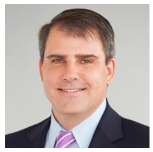
ClearBridge Investments

Mid Cap Strategy



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Key Takeaways

- The Strategy generated positive absolute performance and outperformed its benchmark due to strong stock selection.
- We continue to find compelling opportunities in the market, adding four new positions while exiting five others.
- We are actively monitoring disruptions across global supply chains and manufacturing capacity, and are focused on companies with pricing power to overcome these challenges.

Market Overview

With investors favoring the safety of larger companies, mega cap stocks, mid and small cap stocks suffered third-quarter losses as market volatility increased. The S&P 500 Index rose 0.58% for the period, while the benchmark Russell Midcap Index fell 0.93%. Growth stocks continued to maintain an edge, with the Russell Midcap Growth Index falling 0.76% but outperforming the Russell Midcap Value Index by 25 basis points. However, mid cap value continues to lead growth year-to-date by over 860 basis points.

Despite a boost from strong second quarter earnings, companies continued to be pressured by the spread of the COVID-19 Delta variant and global supply chain constraints. Continued accommodative monetary policy allowed inflation to reach a 13-year high in June. The Fed announced at its September meeting that it could begin tapering its bond purchases as early as November and look to raise rates by 2022. This shift in messaging led to a jump in Treasury yields that weighed on growth and tech companies, while helping to bolster interest-rate sensitive companies in the financials sector.

From a sector standpoint, financials (+3.60%) was the best performer in the benchmark, followed by real estate (+2.48%), health care (+0.85%) and information technology (IT, +0.34%). The communication services (-13.56%) and consumer staples (-5.18%) sectors lagged, as did the supply-chain constrained materials (-2.94%), consumer discretionary (-2.41%) and industrials (-2.40%) sectors.

Financials continued to gain from the economic recovery from COVID-19. Insurance companies, such as Hartford Financial

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Services Group, benefited from rate increases and margin improvements during the quarter, as well as historically high retention and premium growth driving an improvement in ROE. Additionally, regional banks such as Western Alliance Bancorp gained a tailwind from the Fed's mention of rate hikes.

The Strategy's health care holdings were also a positive contributor during the quarter. The need for vaccines and vaccine-manufacturing inputs were a catalyst for the biotechnology and research & development industries. For instance, Maravai LifeSciences produces the chemicals needed in the development and stabilization of Messenger RNA (mRNA) for a growing market of disease research and treatments – expected to produce recurring revenue at high margins. In addition to being financially beneficial, the company's role in helping manufacture the COVID-19 vaccine has accelerated developments within non-COVID mRNA vaccines and therapeutics expected to come to market over the next decade.

Meanwhile, portfolio companies in the industrials and materials sectors continued to grapple with global manufacturing shutdowns and difficulties in sourcing both the labor and raw materials due to COVID outbreaks in major manufacturing centers. While the increase in consumer demand and need for businesses to replenish inventories continue to act as long-term positive drivers for the sectors, the increase in producer prices and labor shortages weighed on their performance.

The ClearBridge Mid Cap Strategy outperformed the benchmark in the third quarter due to balanced contributions from both high-quality growth companies and value stocks with visibility toward improvement.

Portfolio Positioning

Our commitment to constantly improve the risk/reward of the portfolio kept us active during the third quarter in repositioning to capitalize on opportunities we have previously sourced and de-risked. We initiated a position in Sun Communities, a U.S. real estate investment trust (REIT) that specializes in investing in manufactured housing communities, recreational vehicle (RV) resorts and marinas. As the economy works through housing supply constraints, Sun's manufactured housing communities are increasingly appealing to younger, lower income populations in prime growth locations through the Sun Belt. Additionally, Sun's expanded RV park offerings have seen healthy demand from increasing numbers of retiring baby boomers purchasing RVs as well as greater numbers of road trips in the wake of COVID-19.

We sold AMETEK, in the industrials sector, and used the proceeds to add RBC Bearings, which manufactures precision engineered bearings and components for highly technical machines, such as aircrafts, submarines and power transmission systems. AMETEK is a company we have held for many years, and we continued to like their long-term prospects, but believe better upside was available in RBC Bearings due to a temporary stock price dislocation created by an equity offering for a highly accretive acquisition. Already well-positioned to capitalize on a cyclical recovery within the aerospace and industrial sectors, RBC's recent acquisition of DODGE's power transmission businesses should provide substantial synergies including complementary distribution, cross selling opportunities and increased manufacturing capacity that should all contribute to RBC's long-term earnings power.

During the quarter we also initiated a position in Momentive Global in the IT sector. Known for its online survey brand Survey Monkey, Momentive is capitalizing on the growing importance of customer feedback, market research and employee engagement. Momentive's competitive positioning through low-cost pricing has helped it achieve strong brand recognition, with its business enterprise division generating high growth rates and attractive incremental margins.

Outlook

Equity markets continue to face elevated headwinds and increased risk from continued disruption of global supply chains. The impact of COVID-19, as well as the rise of the Delta variant, has caused periodic shutdowns in global manufacturing hubs and skilled labor shortages. This has been particularly prevalent in industries that have suffered decreased investment over the last decade, such as shipping & transportation as well as energy, and are now having difficulty in increasing their production capacity to keep up with the rise in demand.

Based on historical levels of consumer demand and inventories, the time to alleviate these constraints will be measured in years, not months. The result has been an increase in production prices and inflation expectations. While policymakers have reiterated that they see the current uptick in inflation as transitory, we believe that inflation constitutes a greater threat than the market realizes, and have focused on company pricing power as one of the key fundamentals we assess in the portfolio.

As market risks increase, so does the need for prudent active management and constant due diligence. While macroeconomic factors such as inflation and global trade do not dictate our investment decisions, we see them as informative inputs in our bottom-up, fundamental research. We are pleased with our recent performance but continue to search for growth companies with compelling catalysts and value companies with attractive cyclical improvement plans.

Portfolio Highlights

The ClearBridge Mid Cap Strategy outperformed its Russell Midcap Index during the third quarter. On an absolute basis, the Strategy had gains across eight of the 11 sectors in which it was invested during the quarter. The leading contributors were the health care and financials sectors while consumer discretionary was the primary detractor.

On a relative basis, overall stock selection and sector allocation contributed to performance. Specifically, stock selection in the health care, industrials, financials, materials and communication services sectors and an underweight to the communication services sector contributed to relative returns. Conversely, stock selection in the consumer discretionary and real estate sectors weighed on returns.

On an individual stock basis, the biggest contributors to absolute returns in the third quarter were Rexnord, Western Alliance Bancorp, ON Semiconductor, Avantor and Hartford Financial Services Group. The largest detractors from absolute returns were Resideo Technologies, Clarivate, Vertiv, Americold Realty Trust and NCR.

In addition to the transactions listed above, we initiated a position in Definitive Healthcare, in the health care sector. We also exited positions in Shoals Technologies Group and Waste Connections in the industrials sector as well as Cloudera and Arista Networks in the IT sector.