ClearBridge Investments

Large Cap Growth ESG 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.
- 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.
- 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.

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

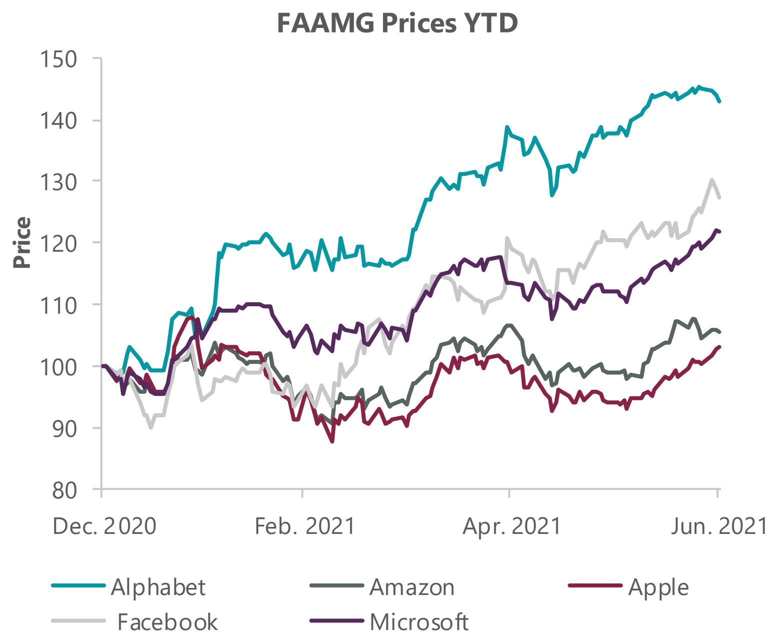
curve following Powell's comments also proved beneficial to longer-duration growth assets.

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 ESG Strategy 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.

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 with the purchase of UiPath and adds to existing positions in Atlassian and salesforce.com. To make room and lighten up our exposure to the cyclical semiconductor industry, we sold long-time holding Texas Instruments.

UiPath is 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 DexCom, a medical device maker of continuous glucose monitoring (CGM) systems for diabetes patients. DexCom has best-in-class technology and leading share in the core Type 1 diabetes U.S. market and expansion opportunities in Type 2 diabetes and non-U.S. markets, areas with low CGM penetration. The company's CGM technology aims to improve clinical outcomes and reduce medical costs for diabetes patients. We believe DexCom can deliver upside to consensus revenue estimates for the next couple of years, driven by the launch of its next generation G7 product, easing COVID headwinds and diminishing pricing headwinds. Risks to our thesis include pricing pressures and timing of a new product launch by its main CGM competitor and slowing international sales.

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 ESG 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 and sector allocation detracted from performance. Specifically, stock selection in the communication services and health care sectors, an overweight to the industrials sector and an underweight to communication

services detracted from results. On the positive side, stock selection in the consumer discretionary and IT 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, Ecolab, Workday and Amgen were the primary detractors on an absolute basis.

In addition to the transactions mentioned above, we added a position in Sea Limited in the communication services sector.

ESG Outlook: 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

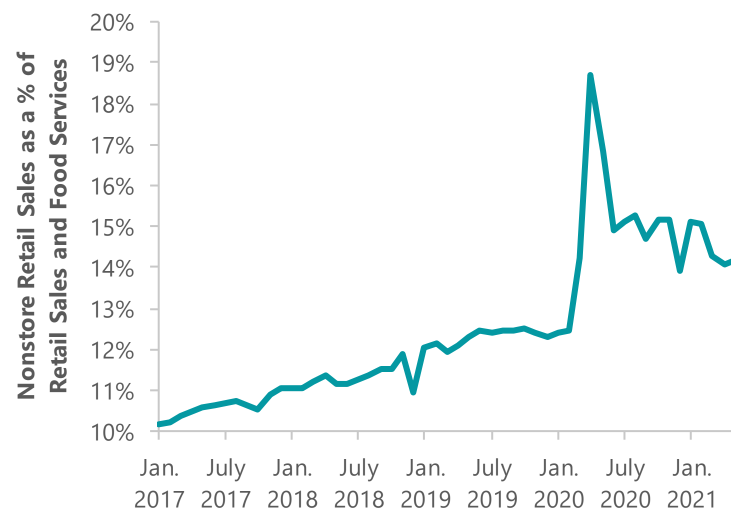
The pandemic has created challenges for businesses large and small; one major challenge for large essential retailers such as ClearBridge holdings Home Depot, Walmart and Costco has been ensuring adequate staffing to meet demand under trying conditions. All three instituted enhanced pay practices during 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 2).

Exhibit 2: 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.

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.

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