Webinar: ClearBridge Large Cap Growth Strategy 3Q21 Update

October 28, 2021

With Large Cap Growth Portfolio Managers Peter Bourbeau (PB) and Margaret Vitrano (MV) and Portfolio Specialist Jacob Drossner (JD)

JD: Hi, everyone. Thank you for joining the ClearBridge Large Cap Growth Update. It's my pleasure to introduce Peter Bourbeau and Margaret Vitrano who have co-managed the strategy since 2012. I have a few topics to kick things off here, but this is your time, so please don't hesitate to ask questions as we go. I'm going to start by turning the call over to Margaret to outline our process. Margaret, what are your performance expectations and how do you and Peter manage risk and construct the portfolio to pave it's way?

MV: Hi, Jake. Thanks for having Peter and me on the call today. So we run the ClearBridge Large Cap Growth Strategy with a mindset that diversification allows us to perform well through a business cycle and through different kinds of market leadership. Unlike some growth managers, we do have evaluation sensitivity that's part of our investing process. We fundamentally don't believe that we have to own any business at any price, um, and we think it helps us manage risk to consider valuation as we're considering fundamentals of any business and to consider the upside, um, scenario and what a business could be worth in that event, but also and equally importantly consider the downside scenario and what could happen then and what the, the investment would be worth.

Our, our bucket approach that you're, you're highlighting on, on slide four is, um, an approach that helps us di- achieve diversification because the strategy includes good quality compounders. Um, you see that as a stable bucket with examples like United HealthCare. It includes opportunistic growth companies like Advanced Auto Parts and Disney that we call our cyclical bucket. And, of course, as a growth fund, we want to have some higher momentum, um, higher risk, higher return names in the portfolio in that select bucket. Um, and you see that with Amazon and Salesforce.

How the portfolio should perform in different markets, it's really an output of that portfolio construction. We would expect the portfolio to fair well in a low GDP growth market. Um, the S&P and the Russell 1000 Growth Index has been up about 12% over the last 50 years, clearly with volatility, um, amidst that. But on average, up 12%. So in that kind of, I'll call it a normal 12% of appreciation market, that's when stock selection in stable and select tends to help us do well overall and outperform the market.

In a down market, the defense that we've built into the portfolio should help us outperform. Our, our down capture is consistently below 1% and you've seen it in practice in the 4th quarter of 2018 when our RLG was down 15.9% and we outperformed by 260 basis points. You saw it this past September when the Russell, uh, 1000 Growth Index also fell almost 6% and we gained about 60 basis points of performance during that month.

That insurance and diversification, of course, has a cost (laughs). When the market has is a momentum led market or there's a beta rally in the market, markets where you see, overall appreciation north of 20 or 25%, those are harder markets for us because we're limiting the amount of beta and the amount of momentum in the portfolio by limiting the size of that select bucket. Um, so just in terms of performance expectations, you know, that's what you should expect.

JD: Thanks, Margaret. I, I want to pivot to Peter to discuss what we've seen in the markets, uh, to help set the stage to how you're positioning moving forward. Peter, what have been some of the catalysts for volatility over the last year and, and how can these periods be exciting for you and Margaret?

PB: Hey, Jake, and good morning everybody, good afternoon. It's a good question, Jake, because the way that Margaret and I are thinking about this, we're really at the tail end of, of an extraordinary period, um, from a liquidity perspective. This is the kinda stuff that probably won't repeat, right? The Fed and the Treasury clearly saved the system, right? They treated COVID as a natural disaster, not, not a recession, right? Which, which meant they used different tools. Um, and now we start thinking about the other side of that, right?

If, if want to use the VIX, right, which is, which is, you know, properly reported on as a, as, as kind of the equity risk barometer, you, you basically pegged it at, at cycle lows all the way through COVID, which was fairly extraordinary if you, if you think about it at the surface. There's no perceived risk, right? The, uh, it was the shortest recession on, on record, right? You never had a retest, never, never bumped along the bottom. Um, the Fed was very transparent on rates. The Treasury was re-liquefying personal balance sheets. There's literally no, no risk in the market, and it was, uh, it was priced accordingly, right?

Uh, there was, there was price distortion, right? We're big fans of the academics that suggests that, credit prices equities, right, it kind of historically for the last 200 years has and it probably always, always will, um, that's probably some of the biggest errors or perceived errors on, on a go forward basis, right? We, we've seen inflation scares, um, twice during the COVID recovery and both times, you know, growth stocks got, got clobbered. Uh, I think this is what we have to look forward to on a go forward basis.

The Fed is giving us probably an incomplete picture on inflation. Our portfolio companies from the discussions that Margaret, myself and our analysts have are quite the opposite. I think that's gonna settle out over the next six to 12 months, um, and, and it might have to force a, a course correction from, from central bankers perspective. Time will tell. Um, but at this point in the cycle, right, if you believe that the economy generally speaking has, has healed, um, it's completely normal to expect rates to rise, right? You've got a healed economy. You've got inflation, and we can debate this, right, but it's certainly much higher than it was. And, and I would argue on a normalized basis, um, it's gonna be even higher. So one should expect rates to gradually move higher.

And Jake, um, to your point, right, we're, we're most active in these periods of volatility and drawdown, right? If you, and I'm sure that many on the call have, have noticed the amount of work that we've done over the last three quarters in terms of positions in and positions out. We're trying to kinda cut the tail a little bit, make sure that we index the portfolio for consistent durable growth over, over the, the cycle. We just haven't seen many of the drawdowns. Margaret pointed out a couple points where, a couple periods where the portfolio performed exceedingly well. It was, you know, kind of within our expectations. Um, but our base case is that the volatility is gonna continue, right, because frankly all of the tonics, all the ingredients that got us herenwill cease to exist, right?

So Margaret and I are spending all of our time thinking about the next three to five years and making sure that our portfolio construction, our white board, our secondary buy list, just trying to make sure that that's robust, right? The last two years doing the books we're just looking forward from, from

here. And then I would just say that, that probably the largest risk, large scale risk to, to the market is policy error. Um, everybody hangs on every last word of Fed Chairman Powell, and I think that's gonna continue over the next, uh, six to 12 months. So Jake, let me throw it back to you.

JD: Thanks, Peter. You and Margaret have, have both acknowledged that maybe you were a bit too defensive coming, coming out of March of last year. So Margaret, now with the, with the benefit of hindsight, what do you think that you underestimated? And then also I, I... could you please address how you've taken a- advantage of volatility since then with the moves that Peter mentioned you've been making in the portfolio?

MV: Sure. Um, I actually think Peter summed it up really well when he said the Fed treated COVID as a natural disaster and not a recession. And I would say that if you had asked us in March of 2020 our view, we would have said we think the economy's in a recession. So, um, so that almost sums it up really well. Thanks, Peter.

Look, I think, I think in the first half of 2020, we consciously did not make meaning most, meaningful changes to our technology position with the view that similar to other recessions technology would be an under performer. That's historically been the case. Um, if you recall, it's seems like it was so long ago, but back in March/April of 2020, strategists and economists were using an alphabet soup of letters to debate what the recovery was gonna look, and I think the consensus was, um, focused around is it gonna be a U-shaped recovery or an L-shaped recovery or a W recovery? But very few people were calling for the V that it actually turned out to be, um, thanks to that incredible amount of monetary and fiscal stimulus that we could see.

Um, so by June of last year, uh, it, it was clear that we had been too cautious in thinking that it was gonna be some, some variation of U, L or W. Um, and the stock market had recovered must faster than we anticipated, much faster than many people anticipated. Um, and the typical victims of a recession, whether it's technology, spending or advertising had actually fared quite well. So, you know, what do we do from there? I would say, um, beginning and then in 2020, and you see it kinda continuing into, uh, uh, 2021, um, we added... At, at first, um, early cycle recovery play, so we added semiconductors to the portfolio. We owned a few, but we added to our exposure. Um, we added ASML and NXPI. We also added consumer discretionary. Um, we added Ulta and Tractor Supply. Um, and, and all of those were names that had not fared as well as some of the software, um, sub-sector of, um, of, of the market. And so the valuations were also still, uh, pretty interesting.

In addition, we, we relaxed the upper limit of, of our select bucket. Um, and I wanna dive into that just a little bit. So historically I, I talked before about that diversified approach and how it has fared us well through, um, through a variety of markets over the last decade or so. Um, but, um, as we thought about, you know, the recovery and the economy, adding a little bit more to software, which, which we were trying to do, um, and looking at the concentration of the index that you're highlighting on, on slide three. Um, we realized that if, if tech and shadow tech, so tech and, uh, internet essentially is 65% of the Russell 1000 Growth Index, and we've always said select is about a third of the portfolio, by definition we're gonna be a lot more conservative than the index. Um, and as we were trying to focus on improving our up capture and improving our participation in, in the economy as it marched higher, we realized that that was such a, that was too big of a, a disparity, a third to 65%. And so we relaxed that, uh, upper limit on the select bucket to be no more than 40% with the idea that this would help us improve our up capture. This would help us add to some software names, which we did, um, like Atlassian, NC, um, to, to participate that our, as the market, uh, marched higher.

Um, you do see some evidence of all the moves that we started making in, on June of last year, um, and is continued making this year, uh, effecting that those ratios. Um, you can see on the slides that you just pulled up, Jake, that, um, that our up capture, that, that blue-green line has improved. It, it

took a little while for it to, to show up in the numbers. But, um, we can see it and feel it in the portfolio. That the portfolio is doing better of keeping up with the market, um, on up days.

And the new names that we've added to the portfolio since June have contributed to 150 or so basis points of, of relative perfer- of relative performance. Uh, so I think that's encouraging. Um, oh, I think your time periods are different, so it's 220 as of now. My bad. I was, um, doing it as of the end of August. Um, and, and, and tech is, you know, has been a contributor to performance, so in the 3rd quarter tech was a nice contributor to performance.

So all of that is to say that I think, you know, we had been positioning or thinking about the economy, um, and the impact of the stock market of a recession in, um, you know, March/April/May. But, but by June I think it, it was pretty clear that, um, that the stimulus had caused a faster recovery than we were anticipating, to Peter's point. Um, and so we've been pivoting the portfolio to, um, to be more balanced and, and less defensive and has better participation in the up market while still trying to make sure that we, you know, do what we've always said we would do which is protect better in a down market as well. Um, and you can see in that up/down capture analysis that even

... and relaxing that upper limit of the select bucket, um, and, and the changes that we've made, thank you. Um, the changes that we've made in the portfolio, uh, the down capture ratios still look, look pretty good.

JD: Thanks, Margaret. I wanna switch gears to some of the recent moves that we're showing on this next slide here, 'cause I think this does a really nice job of highlighting how you and Peter have upgraded the portfolio. So, so Peter, which areas within the health care and industrial spaces have you added to over the last year?

PB: Yeah, Jake, uh, good, good question. Um, but one area that, that we frankly haven't been adding to, um, and for many of you that have been shareholders for, I'll call it the last 30 years in this strategy, you'll notice that we have virtually no therapeutic exposure, right? This is a product that, um, it kind of always had a sprinkling of, of biotech in there. That, that game has, at least the growth rates, have certainly, um, been truncated over the years. Um, you've had mass consolidation in the in- industry, um, and the, the targets, right, the therapeutic targets have become a little bit more difficult.

So we have a gene therapy company in the portfolio which is a small position in Biomarin. Outside of that, we, we really have, have nothing, um, which is, again, for those that you've been following the strategy for a long time, is, is a departure. The things that we have been doing, though, is more in the med-tech and the device space, right? These are, are areas that can kinda operate below the, kinda the reimbursement thresholds. Um, you've got great innovation, um, and you've got, you know, incent- in many cases valuations that are, are digestible.

So, so two new positions in the strategy. Uh, number one is Intuitive Surgical, right? Not a, not a new name for, for many of you on, on the call. I, I think what has changed, though, is this permanent shift. And, and those, for those of you who don't know Intuitive Surgical, it, it's, it's a minimally invasive soft tissue robotic surgery and, uh, so think about bariatric thor, uh, thoracic, urology, uh, indications like, like that, um, where it's a razor, razor blade model. So you have a big, uh, robot called the da Vinci. In, in, uh, in ORs there's about 6500 of them distributed globally, mainly in the United States. And you make a lot of your money, or frankly most of your money on the, uh, on the services side and the, uh, and the, and the kind of the multiuse instruments, right? So staplers, um, energy, um, uh, for ablation and, and those kinds of things.

You also have... What's, what's changed, I think, in soft tissue surgery, um, things like 3D vision and, and AI. So every single procedure, um, that, that, uh, is performed on a da Vinci machine is effectively uploaded into this giant database. So if you're a, if you're a surgeon, um, sitting behind a, a da Vinci

machine, you, you get what's called best practices, right? So you understand maybe where errors have been made in previous, um, procedures from a doctor and wherever it might be, and the machine will literally guide you to areas where there, you wanna be and frankly where you, where you don't wanna be as you're, as you're navigating the instruments.

So it's, it's, uh, it's what being taught in residency and, and med school. Um, and the, uh, and the penetration is still extremely, uh, extremely low. You've got a, another robot that they've introduced. It's call Ion and, and this is where you're taking, um, a lung biopsies in a, in a less invasive manner for cancer screening. The, uh, the outcome studies are, are amazing relative to, to standard of care. And you're very early days. You've got maybe 100 machines spread out globally. But this will, if, if we're right, this will be the new standard of care for, for lung biopsies along with, with many others. The, the, like I said, it's, it's early days here.

On the industrial side, uh, there's a, a name Eaton, which for probably most of you on the call is, is not a new name. It's, it's been around for 100 years. Um, this is the highly engineered product that basically takes energy to some form of, uh, of usability, right? This is not a new concept. The thing that's changed, though, over the last couple of years and, and, and the thing that we believe is the growth opportunity for the next 20 years is you've got much more renewables, right, that, that, uh, where you have to manage energy differently. So it's more two-way. You've got the concept of, of micro-grids, right? And that, that's just because you have limitations in energy transfer and distribution. You've got a lot more, um, battery storage, and this is, this is early days. But you have to kinda imagine your electrical components just because of that.

EV's right? So electric vehicles is probably the largest single contributor to a lot of the modernization that we're gonna see and I think we can all agree, we are very, very early days on this deployment. Um, and then just flat-out modernization of the current grid and then backup, uh, power, right? There's a small company called Generac which has been an amazing, uh, company. It's not, it's not owned in the portfolio, but that is the, the pure play in, in backup power. But you need to slap a bunch of Eaton equipment to the side of your house to, uh, to access that.

The, the one thing I just, I just wanted to say, um, just along those, those lines of, of EV and industrials generally speaking is that we're probably in the midst of, of witnessing one of the largest industrial revolutions, at least of, of our investing, um, generation. This, this migration from internal combustion to, to EV, this is frankly self survival, right? You, you might have a view on, on Elon Musk, but, but the reality is, is he has completely changed not the motor transportation, but, but the propulsion and, and this is gonna be, um, something where if you, if you just kind of read the press releases out from Volkswagen, Toyota, um, the US major OEMs, the Fords, the GMs of the world, the level of, of capital needed to, uh, to make this pivot is, is, is beyond extraordinary and it's very investible. So we've got quite a few assets, um, towards, towards this opportunity.

Just lastly on the industrial, uh, many of you have seen the position UPS also not new to most of, or any of you on this call. The, the thing that has changed is the realization that this is a very under-managed asset, um, for the last 30 years, right? It was a private company for a number of years, um, heavily union oriented, um, you, you, over the last, call it 18 months, you've brought in a new, a new leader with, with Carol Tome who hails from the Home Depot side. She opened up new contracts. She looked at, um, at their footprint and, and basically, uh, making a, a better, not bigger UPS, right? They're no longer taking any package even if it's unprofitable. Uh, they've got unlimited pricing power, especially in this environment.

They successfully made the shift from B2B to B2C, and margins have actually increased relative to, where they've been over the last many, many years. They've put a bunch of capital in the ground, um, made things a lot more, um, automated. Um, and end-to-end, it's, it's probably got the best

distribution footprint on, on the planet, right? They got the best [inaudible 00:21:24] from Asia. They're taking share in ground from, uh, from, from FedEx TNT in, in Europe. So, um, this has just been a, a, uh, a really neat asset where, where I'd argue we're probably middle innings in, uh, in where, in where we're gonna go. So, um, feel, feel great about, about UPS largely because of, of the pricing power that's, that's yet to, to fully catch up to the system.

JD: Thanks, Peter. A lot of the questions we have coming in are, are about interest rates, which, which I think are clearly moving higher here. What do you think that, uh, that rate of change is gonna look, look like? When could the Fed actually in fact hike rates? Do you think it'll be earlier or later than, than what people are currently expecting? And as it ties into these, these health care and industrials exposure, how do your higher growth exposures in those two sectors tend to hold up versus say higher growth technology names?

PB: Yeah. That’s the balancing act Jake. The, you know, the reality is, and again, if you've looked at the last couple scares in, in the market, they've really been related to, to, to rates. Um, what, what I would say is even if, if Powell and team remain dovish, I think the bond vigilantes once you really start unpacking what we feel is much higher inflation for probably much longer, they're gonna start taking charge of the bond market. And that's, like I said, probably the biggest risk to long-term valuations.

What we're looking at, at names that hopefully are less, um, interest rate dependent, right? We really don't own any, any banks in this strategy or anything to play, uh, in the spread business or, or yield curve is, is probably one would expect from a growth investor. But we're, we're certainly aware, um, at, at the power of, of interest rates when you do kinda simple DCFs, right? You put in, you know, put in 1.25 for your 10 year. It's gonna give you an output. You put in 2.50 or 3.0, it's gonna give you a very different output. So lots of sensitivity. Um, the market has been, uh, rewarded handsomely for, for this.

Um, we do have exposure here. There's no question about it, right? We do own some, some fairly expensive software names in SaaS and PaaS names, and they will be impacted. But in totality, and I think that Margaret framed it well, um, our, our risk budget is quite a bit different, um, if you look at, at the benchmark relative to, to how we're positioned. And, and we have a lot less single stock risk, uh, in the portfolio than we, than we ever have, right? The, the, the basket should work nicely.

And again, back to my earlier point, right? If you believe that naturally rates should move higher with a, with a healed economy and a little bit of inflation, for many of our portfolio companies, right, pricing power is, is a good thing, right, and hard lines and soft lines, um, inflation is, is wonderful, right, for, for top lines. So, uh, it, it's, it's undetermined, Jake. It's, it's the, I think it's probably the largest open ended question is where do rates settle and what is the impact to, uh, um, not to growth rates, but, but certainly to, to, to valuations. And obviously we've got a, you know, we've got a, a probably an underweight position, um, for, for interest rate risk going forward.

JD: Thanks, Peter. I, I think you put it extremely well that, that you and Margaret have been focused on taking advantage of volatility to, to try to best position the portfolio for the next five years. Uh, Margaret, with, within the tech space, where do you wanna have exposure over that timeframe?

MV: Right. So, you know, I think it, it's interesting just coming off that conversation of, of interest rates. One could make the argument, well gosh, if you believe that, um, the Fed is gonna start tapering in a month or so, um, that'll finish by mid '22 and then pretty sure later after, late '22, early '23, that that'll start raising rates. Then you would say, the most expen- you know, technology is not a place you wanna be 'cause it's had an enormous run.

Um, some of the, um, some of the SaaS companies are still quite expensive. The whole tech sub-sector is still trading at a six-turn premium to the S&P. So there is a premium valuation. But, um, but I, but I think it's a little, uh, simplistic to say sell all your tech, um, because, uh, because it's gonna get hit

when rates go up. Because, um, the reality is, there, there are some really good secular trends in tech and internet. Um, I think it, it's clear that COVID accelerated certain trends that were already in place in tech. Um, people had been talking about the cloud and, and moving infrastructures to the cloud, um, and certainly internet adoption was growing before COVID, but pa- the pandemic really elevated conversation around digital transformation. I think it made people more aware of how important it is to have a hybrid cloud environment, just to have, um, just to have some duplic- some, uh, duplication in your infrastructure. Um, with all of that shift, of course security became more and more relevant, and security remains one of, um, CIO's top, top spend areas, um, and top, uh, areas of focus for the next... for, for 2021 and probably for 2021 as well. Um, software also continues to be an area that chief, chief technology officers say is gonna be the fastest area of growth.

So, you know, Palo Alto is, is a really good quality security play. We think that's a great beneficiary of all that increased focus and security, Work Day and Salesforce are also two beneficiaries of that focus on, on software and, and digital transformation. So you know, as, as we think about our tech budget and how we wanna spend our tech budget, um, volatility and rising rates are certainly gonna add, volatility particularly within tech. Um, but that sometimes prevents the opportunity. So you know, even with the names that added to the portfolio in the last year, um, Atlassian is a good example and you can see, um, on, on your slide that it's been a nice contributor to success, but, but we bought it on a dip where they were going through some, uh, business model transition that, that created a great entry point for us.

So we're continuing to focus on that and just try to say, okay, you know, we wanna stay balanced. We, we don't wanna cut all of our tech, we still wanna have exposure here just given the secular growth and, and looking out several years, which is the way we think about the portfolio, it's a longer term, uh, hat on. We, we still wanna have exposure to some companies that we think can compound nicely and grow through business cycles, um, and add value that way. So, um, so, so that's what we're kind of doing in tech.

Um, another area that, um, that is really very big trends that were in place, were accelerated by COVID, um, really have to do with the way consumers consume content. Um, so, you know, cable video subscribers had been a pretty mature, um, area of, of the market, but COVID pulled that forward. Um, you see that Netflix and Disney have clearly benefited, um, and been able to, to jump start growth in their ecosystem, so those were top three main video, um, and subscribers in that, uh, part of their business at the expense of more traditional players like Comcast where video [inaudible 00:28:43] were trending down high single digits.

So those trends though, you know, I wouldn't, I wouldn't say that just because, um, hopefully the light is at the end of the tunnel, tunnel with COVID, that, um, Netflix's growth is, is over, nor is Disney's growth over. Um, you know, those, those are multi year trends that we think can continue. So, um, so we think there's opportunity in tech even within a rising rate environment and even given where we are in the, the economic cycle to, um, to continue to, um, to, to add value. And I think we've got some room to do so within tech.

JD: Thanks, Margaret, we've, uh, we've covered a lot of that, uh, of the momentum tree, but I think the other tree that, that a lot of clients have, have been asking about is, is the reopening one. So Peter, I know consumer is one of your more pro- cyclical exposures that certainly participates in that re-flation trade. Do you think that, uh, the reopening story has a second act to it, and, and if not, where have you... could you have potentially been taking some wins recently and where are you finding more compelling opportunities to redeploy?

PB: Yup, no, good question, Jake. Uh, the one thing that's... pardon me, maybe different at this point in a cycle than maybe others is just how well the, generally speaking, the US consumer is positioned, right?

I think we've seen all the credit card companies, all the bank reports, right? Um, reserve releases are high, delinquencies are at cycle lows. Probably generational lows right now and a lot of it obviously is, is the liquidity that the, that the treasury, um, offered. But if you look at, at credit generally speaking, right, accumulated savings, which is somewhere in the neighborhood of two and a half trillion, you know, plus or minus, you know, the ability to pay and the fact that, that we've got a lot of deferred spending, right? Just, you can't find the stuff that you wanna buy. It just doesn't exist, right? Because of supply chain logistics, right?

In an economy that's effectively, let’s say, probably 70% service oriented... you know, the US consumer loves to spend. They spend what they can, they spend what they, what they don't have, right? This is just naturally what... the way that we've, we've all kind of operated. Um, but we're in a different place, right? We, we, we paid, all paid down the, the expensive of revolving debt, we're, we're all super, super liquid, uh, virtually every income cohort, um, that we, that we've looked at. So, um, retail, uh, standard retail, right, not just, not just e-com, right? A- Amazon continues to be our, our largest ba- single position, but the, uh, the companies that have pivoted to omnichannel, right? So Advance Auto, Ulta, Home Depot, Tractor Supply, uh, you, you've successful in pivoting, which were, at one time, just kind of four wall retailers to something much bigger and, and, and much better.

And, and those that, that do will prosper, those that, that won't or don't have the ability to pivot will, will die, right? And they'll, the, those sales will get absorbed by someone else. Um, omni-channel is a, kind of a fancy word to suggest that you'll sell products to anybody in, in anyway and in any channel, right? So it's buy online, pick up in store, right, it's curbside, um, or it's just straight, um, e-comm, where you're shipping from, from a DC.

Um, so, those names that I, I mentioned are all relatively large in, in the portfolio in totality. Now we have taken some, some partial profits, right? We're certainly well area, um, that you've comped and then recomped, um, some, some pretty amazing growth and, and it probably gets a little bit difficult from here, right? Product availability, out of stocks, um, uh, are, are, are potential headwinds, right? We've had a benign, um, promotional environment, right? Because why promote what you don't have, right? If... once, once... once product availability is, uh, is, is, um, is a little more liquid, right that, that might, um, that might change. But we have taken some pr- partial profits, um, after some pretty strong, uh, pretty strong runs. We, we, we deployed some of those into a new position at Nike. Uh, not a new story for anyone on this, on this call.

What’s going on with Nike is, is quite a bit different from, you know, probably most, most brands. Maybe with the exception of, of something like Lululemon, right? Where, where DTC, where you capture 1000 basis points more margin than a traditional wholesale channel, right? You'd sell, you know, you'd sell 1000 skews into Kohls or Walmart, um, or Foot Locker. You know, th- those days are... I'm not suggesting that they're over by any stretch, right? But Nike's done a really nice job of pivoting to control the brand a little bit more, right? You've, you've really condensed the amount of skews both in apparel and, uh, and footwear and, uh, and, and you're capturing a lot more of, of the margin.

The entry point for us with, with Nike, uh, was after, the stock rerated and, and it rerated because they came out with fairly aggressive three and five years plans, um, about, about margin, about growth rates, about cash flow. Um, we, we... we almost completely retraced that, that very large move higher, right? You had, uh, um, you had kind of a summer unrest in China that was directed towards western brands, you had a, a Vietnam manufacturing, uh, shut down because of COVID where, where Nike sources a bunch of, a bunch of their wholesale, sorry their, their, um, their, um, apparel and, and footwear. And then, just like anyone else, right? You're dealing with, with logistics and, and freight challenges from the, the large lanes coming, coming from Asia. So that was our opportunity to start,

um, to start a position, uh, and you can expect that to, uh, [inaudible 00:34:30] weakness to probably go, go higher. So we're just kind of tinkering within, within that, uh, that consumer discretionary part of the portfolio.

JD: Thanks, Peter. Uh, on that topic of the, the reopening versus momentum traits, uh, Margaret, given your comments earlier about the, the balance that you try to maintain in, in your more concentrated portfolio, how would you self assess where you are from a balance perspective today?

MV: I feel like we're pretty good today in terms of, of having, um, having good diversification. If you had asked that same question, um, a year ago, I would have said, gosh, we're too defensive and you could, you could feel it when, when the market was higher, um, that we almost had, uh, too much, too much defense and maybe too much reopening in the portfolio. But now, um, I think we have a good blend of... we, we certainly have a name like Disney, um, where, uh, we like what the company is doing longterm in, in the streaming part of their business, but certainly the theme park continues to be depressed in terms of what normalized, normalized profits are out of that business.

Um, and we have some other names in the portfolio, like, like a visa that's gonna benefit when folks start, um, traveling and spending outside of their home country like a booking, um, that, um, is gonna further benefit when folks start traveling more. So we still do have in the portfolio a couple of I'll call them reopenings, um, more travels, more global travel kinds of plays. Um, we certainly still have a, a good core and a portfolio of just good, quality compounders, um, thinking about, United Healthcare, um, you know, we, we've got some names that are just... I think are just gonna march steadily along and should provide some good balance protection. But, you know, the way we've been working most over the last year has really been on, I think, improving the quality and improving some of the concentration in that select bucket. Um, so you know, um, things like Netflix, um, increasing our positioning in Salesforce, which has been a nice, uh, good contributor to performance of late.

Um, that's, that's kind of really helped us I think have, have better balance in the portfolio and I think you can, you can feel it and see it, um, when, when the market is, is strong. If you had asked me a year ago, I would have said our, our defensive positioning, we could feel our under performance on days when momentum really worked and now, um, we're doing a much better job of, of keeping up.

So the portfolio... and, and I would say the same thing is true, um, in terms of sector, uh, sector allocations where by and large, we're pretty close to the bench mark in terms of our weightings. I know if you look at some of the numbers, you might say, um, we're overweight in industrials, but I'd remind you that Uber is in there and that's really more of a tech spot. So as we think about our sector exposures and our real sector exposures, we're also not making any huge bets, um, on a sector basis right now and that feels about right for, for, you know, the middling part of the economic cycle.

JD: Thanks, Margaret. On that same topic of balancing concentration with diversification, Peter, we just had a question come in about, uh, how we don't own Google in the portfolio. Could you please address why, why that position was negative last year?

PB: Yeah. No, it's, it's a topical question, right? And, and most everybody on this call knows that we, we owned Google for, for a decade, right? And did, did very, very well with it. Just given the massive concentration of names in our benchmark, right, Margaret and I had to undertake a, almost a special project, right? To, to figure out where we had the highest conviction and where we thought maybe we could, we could do better. You know, clearly selling, uh, Google last year, uh, was, was an error, right? It's, it's performed magnificently. I, I'd argue it's not 100% better (laughs) year on year. Certainly their, their operations aren't, aren't 100% better. Um, it, it's a wonderful, wonderful company. There's no, no question, uh, about it. But we have to be very deliberate in, in how we think about our risk budget, and, and I know that there's a slide put up just given the tech, um, direct or indirect and the shadow, uh, exposure which is, which is something like 67% of the bench, which is terrifying, um, in, in the

absolute. And so, um, Margaret and I are a little uncomfortable taking that much single stock risk. Multiply that by, you know, four or five.

So we, we try to kind of pick our, our winners in the group.

... Group. We own a big position, Amazon and, and Facebook, and we've taken the underweights of, of Alphabet, um, uh, Alphabet, Microsoft, and, and Apple, and, and we've, we've redeployed it into areas and names that we think are earlier in their life cycle, have better long-term growth prospects, maybe under-followed, under-owned, uh, and, and where we don't have to really swing on the success or failure of, of any single name. So, Alphabet in isolation was, was a mistake to sell, right? But if you really though that micro- sorry, uh, uh, the Alphabet, but if you really thought that Alphabet is your, is your highest conviction idea, right, you'd have to own, you know, seven or eight percent positions just to, just to be active. Right? And we've got a kind of diversification rule in place, and, and so we have to look at all of our, uh, top five percent names, and be very careful at, at total exposure there.

So, um, again, that, that's not a reflection on the operating prowess of, of the company like I said. It's, it's frankly, you know, one of one, um, but now you're, you're, you're bumping against, um, a model where their sales growth has significantly outpaced their expense growth, and, um, and that has to catch up, and, and, and normalize. And I just say that any tech company, right, that doesn't show, uh, margin, expansion, or leverage, um, will probably lag, and, and that's, that's probably where, where Google's gonna find, find itself in the next kind of six to 12 months that you have to catch up the spend relative to your, to your sales growth. So, um, it, it's just, it's, it's, it's kind of point in time right now, um, but, uh, but we, we thought that we can upgrade the growth profile of the, of the portfolio, but, but again, not doing it with such monstrous single stock risk.

JD: Thanks, Peter. Uh, a lot of the recent news flow has certainly been concentrated on, on some of these big tech and internet companies. Margaret, could you please touch on, uh, how you're sifting through the noise when, when it comes to regulatory risk or controversy? And, and also do you think the portfolio would hold up if, if these risks start to materialize more broadly?

MV: Um, okay. The, um... Thanks for that. The, this is really a two-part problem, because first, we need to understand the regulatory risk with, within a specific company, and the controversy. And then kind of step two of that process is bringing it back to an understanding of the potential impact of the, the fun- the fundamentals of the business. Right? So, you know, think, think about Alibaba and the, um, the investigation that they underwent, um, six, six months ago or so. The, the bega- the investigation itself was concluded with, uh, a payment that was immaterial as, as, um, a percentage of the market cap of the company, but certainly it affected the valuation. So, that's why I think, you know, it's, it's kind of a two part question.

Um, Facebook is probably a good example of kind of walking y'all the way we think about it and what we're doing. Certainly, the, the recent stories about Facebook do not paint it in a favorable light with regard to platform safety, content, algorithms, et cetera. Um, first and foremost, we've, we've been working on, on that part of the, the, the noise about the company. We've been working to understand the criticisms, and what Facebook can do better. Um, and that's going to remain an ongoing dialog. So, um, we, we've done a lot of work and a lot of engagement with the company and with experts about these issues that I think, you know, that, that part of the process is not, um, a one and done, uh, uh, issue that's going to continue.

This is an issue with all of the platforms, including YouTube. So, everybody is contending with these issues that I would say that, you know, it's encouraging to us that Facebook has devoted significant resources to ensuring platform safety to the tune of 40 thousand people working on safety and security, and 13 billion dollars being spent on people and tech in this area since 2016. They do issue transparency reports, um, around the findings, both good and bad of, of usage and the impact on

folks. Um, and they had responded to criticism by pausing work on things like Instagram, Instagram Kids, um, and they repeatedly asked for regulations. So, all of that is to say that, eh, we are encouraged by the fact that they are reacting, they are taking steps. One could argue it's not enough, and they're not doing the right things, but they at least are, um, adapting, and, and moving in the right direction.

So that's the, kind of, the, how we're thinking about one way that we're looking into controversy that's around these companies. On the regulatory front, 'cause this is, it's, it's really two kind of separate issues, all the mega-cap tech names are under scrutiny. Um, the SCC had filed an anti- anti-competitive suit against Facebook. That original suit was dismissed by the overseeing judge in June. The case was refiled, so there's certainly still regulatory risk, but we think the initial ruling probably lowers the probability of, of a worse case outcome, which would be to split the com- of the company. So, on a regulatory side, um, we've actually probably characterized the other internet companies as having higher risk [inaudible 00:44:22] Facebook, and that's the way we are, we think about some of these issues is let's, let's try to rank order where the risk is higher versus lower, and I would say that post, uh, the judge, um, um, his original dismissal of the FCC's suit that probably lowers the regulatory risk, uh, that, that's addressing them.

Next let's go to fundamentals, because I think all, all of this is, to use your word, noise, except we have to make sure it's not impacting the fundamentals. So, um, for, in this specific case, you know, we, we see that Facebook is, is still, um, able to generate double-digit revenue growth, um, and the valuation is, is quite reasonable. We are monitoring whether these controversies are affecting Facebook, whether their affecting user engagement, or whether their affecting advertiser spending. I think that's really, really important. We haven't seen anything yet, but I think that, again, is, is, um, you know, it needs to continue to be monitored. So, all of these, um, issues, I think, it's kind of an ongoing process, where we're trying to stay on top of the, the, the controversy and/or the regulatory risk, um, and then we try to bring it back to is any of this affecting the fundamental value that we see?

Um, all of that is to say that where we are right now, um, we feel that Facebook has taken steps to address many of these issues, um, and we do think that the, the cashflows and the valuations support us continuing to own it. But, you know, w- we'll continue to monitor that question. And I think that, that, that same analysis, um, you know, we're undertaking with whether it's Apple or Google or Amazon. I think that, you know, you have to it with all those companies.

JD: Thanks, Margaret. Uh, Peter, I, I'm sorry to hold you to this, but I, I recently heard you say that it's too late to be negative, which I remember you last saying in, in March of 2020, which is pretty good timing. And when you're thinking about the, the next year, what are you looking forward to most? And when you go about underwriting all of these new names, what would you say are, are your top two or three focus area to, to ensure that you continue this trend of upgrading the portfolio, and to make sure it behaves the way you expect throughout the course of next year?

PB: Yep, good closing question, Jake. The, just to maybe to sum, and I think we addressed some of the points in, in the beginning you have to kind of take the opposite approach right now, right? We've seen something that we've never seen in the history of the capital markets, right, just absolute level of liquidity support, um, in the US and globally. And you have to assume, right, that it gets harder from, from here, right? The ingredients that got us here are, are all abating. Um, and, and, I, I mean, it's, it's an overused comment, right, but you're kind of at peak everything. Right? Peak liquidity, peak earnings growth, peak GDP growth, peak margins, um, and, and as things normalize, like I said, the bill lasts two years. They're, they're in the record books, right.

You have to start thinking about what participates over the next three to five years. If, if you look at the fed dot plots, right, and, and that's very unscientific, right, but you're, and you kind of at mid 2022,

end of 2020, end of 2022, you're, you're back down to, you know, two to three percent, you know, normalized, um, uh, global GDP. That, that is, you know, where we were pre-COVID, and, and, and on an absolute basis, we're, we're gonna see that again. And the, the, the tonic that's lifted, um, in a pretty magnificent way, um, some of, of these, of these assets, right, I, I just think that to underwrite those being future leadership, um, it, it just becomes a little more difficult for, for Margaret and, and myself, right? So, so we are looking on the other side.

I mentioned the, the health of the consumer, and don't underme- est- estimate their willing to spend. The other thing, and this is kind of a, a natural tangent to, to the mess in the supply chain logistics is that, you know, just in time, right, which took 40 years to build, um, pretty much perfected by the, the auto OEMs, you know, crippled these companies in six months, and, uh, the idea of, of having safety stock, um, all of, all of these issues, right, the reshoring, right, the dual sourcing of semi-conductors, whatever it might be, a, a $1.50 analog semi-conductor could have crippled, you know, the shipment of, of, of, of an entire auto. It's, it's pretty amazing what's, what's happened. Um, I, I don't think that any company's gonna underwrite this kind of business risk again. That's the opportunity, right? The, the idea of, of replenishing inventories, um, to get to something that's, that's frankly higher than, than normalized, use their balance sheet, maybe a little bit different than they have, but there's, there's very few companies that wanna underwrite what, what they just experienced over the last two years.

So, there's still opportunities. I would just say that it just gets a heck of a lot harder, um, from here just given the re-rating of, of virtually, um, everything in the markets, and, and the price of failure, as you can imagine, is very, very high, so, just given absolute valuation. So we're being tactical. We're being deliberate. Right? We're, we're spending a lot of time with our, with our analyst. We're hardening stories, um, more so than we probably have in the, in the past, um, and just looking for opportunity. But if you see a draw down, which, which we believe that you will, you know, expect us to get, um, uh, very constructive, and, and very, and very active in the portfolio, and continuing this process of, of, of upgrading the growth profile, um, but doing it in a way that, that doesn't disturb the, uh, the, the, the over, um, the overlying, kind of, risk profile that we've, that we've, uh, uh, demonstrated, um, over the last, over the last 15 years.

So, that's maybe a good ending point, but Jake, I'll throw it back to you, and, and see if there's any additional questions from yourself or, or the, uh, the audience.

JD: Thanks, Peter. I think we addressed all the questions from the audience, and I'm incredibly excited about the future of the strategy. I, I do want to take the time to thank everyone for joining our update for the ClearBridge Large Cap Growth strategy, and, and please do not hesitate to reach out with, to myself in particular, with any follow-up questions that you might have. Thanks again.

About the Speakers

Peter Bourbeau
Managing Director, Portfolio Manager
- 30 years of investment industry experience
- Joined a predecessor organization in 1991
- MBA in Finance from Fordham University
- BSBA in Business Administration from University of Florida

Margaret Vitrano
Managing Director, Portfolio Manager
- 25 years of investment industry experience
- Joined a predecessor organization in 1997
- MBA from the Wharton School of the University of Pennsylvania
- BA in Public Policy and Art History from Duke University

Jacob Drossner
Vice President, Portfolio Specialist
- 4 years of investment industry experience
- Joined ClearBridge Investments in 2017
- BA in Economic History from the University of Pennsylvania

Past performance is no guarantee of future results.
Copyright © 2021 ClearBridge Investments.
The opinions and views expressed herein are of the individuals listed as of the date shown, and may differ from other employees, or the firm as a whole, and are not intended to be a forecast of future events, a guarantee of future results, or investment advice. The statistics have been obtained from sources believed to be reliable, but the accuracy and completeness of this information cannot be guaranteed. Neither ClearBridge Investments nor its information providers are responsible for any damages or losses arising from any use of this information.