ClearBridge Investments

Multi Cap Growth Strategy

Evan Bauman
Managing Director,
Portfolio Manager

Richard Freeman
Managing Director,
Portfolio Manager

Aram Green
Managing Director,
Portfolio Manager

Key Takeaways

- Providing more formalized structure around the Strategy's portfolio construction approach should enable us to better identify and prioritize investment opportunities across a spectrum of growth.
- We anticipate increasing exposure to disruptive companies early on in their lifecycle with long runways for growth ahead, while balancing these high-growth stocks with allocations to durable compounders, cyclical growers and improving growth stories.
- FDA approval of longtime holding Biogen's Alzheimer's treatment demonstrates the potential of innovation in the health care sector to generate long-term growth and attractive returns for shareholders. We expect to maintain overweights to such areas of rapid innovation.

Strategy Overview

The ClearBridge Multi Cap Growth Strategy has delivered long-term value to shareholders by applying a high-conviction, high active share approach to growth investing. We seek to purchase, early in their growth trajectory, attractively priced companies capable of compounding free cash flow and earnings over long time periods. The dynamic nature of markets causes us to constantly evaluate the opportunities we see among growth stocks and evolve our perspective and portfolio construction process to take advantage.

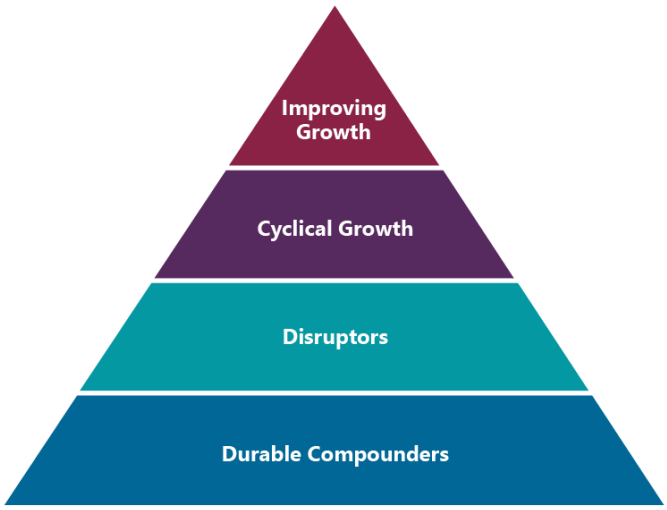
Similar to when Evan Bauman joined Richie Freeman on the team in 2000, the recent addition of Portfolio Manager Aram Green provides a chance to remind clients about our investment philosophy, our expectations for the portfolio, and the changes we envision to position the portfolio for continued success.

We have learned many lessons over our tenure managing the Multi Cap Growth Strategy, one being that different types of growth stocks perform well in different market and economic regimes. The success of the Strategy is more than a series of returns from individual companies. We believe how the companies we own fit together in the portfolio is just as important in seeking to generate consistent, long-term results and helps to inform investor expectations and outcomes.

Portfolio Positioning

A good way to conceptualize how we think about portfolio construction is to picture a pyramid. At the bottom of the pyramid are the durable compounding growth companies that form the strong foundation, resilience and consistency for the Strategy. We think these companies should comprise just under half of portfolio assets and feature annual revenue growth rates ranging from two times GDP up to 20% as well as healthy free cash flow generation.

Exhibit 1: Pyramid of Growth Opportunities



Source: ClearBridge Investments.

UnitedHealth Group, is a good example of a long-term compounder, having grown its revenue base to north of $260 billion over time. It remains constantly focused on investing in new growth drivers such as telemedicine and health care analytics. Broadcom and Comcast have delivered similar long-term appreciation through a combination of organic growth, capital deployment into new and adjacent opportunities through merger and acquisition activity as well as returning capital to shareholders through buybacks and dividends.

Building on this base are disruptors: companies generating rapid growth in revenues (20%+) through highly innovative business models disrupting existing markets or creating new ones. While near-term multiples of disruptors can be significantly higher than existing portfolio holdings, we remain sensitive to valuations and evaluate these companies in the context of the large unaddressed markets they are targeting. We believe the superior products and services offered by disruptive companies have the potential to drive sustained growth and, as their business models scale, generate strong profitability, which justifies higher current multiples.

We are re-emphasizing the Strategy's original focus on being early in identifying and participating in the growth of innovative businesses.

We expect rapidly growing disruptors will comprise roughly a quarter of portfolio assets over time and repositioning over the next several quarters will focus on increasing our allocation to these stocks. Our objective with disruptors is to purchase companies early in the development of their market opportunity. DocuSign, a new purchase in the first quarter that we added to significantly over the last three months, is a company we have been following since it was private. Although the growth of its e-signature business accelerated during COVID-19 lockdowns, DocuSign is targeting additional markets in today's anywhere economy and its strong recent results eased fears that the company was simply a pandemic beneficiary.

We also added to our disruptors exposure in the second quarter with the purchase of Lyft, a leading, U.S. focused ride-hailing business. Lyft operates in a rational duopoly with Uber and has been able to maintain consistent 30%–35% market share for the past several years. The company should be a key beneficiary of the U.S. reopening, with a post-COVID-19 recovery in rideshare demand driving an acceleration in volumes and revenue. We also see considerable runway for growth beyond this rebound, as rideshare remains underpenetrated. Lyft's ability to weather a period of significant demand destruction in 2020 is encouraging and we see opportunity for margin expansion ahead. Despite volatility created by ongoing labor negotiations, we see the potential for new, state-level legislation creating collective bargaining rights for gig economy workers to provide greater certainty around industry labor costs, with increases that should be manageable.

The remainder of the portfolio includes existing holdings that we consider cyclical or improving growth companies. Our cyclical technology holdings, such as digital storage providers Seagate Technology and Western Digital, as well as most companies in the energy, industrials and materials sector fall into the cyclical growth segment. The Multi Cap Growth Strategy has always taken a more concentrated approach and we anticipate being more opportunistic around these holdings in the wake of cycle ebbs and flows. NOV Inc., which we exited this quarter, is a good example of acting to take profits on the cyclical rebound in oil.

In general, improving growth companies are taking specific actions to enhance their growth profiles going forward, whether through a restructuring, business model change, new management team or more productive use of assets. Some of the Strategy's communication services holdings, such as Discovery, which is in the process of combining with WarnerMedia and transitioning its business from linear to direct to consumer delivery through streaming, fall into this bucket. Another recent example is Nuance Communications, which was simplified and reorganized under new leadership in 2018 and subsequently

acquired by Microsoft for a significant premium this quarter. This continues the Strategy's long track record of positioning successfully to benefit from consolidation, with more than 80 companies having been acquired since inception.

Not every portfolio company will neatly fit into one of these four growth segments and some may move from one to another over time. Social media platform Twitter could be considered an improving growth story due to the initiatives put in place to grow and better monetize its user base. With the global return of live events and sports causing a rebound in advertising, combined with other new services beginning to thrive, this is a company with the fundamentals to be categorized as a disruptor.

Outlook

As we look ahead, in addition to rotating some of the portfolio into faster growing disruptors, we also see opportunity to widen out the portfolio's industry weightings. In particular, we are looking at consumer-oriented companies tied to e-commerce and enterprise technology spending, where we currently have more limited exposure. Likewise, even within sectors where we have established overweights, we see room to broaden out into underrepresented subsectors.

We initiated a position in Match Group in the quarter, the leading provider of dating products globally with 50%+ share of global online dating users. While this increases our overweight to the communication services sector, it adds indirect exposure to the consumer and diversifies the portfolio at the subsector level with an interactive media and service company, versus our historical overweight within traditional media. We see Match as a disruptor in the large, relatively underpenetrated market for online dating (there are 620 million global singles between 18 and 65, excluding China, versus the company's 10 million paying subscribers today), and believe the company is well-positioned to benefit from a post-COVID-19 return to normalcy. We are also attracted to Match's strong profitability profile and high degree of visibility given a large portion of revenue is subscription based.

Health care has been a significant part of the Strategy since inception and we plan to maintain meaningful exposure to the sector. Within the growth pyramid, our health care holdings include disruptors like Guardant Health, a provider of advanced diagnostic testing for cancer, as well as more established, durable compounders like Vertex Pharmaceuticals, a leader in the treatment of cystic fibrosis. Biogen saw its long-term investment in research and development pay off again in June with FDA approval of experimental Alzheimer's treatment Aduhelm. Aduhelm became the first drug approved for Alzheimer's in 20 years and the first approved to treat the underlying

pathophysiology of the disease. We believe the rerating of Biogen shares following the decision validates the potential of innovation in the biopharmaceutical industry to be monetized.

The approval of Aduhelm should be broadly supportive of biotechnology and pharmaceutical stocks as it signals the agency's willingness to be flexible and set new precedents to make drugs available to patients in therapeutic areas where the unmet need is significant. And it confirms our confidence that scientific breakthroughs in the industry can support long-term growth. That said, we also see opportunity among other types of disruptive health care companies, such as tools, labs, diagnostics and other related health care services companies.

As market breadth continues to expand after a multiyear period of mega cap leadership, we are as excited as ever about the opportunities before us as high active share investors. We will continue to manage the Multi Cap Growth Strategy as long-term business owners while re-emphasizing its original focus on being early in identifying and participating in the growth of innovative businesses.

Portfolio Highlights

The ClearBridge Multi Cap Growth Strategy underperformed its Russell 3000 Growth Index benchmark in the second quarter. On an absolute basis, the Strategy generated gains across the seven sectors in which it was invested (out of 11 sectors total). The primary contributor to performance was the information technology (IT) sector.

Relative to the benchmark, overall stock selection detracted from performance. In particular, stock selection in the IT, communication services and health care sectors hurt results. On the positive side, stock selection in the materials and industrials sectors, an overweight to communication services and an underweight to the consumer discretionary sector contributed to relative performance.

On an individual stock basis, positions in Biogen, Seagate Technology, UnitedHealth Group, Twitter and DocuSign were the leading contributors to absolute returns during the period. The primary detractors were Discovery, Guardant Health, Citrix Systems, Vertex Pharmaceuticals and Cree.