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## Appreciation ESG Strategy

### Key Takeaways

- ▶ With a trailing 12-month return of 36% for the S&P 500 — the 95th percentile of one-year rolling returns since 1987 — it's hard to describe the market's recent run as anything but superlative.
- ▶ We believe soft landing expectations have heightened the risk to the investment landscape should there be any stall in the disinflationary trend, disappointment in AI-driven capex or realization that the impact from rate cuts is more muted than past cycles.
- ▶ 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

The market roared in the third quarter, with the S&P 500 Index rising 5.9%. It looks like the Fed stuck the soft landing and felt confident enough about inflation to cut rates by 0.5%. The index has now gained in seven of the past eight quarters, including advances in 10 of the past 11 months. The S&P 500's advance of 22% year to date is the strongest three-quarter start to a calendar year since 1997 and the ninth best of all time. With a trailing 12-month return of 36% — the 95th percentile of one-year rolling returns since 1987 — it's hard to describe this run as anything but superlative.

Real estate and utilities — sectors that traditionally benefit from lower interest rates — led the index in the quarter, rising 17% and 19%, respectively. The industrials sector also performed well, climbing 12%, driven by shares of construction and building products companies on hopes lower mortgage and financing rates would spur demand for renovations and new homes.

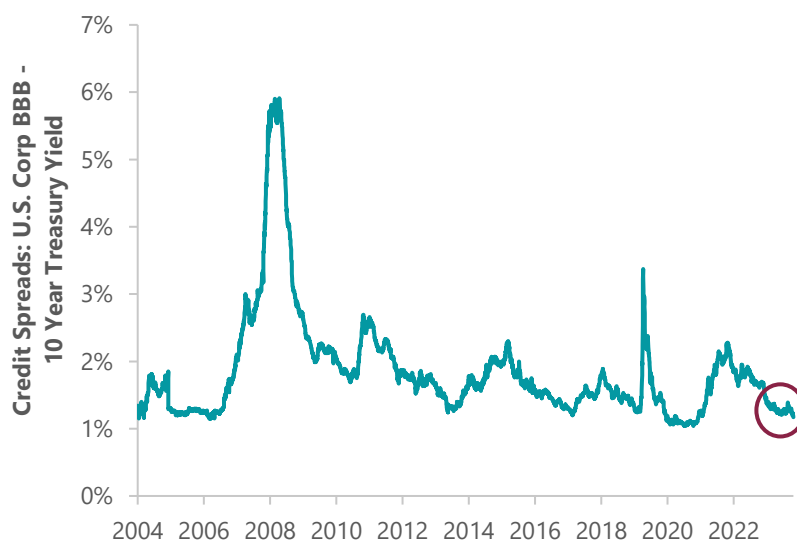
Energy shares were the worst-performing, meanwhile, on the heels of a 16% decline in the price of crude oil, which, at \$68.17 per barrel, is the lowest it has been to end a quarter since March 2021.

Information technology (IT) shares were a rare laggard as semiconductor stocks paused on a relative basis while software stocks struggled for footing as investors grow impatient about seeing these companies monetize their investments in generative AI.

We follow measures of liquidity to assess the environment for risky assets and, at quarter end, liquidity has rarely been so plentiful. Credit

spreads are within an earshot of all-time lows (Exhibit 1), while capital markets funding was wide open (corporate high yield issuance is +44% year to date). The yield curve is positively sloped for the first time in two years while lower interest rates have spurred a wave of mortgage refinancings, which are up over 100% from depressed 2023 levels. As risk-averse investors we had been incorrectly concerned that sustained high interest rates and the withdrawal of liquidity from a shrinking Fed balance sheet would tighten financial conditions. Today, with animal spirits vibrant, our focus is on monitoring risks that could alter the current favorable backdrop.

Exhibit 1: Liquidity Has Rarely Been So Plentiful



As of Sept. 30, 2024. Source: ClearBridge Investments, Bloomberg Finance.

## Outlook

Although conditions today are clearly conducive for risk assets, we are at a key inflection point for investors, in our view. This is largely due to market expectations. First, investors expect the Fed will cut another 175-200 bps from interest rates over the coming 12 months, goosing what's already fairly robust GDP growth of about 3%. Meeting this expectation will require a further moderation in inflation over the coming year, particularly in wages. Although many believe the labor market is weak, given a rise in the unemployment rate, much of [the increase in unemployment](#) can be attributed to an increasing labor force as job openings remain above pre-COVID levels. Moreover, at 4.2%, unemployment remains near a level considered full employment. Should labor prove tighter, the trend lower on wages will likely be bumpier than the market expects.

In addition, expectations for the impact of generative AI on economic growth remain sky high as cloud capex (data center construction, GPU procurement, and custom silicon investments) alone is expected to grow over 40% in 2024 to \$218 billion. At some point investors will demand a return on investment on this capex, requiring

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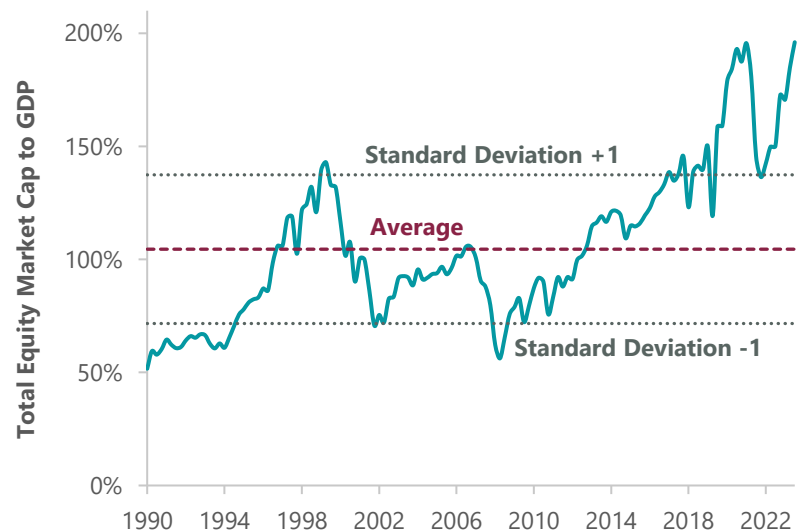
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companies to demonstrate more than just technology-related operating efficiency. Investors need to see applications beyond copilots to justify a continuation of the spend. Power supply also looks likely to constrain data center growth.

That said, there are many anemic areas of the economy that could use a jolt from lower rates. Manufacturing has been in contraction for all but one month over the past two years; the Chicago Fed survey suggests that capital spending expectations over the coming 12 months continue to deteriorate; and housing remains unaffordable by historical standards. The all-important consumer appears to be struggling as spending remains muted while consumer loan delinquencies rise and underemployment trends higher.

We would be remiss not to mention two other risks on our mind. The first is geopolitical. The impact from an escalation of the conflict in the Middle East could have wide-ranging implications on the global economy. We certainly hope for a peaceful resolution but, as of the publishing date, the risk of escalation looks high. Also, the uncertainty of the U.S. presidential election could cause business leaders to take a wait-and-see approach before investing in growth. The second is valuation. By almost any measure the stock market trades at highs last seen at the end of 2021. As example, the Buffett Ratio, which measures total equity market cap to GDP, stands at 196% (Exhibit 2). The last and only time total market cap to GDP stood at this level was December 2021 before the 2022 equity market downturn. While valuation is not a reason to trade, it does suggest to us there is elevated risk in the environment.

Exhibit 2: Buffet Ratio Suggests Valuations Are Extended



As of March 31, 2024. Source: ClearBridge Investments, Atlanta Fed, Bloomberg Finance.

In sum, the soft landing (or no landing) camp is currently in the driver's seat. However, this is a "known known" driving the current risk-on environment and factored into today's stock market

expectations. We believe this dynamic has heightened the risk to the investment landscape should there be any stall in the disinflationary trend, disappointment in AI-driven capex or realization that the impact from rate cuts is more muted than past cycles. Our focus remains on whether: 1) corporate America monetizes its investment in AI enough to justify capital spending levels that support the valuations of AI-related stocks; 2) lower rates ease financial conditions and stoke the consumer into incremental spend; and 3) the deflationary force of technological advancement delivers disinflation supportive of further Fed rate cuts. As risk-conscious investors we believe when the sky is already blue it's important to keep an eye out for storm clouds.

Longer-term, we worry about the sustainability of government debt and the burden of debt service on the budget deficit. At some point the U.S. will need to increase taxes and/or cut spending to prevent debt costs from spiraling out of control. Deficit spending at current levels cannot last forever. Both presidential candidates offer impractical budget plans that would greatly increase the deficit, an outlook that worries us further. Should investors require a greater risk premium (yield) to own a risk-free Treasury the next administration and Congress will face stark choices not in anyone's current playbook. By no means is the U.S. dollar's status as reserve currency our birthright.

While we are optimistic about the long-term benefits generative AI will have on workplace productivity, aggressive assumptions need to be made to justify current valuations for the direct hardware vendors. [Software stocks have lagged this year, creating opportunities](#) in companies that can successfully monetize generative AI. We admire the business models of the largest technology companies but are mindful of their regulatory and concentration risks they create for our portfolio. We are positive on select materials stocks such as construction aggregates where weather has disrupted near-term volume and lower rates could spur incremental demand. We believe select cyclical stocks have such low expectations that sustained economic growth could drive upside. Finally, we believe a steepening yield curve and relatively stable financial conditions will benefit select financial companies such as banks. We do not expect the top-heavy market to continue and believe a diversified portfolio with investments focused on durable growth at attractive valuations is best positioned in this transitioning interest rate regime.

## Conclusion

Although we remain constructive on the medium-term outlook, we are mindful of high expectations and an expensive market. There are myriad risks to today's placid environment, including the potential for escalation in the Middle East and the upcoming U.S. presidential election. We believe investors should anchor return expectations closer to longer-term trends (high-single digits annually) versus the

current ebullient backdrop. There is value in many non-AI corners of the market, especially if Fed easing can reinvigorate more traditional sectors of our economy.

We are long-term investors focused on the risk-adjusted returns a diversified portfolio can deliver through a market cycle. Rather than trying to bet on near-term earnings trends, we believe it is better to look out two to three years and make investment decisions based upon our assessment of a company's longer-term, sustainable growth rate relative to what is implied in today's share price.

### **Portfolio Highlights**

The ClearBridge Appreciation ESG Strategy underperformed the benchmark S&P 500 Index in the third quarter. On an absolute basis, the Strategy had positive contributions all 11 sectors. The financials and consumer staples sectors were the main positive contributors to performance.

In relative terms, stock selection detracted while sector allocation was positive. Specifically, stock selection in the industrials and consumer discretionary sectors detracted the most, while an underweight to IT proved beneficial.

On an individual stock basis, the biggest contributors to absolute performance during the quarter were Apple, Berkshire Hathaway, Oracle, Meta Platforms and Walmart. The biggest detractors were Alphabet, Microsoft, ASML, Amazon.com and Merck.

During the quarter, we initiated a new position in Broadcom in the IT sector and closed positions in United Parcel Service in the industrials sector and Home Depot 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

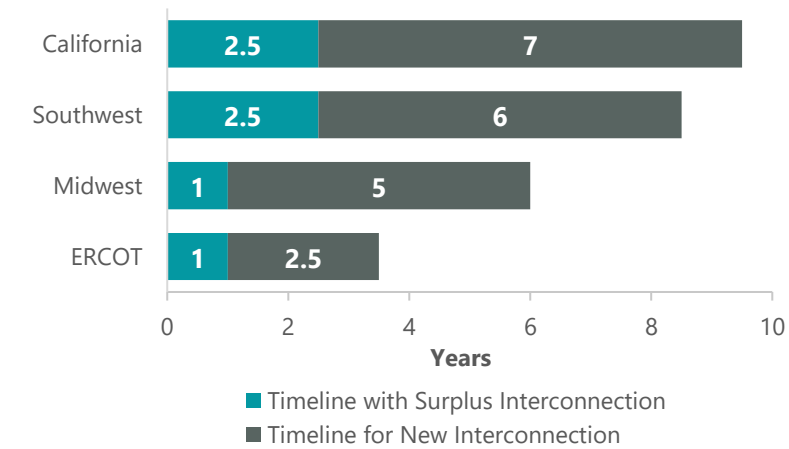
Our fundamental research process includes engaging with companies that are acknowledged leaders in the energy transition, such as ClearBridge holdings NextEra Energy (NEE) and its subsidiary NextEra Energy Partners LP (NEP), two companies accounting for 20% market share of the domestic renewable market. 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 3: 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.

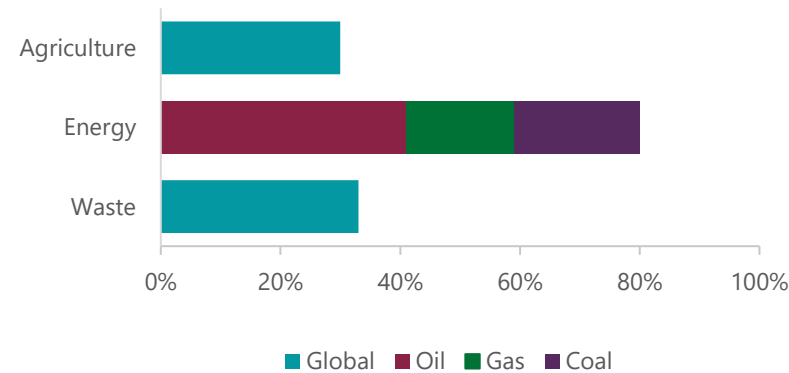
#### Opportunities for Change in the Energy Sector

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 4: 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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