



A Franklin Templeton Company

A Good Time for Quality at a Reasonable Price

July 1, 2024

Key Takeaways

- ▶ Fear of missing out (FOMO) is driving up the prices of a narrow group of recent winners, skewing market indexes toward low-yield stocks and creating good opportunities for active investors scouring for quality at a reasonable price.
- ▶ Consumer staples — a resilient sector with substantial dividends, high margins and returns, and which usually trades at a premium to the market — is currently priced at a discount to the market.
- ▶ Over the last year, dividend growers have trailed the broader market to a degree rarely seen over the past three decades; past instances of similar underperformance have been followed by a strong bounce-back for dividend growers.

Relative Opportunity in High-Quality Names

Much ink has been spilt in the last year about market concentration, with the Magnificent Seven stocks recently making up roughly one-third of the S&P 500 Index weight.¹ While there are excellent businesses in this group, such extreme market concentration underscores the need for diversification to manage risk. Further, as these stocks have soared, their valuations have become stretched, increasing their risk and creating a relative opportunity in the names that have not participated in this AI-driven rally.

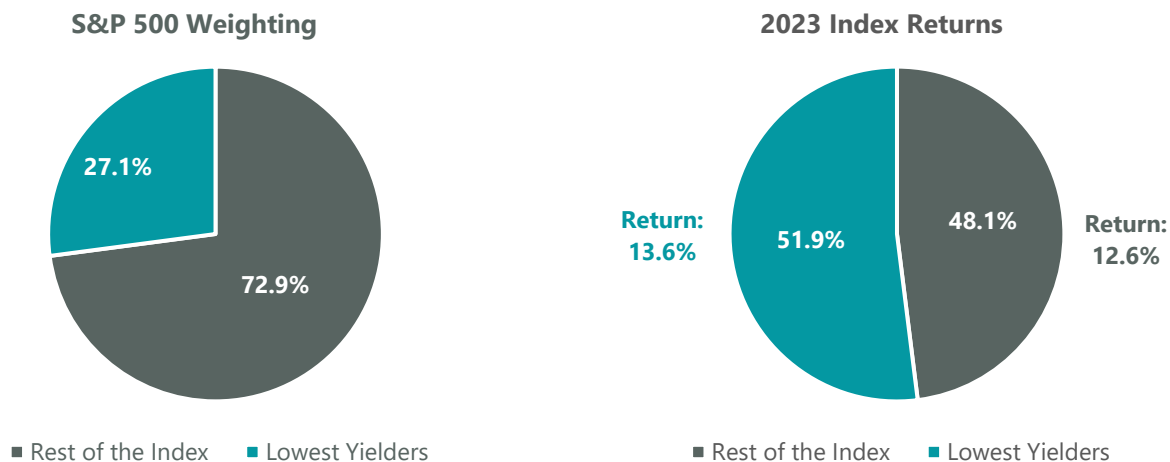
In particular, the recent underperformance of high-quality dividend payers offers investors an attractive opportunity. Companies that pay no or low dividends outperformed meaningfully in 2023, skewing overall index performance. Indeed, this group² made up just over a quarter of the index yet contributed 52% of total return (Exhibit 1).

This phenomenon has not only continued in 2024 — it has accelerated. Stocks yielding less than 50 bps now represent 37.5% of the index and have driven 55% of YTD total return (Exhibit 2). Again, while many of these companies are excellent businesses, this skew suggests animal spirits are causing market participants to pay high prices for a small group of stocks as they chase recent winners.

¹ As of March 31, 2024.

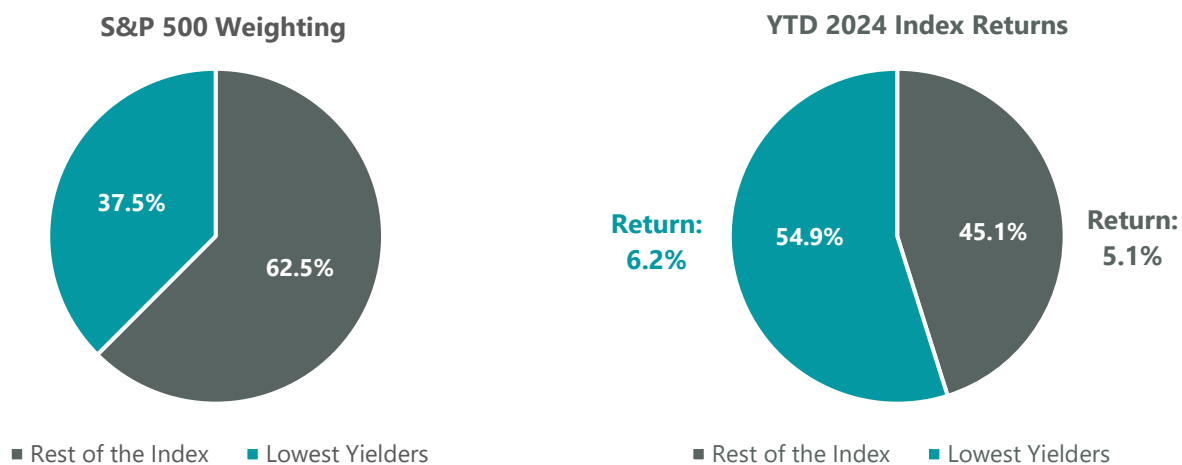
² Defined as those with no dividend or with a yield less than 0.5%.

Exhibit 1: Low Yielders Skewed Index Performance in 2023



As of Jan. 2, 2024. Source: ClearBridge Investments. S&P 500 Index holdings from Jan. 3, 2023, through Jan. 2, 2024.

Exhibit 2: Market Skew Continues in 2024



As of May 31, 2024. Source: ClearBridge Investments. S&P 500 Index holdings from Jan. 2, 2024 through May 31, 2024.

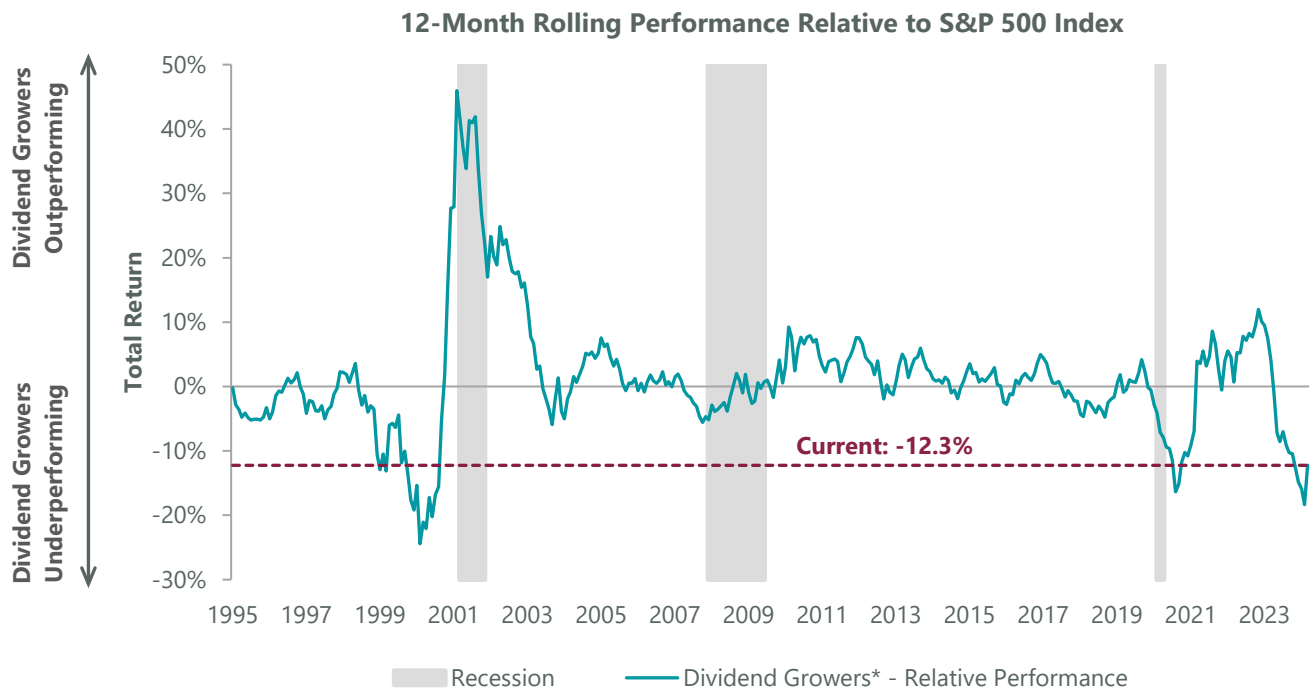
Against this backdrop, the current market offers good opportunities for risk-averse investors seeking quality businesses at a reasonable price. While less glitzy than AI, sectors like utilities, real estate, and consumer staples — all of which lagged in 2023 as the Fed lifted interest rates — offer the potential for attractive total return while embedding a margin of safety. Sempra, a California- and Texas-based utility, stands out. It trades at roughly 15x earnings with an 8% growth rate and a 3.5% up-front coupon. In real estate, we view Avalon Bay, an apartment company, and Public Storage, the largest self-storage company in the country, as well positioned. Both have strong balance sheets, reasonable valuations, nice up-front yields and best-in-class assets. Despite challenges in some parts of the real estate market, Avalon Bay continues to enjoy increasing rental rates, as high interest rates impede renters from buying homes. Near-term fundamentals for Public Storage are more challenged, as the storage sector continues to recalibrate after COVID led to a surge in demand, but the stock trades at a discount to estimated net asset value, a rare phenomenon given the phenomenal attributes of the self-storage business.

High-quality consumer staples typically trade at a premium to the market given their stability, pricing power and attractive returns on investment. Nestle, for example, has historically traded at a 13% premium to the market but

today trades at 19x next-12-month P/E, a 16% discount to the market. We would view this as an attractive valuation for a company with a phenomenal balance sheet, terrific brands and portfolio that is well-diversified by product line and geography. Meanwhile, Haleon is a consumer staple that specializes in everyday consumer health items like Advil and Sensodyne. These products are non-discretionary and are immune to GLP-1 concerns that have weighed on packaged foods companies. A strong balance sheet and good organic growth, as well as a valuation at a discount to the market, where high-quality staples normally trade at a premium, make Haleon an attractive opportunity. Both of these securities offer attractive upfront yields and generate solid free cash flow, and we expect their relative valuations will ultimately improve compared to the rest of the market.

Over the past year, dividend growers have trailed the broader market to a degree rarely seen over the past three decades (Exhibit 3). Past instances of similar underperformance have been followed by a strong bounce-back for dividend growers.

Exhibit 3: Dividend Growers Overdue



As of March 31, 2024. Source: S&P, NBER, Bloomberg. *Dividend Growers are S&P 500 stocks with three consecutive trailing years of positive dividend growth (inclusive of special dividends) on a rolling basis (quarterly), evaluated monthly, equal weighted.

If history is any guide and a rebound for dividend stocks is due, it stands to reason that the group would benefit from stocks from some sectors that AI fervor has left behind, especially those offering quality at a reasonable price.

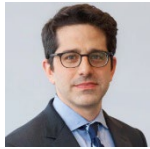
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