over the long term.

Culture Shift Coincides with Transport Boom

The recent acceleration of e-commerce has also meant workers are benefiting from upward wage pressure in freight and transportation. Wage inflation, however, is not enough for employee retention. United Parcel Service (UPS) is going a step further by shaping culture, and it is paying off.

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Under the new CEO, Carol Tomé, UPS has increased its focus on ESG to retain and attract the next generation of workers. The goal is to move from being a "trusted but stodgy" shipper to a modern innovative company through greater attention to sustainability as well as diversity and inclusion. Seeking to be a "people-led" company, UPS has been tracking the employee experience in order to understand and improve employee engagement. UPS measures its employee experience by asking how likely employees are to recommend others work there. That metric stood at 51% globally at the end of 2019 but has improved by six percentage points under Tomé's leadership as UPS drives diversity and inclusion efforts across the company, including investing in training, modernizing appearance standards, and adding a Chief Diversity, Equity, and Inclusion Officer on the executive leadership team. Ultimately, UPS hopes to get this "likely to recommend" metric up to 80%.

UPS is also driving environmental goals through its recent pledge to be carbon neutral in all of its operations by 2050. This aligns with the company's mission to attract next-generation talent. The carbon neutral pledge includes goals of 25% renewable electricity for facilities and 40% alternative fuel for ground vehicles by 2025; 50% reduction in CO2 per package delivered for its global small package operations; and powering 100% of its facilities with renewable electricity and running its air fleet with 30% sustainable aviation fuel by 2035.

Tomé's "people-led" approach builds on a long history of engaged workers at UPS; its employees and retirees own Class A stock, which entitles them to 10 votes per share versus Class B (public stock) at one vote per share, giving employees and retirees disproportionate say in voting matters.

Rideshare Moving Ahead of Peers on Labor

The pandemic has also brought attention to the question of gig worker employment status for companies, including ClearBridge holdings Uber and Lyft. In the U.K., Uber proactively classified its drivers as "workers" ahead of final rulings from the British court system. The worker status in the U.K. is a designation between self-employed and employed status that entitles drivers to minimum wage, holiday pay and in some cases a pension.

ClearBridge has engaged with Uber on labor issues since its IPO, and we have given feedback over that time to the CEO, CFO, Chief Legal Officer and Investor Relations on labor relations as well as strategy and communications. Uber's agreement on this designation is ahead of other competitors in the market and the legal mandate represents a step forward in the company's thinking about labor. The agreement represents a short-term hit to earnings, yet in some ways it places Uber ahead of the market in its ability to balance labor and shareholder interests. Workers benefit from improved conditions, with new contributions amounting to roughly 3% of a driver's earnings, while Uber establishes more certainty on costs and visibility into its regulatory environment and operation conditions in the future.

Continuing to Engage on Important Social Issues

Human capital management is a frequent topic of engagement for ClearBridge with our portfolio companies as it touches on a number of related important social issues in our ESG framework, such as employee health and safety, recruitment and retention, health care affordability and access, union relations, and diversity and inclusion. Our belief is that strong human capital management practices, while they may entail costs that affect the bottom line, are ultimately a competitive advantage, especially when labor is in short supply. In the long run, having the right workforce in place also drives the top line.