ClearBridge Investments

Large Cap Growth Strategy

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Key Takeaways

- Recent additions of higher-multiple select growth companies have enabled the Strategy to keep pace more effectively during periods when momentum and growth have outperformed.
- Mega cap growth stocks that have traded together and driven benchmark returns over the last several years are starting to see their performance separate, an encouraging sign for us as active managers with a more diversified focus.
- We are vetting new opportunities in areas that exhibit cyclical and secular characteristics through multiple market cycles such as health care and companies supporting the infrastructure enabling electric vehicles.

Market Overview

Stocks delivered their fifth-straight quarter of gains in June, the longest such bull streak since 2017 as ongoing stimulus, easy monetary policy and strong earnings provided support. The S&P 500 Index rose 8.6% in the second quarter and is up 15.3% year to date. Large cap growth stocks resumed market leadership, with the benchmark Russell 1000 Growth Index rising 11.9% to outperform the Russell 1000 Value Index by 670 basis points. Value still leads by 400 bps year to date.

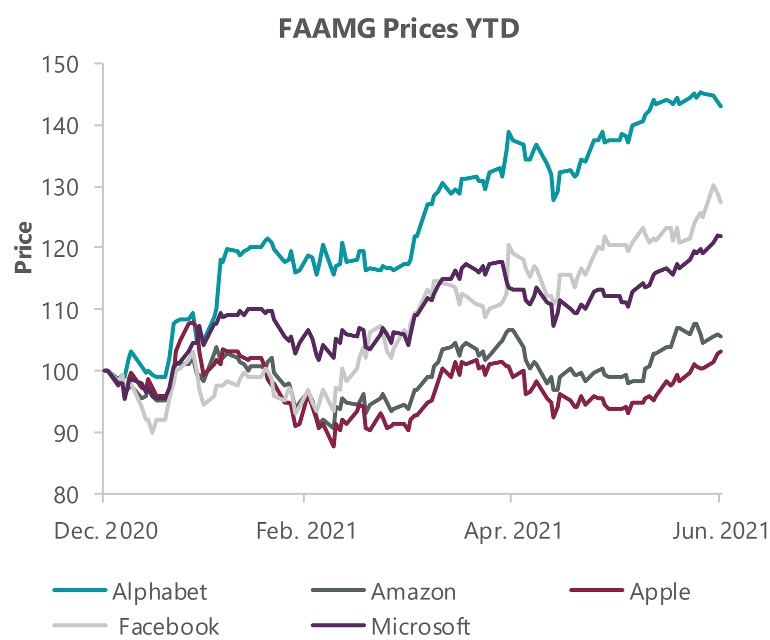
Despite growth's resurgence, market direction was less decisive and participation broader than in the previous two quarters when COVID-19 vaccine approval and the passage of generous fiscal packages offered a strong bid for value and cyclical companies. Growth stocks began to rebound from oversold levels following better than expected first-quarter earnings reports and continued to rise through the rest of the quarter after the Federal Reserve signaled its vigilance in monitoring a recent spike in inflation. Fed Chair Jerome Powell's acknowledgement of the inflation threat and the potential to move up the planned timeline of interest rate increases initially spooked markets. Investors soon became convinced, however, that policymakers won't tolerate runaway inflation and will address the risk progressively rather than wait too long and have to hike rates aggressively. A flattening of the yield curve following Powell's comments also proved beneficial to longer-duration growth assets.

On a sector basis, communication services (+16.2%) was the best performing of the sectors with a meaningful weighting in the Russell 1000 Growth benchmark, while information technology (IT, +13.9%) also outperformed. Health care (+11%) lagged slightly while industrials (+8.7%), consumer discretionary (+7.5%) and consumer staples (+4.1%) underperformed.

Against this backdrop, the ClearBridge Large Cap Growth Strategy slightly lagged the benchmark for the quarter. We are encouraged, however, that recent additions of higher-multiple select growth companies to the portfolio have enabled us to keep pace more effectively during trading periods when momentum and growth have outperformed. Nevertheless, our broader representation across three categories, or buckets of growth companies, acted as a headwind in a quarter where most mega cap growth stocks did well.

The FAAMGs have been treated as something of a monolith over the past several years as they have traded almost as a group. However, looking forward, we believe the market will become more selective and business models will start to separate. We began to see this dispersion pick up in the first half of the year as Alphabet, which we no longer own, and Facebook, where we maintain an overweight position, strongly outperformed the market (Exhibit 1), while Apple and Amazon.com, our other overweight among the mega caps, were not as strong.

Exhibit 1: FAAMG Performance Showing Dispersion



As of June 30, 2021. Source: FactSet.

Ultimately, these businesses are playing for very different things. It is incompatible to simply lump e-commerce with other businesses such as social media, cloud computing and smartphones. Different sectors will face different challenges in terms of regulations and political interference. Indeed, we should not underestimate the potential regulatory burden and political challenges that could face these companies. As it stands, they all have a bullseye on their backs, and have for many years. This time, it is multi-jurisdictional in nature and will likely be dragged out. Such risks will likely cap the multiple that you would want to pay for these opportunities.

We increased our software weighting and reduced the portfolio's underweight to IT in the second quarter.

Facebook saw its antitrust case dismissed by the FTC in late June, an outcome that highlights the challenges regulators face in pursuing these cases. Investors are acutely aware of all the calls for change among the mega caps, but the legal framework around antitrust and privacy laws makes these difficult cases to win. For Facebook, we believe regulatory risk had been overpriced in the stock, while the potential probe into Apple and calls to open up its App Store to outside sellers could be a more material risk.

Portfolio Positioning

Within the portfolio, our semiconductor exposure drove IT performance early in the second quarter, with software taking the reins following Powell's comments on inflation. We increased our software weighting and reduced the portfolio's underweight to IT in the second quarter from 400 bps to about 250 bps with the purchase of UiPath and adds to existing positions in Workday, Atlassian and salesforce.com. To make room and lighten up our exposure to the cyclical semiconductor industry, we sold long-time holding Texas Instruments.

We participated in the IPO of UiPath, a developer of software for robotic process automation that uses AI, natural language processing and design to streamline complex processes across a variety of technology environments. The company is an industry leader with a superior solution for leveraging software to optimize workloads. Organizations around the world are beginning to understand the power of automation, with momentum picking up toward fully automating business processes, a $60 billion market today that could grow to $200 billion or more by 2030. UiPath has a unique pricing model, broad partner ecosystem and thoughtful management team supporting one of the strongest growth profiles in technology. Risks we are watching include a partial cloud transition ahead and increased competition from larger software platforms over time.

As a result of positioning over the last several quarters, the Strategy is more sector agnostic now than it has been in the past, with less dramatic overweights and underweights. One of our largest underweights is in communication services, where we closed a position in Comcast due to a risk of rising competition in the U.S. broadband market impacting the company's core cable segment. There are also a number of regulatory developments ongoing that we think may pose a risk to pricing in the broadband industry. Comcast is still an attractively valued stock but given these risks to our long-term outlook, we see more attractive opportunities elsewhere.

In terms of new opportunities, we're looking at areas that exhibit cyclical and secular characteristics through multiple market cycles such as health care. There are plenty of areas within the sector that will likely avoid any sort of political obstruction and trouble and where companies can steadily grow their top line in the mid-to-high single digits. Add to that buybacks and other capital, and these companies can easily grow earnings in the double digits. Health care is also a sector almost agnostic to market concerns around the direction of interest rates and inflation.

Within health care, we added a new position in Intuitive Surgical, a maker of robotic instruments for soft tissue surgery. The market for such procedures is enormous, including those performed with the aid of the company's DaVinci machines, whose three-dimensional imaging capabilities require smaller incisions, resulting in less nerve damage and bleeding and shorter patient stays. DaVinci machines are a $1 million plus investment by hospitals that can be run continuously through the day, allowing for a greater number of procedures with less physician fatigue. Surgeons are trained on the device from medical school and residency on up. Combining the related training and supply chains, these purchases are very sticky. We see the opportunity for Intuitive Surgical to benefit from more indications for the devices, procedure growth and greater sales in hospitals and surgical centers.

The consumer and pro-cyclical areas of the economy continue to be a portfolio focus and we have seen recent tailwinds from a broadening reopening. Transfer payments, which were a key feature of multiple COVID-19 relief packages, not only kept consumers afloat but also helped improve the overall credit quality. Surprisingly, consumers reacted very differently during this recession. They used a portion of the stimulus windfall to pay down expensive debt as opposed to purely boosting discretionary spending. With restrictions easing, consumers now have the savings and desire to spend. We've already observed the effects of the release of some pent-up demand by way of airline and restaurant reservations. While several of our reopening-related holdings lagged in the second quarter, such robust consumption growth should benefit select consumer-oriented names such as Ulta Beauty, Uber and Disney over the longer market cycle.

Amazon and Home Depot, meanwhile, continue to benefit from consumer shifts to online purchasing and curbside pickup.

One secular consumer trend we are increasingly investing in is electric vehicles (EVs). In addition to owning Aptiv and NXP, leading component suppliers for EVs, we initiated a new position in the second quarter in Eaton, a global manufacturer of electrical, power management and hydraulics components and equipment. Eaton is a critical player in supporting the increasing electrification of the global economy with opportunities in areas ranging from utility generation and distribution infrastructure to EV charging stations, solar power systems and electricity supply for data centers. Eaton has transformed itself over the last decade from a heavy industrial company into a diverse set of businesses levered to the more attractive secular growth of electrification. We anticipate this focus will allow electrical products' revenue to grow in the mid-to-high single digits and support margin improvement.

Outlook

Coming out of this pandemic, some companies did exceedingly well, while others struggled. As earnings start to normalize, we as active managers will have to be more selective and weight our highest conviction ideas accordingly. It is also important to note that last cycle's leaders are rarely the next cycle's leaders. There is an emerging wave of companies going after the market share of established hyperscale cloud services providers and e-commerce platforms. These companies have business models that have been through the ringer and they are quickly learning from past mistakes. Some are even growing well in excess of prevailing market leaders. These names require due diligence, and you'll likely have to squint to understand the business model and future prospects a little better. Indeed, there are opportunities within the tech sector that do not necessarily favor the largest companies.

The issue is how will equities perform as we cycle through a period of lower growth and with less policy support. Our suspicion is that growth stocks might just outperform again, or at least keep up with some of their value counterparts. As growth becomes scarcer, investors will likely pay higher multiples for companies that can continue to post strong growth through the cycle. Just hanging on to entrenched mega cap growth names might not be the best way to outperform over the longer term. Instead, we believe active management is essential to identify the key disruptors of the future.

Portfolio Highlights

The ClearBridge Large Cap Growth Strategy underperformed its Russell 1000 Growth Index benchmark during the second quarter. On an absolute basis, the Strategy had gains across seven of the eight sectors in which it was invested (out of 11 sectors total). The leading contributors to performance were in the IT sector.

On a relative basis, overall stock selection contributed to performance but was offset by negative sector allocation effects. Specifically, stock selection in the communication services and health care sectors, overweights to the consumer discretionary and industrials sectors and an underweight to communication services detracted from results. On the positive side, stock selection in the IT, consumer discretionary and industrials sectors and an underweight to the consumer staples sector contributed to relative performance.

On an individual stock basis, leading contributors to absolute returns in the second quarter included positions in Nvidia, Facebook, Amazon.com, Microsoft and Adobe. Uber, Walt Disney, Booking Holdings, Ecolab and Workday were the primary detractors on an absolute basis.