ClearBridge Investments

All Cap Growth Strategy

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Key Takeaways

- Higher yields as well as uncertainty over inflation, supply chain constraints and the passage of an infrastructure bill have sparked the type of volatility that we as active managers can leverage.
- We want to maintain mega cap growth exposure to participate in the burgeoning cloud and digital services markets but are sizing our positions in relation to valuations and growth rates.
- As economic growth slows and earnings start to normalize, we are gravitating to companies with competitively advantaged businesses in growing end markets and those where we see a multiyear improvement story.

Market Overview and Outlook

Volatility rose to close the third quarter as the spread of the COVID-19 Delta variant, troublesome inflation signs and a subsequent jump in yields pressured U.S. equities, which delivered mixed results. The S&P 500 Index fell sharply in September but managed to eke out a gain of 0.58% for the quarter while smaller cap and value stocks suffered losses for the full three months. The benchmark Russell 3000 Growth Index rose 0.69% as investors returned to the relative safety of mega cap growth stocks, outperforming the Russell 3000 Value Index by 162 basis points. Value continues to lead year-to-date and over the last 12 months, reflecting the tremendous amount of stimulus still working its way through the U.S. economy.

Much of the recent +30 bps move in the 10-year U.S. Treasury comes on the heels of comments from the Federal Reserve that it will start to taper bond purchases as early as November and begin to raise interest rates in 2022. This more aggressive messaging on tightening comes amid what we consider a fully priced market, peak earnings and peak economic growth that have been supported since the outbreak of COVID-19 by historic fiscal and monetary support. Meanwhile, companies are struggling with global supply chain disruptions and labor cost pressures as well as shortages. Combine these forces and higher volatility is not surprising.

On a sector basis, communication services (+1.88%) and information technology (IT, +1.70%) were the best performers in the benchmark among sectors owned in the Strategy while the health care (+0.61%) sector performed in line with the benchmark. The cyclical industrials (-5.14%) and materials (-3.67%) sectors suffered the worst losses while the consumer discretionary (-0.23%) and consumer staples (+0.01%) sectors also lagged.

The ClearBridge All Cap Growth Strategy trailed the benchmark for the third quarter, hurt by our lower exposure to the FAAMGs in a period where our three underweights to the group — Google (no exposure), Microsoft and Apple — outperformed as well as weakness in several of our health care positions. Our structural underweight to this mega cap group is less about a bear case on any of the companies and more about maintaining diversification in the portfolio.

While the resumption of FAAMG leadership that started midway through the second quarter has been a headwind, the recent backup in bond yields as well as macro uncertainty over inflation, supply chain constraints and the passage of an infrastructure bill have sparked the type of volatility that we as active managers can leverage. The evolution of our portfolio construction process has led us to become more tactical and opportunistic in seeding the portfolio with a broader set of disruptive companies early on in their business lifecycle with long runways for growth ahead.

Portfolio Positioning

We continued to add exposure to the disruptive growth category and broaden out the portfolio's industry weightings in the third quarter with the purchase of HubSpot (HUBS), a leading provider of customer relationship management software-as-a-service (CRM SaaS) for small and mid-market businesses (SMB). With 121,000 customers today vs. the roughly 3 million companies in North America and Europe with between 10 and 2,000 employees, we believe HUBS is still considerably underpenetrated relative to its addressable market. In addition to increasing its product breadth, we also see significant room for growth within the company's existing installed base. Furthermore, we believe HUBS is well-positioned to benefit from accelerated digital transformation efforts and an improved economic environment for its customers. Though management is investing heavily, we are encouraged that the business is free cash flow positive and see a significant runway for future operating leverage. The company's focus on the SMB space makes them less susceptible to competition from large enterprise vendors. Likewise, while some of HUBS' customers required relief in the recent macro downturn, we were encouraged the business was more resilient than feared.

Within the broader digital services space, we initiated a position in Netflix where we believe the risk/reward is compelling after the stock traded sideways over the last year due to muted recent subscriber growth resulting from COVID-19-related content production delays. Netflix operates a high-quality subscription business with room for continued growth in a large addressable market. We believe Netflix has a strategic advantage in scaling its business given its large content library and lead versus peers in establishing local content studios and partnerships. The company is also entering the video game market with a focus on mobile games, which could open up new growth opportunities and lower subscriber churn over time. Despite still-heavy content investments, Netflix was free cash flow positive in 2020 and is expected to grow free cash flows in 2022 and beyond. In addition, its progress on margin expansion remains underappreciated.

We have also been looking for multiyear secular trends outside of the IT and Internet sectors to help us maintain a portfolio that can perform well in markets with varied sector or factor leadership. In particular, electrification of the global economy and the transition to electric vehicles (EVs) are areas where we continue to add exposure. We are investing in the brains behind EVs through NXP in the control center, Wolfspeed for power management and Aptiv for safety features. Global rideshare leader Uber will also be a key player in the transition from internal combustion engines to EVs. We extended our exposure to electricity infrastructure critical to power EVs with the purchase of Eaton, a manufacturer of power management products for a variety of end markets. We believe upgrading the power grid to be more resilient and capable of handling the increasing needs of EVs through the two-way flow of electricity is a decade-long trend. For the U.S. and Europe to meet aggressive EV production goals, existing EV infrastructure must be upgraded to enable home and commercial car charging much more broadly. Eaton has 30% share of the equipment needed to satisfy many of these residential and commercial upgrades. The passage of an infrastructure bill would add to this trend.

To make room for our new positions and better concentrate the Strategy in our highest-conviction names, we exited nine positions during the quarter. These included software maker VMware, which is in the earlier stages of an on-premise to cloud transition that could add volatility to growth and cash flow in coming years. At the same time, the company also recently announced several key leadership changes and will have higher financial leverage following the upcoming spinoff from Dell — expected in the fourth quarter. We exited Amgen after the biotechnology company endured several pipeline setbacks recently, including a slow transition of its Lumakras treatment into first-line lung cancer, a slower than expected development of its treatment for myeloma as well as the company's asthma

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treatment Tezepelumab missing its primary endpoint in a Phase III study. We also closed a position in steel maker Nucor after the shares had more than doubled over the last year as a direct participant in the recovery of the U.S. economy and rebound in industrial activity.

Innovation within the health care sector has long been an area of focus in the Strategy and we plan to maintain a meaningful overweight to the sector. That said, we expect this will be reflected in more diversified exposures beyond therapeutics companies. Some of the emerging areas of interest include diagnostics, life science tools, labs and medical devices, where we own liquid biopsy leader Guardant Health and eyecare device maker Alcon and are vetting potential new positions.

Outlook

The distortions of the economy and capital markets wrought by the extraordinary global policy response to COVID-19 have lessened over the last 18 months but have yet to fully run their course. And after a first-half growth surge as the U.S. reopened, GDP estimates are being revised lower and inflation is moving from a transitory concern into a longer-term risk. Monetary policy is slowly creeping toward normalcy, but we expect it will still be several quarters before company fundamentals rather than the availability of liquidity drive the multiples and performance of the growth companies we target.

Given the many uncertainties facing investors in the current environment, we would not be surprised to see continued volatility going forward. Regardless of whether market leadership broadens again from the mega cap growth names, we expect to be opportunistic during market and short-term stock dislocations to continue to seed the portfolio with attractive growth businesses that can thrive regardless of investor flows or general sentiment. As growth becomes scarcer and earnings start to normalize, we are gravitating to companies that can continue to post strong results through the cycle. Active management is essential to take advantage of volatility to create attractive entry points in competitively advantaged businesses in growing end markets and those where we see a multiyear improvement story.

Portfolio Highlights

The ClearBridge All Cap Growth Strategy underperformed its Russell 3000 Growth Index benchmark during the third quarter. On an absolute basis, the Strategy had losses across seven of the eight sectors in which it was invested (out of 11 sectors total). The lone contributor was the materials sector while the primary detractors from performance were in the communication services, health care and consumer discretionary sectors.

On a relative basis, overall stock selection and sector allocation detracted from performance. Specifically, stock selection in the communication services, health care, IT and consumer discretionary sectors hurt results. On the positive side, stock selection in the materials sector contributed to relative performance.

On an individual stock basis, leading contributors to absolute returns in the third quarter included positions in Atlassian, Palo Alto Networks, Salesforce.com, Thermo Fisher Scientific and Microsoft. Biogen, Twitter, Amazon.com, Western Digital and Vertex Pharmaceuticals were the primary detractors on an absolute basis.

In addition to the transactions mentioned above, we closed positions in Nuance Communications in the IT sector, Freeport-McMoRan in the materials sector, Raytheon Technologies and L3Harris Technologies in the industrials sector, Alibaba in the consumer discretionary sector and Zoetis in the health care sector.