ClearBridge Investments

Mid Cap Strategy

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Key Takeaways

- The Strategy took a pause as some of our best performing stocks over the last several quarters lagged in a strong up market.
- We remained active in seeding the portfolio, adding five new positions while exiting three others.
- Pricing power is a key metric we are assessing among our portfolio holdings as we believe inflation is a more serious threat than policymakers are willing to admit. That said, we like our positioning for a period of rising inflation with companies able to push through price increases above input costs.

Market Overview

Stocks delivered more solid gains in the second quarter as ongoing stimulus, easy monetary policy and strong corporate earnings provided support. The S&P 500 Index rose 8.6% in the quarter while the benchmark Russell Midcap Index advanced 7.5%. Market leadership shifted back to growth after a strong run for value with the Russell Midcap Growth Index rising 11.1% to outperform the Russell Midcap Value Index by 540 basis points. Value still leads by 900 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. A flattening of the yield curve following the Fed's comments also proved beneficial to longer-duration growth assets.

From a sector standpoint, energy (+15.3%) was the best performer in the benchmark as crude oil prices rose 25%, followed by health care (+11.3%), real estate (+10.9%) and information technology (IT, +9.2%). The income-oriented utilities (-0.1%) and consumer staples (+1.6%) sectors lagged as did the cyclical industrials (+5.6%), consumer discretionary (+5.8%), and materials (+6.4%) sectors.

Current inflation is partly a function of massive liquidity but also supply chain and employment disruptions caused by COVID.

The ClearBridge Mid Cap Strategy owns a blend of high-quality growth and value stocks built for many types of market environments but trailed the benchmark in the second quarter. We have been active and aggressive in shifting the portfolio over the last 18 months, activity that has been beneficial for most of the span. The portfolio took a pause in the second quarter as some of our best performing stocks over the last several quarters underperformed in a strong up market.

Stocks that took a breather included Performance Food Group, which declined on negative sentiment toward its planned acquisition of convenience store distributor Core-Mark, as well as Hartford Financial, which received an unsolicited bid for the company, and traded off when the deal didn't come through. A lot of these corporate actions are near-term performance headwinds but we believe are positive moves for the long term. The Strategy also saw some give back among banks such as Western Alliance Bancorp as the yield curve flattened and recent strong performers ON Semiconductor and Casey's General Stores.

Portfolio Positioning

We remain active in positioning the portfolio and continue to find good opportunities in new positions like ATS Automation Tooling Systems, a Canadian company that integrates automation equipment in many levels of manufacturing supply chain in such industries as health care, food and beverage, as well as lithium battery production. The more complex the manufacturing process, the more efficiency ATS systems can add. New purchase Sensient Technologies, in the materials sector, also serves the food, as well as cosmetics and personal care, markets as a supplier of flavors, colors and additives. As demand for natural and more healthy consumer products increases, Sensient should benefit.

Endeavor Group, in the communication services sector, was the largest new addition in the second quarter. Endeavor own sports leagues like UFC and Professional Bull Riders as well as leading sports agency IMG and its IMG Academy. Streaming companies are hungry for content and rights prices for programming owned by Endeavor are rising. Endeavor, as a representative to many of the world's most well-known athletes, should also benefit from soaring sports salaries.

Purple Innovation, in the consumer discretionary sector, adds to innovative, high-growth exposure. The mattress maker operates a direct-to-consumer business that has taken off due to its superior marketing technology and the quality of its internally manufactured, unique, purple-colored "hyper-elastic polymer" products.

We also closed three positions during the quarter, taking profits in semiconductor equipment supplier Lam Research as it grew out of our market cap range as well as life science diagnostic products maker Bio-Rad Laboratories as it reached our assessment of fair value. Concerns about slowing growth and pricing power, meanwhile, caused us to exit Reynolds Consumer Products.

Outlook

Pricing power is one of the key fundamentals we are currently assessing among our portfolio holdings as we believe inflation is a more serious threat than policymakers are willing to admit. The CEOs we engage with every day mention higher inflation as a key concern going forward. When inflation spikes, investors find out quickly who has legitimate pricing power to offset rising raw material and transport costs. The U.S. has not seen real inflation in 40 years, and we are also closely monitoring consumer behavior and how they will react to rising prices.

Current inflation is partly a function of massive liquidity but also the global supply chain and employment disruptions caused by COVID. With goods like semiconductors for autos and other high-end applications scarce and manufacturers struggling to bring on labor and capacity, the natural response is to raise prices to capture as much value as possible. We also like our positioning for a period of rising inflation with companies like Casey's, Waste Connections and Masonite who are able to maintain strong pricing power and push through price increases above input costs.

As bottom-up active managers, we are looking forward to a time in the second half of this year or into 2022 when the COVID-19 narrative fades away and fundamentals begin to matter more. Corporate earnings have been outstanding since the early stages of the recovery, but we expect to see a separation of high-quality franchises driven by strong execution and sound balance sheets from lower-quality companies as stimulus measures fade and liquidity returns to more normal levels.

Despite recent performance headwinds, we will continue to manage a diversified portfolio of high return growth companies and more value-oriented names with visible paths to improvement with the potential to be successful in a normalizing market and macro environment.

Portfolio Highlights

The ClearBridge Mid Cap Strategy underperformed its Russell Midcap Index during the second quarter. On an absolute basis, the Strategy had gains across eight of the 11 sectors in which it was invested during the quarter. The leading contributors were the information technology (IT), industrials and health care sectors while consumer staples was the primary detractor.

On a relative basis, overall stock selection and sector allocation detracted from performance. Specifically, stock selection in the consumer staples, financials, materials, energy and consumer discretionary sectors and an underweight to the real estate sector hurt results. On the positive side, stock selection in the health care and industrials sectors contributed to relative returns.

On an individual stock basis, the biggest contributors to absolute returns in the second quarter were Vertiv, Avantor, Aptiv, Syneos Health and Marvell Technology. The largest detractors from absolute returns were Performance Food Group, Casey's General Stores, Hartford Financial, ON Semiconductor and Regal Beloit.

In addition to the transactions listed above, we initiated a position in Molina Healthcare in the health care sector.