ClearBridge Investments

Select Strategy

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Key Takeaways

- The Strategy outperformed in a second-quarter rotation into growth stocks, fueled by a comeback in the higher growth disruptors we have owned for a number of years.
- We took advantage of attractive entry points and a robust new issue market to increase our exposure to disruptors, participating in several IPOs and a private placement in companies using technology to increase efficiency across industries.
- Over the last year, the market has overlooked what we view as compelling opportunities among steady compounders, an area where we are looking to add more exposure.

Market Overview

Growth stocks reasserted themselves in the second quarter after an accelerated run for cyclicals post the COVID-19 vaccine approvals. Performance was particularly strong among larger cap growth companies, many of which had moved sideways since an initial performance spike in the early days of the pandemic. The S&P 500 Index rose 8.6% for the quarter while the benchmark Russell 3000 Index advanced 8.2%. The Russell 3000 Growth Index gained 11.4%, outperforming its value counterpart by over 600 basis points, but still trails year-to-date by nearly 500 bps. Style dispersion was less pronounced among smaller cap stocks.

The reversionary nature of equity markets is why we focus in the ClearBridge Select Strategy on individual companies we believe are well positioned on their own for the current environment. The Strategy outperformed in the second quarter, fueled by a comeback in the higher growth disruptors we have owned in the portfolio for a number of years. This was reflected by the performance of our holdings in the information technology (IT) sector, where portfolio names gained 20.3% for the quarter compared to 11.4% for the benchmark, as well as in the consumer discretionary sector, where portfolio companies rose 12.8% versus 6.7% for the benchmark.

DocuSign illustrates the above-average secular growth characteristics we seek in disruptors. The company delivered first-quarter results that blew past expectations, quelling fears the e-signature provider was simply a COVID-19 beneficiary that would struggle to beat tougher comparisons. Instead, DocuSign

highlighted new cloud-based functionality covering the full lifecycle of agreements that doubles its addressable market. The company has already made the investments to expand from its initial business of streamlining the signing of contracts to offer business intelligence and analytics that can help companies run their operations more efficiently. We expect revenues from this new market will begin to ramp up in 2022.

The reversionary nature of markets is why we focus on individual companies specifically well positioned for the current environment.

Shopify and Sprout Social, companies that have become go-to platforms for small and medium size businesses (SMBs) engaged in e-commerce and social media marketing, rebounded strongly in the quarter after being caught in the selloff among high-multiple growth names since Vaccine Monday. These and the portfolio's other disruptors had thrived through the first part of the pandemic, leading us to trim positions into strength and reallocate cash into more attractively priced evolving opportunities and steady compounders that had been overly punished by lockdowns and a drop in economic activity. While some of our evolving names continued to perform well in the second quarter as consumers resumed discretionary spending, like Crocs and American Eagle Outfitters, others such as Performance Food Group sold off after surging in prior quarters.

Portfolio Positioning

While the active repositioning we have done since the onset of the pandemic has created good balance in the portfolio, we continue to leverage our research of both public and private markets to identify new investment opportunities. The recent value rotation improved the risk/reward among disruptors and we sold some positions that had either run up in price where the forward looking risk/reward had become more neutral or were facing commodity cost pressures. Using these proceeds to fund new purchases, we added eight new common stock positions not including SPACs as well as two private placements.

The new issue market remains an attractive source of new ideas and we participated in four IPOs in the latest period. Paymentus is a payment company using invoicing in more consumer-friendly channels. The company's services allow a utility to send a customer a text message to connect a bank account and pay their bill. Paymentus is expanding its streamlined payment process to SMBs like gardeners and local merchants. Confluent sells and distributes a commercialized version of open source software called Kafka created by former executives at LinkedIn. The solution allows enterprise users the ability to capture data in real time as it is streaming. A prime use case is capturing real-time inventory across retail stores and distribution centers to enable omni-channel commerce. We believe it is early days in the company's commercialization of this technology which can capture data in both on-premise and hybrid cloud environments. Global-e Online,

meanwhile, removes many of the frictions around cross-border e-commerce by handling the different tax structures, languages, currencies, local logistics and fulfillment/returns for any size retailer. The company's initial customers have been mostly mid to higher end retailers but an investment by Shopify should enable Global-e to significantly increase merchant reach. Private placement purchase Klaviyo also targets the retail industry through a customer data platform that allows businesses to analyze all their customer information to understand what customers they should target, when and with what message.

In addition to these disruptors, we added exposure in evolving opportunities through the IPO of Endeavor Group. Endeavor owns sports leagues like UFC and Pro Bull Riders which should benefit from the return of live events as well as leading sports agency IMG and its IMG Academy training franchise. 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.

The Strategy remained engaged in the SPAC market as well. Most of our recent activity involved selling out of common stock positions in SPACs that announced acquisitions that we either didn't like or where the valuation had become stretched. We held onto the warrants in most of these SPACs to continue to participate in the upside for these newer to market companies.

Other new additions included the repurchase of disruptors Twilio at a lower multiple that provided a good entry point, and Unity Software through an options strategy. Twilio's platform provides developers with the toolkit and building blocks to incorporate capabilities across voice, messaging, video, customer data, email, and additional applications while Unity provides development tools for 3D and virtual reality content on digital devices. Both stocks are up strongly since the trades and we are holding our positions.

Outlook

Heading into the third quarter, opportunities in higher multiple, higher growth stocks like these are becoming more stretched. Disruptors appear to have just gone through what cyclicals experienced in the first quarter; these companies look more attractive just as the upcoming comps begin to get tougher. Cyclicals are now seeing peaking numbers and with inflation also pushing higher, investors are growing concerned that the lower quality recovery trade might not get much better. Another worry is the uneven nature of the global reopening with many regions still struggling with COVID.

We are seeing a lot of cash coming off the sidelines that is keeping the market buoyant. Since November, investors have seesawed

between cyclicals and growth stocks, overlooking what we view as compelling companies in the steady compounder camp. These stocks, like existing holdings SBA Communications and Constellation Brands, and new addition Vertex Pharmaceuticals, are not COVID beneficiaries or cyclicals that had been lapping easier comps and are an area where we are looking to add more exposure.

Portfolio Highlights

The ClearBridge Select Strategy outperformed its Russell 3000 Index benchmark in the second quarter. On an absolute basis, the Strategy had gains across nine of the 10 sectors in which it was invested during the quarter (out of 11 sectors total). The IT, consumer discretionary and health care sectors were the primary contributors to performance.

In relative terms, overall stock selection contributed to performance. Specifically, stock selection in the IT, consumer discretionary and health care sectors were the primary drivers of results. Conversely, stock selection in the consumer staples sector and an overweight to industrials detracted from results.

On an individual stock basis, the largest contributors to absolute returns during the second quarter were DocuSign, Surgery Partners, Shopify, Crocs and Fortinet. Performance Food Group, Ultragenyx Pharmaceutical, Compass, Uber and Teladoc Health were the greatest individual detractors from absolute returns.

In addition to the transactions mentioned earlier, the Strategy initiated positions in Compass in the real estate sector, SPACs SVF Investment, Altimeter Growth and Edify Acquisition and participated in a private placement for Caris Life Sciences in the health care sector. We also closed positions in Alibaba and DoorDash in the consumer discretionary sector, Shift Technologies, Cornerstone Ondemand and JFrog in the IT sector, Bio-Rad Laboratories and SmileDirectClub in the health care sector, Vital Farms in the consumer staples sector as well as Array Technologies and Tennant in the industrials sector.