

ClearBridge

Investments

Large Cap Growth Strategy



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Key Takeaways

- ▶ Recent positioning moves have better targeted our focus on enterprise software and Internet companies with the most compelling risk/reward profiles and expanded our exposure to the secular growth trend of electrification.
- ▶ 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

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 1000 Growth Index was the market's top performer, rising 1.16% despite a late September rout as investors returned to the relative safety of mega cap growth stocks and outperforming the Russell 1000 Value Index by 194 basis points.

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, health care (+3.66%), communication services (+2.12%) and information technology (IT, +1.79%) were the best performers in the benchmark among sectors owned in the

We participate in the growth of the cloud and enterprise technology spending through Amazon and software companies.

Strategy. The cyclical industrials (-5.85%) and materials (-2.96%) sectors, as well as real estate (-2.24%), suffered the worst losses while the consumer discretionary (+0.12%) and consumer staples (+0.40%) sectors also lagged the Russell 1000 Growth Index.

The ClearBridge Large 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 e-commerce 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. We achieve this balance and seek to deliver consistent results through the cycle by targeting stocks across three growth profiles: cyclical, stable and select. On the positive front, the IT sector in aggregate was a positive contributor to performance in the quarter, led by strong stock selection among our software holdings.

Actively Managing Mega Cap Exposure

Over the last year, we have sought to improve the up capture of the portfolio by expanding exposure to the select bucket of companies growing revenues and earnings at meaningfully above-average rates and targeting large total addressable markets. Newer names in the select bucket like ASML, Atlassian, NXP Semiconductors and Sea Limited have been strong contributors to relative performance over this period. We believe that owning a broader group of IT and Internet companies with different drivers to the businesses helps manage some of the risk in this relatively more expensive subsector.

While Amazon.com and Facebook, the Strategy's overweights in the mega cap group, underperformed both their FAAMG peers and the benchmark in the third quarter, we maintain conviction in these names because they have the highest growth profiles. Amazon is projected to grow earnings per share at 19% next year and Facebook at 13%, while Apple is expected to see only breakeven earnings in 2022 (Exhibit 1). Amazon is spending at an elevated level right now, but the underlying demand trends are healthy, and we believe that once the rate of spending moderates, returns will improve. Facebook remains at the center of regulatory attention, although we believe that the worst-case scenario options are low-probability events and that the digital advertising market continues to be quite healthy.

Exhibit 1: Some FAAMGs Look More Attractive Than Others

Multiples and Growth Rates of Mega Cap Growth Names

	P/E	EPS Growth (2022E)	PEG
FB	18.4	13%	1.4
AMZN	39.2	20%	2.0
GOOG	21.4	9%	2.3
NFLX	48.9	19%	2.6
MSFT	31.1	11%	2.9
AAPL	24.3	0%	55.1

Price to earnings multiple calculated with closing prices as of October 5, 2021 and 2022E consensus calendar year adjusted EPS. Source: Bloomberg.

Since we cannot own all of the mega cap technology names and still maintain a diversified portfolio, we consider business exposures in some of our big underweight positions. For example, the Strategy's underweight to Microsoft is less pronounced when you consider how we participate in its two primary revenue drivers, cloud and enterprise technology spending, through ownership of Amazon.com and enterprise software companies like Salesforce. Amazon's AWS division is the leading cloud service provider with a third of total market share compared to less than 20% for Microsoft Azure and less than 10% for Google Cloud. AWS revenue continues to grow over 30% with close to 30% margins and is accelerating across a broad range of customers. Given AWS's position and the expected growth trajectory of cloud, on some measures Amazon could be considered undervalued at current levels. Meanwhile, with a new CFO focused on delivering consistent growth and expanding margins, Salesforce could soon surpass SAP as the world's largest enterprise applications provider with an all-subscription-based model. The recent acquisition of Slack should better connect the company's products and services with its users as the messaging platform becomes more dynamic and interactive.

In a similar way, we prefer to play the secular growth trends in digital advertising through Facebook rather than Google and the rollout of 5G via Qualcomm instead of Apple. Facebook has multiple products that can continue to drive attractive revenue growth including direct e-commerce solutions, payments, AR/VR and monetizing WhatsApp. In addition, the Federal Trade Commission's dismissal of the government's antitrust case against Facebook (even though the case was subsequently re-filed) supports our view that antitrust action against the company will be difficult to achieve. At the same time, regulatory action against Google and Apple may be underappreciated by the market given Google's dominant market share in search and the growing focus around Apple/Google app store economics from regulators and market participants. On the 5G front, the current iPhone cycle

continues to have upside, but we are concerned about the pull-forward of demand from the 2022 and 2023 iPhone models. Qualcomm has diversified away from Apple and into the mid and low tiers of the market where 5G penetration has yet to take hold. This should enable Qualcomm to still grow as 5G penetration expands through different manufacturers in different market tiers, even if the high end of the market remains flat. Qualcomm is also positioned for strong content growth on Apple phones as well as other manufacturers as 5G ramps up.

Portfolio Positioning

Within the broader digital services space, we recently 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.

To make room for Netflix and better concentrate the Strategy in our highest-conviction names, we exited positions in software makers VMware and Nutanix. VMware, best known for its system visualization software, 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. Nutanix, a leader in hyperconverged infrastructure (HCI) that enables storage, computing and networking to operate as a single platform, has successfully pivoted from a license to a subscription model and under new leadership has improved execution. While business fundamentals should remain healthy, we see more upside in our application software and Internet holdings.

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 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 recent purchase of Eaton, a manufacturer of power management products for a variety of end markets, a position we added to during the quarter. 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.

The other significant move during the quarter was the sale of Amgen. The biotechnology company has 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 treatment Tezepelumab missing its primary endpoint in a Phase III study. Given the still-challenging regulatory backdrop for biopharmaceutical companies and increasing costs of merger and acquisition activity, we have pivoted our health care focus toward medical devices companies such as Intuitive Surgical and Alcon.

Large cap companies continue to serve an ever more global marketplace, leading us to research growth opportunities beyond the U.S. We first purchased Alibaba, China's leading e-commerce and digital payments platform, in 2018 to gain greater exposure to the emerging Chinese consumer market. Recently, Alibaba has borne the brunt of Beijing's regulatory crackdown on technology companies that began in late 2020 with the postponement of the Ant Financial IPO. While the stock was the primary detractor from performance in the third quarter, with the Chinese government's antitrust investigation of Alibaba now closed and Ant Financial being revamped, we believe Alibaba is moving past major regulatory risks. The stock now trades at a substantial valuation discount relative to its growth potential. We continue to view Alibaba as a durable business with the potential for sustained revenue and profit growth and the scale to weather periods of disruption due to its size, balance sheet and importance to the Chinese economy.

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.

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.

Using this framework, we've added a number of new names to the portfolio over the last year and continue to populate our white board with quality growth franchises we are ready to own at the right price. Despite the recent resurgence of mega cap growth stocks, we are sticking to our process and maintaining balance across the spectrum of growth. The Strategy held up better than the benchmark in the selling pressure of the last month and remains well-positioned for lower growth or down markets. Given the moves we have made to increase our weighting to select growth companies, we also expect the Strategy to keep up better in the event of a melt up and provide a more balanced distribution of returns over the next year.

Portfolio Highlights

The ClearBridge Large Cap Growth Strategy underperformed its Russell 1000 Growth Index benchmark during the third quarter. On an absolute basis, the Strategy had gains across four of the eight sectors in which it was invested (out of 11 sectors total). The leading contributors to performance were in the IT and health care sectors, while the consumer discretionary and industrials sectors were detractors.

On a relative basis, overall stock selection and sector allocation detracted from performance. In particular, stock selection in the consumer discretionary and consumer staples sectors and an overweight to the industrials sector weighed on results. On the positive side, stock selection in the IT sector and an overweight to health care 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. Alibaba, Amazon.com, United Parcel Service, Qualcomm and Visa were the primary detractors on an absolute basis.

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