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## Large Cap Value ESG Strategy

### Key Takeaways

- ▶ U.S. equities made strong gains in the third quarter, overcoming an economic growth scare that sent parts of the equity market into correction territory before a 50 basis point interest rate cut from the Fed induced a broad rally.
- ▶ Our process lends itself toward high-quality, less commoditized and less cyclical stocks, which tend to lag in very strong markets, although we believe, over time, higher-return businesses compound value at a higher and more sustainable rate than deeper value peers.
- ▶ 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

U.S. equities made strong gains in the third quarter, overcoming an economic growth scare that sent parts of the equity market into correction territory before a 50 basis point interest rate cut from the Federal Reserve induced a broad rally. The benchmark Russell 1000 Value Index gained 9.43% for the quarter, over 600 basis points ahead of its growth counterpart, led by the rate-sensitive utilities and real estate sectors, while weakness in China kept oil prices depressed, leaving energy as the only sector in the red.

The Strategy trailed the value index benchmark in the quarter partly due to our investment style, but also because of stock-specific idiosyncrasies impacting several of our large holdings. The quarter's value rotation was driven by what we consider to be deeper value stocks as well as commodity-sensitive and cyclical areas of the market.

Our process lends itself toward high-quality, less commoditized and less cyclical stocks, which tend to lag in very strong markets as we have seen in recent quarters, although we believe investing in businesses with strong franchise characteristics leads to outperformance through cycles as higher-return businesses compound value at higher and more sustainable rates than deeper value peers. For example, since the Global Financial Crisis (GFC) in 2007, in the past 58 quarters, the value index has returned more than 500 basis points a little over half the time (55%). During those periods, the Strategy has outperformed the benchmark 44% of the time.

However, in all other market environments, the Strategy outperformed the benchmark 62% of the time. The Russell 1000

Value Index has exceeded this 500 bps threshold in three of the last four quarters, a feat only matched during the furious rallies following the GFC in 2009 and 2010 and the impressive market bounce during COVID in late 2020 and early 2021 when vaccines were introduced. As a result, we expect that market returns will likely be more “normal” going forward, which should benefit our Strategy.

While the market environment clearly was a headwind in the third quarter, several of our large positions also faced challenging conditions, which negatively impacted results. In the information technology (IT) sector, Intel has come under additional pressure due to continued softness in the company’s core PC and server markets as well as concerns on the company’s longer-term competitive position. While Intel’s turnaround is not happening overnight, we are constructive on the outlook into 2025: the company’s product positioning should be much improved and it should be positioned to gain market share in a cyclical upswing in which it has strong earnings power. A somewhat adverse spending environment due to AI myopia has weighed on shares, but we still think the market is undershipping PCs and general servers following a COVID normalization period that saw demand get pulled ahead and then languish as companies froze IT budgets. The installed base is now getting older, and we expect a strong refresh cycle into next year. The delay is actually beneficial to Intel, whose product positioning will be all the more improved. While our investment case is not predicated on an M&A transaction, and we believe one is unlikely, the expression of interest in the company speaks to the value of the assets, which we think still trade at a meaningful discount to fair value.

In a similar case of post-COVID market normalization, drug distributor McKesson lowered profit guidance for its medical-surgical business twice during the period, most likely due to continued post-COVID headwinds as primary care sites are consuming less of its equipment, while its prescription technology solution segment is tied to volumes of certain high-value specialty drugs. We still believe McKesson’s core pharma distribution business is very healthy, however, and it is ramping up its Optum contract in the second half of the year, while its most recent oncology practices acquisition should be accretive over the long term, enabling McKesson to continue delivering low-double-digit earnings growth without much economic sensitivity.

Despite these stock-specific headwinds, we’re confident our portfolio continues to own high-quality franchises able to generate excess returns in various economic environments. Sherwin-Williams, for example, has seen its shares rise even while its end markets have not really recovered. As the Fed raised rates aggressively to combat inflation, existing homes turnover came to a halt. Turnover of existing housing stock is Sherwin-Williams’s bread and butter business as homeowners typically paint as they are ready to sell and new owners repaint when they buy. Despite slow end market demand and

because Sherwin-Williams is a best-in-class operator, it continues to execute well and gain share, taking advantage of some disarray among competitors, allowing it to hold on to pricing and benefit from some raw material deflation.

Air Products and Chemicals (APD) has also made strong contributions recently, delivering operationally and announcing a major offtake agreement for its NEOM green hydrogen project in June. Strong fundamentals for APD are shining through a soft Chinese industrial economy, and it continues to shore up the strength of its core industrial gases franchise, committing to not invest additional capital on big projects until they soak up existing capacity, putting a management structure in place to allow for more accountability and announcing board-initiated succession planning that will help build investor confidence for the future. The company is also tightening up its operational focus by divesting non-core assets and streamlining operations.

From a sector perspective, meanwhile, our utilities overweight was positive, with Edison International a strong contributor. The company reached a tentative deal to recoup \$1.7 billion of wildfire and mudslide expenses in California, bolstering its balance sheet, increasing earnings and demonstrating the favorable regulatory environment in California, benefiting both Edison as well as Sempra, our largest utility holding. Another rate-sensitive area — real estate — was the second-best sector performer as rate cuts boosted valuations in this area. Our REITs underweight, however, was a headwind during the period.

### **Portfolio Positioning**

While market volatility, driven largely by factor moves, was detrimental to short-term performance, it also created more opportunities than usual and portfolio activity was elevated as a result.

Skepticism over the consumer has left some high-quality stocks with depressed valuations and allowed us to reduce our consumer discretionary underweight with the addition of O'Reilly Automotive and Starbucks. While we have been cautious on retailers for quite some time, auto parts retailer O'Reilly is a best-in-class, high-quality operator with high returns on invested capital and a solid history of consistent execution and sustainable share gain, and it enjoys rational competitive dynamics in the broader industry. In addition, auto parts retailing carries some counter-cyclicality as consumers tend to hold on to their cars longer, requiring more repair and maintenance, during softer economic environments. We think a high-quality franchise like O'Reilly trading at a reasonable valuation in an otherwise expensive market is worth our attention and we initiated a starter position.

Starbucks is an iconic global coffee roaster brand with a deep-rooted heritage of communal experience centered around coffee

consumption. From the business standpoint, it offers attractive exposure to breakfast/morning food and beverage consumption, which tends to be stickier and more habitual. While the company has been going through a challenging period operationally, we think new CEO Brian Niccol brings enormous credibility supported by a long and successful career that includes impressive turnarounds at Taco Bell and Chipotle. Niccol's operational expertise gives us confidence he can improve the customer experience while restoring business profitability by taking Starbucks to its successful roots. We think the stock offers very good value for what the business is capable of on a normalized basis.

In IT, we bought Broadcom as we believe the company has a long runway for growth with its custom silicon business, which should be more durable and less volatile than other components within the AI food chain. We also believe the acquisition of VMware creates another opportunity for steady, subscription-based durable growth that is still in its early innings. We believe the stock has an attractive risk/reward profile given the reasonable visibility toward mid-teens EPS growth at a low-20s P/E multiple. We made room for Broadcom by exiting Lam Research, whose shares we believed priced in a full recovery, while we grew increasingly concerned that China exposure might create an air pocket.

In industrials, we trimmed Illinois Tool Works and initiated a position in a similar high-quality diversified industrial franchise, Parker-Hannifin, a motion and control technologies company with growing aerospace and defense exposure currently representing about 40% of the business. While both companies are high-quality diversified industrial franchises, the latter has been able to grow faster by pivoting toward a longer-cycle A&D business, yet its stock continues to trade at a discount relative to its peers. Among transports, we maintained our preference for less than truckload (LTL) provider XPO, to which we added during the period. We funded the XPO addition first by trimming and ultimately exiting United Parcel Service. While UPS remains a high-quality business run by a competent management team, weak industry volumes, consumers shifting to lower-priced shipping options and industry overcapacity create less than optimal pricing dynamics. In addition, as a union shop, UPS operates in a fiercely competitive industry, while two of its main competitors, FedEx and Amazon.com, operate with a non-union labor force, putting UPS at a cost disadvantage, at least when it comes to labor. UPS's undemanding valuation notwithstanding, we think a healthier industry structure and better pricing dynamics make XPO a better longer-term investment.

## Outlook

While the macroeconomic backdrop remains soft as consumers are pinched by stubbornly high inflation and industrial activity remains depressed, the market's strong performance over the past 12 months

clearly anticipates a re-acceleration in economic activity driven by monetary easing in the U.S. and abroad. Although we remain macro aware, we are also careful not to make macro bets and instead believe that volatile markets create dislocations between stock prices and underlying franchise values that provide opportunities for active, fundamentally focused long-term value investors. While we are monitoring major developments such as the U.S. election, the evolving employment picture, and geopolitics, to name a few, we are ultimately more concerned with value creation potential at the company level, and recent breathtaking market performance driven by momentum stocks has been creating attractive entry points in the types of high-quality companies we prefer. In a historically crowded and fairly narrow market, we've attempted to remain diversified with exposure to these high-quality defensible franchises, which we believe will do well over the medium and longer term, regardless of whether the economy improves or softens.

### **Portfolio Highlights**

The ClearBridge Large Cap Value ESG Strategy underperformed its Russell 1000 Value Index benchmark during the third quarter. On an absolute basis, the Strategy had positive contributions from 10 of the 11 sectors in which it was invested for the quarter. The financials, industrials and utilities sectors contributed the most, while the IT sector was the detractor.

On a relative basis, overall stock selection effects detracted from performance, while sector allocation was beneficial. In particular, stock selection in the health care, IT, financials, industrials and communication services sectors and a real estate underweight weighed on relative returns. Conversely, stock selection in the energy, materials and consumer staples sectors, an energy underweight and a utilities overweight were contributed positively.

On an individual stock basis, the largest contributors were Haleon, Air Products and Chemicals, Edison International, Sherwin-Williams and American Express. Positions in Intel, McKesson, Charles Schwab, Microchip Technology and Lam Research were the main detractors.

In addition to portfolio activity discussed above, during the quarter we initiated a new position in Williams Companies in the energy sector and exited TC Energy in the energy sector and Nestle in the consumer staples 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.

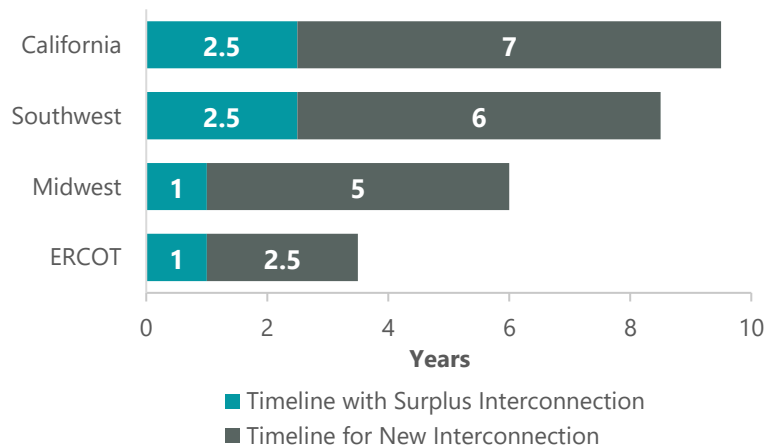
As we discussed recently in engagements with NextEra's management team, growth for both entities is underpinned by a bullish power demand outlook, with a 38% increase in demand expected through 2040, driven by decarbonization and electrification.

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 1), 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 1: 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

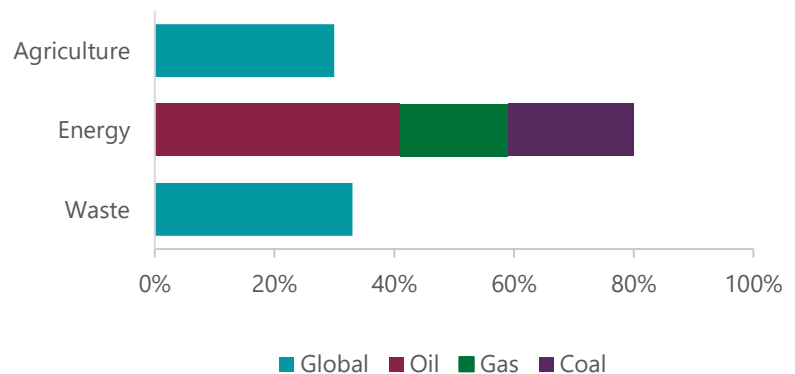
The energy sector will also be key to the energy transition, which makes engaging with holdings all the more important as there is significant progress they can make to reduce their environmental impact. The sector is one of the more blamed but necessary industries for ClearBridge's net-zero target as 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 2), making it a fruitful beneficiary for engagement.

Exhibit 2: 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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