ClearBridge Investments

Large Cap Value Strategy

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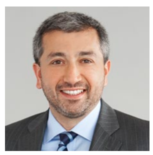

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Key Takeaways

- Equities delivered a flattish third quarter amid a COVID-19 resurgence and intensified labor and supply shortages, though they remain up strongly year to date.
- The quarter was a tale of two cyclical areas of the market, with financials beneficiaries of gradually rising interest rates and industrials and materials feeling the pinch of broad-based supply chain pressures.
- While the market balances a still-accommodative Fed, continued government stimulus and a healthy consumer with worries over inflation, we remain disciplined in our approach.

Market Overview

After generating strong returns and achieving multiple record new highs in 2021, markets peaked in early September. The broad market S&P 500 Index delivered a flattish third quarter despite being up a still-impressive 15.92% year to date. Value stocks gave up some ground, though the Russell 1000 Value Index, up 16.14% year to date, remains roughly 200 basis points ahead of its growth counterpart. Already challenging labor and supply shortages, combined with broad-based inflationary pressures, intensified during the quarter.

Early in the quarter the Delta variant put a pause on recovery plays, which in combination with technical factors pressured Treasury yields from 1.47% to as low as 1.18%, bolstering large tech companies that benefit from both lower yields and a stay-at-home environment and proving a headwind for energy and financial shares. Meanwhile, inflation reached a 13-year high in June and July. The Fed signaled in September that it would reduce its bond buying as early as November and potentially raise the fed funds rate in late 2022 or 2023. A subsequent recovery in Treasury yields to prior quarter-end levels hurt tech stocks while boosting financials. Shipping delays, labor shortages and raw material inflation weighed on industrials and materials companies. Energy felt crosswinds from a slowing Chinese economy even while global demand remained strong, leading oil prices on a round trip from $73 to $62 to $75 for a barrel of WTI crude.

The Strategy modestly outperformed during the period in a slightly down market for value stocks. Financials was the top contributor in the broad market S&P 500 Index, the benchmark

Russell 1000 Value Index and the portfolio. Holdings JPMorgan Chase and Bank of America contributed to portfolio performance, helped by improved investor sentiment with respect to net interest margins in light of a slightly more hawkish Fed and a pull-forward of expectations of an interest rate hike into 2022, resulting in the late-quarter rally in Treasury yields.

The Delta variant notwithstanding, the quarter saw improved travel and entertainment volumes, helping our meaningful active positions in American Express and online travel agency Booking Holdings contribute positively.

While the information technology (IT) sector in the benchmark stalled amid rising rates, our holdings outperformed in relative terms, helped in part by a strong quarter from Oracle, the dominant provider of on-premise database software for large enterprises globally and an increasingly viable cloud competitor. Solid quarterly results, raised guidance, healthy underlying metrics and an attractive valuation contributed to strong performance during the period.

The quarter was in many ways a tale of two cyclical areas of the market. Financials gained amid a goldilocks scenario where interest rates looked poised to rise gradually while a strong economy and healthy balance sheets supported historically low credit losses. Whereas financials are relative beneficiaries of gradually rising interest rates potentially driven by higher inflation, industrials and materials are feeling the pinch of broad-based supply chain pressures such as shipping costs, semiconductor shortages, scarcity of labor and wage pressure, as well as raw material inflation.

Such was the case with Vertiv, a market leader in thermal and power management solutions for the data center, communications infrastructure and industrial markets. After a +36% gain in share price in the second quarter, Vertiv saw unexpectedly strong inflationary cost pressures from air freight and chip shortages extend into the third quarter and is seeing near-term margin pressure from previously priced orders. From a demand standpoint, the company continues to see its backlog increase with hyperscale and telecom customers, while enterprise demand continues to improve. Vertiv benefits from attractive end markets as hyperscalers such as Amazon.com, Microsoft, Alphabet and Facebook continue to build data centers needed to support cloud migration and broader digital transformation across various industries.

United Parcel Service (UPS), coming off extraordinary performance in the second quarter, saw some weakness after its margin guidance disappointed, partly due to remaining contract renegotiations skewing to large enterprises where price increases will be tougher to implement, while labor availability and costs are also expected to pressure margins. It also traded down in sympathy with Federal Express, which cited constrained labor supply affecting network efficiency and exacerbating margin pressure from higher wages. In UPS's case, concerns around wage inflation could be overstated as UPS has baked in wage hikes in long-term contracts and has somewhat less exposure to short-term market wage rates. We remain confident in UPS's strategy of profitable growth and disciplined pricing as it focuses on its high level of on-time delivery and customer satisfaction, a formula that should hold the company in good stead for the long term.

In the materials sector, raw material inflation and shortages weighed on coatings company PPG, while Air Products and Chemicals moved down amid softer earnings and uncertainty regarding the timing of several large projects. Notwithstanding short-term volatility, Air Products is well-positioned to participate in the energy transition, particularly in hydrogen and carbon capture, as the world focuses on lowering emissions.

Portfolio Positioning

It was a relatively quiet quarter in terms of portfolio changes, although we took advantage of very strong performance to exit semiconductor equipment manufacturer Lam Research. While Lam has extremely valuable technology and an exceptionally robust secular growth story, it is also highly cyclical, and we chose to exit our position after a period of extraordinary performance.

We reinvested a portion of the proceeds into existing holding Cisco Systems, which also has highly valuable technology and an improving secular growth story with its leading position in core networking hardware, as well as in its growing software and services business. Cisco has refocused on winning share in the large and growing hyperscale market and has been investing aggressively in R&D to support growth. We believe Cisco has found new legs after previously ceding some growth opportunities in cloud while maintaining its strong presence in the carrier and enterprise markets. Cisco boasts a strong balance sheet and accelerating multiyear growth while trading at a modest multiple of earnings.

We also seized the opportunity to add to our position in energy producer ConocoPhillips at what we considered an attractive valuation. The market rewarded this move late in the quarter after ConocoPhillips announced its purchase of Permian Basin assets from Shell, making the company the second-largest oil and gas producer in the contiguous U.S. We view this as a positive strategic transaction for a well-run, ESG-cognizant oil producer. With this and prior transactions, the company continues to press its cost advantage and is well-positioned to benefit from ongoing energy demand recovery to pre-pandemic levels.

The market's sensitivity to countervailing forces at this point is not surprising.

Outlook

Materially higher inflation readings, as well as company comments highlighting supply chain pressures touching all areas of the market, seem to bely Fed messaging surrounding inflation's purportedly transitory nature. At the same time, given the large scale of monetary and fiscal stimulus supporting asset prices, the market's sensitivity to countervailing forces at this point is not surprising.

While the market balances a still-accommodative Fed, continued stimulus from the federal government and a healthy consumer with worries over inflation and supply chain shortages, we remain disciplined in our approach. We continue to focus on high-quality franchises with resilient and durable businesses, at attractive valuations and capable of generating superior risk-adjusted returns over the medium to long term

Portfolio Highlights

The ClearBridge Large Cap Value Strategy outperformed its Russell 1000 Value Index benchmark during the third quarter. On an absolute basis, the Strategy had gains in six of 11 sectors in which it was invested for the quarter. The strongest contributions came from the financials and consumer discretionary sectors. The industrials, materials and health care sectors were the main detractors.

On a relative basis, overall stock selection contributed to performance, while sector allocation detracted. In particular, stock selection in the communication services, IT and consumer discretionary sectors added to relative returns. Conversely, stock selection in the health care, materials and utilities sectors weighed on relative results.

On an individual stock basis, the largest contributors were ConocoPhillips, JPMorgan Chase, Booking Holdings, Motorola Solutions and Bank of America. Positions in United Parcel Service, Vertiv, Air Products and Chemicals, PPG Industries and T-Mobile were the main detractors.