



Value Strategy



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Key Takeaways

- ▶ The Strategy underperformed its benchmark in the third quarter as detractors in financials and communication services overcame positives in health care and utilities.
- ▶ Capital flows are dominating today's markets. With inelastic buyers distorting risk signals, valuation discipline and resilient diversification is essential to harness long-term potential while avoiding manufactured risks.
- ▶ We are combining markets' potential energy of undervalued assets with the kinetic energy of selective momentum to create a differentiated, diversified portfolio designed to compound returns despite short-term capital flow distortions.

Market Overview

One of the core concepts in thermodynamics is that energy flow drives most systems. This principle also helps explain the behavior of economies, life and — importantly — financial markets, where capital flows act as the system's energy source, with potentially massive impacts. For instance, the Inelastic Market Hypothesis (IMH) suggests that for every \$1 of capital flows, the market's aggregate value changes by roughly \$5, which goes a long way in describing why stock prices are so much more volatile than underlying changes in fundamentals and intrinsic value would suggest, as well as why the market often seems to ignore obvious risks as it cycles across the long arc between fear and greed. We believe the IMH is a critical short- to intermediate-term driver, setting up the long-term valuation-driven returns that we try to capture through our investment process.

Market data supports the IMH by showing that the price elasticity of demand of the aggregate stock market is relatively small — a fancy way of saying that higher stock prices don't dampen buying demand much at all, while low prices don't increase demand. In fact, if anything, elasticity drops as you get into extremes as the emotions of greed and fear take over in the tails.

In contrast, our valuation-disciplined process is highly price elastic. We think long-term potential returns rise and fall as prices dislocate to extremes around our assessed intrinsic value. As a result, we become aggressive buyers when markets experience fear-driven collapses, and actively shed risk when greed takes over. The elasticity gap between our process and the market has only widened due to ongoing structural market changes, which have mostly arisen from

When markets
crave risk,
it is manufactured —
our job is to
avoid the crowd.

two effectively valuation-blind buyers of assets, who are price inelastic by design.

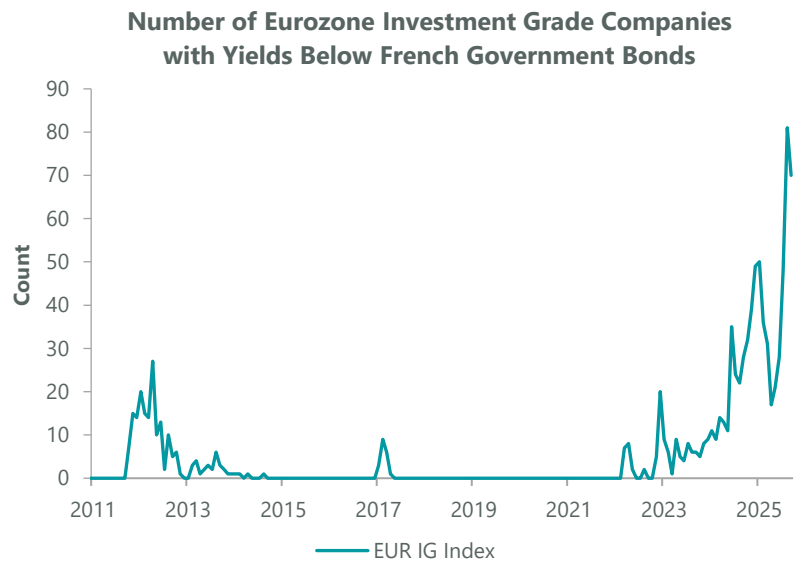
Inelastic Buyers: The Fed and Passive Investors

The first inelastic asset buyer was the Federal Reserve, who launched its quantitative easing (QE) program coming out of the Global Financial Crisis. QE's explicit goal was to manipulate market pricing signals in fixed income markets, resulting in an extended period of negative real, and in many cases negative nominal, interest rates. Many investors argued there were simply not enough risk-free assets to go around, and in December 2020 negative-yielding government debt peaked at over \$18 trillion globally. This bubble in risk-free assets spilled over to equity markets, driving up the prices of low-volatility "bond-proxy" stocks to historically high levels thanks to inelastic buying. In response to this market regime, often described as an inverted bubble, we did the opposite of the crowd and bought higher-volatility stocks where we were getting paid extremely well by the market to take risks. This contrarian approach set up the attractive nominal and relative returns we have realized since the 2020 peak of investors paying governments to take their money.

However, the problem with distorting fundamental price signals with price inelastic buying is that you end up with lingering issues from misallocated capital and distorted policy. In the case of the inverted bubble, the supply of government debt exploded. This solved the shortage of "risk-free" assets but has left us on an unsustainable fiscal path where the sovereign debt of many developed countries is now compounding well above underlying economic growth. An increasing number of corporate borrowers have debt yielding below that of their respective sovereign debt yields. This inverted risk premium is theoretically not supposed to happen, but begs the question: what happens to global markets if we lose the anchoring bedrock of a credible true risk-free rate? Arguably the probability of a sovereign debt crisis is rising, which is fueling a powerful casual narrative in support of the ongoing bull market in gold and bitcoin (Exhibit 1).

The second inelastic asset buyer is the growing dominance of passive investing. According to the IMH and observed data, for every \$1 of passive inflows the market's aggregate value increased by approximately \$3 to \$8. This would make passive inflows the dominant driver of equity prices and explains why markets have been so incredibly resilient to outside risk factors. When factoring in the recent decline in new equity supply from historically low issuance and a current record level of U.S. stock buyback activity, the path of least resistance for equities has been up. This process also creates a powerful feedback loop as higher prices bring in more flows, driving higher prices, similar to a perpetual motion machine.

Exhibit 1: European Corporate Yields Spike over Sovereign Concerns



As of Sept. 3, 2025. Sources: iBoxx, Goldman Sach Investment Research.

This passive feedback loop has generated the exact opposite effect of the fear cycle and perceived shortage of risk-free assets seen during the QE era. As animal spirits have shifted from fear to greed in recent years, the market is acting like we are running out of volatility and risk assets. Just as casinos and online betting firms manufacture risk for gamblers, the market is increasingly acting like the world's largest casino in manufacturing volatility and risk for investors. We are seeing this in the proliferation of double- and triple-leveraged ETFs and the explosion in options volume. Current estimates are that the notional daily value of options trading ranges from 150% to 250% of the cash market volume, adding tremendous rocket fuel to the IMH framework.

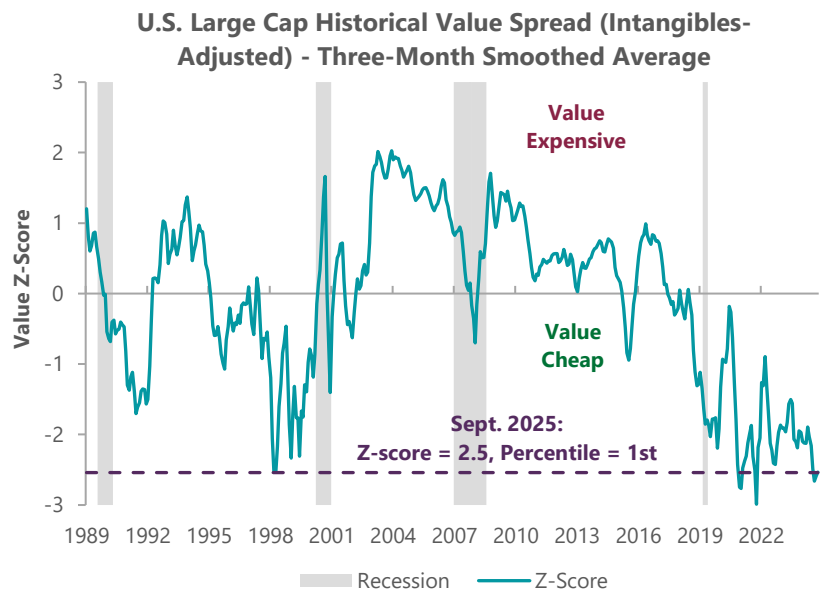
The paradox of this aggressive chasing of risk is that the measures of current risk have effectively been put to sleep, although this is not an unexpected outcome in systems like markets where positive feedback is present. However, the level of risk premiums — along with volatility, correlations and credit spreads — across markets is at historically extreme and unsustainably low levels. If financial markets are good at anything, it is supplying what investors are demanding; just as risk-free assets have caught up with demand, the risk that markets are currently craving is being manufactured at an accelerating rate. Ultimately, when the risk catches up and inevitably overshoots demand, risk measures typically all move higher together as correlations spike. The only real protection, therefore, will be to avoid these crowded areas of awakening risk through resilient diversification.

We combine potential value energy with selective kinetic momentum to build a differentiated portfolio.

Diversification Requires Both Potential and Kinetic Energy

To describe how we are doing this, we need to explain the difference between another thermodynamic concept: kinetic and potential energy. Kinetic energy is being used when something is in motion, while potential energy is stored. In markets, price momentum is kinetic energy, while valuation is potential energy. Currently, the market's kinetic energy is extremely high as massive amounts of capital flow into concentrated U.S. indexes. However, this creates the risk that momentum can reverse suddenly, where even small reversals in capital flows can lead to violent market corrections and crashes at an accelerated rate. Hence the old trader adage that "the market takes the escalator up but the elevator down." Managing this risk requires recognizing that this potential and kinetic energy are diversifiers to one another — and most of the time a mix of both is ideal. Right now, however, the gap between the kinetic energy of growth and the potential energy of value are near record levels as capital chases the market's crowded, kinetic energy. We think the best way to reduce risk from a reversal in capital flows is by diversifying with the potential energy of absolute value.

Exhibit 2: Spread Between Potential and Kinetic Near All-Time Highs



As of Sept. 30, 2025. Sources: AQR, ClearBridge Investments.

While investors cannot escape risk, our valuation discipline looks to get paid for the risk we are taking while also diversifying away as much of it as possible. In a market with very low risk premiums and correlation, doing this is easier said than done. However, it's exactly the challenge our active absolute valuation investment process is designed for.

- Valuation-wise, we are still finding stocks with free cash flow yields in the high single to low double digits — a powerful compounding advantage with indexes selling well below 3% free cash flow (FCF)

yields. We are finding these where the potential valuation energy is the greatest, including bond proxies, especially within health care, that have fallen out of favor as the market arced from extreme fear to greed. We are also finding attractive FCF yields in the material and energy sectors, which are cheap hedges against inflation and other mounting policy risks.

- On the diversification side, one of the most robust ways to diversify a portfolio is to mix the potential energy of value with the positive momentum of kinetic energy. The greatest area of kinetic portfolio diversification is in AI and related infrastructure, where we have reduced our exposure where price and value have converged the most, but still maintain a sizeable active bet. The U.S. economy and market are increasingly being led by investment rather than consumption — a structural shift that we believe will persist for many years, albeit with high levels of volatility. Consistent with this framing, we remain very underweight consumption-driven areas, especially the consumer discretionary sector.

Quarterly Performance

The ClearBridge Value Strategy underperformed its Russell 1000 Value Index benchmark in a subdued period for value stocks, which delivered steady but unremarkable returns amid persistent growth leadership.

Stock selection within the health care sector was the greatest contributor to relative performance and included three of our top five contributors: UCB, Argenx and Elanco Animal Health. Neurology and immunology disease treatment company UCB was bolstered by renewed confidence in its leading product as a key rival drug reported inferior efficacy results; autoimmune disease treatment company Argenx continued to see strong uptake of its myasthenia gravis and chronic inflammatory demyelinating polyneuropathy treatments; and Elanco raised its full-year guidance and expectations for margin expansion thanks to new product drivers and innovation. However, health care performance was tempered by our holding in Novo Nordisk, whose shares declined following management's lowering of full-year guidance; it cited weaker U.S. sales driven by increased competition and continued availability of compounded Wegovy. Combined with an unexpected management transition at a critical junction for the company, we exited the position in favor of more compelling opportunities.

Stock selection in the financials sector was the leading detractor from returns, largely due to declines in holdings Corebridge Financial and Fiserv. Despite solid second-quarter earnings driven by better-than-expected spreads and stronger variable investment income, retirement solutions and insurance products company Corebridge came under pressure after an announced secondary offering for 30 million shares by parent company AIG. Payments and fintech company Fiserv declined due to softer-than-expected earnings, margin pressures and a

reduction in full-year guidance tied to weaker consumer spending and slower merchant activity.

Portfolio Positioning

One of the largest new positions during the quarter was online retailer, advertising and cloud services provider Amazon.com, in the consumer discretionary sector. We believe the company is trading at an absolute valuation discount given its positioning as a potential AI beneficiary. Given the company's fortress-like balance sheet, likely expansion of its commercial presence in AI cloud, and expected acceleration in FCF generation despite AI investment, we believe that the company represents an attractively valued and compelling opportunity to get further exposure to strong secular AI tailwinds.

Also in the consumer discretionary sector, we exited our position in online travel company Expedia, capturing profits after its relatively strong run-up and on increasing concerns about how the development and buildout of AI travel agents could pose a medium- to long-term threat to Expedia's business model.

Outlook

Persistent investment edge in active management requires being different. We are increasingly different in our absolute valuation discipline and how we put portfolios together. We think very few portfolios combine the kind of robust mix of potential value energy with kinetic momentum energy that we have, resulting in a portfolio selling well below its respective index on valuation but with much higher expected growth. We also have a compounding advantage by diversifying across time scales. While according to the IMH capital flows are the dominant driver of markets over the short- to intermediate-term, valuation remains the dominant long-term signal in driving returns. Given the current level of risk chasing in markets, we think an absolute value lens is our greatest diversifier and edge.

Portfolio Highlights

The ClearBridge Value Equity Strategy underperformed its Russell 1000 Value Index during the third quarter. On a relative basis, the Strategy had positive contributions from six of the 11 sectors in which it was invested. The leading contributors were the health care and utilities sectors, while the financials sector detracted the most.

On a relative basis, overall stock selection detracted from performance. Stock selection in the financials, communication services, materials, real estate and energy sectors weighed on performance. Conversely, stock selection in the health care, IT and utilities sectors and an underweight to the consumer staples sector proved beneficial.

On an individual stock basis, the biggest contributors to relative returns were Newmont, UCB, Talen Energy, Elanco Animal Health and Argenx. The largest detractors from relative returns were Alphabet, Charter Communications, Novo Nordisk, Corebridge Financial and Constellation Brands.

During the period, in addition to the transactions listed above, we initiated new positions in Keurig Dr Pepper in the consumer staples sector, Taiwan Semiconductor Manufacturing and Salesforce in the IT sector, TG Therapeutics and Becton Dickinson in the health care sector, International Flavors & Fragrances in the materials sector, Alphabet in the communication services sector and Chevron in the energy sector. We exited positions in Atlas Energy Solutions and Hess in the energy sector, Globant and Intel in the IT sector, AbbVie in the health care sector and Constellation Brands in the consumer staples sector.

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