ClearBridge Investments

Appreciation ESG Strategy

Scott Glasser
Managing Director, Chief Investment Officer, Portfolio Manager

Michael Kagan
Managing Director, Portfolio Manager

Mary Jane McQuillen
Managing Director, Head of ESG Investment, Portfolio Manager

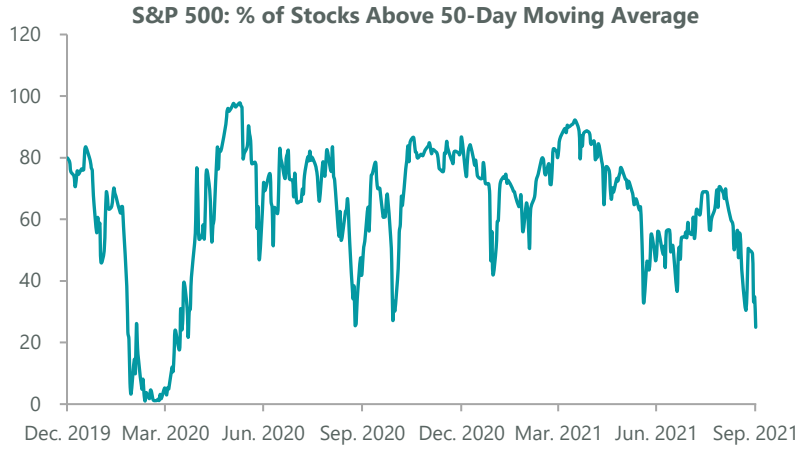
Key Takeaways

- For the first time since the 1970s, cost-push inflation seems widespread and persistent enough to materially lift inflation expectations; COVID-19 disrupted the system of tight, just-in-time inventories.
- Deteriorating breadth throughout the third quarter has provided a handful of idiosyncratic opportunities to initiate and build positions with attractive long-term prospects.
- Public equities are moving the needle on the four goals of COP26 and ClearBridge is spurring and guiding this activity through our role as large shareholder, fiduciary and trusted partner in advising on sustainable business practices.

Market Overview

The market hit a new high and rose 0.58% during the third quarter of 2021, marking the sixth consecutive quarterly increase and the index's longest quarterly winning streak since 2017. However, the market swooned -4.65% in September due to the apparent bankruptcy of China's largest property company, Evergrande, and fears of rising inflation. Market breadth, as measured by the number of stocks above their 50-day moving average, has deteriorated since April, suggesting risk of further market declines (Exhibit 1).

Exhibit 1: Market Breadth Has Deteriorated Since April



As of Sept. 30, 2021. Source: Bloomberg Finance L.P., ClearBridge Investments.

Financials — led by banks — was the S&P 500's best-performing sector in the third quarter as investors began to embrace the possibility of higher interest rates driven by expectations the Fed will taper extraordinary monetary policy accommodation. Financials haven't led the S&P 500 in a quarter since the second quarter of 2019 (when the federal-funds rate was 2.50%). Industrials were the worst-performing sector in the quarter as freight/logistics stocks and railroads were hit especially hard by input costs and volume bottlenecks. Materials were also a notable laggard as steel and copper miners pared back after a strong run. Several specialty chemicals companies warned of earnings pressure from higher raw materials. Of note, energy had a wild intra-quarter swing. At the end of August energy sector underperformance versus the index was over 15 percentage points, but a powerful run in September left the sector only two percentage points behind the index for the quarter. No doubt, energy's performance was driven by the roller coaster ride in the oil market. The price of a barrel of oil went from $75 down to $62 and back to $75 within the 90 days.

As we enter the final quarter of 2021, our wall of worry has grown as second-derivative headwinds abound. Expectations for U.S. GDP growth are being revised downward as supply bottlenecks crimp output across the economy; rising costs on everything from gasoline to groceries are hitting disposable incomes; rising wages and input costs are paring corporate profit margins; extraordinary monetary policy is likely to taper soon; and corporate taxes seem poised to rise.

For the first time since the 1970s, cost-push inflation seems widespread and persistent enough to materially lift inflation expectations. COVID-19 disrupted the system of tight, just-in-time inventories. A dearth of shipping containers in China and surpluses in the West, caused by the U.S.'s tariff battle with China, compounded the problem. China's desire to reduce heavy industry pollution reduced exports of steel and aluminum and drove steel to record prices and aluminum to 14-year highs. The world underinvested in traditional energy starting in 2017, but new renewables sources have not come online fast enough to fill the supply gap. The U.S. has ample jobs available, but workers lack the necessary skills and live in the wrong places. Wages are up from $8/hour to just under $15/hour at major retailers in the last five years. There is a lot of discussion of stagflation in the market, but this seems wrong to us. Demand is strong — too strong — while supply is held back by temporary issues that will ease as we emerge from COVID-19. The Federal Reserve is looking for 2% inflation. We think it will exceed that, probably for several years.

Meanwhile, the outlook in China — and its impact on global growth — is a mystery. President Xi's "common prosperity"

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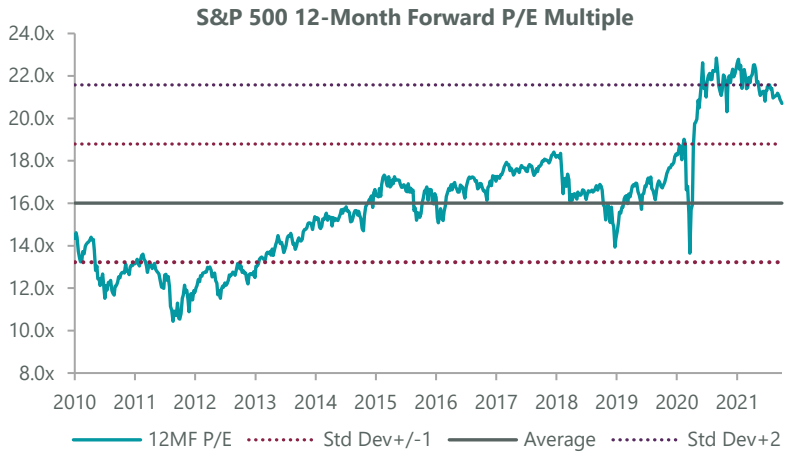
platform threatens to disrupt its technology industry. Chinese debt as a percentage of GDP exploded from 80% in 2008 to 400% now. Evergrande, the largest Chinese property company, is functionally bankrupt. Another Chinese real estate company, Fantasia, is in default and three other large companies saw their bond prices collapse. A quarter of the Chinese economy is real estate. Individuals have much of their wealth invested in it. Chinese bankruptcy laws are different than the West's and they will intervene in markets in a way that Western governments will not. But the hangover from the orgy of debt creation is likely to be significantly lower growth during the next several years.

Given the concerns detailed above, it might come as a surprise that the S&P 500's valuation remains nearly two standard deviations above historical average (Exhibit 2). As discussed in our second-quarter letter, we believe the broad market is being supported by unprecedented positive EPS revisions. To wit, the S&P 500's 2021 consensus EPS forecast is +23% since July 2020 versus the average historical estimate revision of -4.7% (consensus tends to overestimate future earnings and revise downward as a year progresses). However, September represented the first negative revision to 2021 and 2022 EPS expectations since the year began, which makes third-quarter earnings and 2022 outlooks of critical importance. We would view a return to historically average EPS revision patterns as a market headwind given currently stretched valuations.

Exhibit 2: S&P 500 Valuation Multiples Are Stretched



As of Sept. 30, 2021. Source: Bloomberg Finance L.P., ClearBridge Investments.

A market with valuations near all-time highs makes it challenging for us to find stocks to buy. However, deteriorating breadth throughout the third quarter has provided a handful of idiosyncratic opportunities to initiate and build positions with attractive risk/reward prospects. Banks are likely to benefit from a strong economy, low default rates and higher interest rates. We believe there are pockets within the technology sector at

reasonable valuations that will benefit from a return to the office. However, we would be wary of semiconductors, given glimmers of supply shortages easing. We are also optimistic the third quarter's soft patch in volumes for railroad companies is an opportunity for the patient investor as bottlenecks ease. We believe commodity cost concerns at specific coatings and specialty chemical companies will be offset by price increases in the first half of 2022, providing an opportunity for margin-driven outperformance. Finally, we view housing and housing-exposed enterprises as having a longer tail than investors appreciate as we work off a decade of below-trend household formation and folks incrementally migrate away from cities.

Outlook

Our outlook is essentially unchanged from last quarter. We remain at a crossroad uncertain whether low rates and peaking growth will drive a narrow market led by secular, growth-oriented stocks; whether economic momentum and reduced Fed accommodation will drive outperformance from cyclical and interest-rate-sensitive stocks; or whether Fed policy will truncate the expansion and usher in a bear market. We believe the latter two scenarios are more likely from here and believe the Appreciation ESG Strategy is well-positioned should our forecast materialize. The former environment — a narrow, tech-driven market — would continue to be more challenging for our Strategy.

Although risks have heightened, we remain constructive on the outlook for economic growth and believe businesses levered to improved economic activity have on average a better risk/reward than the mega cap secular growth companies. This is especially true if inflationary pressures linger longer than investors expect. We remain focused on high-quality earnings compounders with quality balance sheets and durable competitive advantages that we believe will protect investor downside.

Portfolio Highlights

The ClearBridge Appreciation ESG Strategy had a positive return during the third quarter of 2021, underperforming the Strategy's benchmark.

On an absolute basis, the Strategy had gains in five of 11 sectors in which it was invested during the quarter. The main contributors to the Strategy's performance were the information technology (IT), consumer staples and health care sectors. The materials, industrials and communication services sectors were the main laggards.

In relative terms, the Strategy underperformed its benchmark due primarily to stock selection. In particular, stock selection in the

communication services and consumer discretionary sectors and an overweight to the materials sector weighed the most on relative performance. Conversely, stock selection in the consumer staples sector proved beneficial.

On an individual stock basis, the biggest contributors to absolute returns during the quarter included positions in Costco, Microsoft, Thermo Fisher Scientific, Apple and JPMorgan Chase. The greatest detractors from absolute returns were positions in PPG Industries, Pinterest, United Parcel Service, Amazon.com and Air Products and Chemicals.

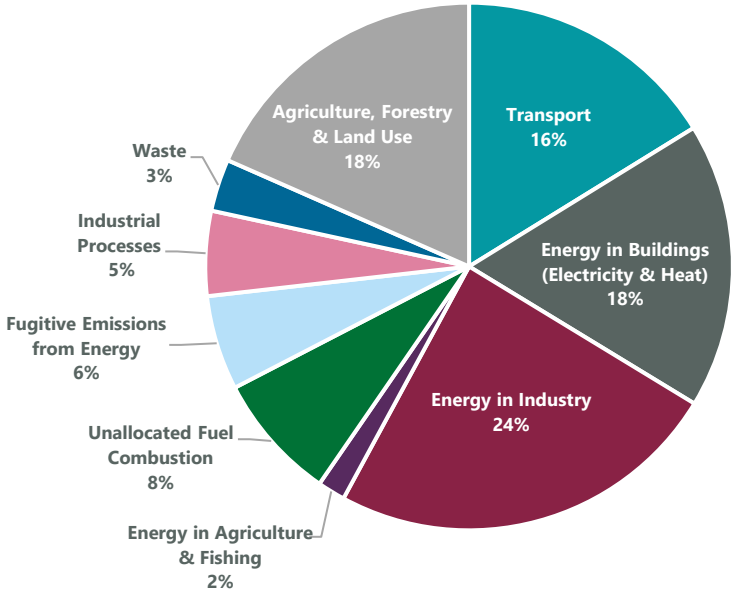
During the quarter we initiated new positions in Cisco Systems in the information technology (IT) sector and Activision Blizzard in the communication services sector. We closed positions in Amgen in the health care sector and International Business Machines in the IT sector.

ESG Highlights: COP26 Underscores Climate Opportunities in All Sectors

The conference that brought us the Paris Agreement in 2015 is meeting again in November in Glasgow, where the 26th U.N. Conference of the Parties (COP26) will seek to accelerate action to fight global warming. The four goals of COP26 — 1) speed emissions reductions, 2) protect communities and natural habitats, 3) mobilize climate finance, and 4) build public-private-civil partnerships — intersect in many ways with those of ClearBridge's ESG integration practices. We are excited to see topics ClearBridge regularly addresses with portfolio companies take center stage as governments increase their focus on climate change.

ClearBridge and other investment firms play a crucial role in providing climate financing, one of the main goals of COP26, in ClearBridge's case through our stewardship of capital and our outreach as a large public shareholder. Many companies ClearBridge owns and engages with are playing important roles in meeting the goals of COP26. Importantly, these contributions come from innovative companies working across the economy. We believe contributions to large-scale challenges related to climate change will have to come from all sectors (Exhibit 3). We know renewables cannot do it on their own.

Exhibit 3: Share of Global Greenhouse Gas Emissions



Source: Hannah Ritchie and Max Roser (2020) - "CO_2 and Greenhouse Gas Emissions". Published online at OurWorldInData.org. Retrieved from: 'https://ourworldindata.org/co2-and-other-greenhouse-gas-emissions' [Online Resource]

COP26 Goal 1: Speed Emissions Reductions

The first goal of COP26, to speed emissions reductions through activities such as phasing out coal, accelerating the adoption of electric vehicles (EVs) and encouraging investment in renewables, speaks to investment themes across ClearBridge, where emissions reductions are being enabled by companies across sectors. We have written extensively of our engagements with AES and Vistra Energy, two power companies retiring and disrupting coal power, expanding into renewables and improving their valuations. Similarly, ClearBridge holdings across the EV value chain, such as TE Connectivity and Aptiv, which make connectors, and even coatings company PPG, which provides thermal, fire and corrosion protection for EV batteries, are helping speed the switch to EVs.

While renewable energy from utilities or solar and wind equipment makers in ClearBridge portfolios is having an impact, many innovations outside of renewable energy are combating climate change and its effects. Resideo Technologies is enabling greater sustainability in the home with “behind the wall” products that enable energy and water conservation. With motors consuming 45% of global electricity production, electric motor and control maker Regal Beloit’s focus on improving efficiency can have a meaningful impact on greenhouse gas (GHG) emissions among its customers. Digital infrastructure company Equinix, in the real estate sector, serves hyperscale cloud companies; it is a leader in renewable energy sourcing and

supporting co-location computing efficiency and data security provision. Recyclable aluminum beverage can company Ball has introduced an infinitely recyclable stadium cup and continues to raise the goals for worldwide aluminum recycling from 69% today to 90% in the future. Recycled aluminum only uses 5% of the energy needed compared to that for virgin aluminum.

A diversified mega cap company like Amazon.com could also be a large contributor, given its reliance on and involvement in heavy transport. The company is creating a fleet of 100,000 electric delivery vehicles to help reach a goal of at least 50% of all shipments being net-zero by 2030, and it has a clear opportunity, given its volume and reach, to implement climate-friendly changes to delivery infrastructure, including air and rail, that would benefit all e-commerce and society at large.

COP26 Goal 2: Protect Communities and Natural Habitats with Resilient Infrastructure and Agriculture

While we work to reduce emissions, managing the effects of climate change will require protecting communities through weather resilience, part of the second goal of COP26. Across U.S. states facing extreme weather events, one lesson seems to be that early movers in adapting to climate-related threats are better positioned to thrive; their preparedness and resilience protect the community and pave the way for better investor returns.

In the U.S., we're seeing significant impact of climate change on the West Coast. Wildfire season, which used to generally run for four months, now lasts six to eight months due to earlier snow melts and delayed rain seasons. The extent of wildfire damage has been increasing. According to the California Department of Forestry and Fire Protection, which has looked at the largest wildfires in the state since 1932, 9 of the 20 largest fires happened in 2020 and 2021. The average acreage burned by wildfire over the course of the 2020–2021 wildfire season exceeds the five-year average by almost 3x.

We spoke to Edison International recently, who observed that the majority of fires so far this year were from dry lightning and not caused by utilities. This lack of utility-related fires reflects the better operational preparedness of the companies and the state's increased focus on the issue. With the passage of California's sweep of wildfire prevention, mitigation and response bills in 2019, the state has sizably increased its funding for wildfire prevention and suppression efforts and vegetation management. The wildfire bill requires utilities to pass annual wildfire safety certification and allocate significant spending to wildfire mitigation measures.

In addition to legislative changes, utilities in the state are making operational improvements, directing spending to resilience

measures such as better insulation or undergrounding of transmission lines, regular line inspections, vegetation management, weather condition monitoring and focusing on circuit-specific mitigation plans. Both the state and companies have also invested in firefighting abilities through expanding firefighting crews.

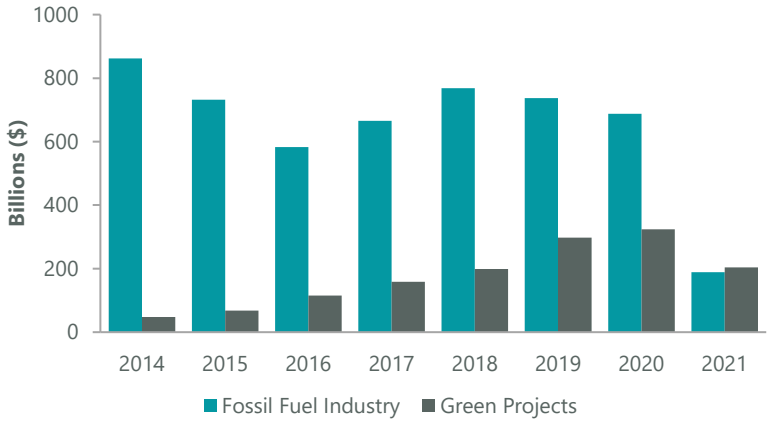
California utilities are adapting to climate change realities, and we notice a trend of early movers thriving while better protecting the community. Following wildfires in San Diego Gas & Electric's territory in 2007 and 2008, Sempra Energy (SDG&E's parent) began what is now a decade of enhancements to infrastructure and technology to limit the risk of utility-related wildfires, and, with a state-of-the-art wildfire monitoring system among other resources, the company is now a recognized industry leader in this regard.

COP26 Goal 3: Mobilize Climate Finance

Financial services companies ClearBridge owns and engages with are also doing their part, making big commitments to support climate-friendly businesses through climate financing, the third goal of COP26, as well as through their own operations. Bank of America, for example, recently announced a goal of deploying and mobilizing $1 trillion by 2030 in its Environmental Business Initiative in order to accelerate the transition to a low-carbon, sustainable economy. JPMorgan Chase has pledged to facilitate over $2.5 trillion over 10 years to address climate change and contribute to sustainable development. It has also developed a method for measuring GHG emissions of its financing clients in order to set Paris-aligned targets for carbon reductions. These involve a goal of a 41% reduction in carbon intensity for new autos, including tailpipe emissions, a 69% reduction from electric power generation and a 35% reduction in operational carbon intensity from oil and gas. Morgan Stanley has pledged to mobilize at least $750 billion of low-carbon solutions; its institutional securities business also issues a wide variety of green bonds that may include financial advisory and underwriting services designed to improve the environmental impact of borrowers.

Large financial institutions are looking to help companies they invest in change their businesses to be better for the environment, and we view these commitments as ambitious, realistic and appropriate to the size of these institutions. They come against an encouraging backdrop of growing green debt issuance, which, while historically trailing finance related to fossil fuel, is closing the gap and in 2021 looks poised to overtake it (Exhibit 4).

Exhibit 4: Green Project Financing Near a Milestone



As of May 14, 2021. Source: Bloomberg Finance L.P. Data covers almost 140 financial services institutions worldwide and compares oil, gas and coal-related finance with bonds and loans to renewable projects and other climate-friendly ventures.

Private Equity Also a Source of Climate Financing

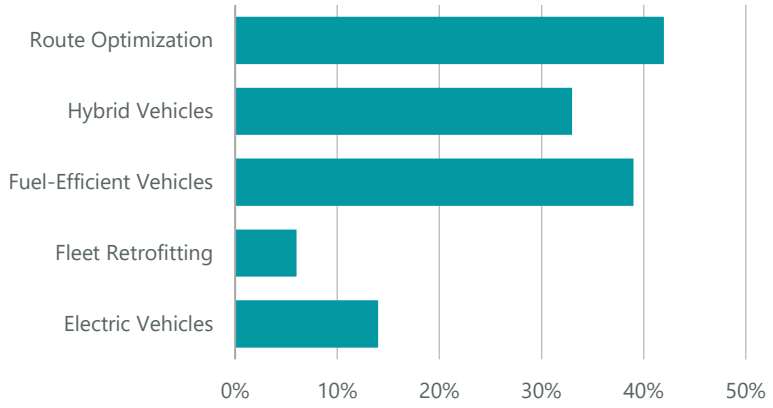
On the private equity side, alternative asset managers are also helping meet the third goal of COP26. Blackstone has set a goal of reducing carbon emissions by 15% within the first three years of buying any asset or company across its portfolio. The goal, equating to 5% in reductions each year for three years, is scientifically aligned with an overall goal of getting halfway to net-zero by 2030. Blackstone also invests in climate solutions and has spent $11 billion over the past three years on companies and projects supporting the energy transition. Projects include the Champlain Hudson Power Express, which will deliver a 24/7 firm supply of renewable energy to New York City, and 10 million square feet of solar panels all together on the rooftops of Blackstone's large portfolio of U.S. logistics warehouses and on Stuyvesant Town, a residential development in New York City.

Meanwhile, Apollo Global Management invests in and lends to many companies in the renewable energy space, and it has over $1.6 billion in capital committed or invested in renewable investments. It has also participated in debt syndication with sustainability-linked covenants, where companies can lower the price of their debt by cutting carbon emissions. The company is working to introduce similar covenants to deals it originates privately.

In an ESG program in place now for 13 years, Apollo asks its companies to measure upwards of 156 environmental, social and governance metrics. Through the program, Apollo transforms the operations of portfolio companies, improving transparency around emissions and instilling efficiency-boosting best practices that reduce emissions (Exhibit 5). In a recent ClearBridge engagement with Apollo Global Management, the company discussed its success in implementing lasting sustainability

changes in operations of portfolio companies even after Apollo had exited its ownership position.

Exhibit 5: Apollo Reporting Companies with Fuel Reduction Initiatives



Source: Apollo ESG Report Volume 12.

COP26 Goal 4: Build Public-Private-Civil Partnerships

The fourth COP26 goal, to work together to deliver on the Paris Agreement, affirms ClearBridge's partnership approach and throws into relief the value of ClearBridge's participation in investor-led initiatives and climate-focused organizations. We believe investors working together is crucial in terms of articulating expectations on behalf of the investment industry to government. For example, ahead of COP26, ClearBridge has signed the 2021 Global Investor Statement to Governments on the Climate Crisis, which unites 587 investors representing over $46 trillion in assets and aims to deliver on the Paris Agreement by raising climate ambitions and implementing meaningful practices. We also maintain active relationships with many organizations that support climate-related ESG goals, such as CDP, Ceres Investor Network on Climate Risk, Net Zero Asset Managers Initiative, Climate Action 100+ and the Task Force on Climate-Related Financial Disclosures (TCFD).

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