



A Franklin Templeton Company



Michael Kagan
Managing Director,
Portfolio Manager



Stephen Rigo CFA
Managing Director,
Portfolio Manager

Appreciation ESG Strategy

Key Takeaways

- ▶ While market participation broadened in the fourth quarter, 2025 was again dominated by mega cap technology and the AI ecosystem.
- ▶ An easing Fed, a positively sloped yield curve, tight credit spreads and open capital markets make for a positive backdrop for stocks, yet speculative risks appear to be building especially around AI, and there is little valuation support to fall back on.
- ▶ The continued — and apparent increase in — relevance for governance topics reflects our view that good governance is a catalyst for value creation.

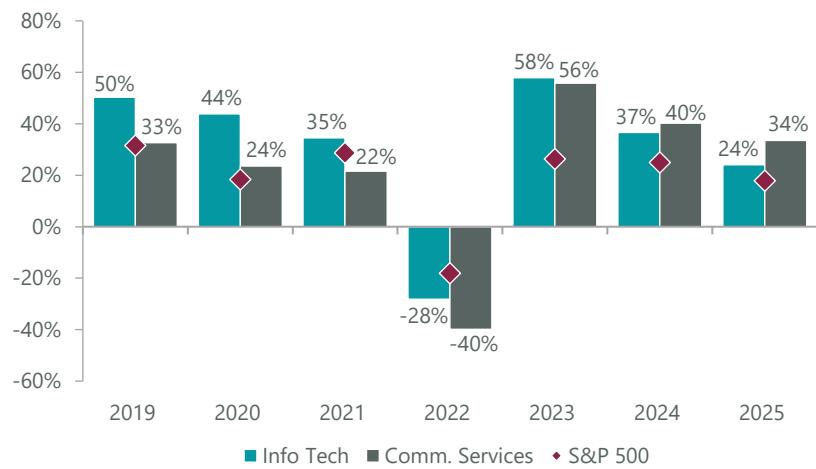
Market Overview

The S&P 500 Index extended its advance in the fourth quarter, rising 2.7% and finishing the year up 17.9%. Following the "Liberation Day" selloff, the index posted gains in each subsequent month (eight consecutive monthly advances), climbing 37% from the April 8 market low.

At year end, the S&P 500's trailing three-year annualized return was 23%. That level has been exceeded in only five calendar years since 1930: 1935 (as the market emerged from the Great Depression), 1997-1999 (the Internet boom) and 2021 (at the end of the COVID stimulus rally).

While market participation broadened in the fourth quarter, 2025 was again dominated by mega cap technology and the AI ecosystem. In what has become an all-too-common theme, the S&P 500's 10 largest companies contributed 53% of the benchmark's 2025 return and now account for more than 40% of the index's market cap — more than double their weight a decade ago. Unsurprisingly, the communication services and information technology (IT) sectors led benchmark performance by a wide margin, rising 34% and 24%, respectively. Notably, despite these strong gains, 2025 marked the lowest absolute return for both sectors over the past three years (and IT's second-lowest calendar year return since 2018), underscoring the magnitude of the prior two years' AI-driven advances (Exhibit 1).

Exhibit 1: IT and Communication Services Calendar Year Returns



As of Dec. 31, 2025. Sources: ClearBridge Investments, Bloomberg Finance.

2025 marked the lowest absolute return for IT and comm services over the past three years, underscoring the magnitude of the prior two years' AI-driven advances.

Breadth in the fourth quarter reverted to roughly historical norms: 55% of benchmark shares traded above their 100-day moving average (versus 58% historically). The increased breadth drove more muted sector dispersion, with only two sectors deviating from the benchmark by more than five percentage points, the smallest variance since the third quarter of 2021. Paradoxically, leadership at the sector level remained concentrated: only two of 11 GICS sectors outperformed in the quarter, the fewest sectors to outperform in a quarter since the first quarter of 2018. Health care led the advance, rising 11.7% on the heels of a strong rally in pharmaceutical stocks. Communication services was the only other sector to outperform, helped by strong performance from Alphabet, which rose 29% and represents roughly half of the sector's weight. Real estate, meanwhile, declined 2.9%, capping a difficult 2025 as the benchmark's laggard sector. Utilities were the only other sector to post a negative absolute return in the quarter, down 1.4%.

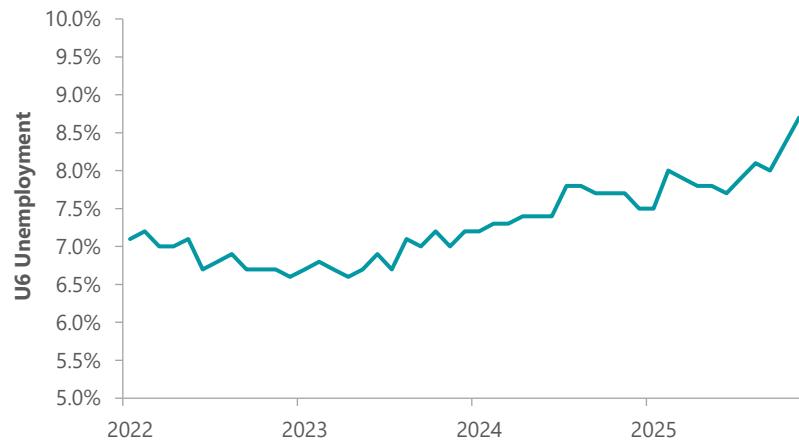
Outlook

As long-term investors, we find ourselves at a crossroads. On one hand, the backdrop for equities remains constructive: the Fed has begun easing monetary policy and is likely to continue cutting rates; the yield curve is positively sloped with short rates anchored; credit spreads are tight; and capital markets remain wide open. On the other hand, speculative risks appear to be building, as evidenced by a growing number of vendor-supported partnerships designed to finance unprecedented capital outlays to untested business models at elevated valuations. That circular dynamic — where vendors (or capital markets) are required to fund buildouts — increases risk, particularly given the optimistic growth assumptions used to justify the spending. Given the enthusiasm around AI and sharply higher stock prices, it is increasingly easy to draw parallels to the late 1990s period of excess.

Valuation alone is rarely a reason to sell, but by several measures equities have never been more expensive.

Adding to our concern, for the first time since before COVID we are becoming attentive to the stability of the U.S. consumer, whose resilient spending has been central to U.S. economic growth. The job market has seemingly stalled. ADP data suggests nonfarm payrolls were negative in four of six months in the second half of 2025, versus only one month of negative payrolls in the preceding 58 months following the 2020 COVID shock. Underemployment, as measured by Form U6 filings, rose one percentage point to 8.7% in the back half of 2025 (Exhibit 2). In addition, decelerating wage growth alongside stable inflation suggests a more challenging environment for disposable income, forcing consumers to strain their savings. Notably, residential housing — historically an important contributor to household wealth — is stagnating and remains unaffordable for all but the wealthier half of households.

Exhibit 2: Underemployment on the Rise



As of Dec. 31, 2025. Sources: ClearBridge Investments, Bloomberg Finance, Bureau of Labor Statistics.

Offsetting these concerns, corporate earnings continue to exceed market expectations. Technological advancements are driving productivity gains across the economy, from the automation of repetitive tasks and improved logistics efficiency to higher returns on advertising. To date, rising equity prices and the wealth effect have helped offset a more challenging employment backdrop. The interaction between productivity gains and labor market conditions is a key variable as we evaluate the path for stocks in 2026.

Valuation alone is rarely a reason to sell, but by several measures equities have never been more expensive. For example, the Buffett Ratio, which measures total equity market cap to GDP, stands at 215%, its highest reading since the series began in 1990 and more than two standard deviations above its long-term average. We interpret this as a market already discounting a sizable share of AI's hoped-for gains in GDP and corporate profits, leaving limited margin for delays or disappointments. We would also note that the Fed Model — comparing the 10-year Treasury yield relative to the S&P 500 earnings yield (earnings yield is the inverse of the P/E ratio) — is close to equilibrium, a situation rarely seen since 2002 (Exhibit 3).

Today's risk-free rate is a far more competitive alternative relative to risk assets than at almost any time over the past 25 years.

Exhibit 3: Fed Model — S&P Earnings Yield vs. 10-Year Treasury Yield



As of Dec. 31, 2025. Sources: ClearBridge Investments, Bloomberg Finance.

Conclusion

Like in the past year, policy today remains supportive of near-term growth, and capital markets conditions suggest risk assets — such as stocks — can continue to perform. But for the first time in the post-COVID period, we see pockets of weakness that could result in a more challenging economic backdrop.

Given signs that markets may be entering a more speculative phase, we believe the probability of a correction (a peak-to-trough decline of >10%) has risen, and the possibility a selloff could prove more prolonged than in recent years makes the "buy the dip" mentality more precarious. In our view, capital markets will determine whether equities can sustain their advance. If investors continue to reward AI-related capex with higher share prices the cycle can persist. However, if markets tire of new multiyear infrastructure commitments or funding AI firms at ever richer valuations, there is little valuation support to fall back on. With half of consumers already showing signs of strain, we view any correction as posing more risk than any time in recent memory.

We remain focused on through-the-cycle outperformance via downside protection, and we increasingly believe risks may be starting to outweigh the prospective rewards. Accordingly, we're keeping a close eye on balance sheet and cash flow durability across our AI-exposed holdings to ensure our exposure is concentrated in companies with the financial wherewithal to weather a potential cooling in today's white-hot environment.

Portfolio Highlights

The ClearBridge Appreciation ESG Strategy underperformed the benchmark S&P 500 Index in the fourth quarter. On an absolute basis, the Strategy had gains in four of 11 sectors. The health care and communication services sectors were the main positive contributors, while the industrials and materials sectors were the main detractors.

In relative terms, overall stock selection detracted; stock selection in the communication services, industrials, IT and materials sectors detracted the most. Conversely, stock selection in health care and consumer discretionary and a communication services overweight proved beneficial.

On an individual stock basis, the biggest contributors to relative performance during the quarter were Eli Lilly, Alphabet, Thermo Fisher Scientific, ASML and an Oracle underweight. The biggest detractors were Netflix, Eaton, Costco, Automatic Data Processing and not owning Micron Technology.

During the quarter, we initiated new positions in Ferguson in industrials, Boston Scientific in health care and Amphenol and Arista Networks in IT. We exited Canadian Pacific Kansas City in industrials, Lennar in consumer discretionary and Oracle and Texas Instruments in IT. We also received shares of Solstice Advanced Materials in materials following its spinoff from Honeywell International.

ESG Highlights: The Evolving Proxy Landscape

Of the tools public equity investors can use to advocate for sustainable business practices, proxy voting is one of the more visible and powerful. It was vigorously debated in 2025. Throughout the year the SEC tightened parameters for shareholder proposals, strengthening the grounds on which they can be excluded from annual meetings.¹ It announced it would no longer “respond to no-action requests for, and express no views on, companies’ intended reliance on any basis for exclusion of shareholder proposals under Rule 14a-8,” with minimal exceptions.² The likely result will be to enable companies to exclude proposals without having to seek SEC approval, leading to fewer shareholder proposals making it to a vote.

Against this backdrop, the broad trends of the 2025 proxy season were a decline in environmental and social proposals and heightened scrutiny on governance issues. Major topics of environmental proposals filed included emissions disclosures and climate risk and plastic pollution. Social proposals, which were reduced in number, showed continued concern with workforce-related risks like pay equity, workplace safety, and diversity and inclusion. Like environmental proposals, social proposals received less support in 2025 than in previous years, although many of these proposals filed

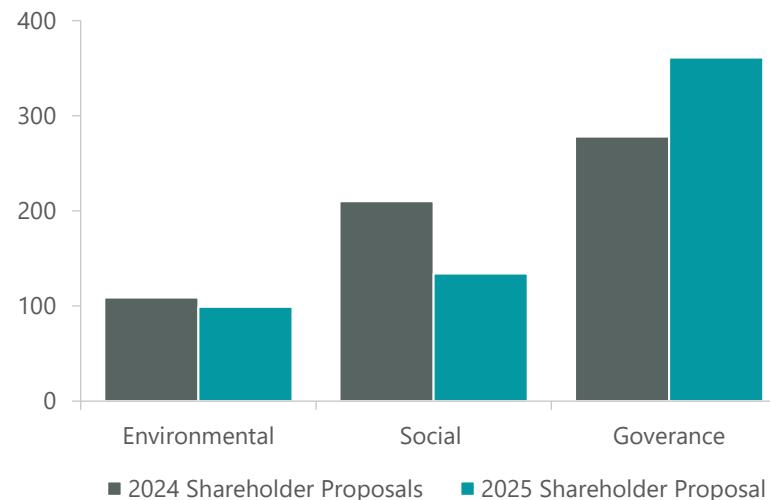
¹ Staff Legal Bulletin No. 14M.

² Statement Regarding the Division of Corporation Finance’s Role in the Exchange Act Rule 14a-8 Process for the Current Proxy Season, Nov. 17, 2025. U.S. Securities and Exchange Commission.

were perhaps “overly prescriptive, duplicative of existing disclosures, or insufficiently tailored to company-specific issues,”³ a reminder that such proposals need to be judged on a case-by-case basis.

Declines in environmental and social proposals and an increase in governance proposals (which received steady support, all told) were also reflected in ClearBridge’s voting activity in 2025 (Exhibit 4).

Exhibit 4: Shareholder Proposals Voted on by ClearBridge



As of December 2025. Source: ClearBridge Investments.

The continued — and apparent increase in — relevance for governance topics reflects our view that good governance is a catalyst for value creation: board and chair independence reduces insular oversight; separating CEO and board chair roles reduces the potential for conflicts of interest; diversity on the board leads to more varied views and strengthens governance; board tenure should balance experience with innovation; linking compensation with sustainability factors could improve environmental stewardship and ensure the social license to operate. We have seen incremental improvements across many of these goals in recent years, and they remain worthy of supportive company dialogue.

Voting on a Case-by-Case Basis

Per ClearBridge’s Proxy Voting Policy, we evaluate certain environmental and social proposals on a case-by-case basis. While we would generally be supportive of ESG proposals, we also consider whether the ask from the shareholder proposal has merit and whether the wording in the proposal diminishes or enhances shareholder value.

We also take note if a proposal does not seem to recognize substantial improvements by the issuer on the requests being addressed. This is an important element of ClearBridge’s approach to

³ “2025 Proxy Season Review: From Escalation to Recalibration,” Harvard Law School Forum on Corporate Governance. Sept. 15, 2025.

proxy voting and our partnership approach to active ownership: we engage with CEOs, CFOs and other company leaders regularly about all factors that could materially affect value creation. This provides a valuable information component for assessing the merits of shareholder proposals.

Here we offer highlights of some recent ClearBridge votes and our thinking behind them.

Companies Are Making Sustainability Improvements

Amazon.com is a good example of a company that has made substantial improvements in areas where it nevertheless continues to see proposals: in 2025, for example, we examined a shareholder proposal asking the company to report on efforts to reduce plastic packaging. The company has received similar proposals for the past five years but has been making significant progress, addressing the resolutions of the proposals with improvements each year.

We chose not to support this proposal this year on the grounds that the company has already been reporting its plastic packaging reduction efforts and has quantified and published the improvements to the public each year. Such improvements include transitioning away from plastic in its outbound packaging and working with its vendors to let them ship in their own brand packaging via their Ships in Product Packaging (SIPP) program — reducing the use of an Amazon box on top of the product packaging. In addition, as of October 2024, Amazon has removed all plastic air pillows from delivery packaging used in its global fulfillment centers, which to date is the biggest decrease in plastic packaging in North America.

Moreover, through innovation and investment in technologies, processes and materials since 2015, Amazon has been able to reduce the weight of the packaging per shipment by 43% on average and avoided more than three million metric tons of packaging material. There are other achievements in packaging (both plastic and other materials) that the company has reported publicly.

Amazon is advancing partnerships and research to improve recycling infrastructure, engaging with organizations such as the Ellen MacArthur Foundation and The Recycling Partnership and demonstrating its efforts to align with industry peers, even if Amazon is not formally a signatory to the New Plastics Economy Global Commitment. We would still like to see Amazon publish an overall baseline of plastic used across its entire supply chain, to add to its robust reporting levels for outbound packaging practices.

Voting Requires Deep Knowledge of the Company

Our portfolio managers chose not to support a shareholder proposal asking Microsoft to report on the risks of its European Security Program (ESP) being used for censorship of free speech. We thought this proposal appeared to conflate a cybersecurity initiative with speech regulation and could mislead investors on the nature of the

ESP. The company launched the ESP in response to the sharp rise in ransomware and cyberattacks involving espionage, data theft and disruption of democratic institutions.

Microsoft's ESP provides structured, limited-scope support to governments by sharing insights into these threats and aligns with Microsoft's Information Integrity Principles, which emphasize trusted information and freedom of expression rather than content moderation, surveillance or speech regulation. The company also participates in the Global Network Initiative (GNI), which independently evaluates its adherence to principles protecting privacy and free expression.

Executive Compensation Should Be Reasonable

We actively engaged UnitedHealth Group's Board of Directors over the course of 2025 about the appropriateness of the compensation for their executive team.

The company serially missed earnings expectations, resulting in underperformance relative to the S&P 500 Index by 20% in both 2023 and 2024. Further, UnitedHealth had a major cybersecurity incident that jeopardized payments throughout the U.S. health care system, and public sentiment toward the company was at historic lows. Despite poor results, United asked investors to support pay increases for the CEO and CFO, while withholding any bonus payment to the family of murdered executive Brian Thompson. We opposed the proposed pay scheme, as did 40% of voting investors, and we accordingly expressed our views to the board.

Following the proxy vote, UnitedHealth announced it would replace both the CEO and the CFO. UnitedHealth's board failed to hold either outgoing executive accountable for poor performance, and it allowed both of them to keep very significant unvested compensation. We again expressed our dissatisfaction to the board about its compensation decision.

Seeking to Enhance Shareholder Value

In voting proxies, we are guided by general fiduciary principles. Our goal is to act prudently, solely in the best interest of the beneficial owners of the accounts we manage. We attempt to provide for the consideration of all factors that could affect the value of the investment and will vote proxies in the manner that we believe are consistent with efforts to maximize shareholder values.

Among these factors would also be issuance of preferred shares. For example, the ClearBridge Emerging Markets Strategy portfolio managers considered a proposal at Localiza, a Brazilian car rental company, which held an out-of-cycle extraordinary general meeting to approve the creation of preferred stock.

Although the issuance of preferred stock adds complexity to common shareholders, the background here was telling: Brazil was to initiate a new dividend tax in January 2026 and companies were

advancing dividends and bonus share issues to use up distributable reserves before the year end.

We judged that shareholder voting rights were being maintained and the company was attempting to issue bonus shares before the year-end tax increase. Ultimately, we agreed with management that the share issue was in the interest of shareholders and voted in favor of the proposal.

Past performance is no guarantee of future results. Copyright © 2025 ClearBridge Investments. All opinions and data included in this commentary are as of the publication date and are subject to change. The opinions and views expressed herein are of the portfolio management team named above and may differ from other managers, 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. This information should not be used as the sole basis to make any investment decision. 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, LLC nor its information providers are responsible for any damages or losses arising from any use of this information.

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