Appreciation ESG Strategy

Michael Kagan
Managing Director,
Portfolio Manager

Stephen Rigo CFA
Managing Director,
Portfolio Manager

Key Takeaways

- The technology-driven rally in the second quarter was truly unprecedented and marked a sharp reversal from the geopolitical malaise that plagued the first quarter: internal dynamics bore several similarities to the historic run of 1999's fourth quarter.
- Animal spirits remain elevated, with momentum stocks increasingly held by a more levered investor base at valuations leaving little margin for error; we believe current conditions argue for a more cautious stance.
- Social media litigation is entering a new phase, with recent court decisions suggesting legal and regulatory risk is shifting away from user-generated content toward platform design, with claims increasingly focused on addictive features and youth mental health.

Market Overview

The technology-driven rally in the second quarter was truly unprecedented and marked a sharp reversal from the geopolitical malaise that plagued the first quarter. Although the S&P 500 Index's 15.2% return was "only" the 12th best quarter for the index since 1950, it was the first time since the creation of the Global Industry Classification Standards (GICS) in 1999 that only one sector outperformed the benchmark: information technology.

The second quarter's internal dynamics bore several similarities to the historic run of 1999's fourth quarter. First, it was the only quarter besides 4Q99 that nine of 11 GICS sectors underperformed the index by more than five percentage points. Second, 13 S&P 500 stocks appreciated by more than 100% during the quarter, the most on record. All but one of these companies (Humana) were technology stocks. This exceeded the prior record of 11 such stocks in 4Q99. AI bubble or not, the historic nature of the second quarter's performance is difficult to ignore.

After pausing during the first quarter, technology shares reasserted market leadership. Technology returned a remarkable 31.8%, more than double the return of the index. Following this blowout quarter, the sector appears poised to outperform the S&P 500 for a fourth consecutive year in 2026.

Industrials was the only other sector to even come close to the S&P 500's return, rising 14.9%, or 0.3 percentage points below the benchmark. Within the sector, businesses linked to construction and energy infrastructure are broadly benefiting from data center and semiconductor foundry capital expenditures.

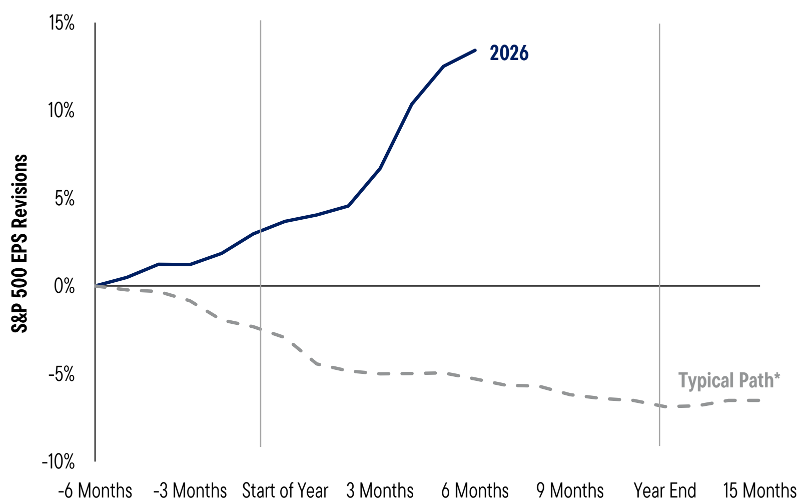
Every other sector lagged meaningfully. Energy shares were the largest detractor, declining 13.5%, or -28.7 percentage points below the S&P 500, as oil prices fell 30% to below $70 per barrel following the ceasefire agreement between the U.S. and Iran. Traditional defensive areas such as utilities and consumer staples were essentially flat, underperforming the index by roughly 15 percentage points, as investors used these sectors as sources of capital to re-risk portfolios back into the AI thematic.

Outlook

We believe the backdrop is nuanced. Fundamentals remain broadly supportive of risk assets, while several risks percolate beneath the surface.

Technology-driven capital expenditures are fueling a cyclical expansion in the industrial economy, which appears likely to serve as a tailwind to growth for the remainder of 2026. Indeed, the ISM Manufacturing Index has now spent six consecutive months in expansion, the first such stretch since the 29-month expansion between January 2020 and October 2022. At the same time, corporate profits have exceeded analyst expectations at a rate rarely seen outside of a post-recession economy (Exhibit 1).

Exhibit 1: Corporate Profit Expectations Unusually High

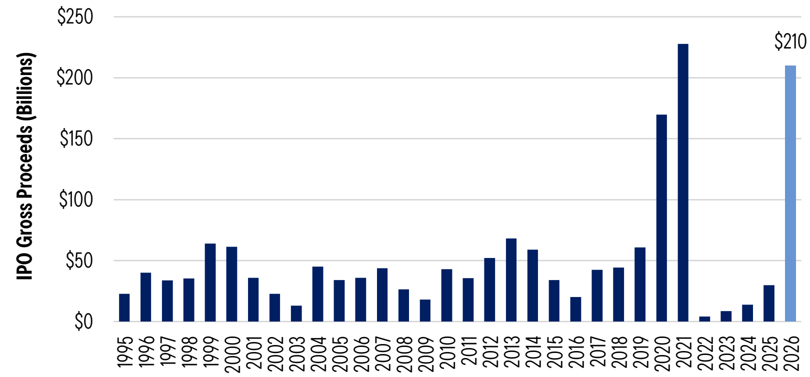


As of June 30, 2026. Source: ClearBridge Investments, S&P, FactSet.

Capital markets also remain wide open, supported by ample liquidity. Year to date, investment grade and leveraged loan issuance has already surpassed any full calendar year on record, while the high-yield issuance appears likely to exceed prior peaks. Buoyed by the successful SpaceX IPO, gross IPO proceeds are also likely to surpass any previous calendar year total (Exhibit 2). Finally, credit spreads are back to generational lows following a brief increase during the U.S.-Iran conflict.

Among the many risks facing markets today, euphoria and valuation are logical starting points. At 230%, the current ratio of equity market cap to GDP is now more than three standard deviations above its long-term average and well above any prior level in modern history. Yes, fundamentals are strong and profit margins are at record highs, but valuations suggest that expectations for future growth are also extremely elevated.

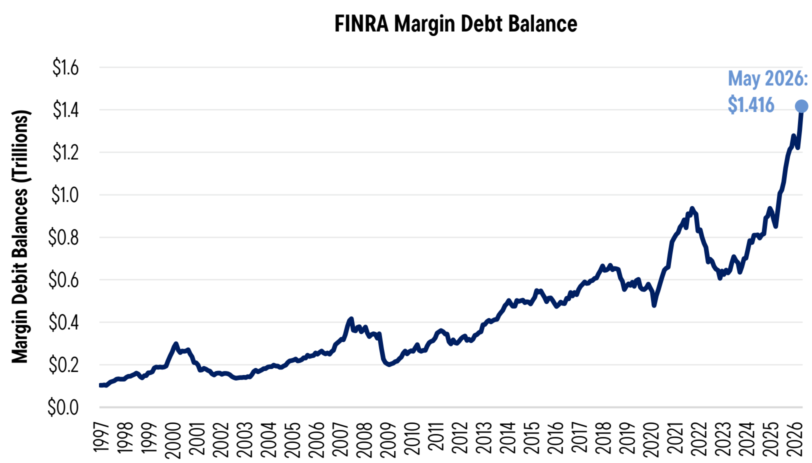
Exhibit 2: A Bumper Year for IPO Gross Proceeds



As of June 30, 2026. Source: ClearBridge Investments, FactSet. NYSE and Nasdaq listed companies; 2026 YTD is annualized.

Leverage is proliferating across the stock market. According to FINRA, margin debt balances rose 50% year over year and now stand at all-time highs (Exhibit 3). Zero-day-to-expiration (0DTE) options now account for 28% of all U.S. options volume, up from 18% three years ago, representing a five-fold increase since the 2022 launch of daily expirations. Today, zero-day options exceed $1 trillion of daily notional trading. Meanwhile, leveraged ETFs have become increasingly popular, providing investors with targeted, levered exposure to the market's hottest trades. Leveraged ETFs now generate 13% of all ETF trading volume despite being only 2% of total ETF assets, underscoring robust demand from both traders and retail investors.

Exhibit 3: Margin Debt Balances at All-Time Highs



As of May 2026. Source: FINRA Margin Statistics; values shown are USD.

Other tangible risks bear watching. Inflation remains stubbornly elevated, as technology component shortages are challenging the decades-long assumption that technology advancement is inherently deflationary. The U.S.-Iran ceasefire remains tenuous, leaving energy markets subject to renewed volatility. The Federal Reserve appears to be in a position where raising rates remains the path of least resistance, with the yield curve flattening as short rates rise in anticipation of such a move. Finally, the midterm elections are likely to be contentious and could pull AI further into the political debate.

Conclusion

As through-the-cycle investors with an emphasis on downside protection, we believe current conditions argue for a more cautious stance. Animal spirits remain elevated, with momentum stocks increasingly held by a more levered investor base at valuations leaving little margin for error.

That said, given ongoing economic momentum and sustained technology-related capital expenditures, we don't see meaningful risk of a recession. Rather, we view today's herd mentality as evidence of a market that is overdue for a speculative washout. Such a correction would force investors to retrench and focus on their highest-conviction, long-term ideas rather than continuing to blindly chase momentum.

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We would view a correction, even a reasonably sharp one, as healthy for the long-term durability of the bull market.

Portfolio Highlights

The ClearBridge Appreciation ESG Strategy underperformed the benchmark S&P 500 Index in the second quarter of 2026. On an absolute basis, the Strategy had positive contributions from eight of 11 sectors. The IT sector was the main positive contributor, while consumer staples and energy were the main detractors.

In relative terms, stock selection and sector allocation detracted. Stock selection in IT, industrials, communication services, consumer staples, consumer discretionary and financials, overweights to consumer staples and materials and an IT underweight detracted the most. Conversely, stock selection in materials and an energy underweight were beneficial.

On an individual stock basis, the biggest relative contributors during the quarter were ASML, Palo Alto Networks and not owning Exxon Mobil, Chevron and Palantir. The biggest detractors were Netflix, Costco, TJX, an underweight to Micron Technology and not owning Intel.

During the quarter, we initiated new positions in SpaceX in communication services, Micron Technology, Cisco Systems, Advanced Micro Devices and Texas Instruments in IT and Diamondback Energy in energy. We exited Roblox in communication services, Boston Scientific and AbbVie in health care and Solstice Advanced Materials in materials. We also received shares of Honeywell Aerospace in the industrials sector following its spinoff from holding Honeywell International.

ESG Highlights: Social Media Under Scrutiny

Social media companies are coming under increasing pressure from state attorneys general, school districts and parents arguing platforms such as Meta Platforms' Facebook and Instagram, Snapchat, TikTok and Alphabet-owned YouTube knowingly designed features that are addictive to young users and failed to adequately warn about mental health risks.

The success of recent lawsuits in California and New Mexico against Meta and YouTube could be impactful for social media broadly, raising regulatory and financial risk and creating the potential for reputational damage.

In New Mexico, a jury awarded $375 million in civil penalties against Meta for misleading the public about predator exploitation on its platforms in violation of state consumer protection law.

Not long after, a jury in Los Angeles became the first to hold social media companies responsible for contributing to a plaintiff's mental health harm via addictive design. The jury determined that Meta and YouTube were liable for negligence and failure to warn related to the plaintiff's alleged social media addiction. The plaintiff was awarded $6 million in damages.

These lawsuits are notable for not seeking action against the content featured on the platforms — for years, such attempts were unsuccessful, largely due to Section 230 of the Communications Decency Act, which protects social media companies from liability related to content posted by their users. Instead, the lawsuits attempt to find fault in the design of the products.

They also follow several milestone national regulations around the world that have involved restrictions on youth access to social media (Exhibit 4). Several U.S. states — such as Utah, Arkansas, Louisiana, Florida, Georgia, Tennessee and Nebraska — have also passed laws restricting minors' use of social media, although many of these are currently being challenged in court.

Exhibit 4: National Restrictions on Youth Access to Social Media

2023	France	Prohibits most social media accounts for children under 14 and parental consent for ages 14-15
2024	Australia	First country to enact nationwide min. age of 16 for social media
2025	Australia	Under 16 ban enters into force
2025	Malaysia	Establishes nationwide min. age of 16 for social media
2025	Portugal	Establishes nationwide min. age of 16 for social media

As of June 30, 2026. Source: ClearBridge Investments.

Social Media Platforms and Active Ownership

ClearBridge owns both Meta and Alphabet in several portfolios, and we are cognizant of the risks to both society from social media and the companies via potential liability. Against this backdrop, we recently engaged with Meta to discuss youth safety. In our conversation in May, we sought to test the real-world effectiveness, credibility and trade-offs of Meta's youth safety efforts, while probing regulatory risk, reputational risk with financial penalties and competitive positioning.

Meta shared that it believes its youth safety measures such as AI-based age verification, content moderation and privacy and parental controls are best-in-class, although this could be challenged. The company also shared that it supports youth safety regulation; its requests for regulation would be for no outright bans, consistency across geographies and equal application to all social media companies.

ClearBridge's approach focuses on the companies' risk management regardless of the source of risk.

Meta noted that its Teen Accounts enable the above safety measures by default, it employs AI to screen account content for signs that a user may have lied about his or her age and it automatically age gates as appropriate. In aggregate, these features have led to a "marked improvement" in compliance and outcomes, according to the company. In response to critics that claim these features still let through inappropriate content, the company believes these instances of algorithm failure are exceptions rather than the norm.

We advised the company to disclose the data supporting its claims that its youth initiatives are working and leading to "marked improvement," as it did not provide any during the meeting. Further, we shared our preference that, to lend greater credibility to the claims, this data should be audited by a third party.

We also explained our difficulty in locating information on these issues on Meta's websites. We noted that information difficult to find for professional investors would likely be even more challenging for everyday users — parents, for example — to locate and to inform their decisions to use the platform. We asked the company to consolidate all its statements on this subject in a single place — rather than spread it out across several different websites — to make it easier for various stakeholders to find and evaluate, similar to what the company does for its environmental disclosures. Meta was receptive to our input.

In June a trust and safety company that helps platforms and AI developers detect and prevent harmful online behavior and unsafe AI outputs published a study in cooperation with Meta that used Meta's content standards to compare the Teen Accounts content experience on Instagram versus a competitor platform. Testing was conducted from mid-December 2025 to mid-January 2026 and found that the safeguards applied to Teen Accounts on Instagram performed better than a competitor platform across several dimensions. While the period may seem short for such a study, Meta has disclosed that Teen Accounts are in the hundreds of millions; as users access the apps multiple times a day, this would aggregate to a statistically significant sample, although ideally the company could disclose time series data showing content moderation improvement over a longer horizon. Also in June, Meta rolled out its Teen Accounts protections globally to all apps as well as parental alert notices for inappropriate content searches by teens.

Conclusion

Content responsibility remains a key component in assessing social media platforms such as those operated by Meta and Alphabet. ClearBridge's approach stresses several components of this topic: rigorous content moderation can potentially limit harmful or illegal content while seeking to maintain platform integrity, and child safety raises questions of regulatory and reputational risk.

Over the years of ClearBridge's ownership with Meta and Alphabet, we have witnessed both companies improving their content responsibility (Exhibit 5). Meta has made progress on its content policy by appointing an independent content oversight board and then growing its scope. After historically having some issues around brand safety and protecting children from sensitive content, YouTube has made significant progress in this area through staffing, technology and policy development. In 2021, YouTube became the first digital platform to receive accreditation for content-level brand safety from the Media Rating Council (MRC), following an independent audit of its content moderation, monetization and ad placement systems.

At the same time, recent litigation with social media suggests the risk profile for these companies is evolving; regulatory risk is shifting from content moderation to product design. ClearBridge's approach focuses on the companies' risk management regardless of the source of risk. As our engagement with Meta shows, we also focus on transparency, as investors need evidence that youth safety initiatives are working in practice, not only descriptions of policies or tools.

Exhibit 5: Content Responsibility Improvement Timeline

Year	Meta	Alphabet
2018	Announces Oversight Board	Expands AI moderation investments
2020	Oversight Board established	COVID-19 misinformation policies
2021	Oversight Board begins issuing decisions	First MRC content-level brand safety accreditation
2022	Updated Community Standards enforcement, explanation and review	Enhanced election misinformation measures
2023	AI content labeling initiatives launched	Generative AI safety commitments
2024–2025	Expanded AI-generated content policies	Gemini AI safeguards and synthetic media labeling

Source: ClearBridge Investments.

Social media is a fast-moving topic involving billions of participants — Meta reports 3.5 billion daily active users, while Alphabet reports over 2 billion signed-in monthly users for YouTube. We continue to educate ourselves on the sustainability factors affecting this industry as we monitor the evolution of litigation and the broader social media bans; we will continue to actively incorporate this analysis into our investment process and stewardship activity.

Performance source: Internal. Benchmark source: Standard & Poor's.