



Sustainability Leaders Strategy



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Key Takeaways

- ▶ Strong execution was a common factor for top contributors in the health care sector, where biotech, equipment suppliers and health care providers led performance.
- ▶ Recent positioning moves attest to how we value portfolio balance and exposures to diverse drivers of returns, complementing AI with heavier lifters in the industrials and materials sectors.
- ▶ Environmental issues like climate change and the energy transition create large risks and opportunities at the company level and should continue to do so as short-term macroeconomic developments evolve.

Market Overview

U.S. equities delivered solid gains in the third quarter as the market overcame an early growth scare with the help of the Federal Reserve, which cut interest rates by 50 basis points in September. Leadership rotated from information technology (IT) amid some disappointing earnings results for AI-related stocks and into rate-sensitive utilities and real estate sectors, which led the market. Commodity-sensitive and cyclical industrials, financials and materials sectors also outperformed.

Against this backdrop the ClearBridge Sustainability Leaders Strategy delivered strong absolute gains but trailed the benchmark Russell 3000 Index, due primarily to some overweights in mega cap tech and semiconductor exposure, while our health care holdings had strong showings.

Strong execution was a common factor for top contributors in the health care sector, which included Gilead Sciences, which made gains following highly successful results from two trials of its HIV pre-exposure prophylaxis treatment, which reduced HIV infections by 96%-100%; UnitedHealth, which is delivering consistent earnings beats, allaying fears about its Medicare Advantage business, and handily raising its dividend; and Cooper Companies, a maker of contact lenses and women's health products that exceeded earnings and revenue expectations and raised its guidance for the year. Relative outperformance in our health care holdings came despite GLP-1 leader Novo Nordisk taking a pause from a strong runup amid regulatory pressures over pricing for its Ozempic (diabetes) and Wegovy (weight loss) drugs, as well as ongoing effort to increase supply.

Other positive standouts included cyclical industrials holdings such as Trane Technologies, whose commercial HVAC business is positively exposed to data center construction, Regal Rexnord, which is benefiting from an improved outlook for the macroeconomy, and Veralto, which continues to deliver solid results across its water and product quality and innovation segments.

Main detractors were largely IT names. Concerns about the impact of potential incremental U.S. export control restrictions, a reduction in capex spend announced by Intel for next year during its most recent earnings call and rising concerns around memory equipment spending weighed on the shares of semiconductor capital equipment companies Lam Research and ASML. Both companies operate in a high-growth cyclical industry and have seen strong performance in the past 24 months, as the market has gained more confidence in the recovery of both memory and advanced logic capex. Although there are risks to the pace of capex recovery in both those end markets over the coming quarters, given the selloff and more attractive valuation of the shares of those companies today, as well as positive long-term trends, we continue to have conviction in our thesis on the stocks and see solid long-term value from continuing to own these companies.

Synopsys, a leading provider of electronic design automation software and services to the semiconductor industry, was also lower along with AI-related parts of the IT sector, although the company continues to benefit from the AI chip cycle, with strong customer demand and contract commitments. Dell, which is enjoying high demand for its AI-optimized servers, was also weaker in this market, allowing us to express our conviction in the name by adding on weakness.

Portfolio Positioning

A volatile quarter enabled us to actively reposition the portfolio as what we view as attractive opportunities sold off. In IT, the AI-related selloff created an entry point for us in Nvidia, the leading developer of graphic processing units (GPU) for use in generative AI as well as gaming and enterprise applications. While the stock declined sharply early in the quarter, estimates of hyperscaler capex increased, which resulted in the valuation becoming more palatable. While there is always a risk of near-term overspending should AI product development prove slow, long-term compute demands for AI will rise. At the same time, Nvidia is an undisputed leader in AI, is on the fastest innovation cadence in the industry, has a software-enabled moat around the business and is very profitable. Power usage is an important consideration in AI penetration, and Nvidia's focus on driving continued power efficiencies in its products help enable more sustainable use of computing power.

Elsewhere in semiconductors, we believe that the visibility on the turnaround in Marvell's non-AI business has been pushed further out. At the same time, our research strongly suggests that Broadcom is in

a better position to win more deals in the custom silicon space. As a result we decided to sell our Marvell position and re-allocate the proceeds to Broadcom.

While tech companies, especially those central to the growth of AI, have been the prime movers in the market in the past 18 months, recent positioning moves also attest to how we value portfolio balance and exposures to diverse drivers of returns. We seek sustainability leaders across the market and have found new additions in recent quarters in the industrials and materials sectors that we believe are responsibly doing some heavy lifting in the economy. Veralto, for example, is the market leader in water quality analysis and offers water treatment solutions that improve the water cycle. It also provides packaging printing solutions that include traceability applications for food and beverage, consumer packaged goods and pharmaceutical products. Republic Services is a waste disposal company whose services include non-hazardous solid waste collection, waste transfer, waste disposal, recycling and energy services. The company benefits from high-returning sustainability investments in polymer recycling and renewable natural gas, which also improve its emission and circularity profile.

To this list of sustainable heavier lifters we added Vulcan Materials in the third quarter. Vulcan is the largest producer of construction aggregates such as crushed stone, sand and gravel in the U.S. Aggregates account for 90% of the business, with exposure skewed to the southern U.S. in states such as Texas, Georgia and Alabama. We view Vulcan as a long-term compounder in a regional monopoly/oligopoly with high barriers to entry, which drives time-tested pricing power as well as volume growth. While the market appears to understand the quality of the business, shares have underperformed due to weather-related concerns over 2024-2025 volumes, providing an opportunity for us to purchase the stock. Aggregates play an essential role in constructing all types of infrastructure (roads, bridges, buildings), and infrastructure is a key foundation of economic development and a tenet of the U.N. Sustainable Development Goals. There is no reliable substitute for aggregates and their production process tends to carry a low-emissions profile. We believe the public's focus on this need will drive continued growth of volumes for Vulcan Materials.

Outlook

Recent data pointing to a healthier consumer, steady job growth and higher corporate profit margins, along with aggressive Chinese stimulus and the start of a rate-cutting cycle in the U.S., are positive signs for the economy and equity markets. Positive GDP growth looks poised to continue. While we take a stock-specific approach to portfolio construction, we believe the recent equity leadership rotation is a preview of what should continue to play out in the coming quarters, as an accelerating economy makes earnings growth

less scarce and helps drive broader market participation. This should bode well for a diversified and balanced portfolio of companies exhibiting leading sustainability characteristics.

Portfolio Highlights

The ClearBridge Sustainability Leaders Strategy underperformed its Russell 3000 Index benchmark during the third quarter. On an absolute basis, the Strategy had gains in eight of 10 sectors in which it was invested (out of 11 sectors total). The main contributors were the financials, health care and industrials sectors, while the communication services and IT sectors were the detractors.

On a relative basis, overall stock selection detracted, while sector allocation was positive. In particular, stock selection in the IT and communication services sectors weighed on relative results, while stock selection in the health care sector and a lack of energy holdings proved beneficial.

On an individual stock basis, Apple, Home Depot, Trane Technologies, Gilead Sciences and Hartford Financial Services were the largest contributors to absolute performance in the quarter. The main detractors from absolute returns were positions in Lam Research, Alphabet, Novo Nordisk, Microsoft and ASML.

Besides portfolio activity mentioned above, during the quarter we exited McCormick in the consumer staples sector, Cisco Systems in the IT sector and Aptiv in the consumer discretionary sector.

ESG Highlights: Investing in the Energy Transition is Stock Specific

In an environment of transitory macro crosswinds, ClearBridge believes a stock-specific approach to analyzing environmental, social and governance (ESG) risks and opportunities remains all the more important. In our pursuit of positive outcomes for our clients, we are guided by research-driven stock selection as we seek to generate portfolios distinct from the market and supported by positive ESG characteristics. For example, environmental factors such as climate change remain material issues for investors to consider on a stock-by-stock basis, and the energy transition remains central to our company conversations as our holdings continue to reduce their emissions, often through cost-saving efficiency improvements, and set goals for further reductions.

As a major concern of sustainable investing, climate change and the energy transition represent large opportunities — and risks — at the company level, no matter the macroeconomic and political environment. ClearBridge continues to engage with our holdings to ensure they are building businesses with long-term viability in a lower-carbon economy.

Engaging with Part-of-the-Solution Companies

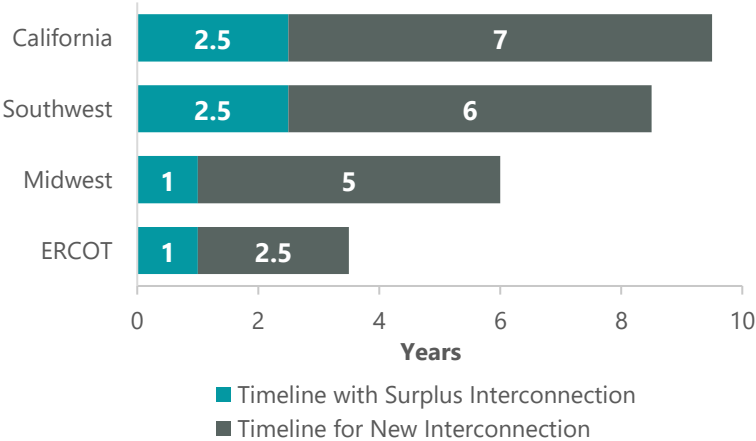
Our fundamental research process includes engaging with companies that are acknowledged leaders in the energy transition, such as ClearBridge holdings NextEra Energy (NEE) and its subsidiary NextEra Energy Partners LP (NEP), two companies accounting for 20% market share of the domestic renewable market. NextEra is still capitalizing on the Inflation Reduction Act through investing in solar and battery power, where it expects stronger growth in the near term, while wind generation additions are expected to see some catching up over the subsequent years.

As we discussed recently in engagements with NextEra's management team, growth for both entities is underpinned by a bullish power demand outlook, with a 38% increase in demand expected through 2040, driven by decarbonization and electrification.

More recently, the already strong demand for renewables is being amplified by AI and data center expansions, which are expected to double the current 4% of overall power demand currently represented by data centers. The share of AI and data center companies represents 6 GW, but growth in this customer segment will start impacting NextEra's growth estimates more significantly after 2027. Management has conveyed to us that it will take time to add incremental demand from data centers onto the grid given existent grid constraints (transmission access) are present across all power markets. For example, even in the unregulated Texas power market, where customer growth is faster and generation additions are typically easier, the regulated grid remains a big bottleneck. Adding data center customers to the grid is complicated, as it involves both grid operators and power producers.

In an environment where transmission interconnects (connections between segments of the grid that allow for the transfer of electricity from power generation sources to customers) take years (Exhibit 3), NextEra's 150 GW of interconnect queue positions become more valuable. Having surplus interconnections reduces renewable projects' timelines. In the meantime, NextEra's analytics tools have been helpful in identifying the best data center locations and putting NextEra at a competitive advantage through access to land and transmission.

Exhibit 1: Average Years for Interconnection



ERCOT stands for the Electric Reliability Council of Texas. As of June 2024. Source: NextEra Energy.

We have also discussed the favorable emissions profile at NextEra’s regulated utility, Florida Power & Light (FPL), whose generation mix is dominated by natural gas (73%), along with nuclear (20%) and solar and storage (6%). The utility’s cleaner generation fleet explains its favorable emissions profile, with emissions below the national average across three main pollutants (20% below the national average for carbon dioxide, 98% below for sulfur dioxide and 71% below for nitrogen oxide). FPL’s plan is to expand its solar and storage footprint from the current 5 GW to 30 GW in 2033, with the utility’s storage capacity growing from last year’s 469 MW to 4.5 GW in 2033 (or 25% compounded annual growth), taking the solar and storage generation share of FPL’s generation portfolio from 6% to 38% in 2033.

The Energy Transition Supply Chain: Environmental and Social Dimensions

Electrification, or the move to power more of society with electricity from renewable energy sources, will be reliant upon critical minerals like copper, which we know comes with environmental and social challenges. As part of PRI Advance, a collaborative initiative for investors to address human rights and social issues, ClearBridge has been engaging with holding Freeport-McMoRan (FCX) on these issues since 2022, and the copper producer has been making progress on several areas central to our engagement.

In a recent engagement we continued our discussion on the environmental and physical impact of the company’s operations on Indigenous land. The company shared that it has developed an action plan to better understand its adverse impacts at several high-risk sites. On tailings, or mining waste, FCX has adopted the global tailings standard, yet its Grasberg operation in Indonesia remains a controversial asset, in particular due to its impact on water. We asked when we could expect the company’s next Water Monitoring

Summary report; the company said by end of 2024 was a strong possibility, both for site-level findings and broader tailings for Grasberg. While FCX indicated it was not possible to do so at this time, we shared that we consider providing water monitoring data as a live stream for stakeholders a best practice.

FCX highlighted Grasberg as well as Sierrita, Arizona, as communities it is prioritizing from a social standpoint due to the more complex nature and higher risk profile of those operations. The company stressed how it considers the concept of its social license to be foundational and central to its operations and recognizes it can't be successful without local input and buy-in, for which community engagement is critical. The company seeks to socialize grievances to make sure all stakeholders and communities are aware of the complaint process and it reports on grievance results in quarterly meetings with community partners. We mentioned that other mines commit to address complaints in 30 days and report on the outcome; FCX shared its belief that resolving complaints in a certain time frame is not necessarily indicative of the performance of the grievance system, although it is still looking for a reliable metric for satisfaction of resolutions.

FCX also shared that it engages voluntarily with several Indigenous populations to build trust; unique to FCX, it has a Native American representation team. Several representatives are members of local impacted tribes and report directly to the company's president. This reporting structure has helped to better equip company management with a more in-depth understanding of local cultures and traditions within its Arizona operations. As a result, it will be implementing a Native American Training Program in the near future.

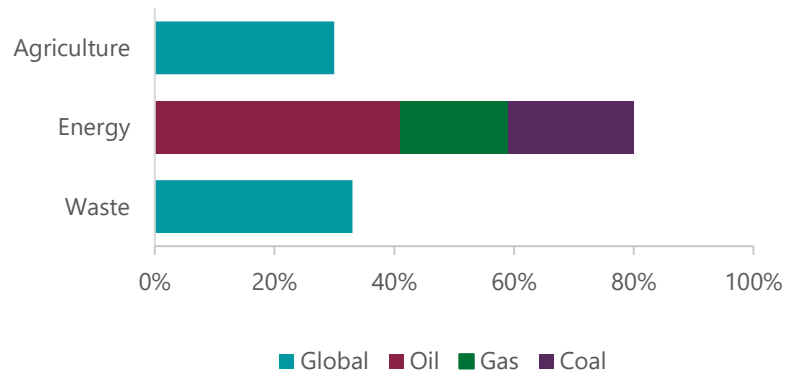
Opportunities for Change in the Energy Sector

The energy sector will also be key to the energy transition, which makes engaging with holdings all the more important as there is significant progress they can make to reduce their environmental impact. The sector is one of the more blamed but necessary industries for ClearBridge's net-zero target as part of the Net Zero Asset Managers Initiative (NZAM). ClearBridge remains on track to achieve our NZAM-related goals of having at least 66% of current in-scope assets net zero aligned or subject to engagement, aligning 100% of our assets with the pathway to net zero by 2050 and achieving net-zero emissions across all ClearBridge portfolios by 2050.

As many holdings in the energy sector have similar company-specific dynamics, we take a sector-wide approach to engagement. This enables us to use company-specific information to improve conversations, share best practices and benchmark peers. Central questions include methane and ensuring the cleanest possible natural gas.

We share with companies our view of the importance of methane emissions, which can be considered an easily attained target, but which represent a significant amount of emissions globally. The IEA estimates that production and use of fossil fuels resulted in ~120 million tons of methane emissions in 2023. While agriculture represents the main source of methane emissions, the energy sector has more abatement potential (Exhibit 4), making it a fruitful beneficiary for engagement.

Exhibit 2: Methane Abatement Potential to 2030



As of March 2024. Source: IEA.

Natural gas producer EQT is a leader among ClearBridge energy holdings, and it remains vigilant on its path to achieve net zero on a Scope 1 and 2 basis by the end of 2025, which would make it the first ClearBridge energy holding to do so. In a recent engagement with EQT’s CEO and CFO we discussed how the company sees significant value in eliminating pushback on GHG emissions and wants to ensure that U.S. natural gas will be the cleanest answer to the globe’s environmental and energy security goals.

While company footprints will differ, we share how a net-zero target such as EQT’s is exemplary for other energy holdings and we use it as an informal benchmark in other engagements. We emphasize how EQT spent nearly \$30 million to reduce its emissions, and we share how we believe shareholders and other stakeholders would be supportive of expenditures that are modestly uneconomic in the near term, like EQT’s, if those expenditures are able to significantly reduce emissions.

Elsewhere in the space, we have discussed with integrated oil and gas producer ConocoPhillips how it is emphasizing its methane emissions reductions, even using autonomous drones, and eliminating routine flaring. French integrated firm TotalEnergies’ methane, down 47% since 2020 nearly in line with its 50% by 2025 goal, is strong and improving, as we learned in recent engagements. Engagements with other producers like Diamondback Energy and Chesapeake Energy also emphasized the installation of continuous monitoring devices to provide real-time visibility into methane emissions performance. This practice not only boosts transparency

and disclosure, but it can also support faster response times to potential leaks.

Leveraging a Long-Term Focus

As sustainability-informed investing moves in and out of the crosshairs of macroeconomic cycles and political debates dominated by shorter-term thinking, ClearBridge remains guided by the long-term fundamental arguments for incorporating ESG factors into the investment process. These ensure we're considering how companies will thrive amid environmental, social and technological changes such as the energy transition. Leveraging our long-term focus and our strong and lasting relationships with company managements, we will continue to use engagement to drive positive change in public equities as part of our investment decision making and active ownership.

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