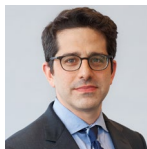




John Baldi
Managing Director,
Portfolio Manager



Michael Clarfeld, CFA
Managing Director,
Portfolio Manager



Peter Vanderlee, CFA
Managing Director,
Portfolio Manager

Dividend Strategy

Key Takeaways

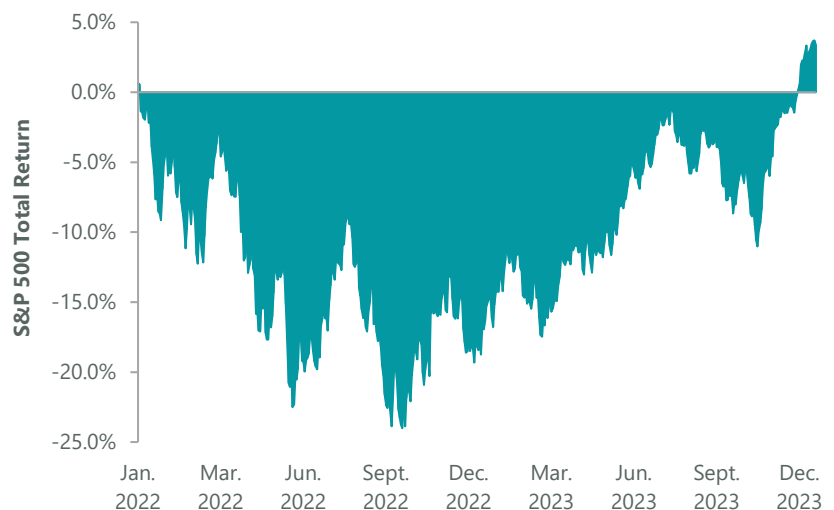
- ▶ The market bounced in 2023, after a sharp decline in 2022, driven by enthusiasm for AI and an improving interest rate outlook.
- ▶ Throughout 2023 we took advantage of oversold conditions to meaningfully increase our exposure in pipelines, utilities and real estate and also found opportunities in overlooked areas of health care.
- ▶ With 2023's terrific bounce leaving valuations high, capital appreciation is likely to be more restrained in 2024, underscoring the value of a diversified portfolio of high-quality dividend growers.

Market Overview

The fourth quarter marked a strong end to a strong year for the stock market. The S&P 500 Index increased ~12%, while the ClearBridge Dividend Strategy captured about 85% of those gains. For the full year the market was up 26%, while the ClearBridge Dividend Strategy was up a little over half as much. Viewed in isolation, 2023 was a great year for the markets.

Of course, nothing happens in isolation. 2023 followed 2022, one of the worst years for investors in all of history. On a combined basis, the last two years represent much ado about nothing: despite the see-saw action, the market is essentially flat with where it ended 2021 (Exhibit 1).

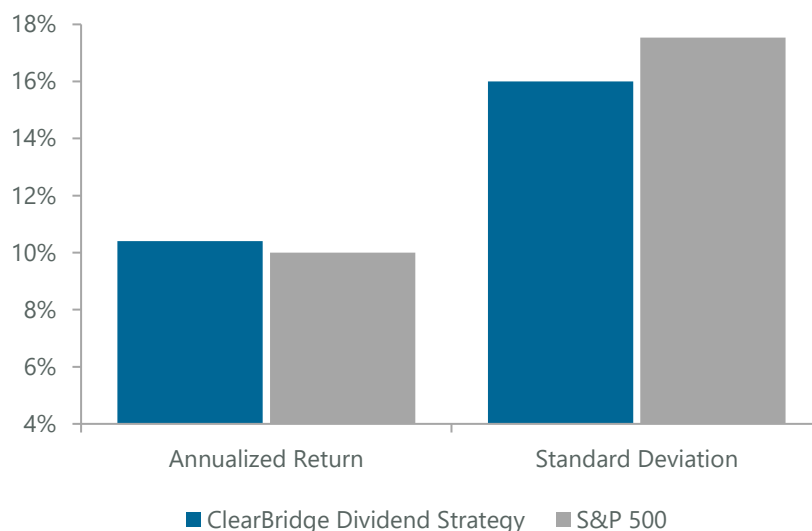
Exhibit 1: Most of 2023's Big Gains Simply Recouped 2022's Losses



As of Dec. 31, 2023. Source: ClearBridge Investments, FactSet.

Our pattern of relative performance over the last two years is consistent with our expectations. In 2022, the S&P 500 was down about 18%. The ClearBridge Dividend Strategy was down less than half as much. In 2023 the market bounced sharply. We profited as well, though less than the market because our 2022 losses were so much smaller than the market's. Over a full market cycle, we strive to provide comparable-to-better performance than the market with less volatility (Exhibit 2).

Exhibit 2: Strategy Returns and Volatility (Three-Year)



As of Dec. 31, 2023. Source: ClearBridge Investments, FactSet. Returns are shown net of fees.

The S&P 500 is generally considered to be a broad market index, but most of its returns in 2023 came from just seven stocks. The so-called Magnificent Seven (Alphabet, Amazon.com, Apple, Microsoft, Meta, Nvidia and Tesla) rose 76%, generating 62% of the S&P 500's returns in 2023. Indeed, the remaining 493 stocks were up just 14% and made up 38% of total gains. Years like this present challenging comparisons for dividend investors. Most of the Magnificent Seven do not pay meaningful dividends and so are not suitable candidates for the ClearBridge Dividend Strategy.

The Magnificent Seven make for splashy headlines and do, indeed, tell much of this year's story. Underlying this catchy tagline, however, are three factors that merit further discussion: 1) depressed 2022 year-end stock prices in technology, 2) investor enthusiasm for AI and 3) inflation and interest rates.

Annual performance is a snapshot from one December 31st to the next: starting points matter. In 2022 the broad market was down 18%, the Russell 1000 Growth Index was down 29% and the Magnificent Seven were down 39%. Fast forward to early 2023: AI mania took off, technology spending increased and the gloom over the IT sector lifted. Improving sentiment combined with easy comps set the stage for a terrific year.

Investors tend to overestimate the impacts of technology one year out but underestimate the impacts 10 years out.

Most of the noise around AI so far is still just that: noise. There are currently few large-scale, commercialized applications of AI. Nevertheless, AI is very real, will profoundly impact the economy and society, and is just around the corner. Investors tend to overestimate the impacts of technology one year out but underestimate the impacts of technology 10 years out.

As we have learned from previous technology cycles, the “sure things” of the early days are not always the long-term winners. Consider AOL, MySpace, Nokia, Sun Microsystems, Yahoo, etc. Nvidia, the premiere manufacturer of computer chips used in AI, was the market darling of 2023. Its stock surged over 200%, adding nearly a trillion dollars to the company’s market capitalization! Given the difficulty in designing and producing cutting edge chips, it is hard to imagine Nvidia being displaced like AOL or Yahoo. But given the size of the opportunity and the importance of the technology, many companies are trying to do just that.

Microsoft is the largest holding in our portfolio. Given its partnership with OpenAI and leading position in the cloud, Microsoft is well-positioned to profit from the boom in AI. However, due to Microsoft’s tremendous scale and diversification, the company is not dependent upon AI for its success. Microsoft’s diverse portfolio of software and cloud offerings ensures the company will thrive even if the next hot thing, like AI, fizzles out. In this way, Microsoft is emblematic of our broader investing approach. We seek to benefit from powerful trends, but we do so with an eye toward managing risk and limiting downside in case the future turns out to be less rosy than hoped for.

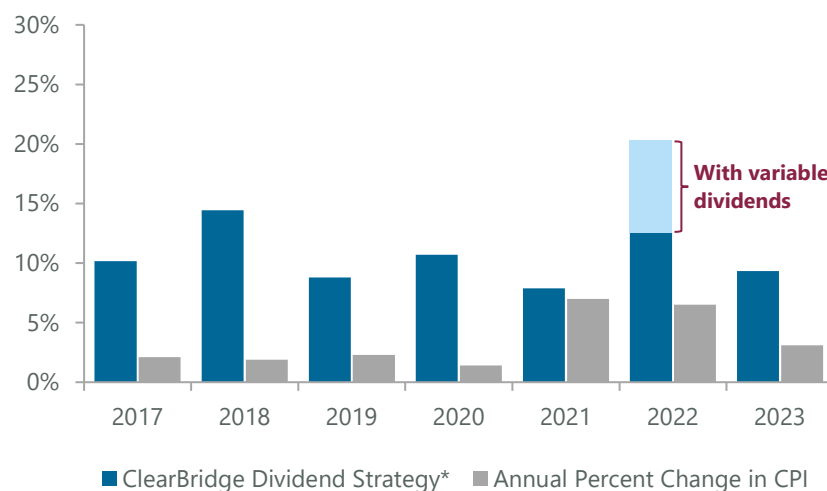
As we trace the market’s broader performance over the last two years, the biggest drivers have been inflation and interest rates. Soaring inflation led the Fed to hike rates sharply in 2022, spooking investors and pushing markets lower. In 2023, inflation eased significantly, giving the Fed room to pause and contemplate future rate cuts. While we are pleased to see inflation ease, it is premature to declare victory. History is replete with episodes where inflation has abated only to resume climbing.

Portfolio Positioning

Regardless of the direction of interest rates, we believe we are well-positioned. If rates decline, dividend growers should thrive as their yields become more attractive; particularly higher-yielding investments such as our pipelines, utilities and real estate holdings. Indeed, throughout 2023 we took advantage of undue declines in these areas to meaningfully increase our exposure in American Tower, Enbridge, Public Storage, Sempra and Williams.

Conversely, if inflation and interest rates resume their ascent, our portfolio of dividend growers should provide safe harbor. Growing dividends are one of investors' few tools for combating the ravages of rising interest rates and inflation. So long as dividends grow faster than inflation, purchasing power is preserved and, indeed, expanded (Exhibit 3). This feature of dividend growth is critical as we think about saving for and sustaining retirement, and contrasts sharply with bonds — where inflation and rising rates erode one's principal and reduce one's purchasing power.

Exhibit 3: Dividend Growth Is Critical to Offsetting Inflation



*The ClearBridge Dividend Strategy is an SMA – Nominal Dividend Growth.

Data as of Nov. 30, 2023. Source: FactSet, BLS, St. Louis Fed (FRED), Federal Reserve Bank of Minneapolis.

As we have discussed several times over the last few years, rising interest rates present a meaningful headwind to asset values. By increasing the denominator used to discount future cash flows, rising interest rates reduce their present value. This phenomenon reduces the value of all assets, but most severely impacts assets whose value is determined by cash flows far into the future, like high-multiple growth stocks. Over the last few years, we exited a handful of terrific companies — Ecolab, NextEra and Zoetis — as we deemed their growth insufficient to sustain their asset values amid higher rates. Along these lines, we meaningfully reduced our exposure to Apple in 2023.

Apple is the largest company in the world and produces terrific products that engage users for hours each day. Despite the company's size, ubiquity and relevance, however, Apple's growth has slowed dramatically. Its fiscal 2023 earnings were flat with those of 2022. Apple trades at 30x earnings; sustaining that multiple will require a meaningful acceleration in revenues. While such an improvement is possible, we do not see any obvious catalysts for adding tens of billions of dollars to Apple's topline. Consequently, the risk-reward skews negatively.

In the second half of 2023 — as we were selling low-growth, high-multiple stocks and taking advantage of oversold conditions in infrastructure, real estate and utilities — we also found opportunities in overlooked areas of health care. After adding Gilead in the third quarter, we bought AstraZeneca in the fourth quarter. Each of these stocks present distinct investment cases, but both are reasonably valued and have limited patent expiry or pipeline risk. Gilead's strength comes from its dominant franchise in HIV. It offers lower growth, but it yields nearly 4% and trades at 11x earnings. AstraZeneca possesses a diversified portfolio of pharmaceuticals, which should deliver double-digit earnings growth, yet it trades at just 16x earnings. These stocks were underwritten individually, but collectively we like the idea of increasing our exposure to defensive and growing health care names at below-market multiples.

Looking forward to 2024, we are optimistic about the economy. Employment remains robust, inflation is easing and interest rates may have peaked. This combination should make for solid earnings and dividend growth. Given the starting point, however — with higher valuations post 2023's terrific run — capital appreciation is likely to be more restrained. Against such a backdrop, we believe a portfolio of high-quality dividend growers is well-positioned.

Portfolio Highlights

The ClearBridge Dividend Strategy underperformed its S&P 500 Index benchmark during the fourth quarter. On an absolute basis, the Strategy saw positive contributions from all 11 sectors in which it was invested for the quarter. The information technology (IT), financials, industrials and materials sectors were the main positive contributors.

On a relative basis, sector allocation detracted, while stock selection contributed positively. In particular, stock selection in the energy and materials sectors and an overweight to the real estate sector added to relative results. Conversely, stock selection in the health care, communication services and consumer staples sectors, energy and consumer staples overweights and an underweight to the IT sector detracted.

On an individual stock basis, the main positive contributors were Microsoft, Broadcom, Intel, JPMorgan Chase and American Tower. Positions in Becton Dickinson, Pfizer, Exxon Mobil, Cisco Systems and Chesapeake Energy were the main detractors from absolute returns in the quarter.

In addition to portfolio activity discussed above, we also initiated a new position in Exxon Mobil in the energy sector.

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CLEARBRIDGE DIVIDEND STRATEGY

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