

Canadian Plus Equity Strategy



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Key Takeaways

- ▶ The Strategy delivered solid absolute returns but underperformed the benchmark in a momentum-driven market, with weakness in information technology and communication services offsetting strength in consumer staples.
- ▶ We continued to increase exposure to rate-sensitive holdings as recent monetary tightening has improved their risk/reward. While the Strategy is typically low turnover, we will continue to be decisive when warranted and as further opportunities arise.
- ▶ With the equity market discounting an ideal scenario including rate cuts, continued economic growth and healthy corporate earnings, we see little margin for error. Accordingly, our bottom-up approach continued to drive the Strategy toward more defensive positioning than is typical.

Market Overview

The Canadian equity market kicked off 2024 with a robust 6.6% first-quarter advance, building on the solid 11.8% return registered in 2023. In fact, equity market returns accelerated throughout the quarter with strength in March helping propel the S&P/TSX Composite TRI to new all-time highs. That said, gains in Canadian equities continue to pale in comparison to the ongoing boom in U.S. equities, with the S&P 500 TRI returning 13.3% (in Canadian dollars) in the first quarter on top of 23.3% in 2023 — a large portion of these gains derived from mega cap information technology (IT) and related names.

Benchmark 10-year interest rates in Canada and the U.S. ended the first quarter higher at 3.47% and 4.21%, respectively. Although below their 4.24% and 4.99% respective October 2023 peaks, around the time of the Federal Reserve's dovish pivot, 10-year rates steadily inched back up in the first quarter and remain at levels not seen since the Global Financial Crisis. Meanwhile, consensus expectations for Fed rate cuts in 2024 tempered meaningfully — with federal-funds futures now pricing in three cuts from six just a few months ago. With peak inflation behind us, and tempered rate cut expectations ahead, we remain mindful of the potential impact on equities from a structurally higher interest rate environment. With average market interest rates proximal to earnings yields in the equity market, cost of capital implications and competing investment alternatives for stocks will remain critical considerations as investors continue to re-acclimatize to a non-ZIRP (zero interest rate policy) and non-TINA (there is no alternative) world.

The first quarter advance in Canadian equities was broad based, with nine out of 11 sectors posting positive returns. The health care sector, lacking in relevance due to its sub-1% weighting in the benchmark, was the top performing sector, followed by energy and industrials. These were also the only sectors to outperform the benchmark. At the other end of the spectrum, defensive/non-cyclical and interest-rate-sensitive sectors — utilities, communication services and real estate — were the biggest laggards. The U.S. equity market saw similarly broad participation with all 11 sectors in the S&P 500 TRI in the black, led by communication services, energy, financials and IT while real estate, utilities and consumer discretionary lagged.

The underperformance of communication services was notable as wireless and wireline competitive pressures remain heightened in Canada, particularly in Quebec. Post the Rogers acquisition of Shaw and the continuing integration of the two brands, wireless pricing has been under material pressure with Quebecor, now the fourth national wireless operator, leveraging its newfound competitive offerings from Freedom Mobile to gain wireless market share. Overall, expectations for growth in the sector's profitability have tempered, while the potential for continued regulatory scrutiny continues to weigh on the industry.

Elsewhere, with investor enthusiasm surrounding advances in generative artificial intelligence (AI) remained top of mind, returns for the IT sector in Canada, lacking meaningful AI enablers, were muted. In energy, strength was driven by E&Ps and integrated oil companies as crude oil prices rose 16.1% to end the quarter at US\$83.17/bbl (West Texas Intermediate), and despite natural gas prices decreasing 29.9% to finish the quarter at US\$1.76/mmbtu (NYMEX). As it relates to oil, with a surprisingly resilient economy, increased geopolitical concerns in the Middle East, muted U.S. activity/production, and OPEC+ production curtailments serving to tighten the supply-demand outlook for global crude, prices have been climbing. In materials, gold bullion advanced 7.0% for the quarter to reach a new all-time high at US\$2,217/oz (COMEX). Copper advanced 3.0% to finish at US\$4.01/lb (COMEX).

Performance Overview

Within the context of this equity market environment, the ClearBridge Canadian Plus Equity Strategy underperformed a blended benchmark allocated to the S&P/TSX Composite TRI and the S&P 500 TRI, with solid absolute returns falling short of the advance of the benchmark.

Our largest materials holding, Agnico Eagle Mines, contributed nicely in the quarter as gold prices rose to new all-time highs. The company provided solid production guidance and project and reserve updates in the first quarter, along with better than expected cost control. Additionally, management outlined an easing of

We believe the Strategy performed well in the quarter given the market's strength and our lower beta approach.

inflationary pressures, where higher costs impacted areas such as labor, spare parts and maintenance.

In industrials, SNC-Lavalin continued to impress with the strategic re-focus of its overall engineering business in recent years paying dividends. The company is benefiting from strong industry activity including exposure to the growing number of opportunities in nuclear. Overall, SNC-Lavalin continues to see strong progression in its base engineering business, handily exceeding recent expectations and entering 2024 with a record \$13.7 billion backlog. Furthermore, potential catalysts remain with possible dispositions of non-core assets (Highway 407, Linxon) and recoveries on legacy lump sum turnkey contracts.

In the U.S., our most notable relative performers included JPMorgan Chase and Wells Fargo in financials as well as Walmart in consumer staples.

Detractors were largely centered around the more interest-rate-sensitive names in the Strategy, with communication services and utilities being two of the weakest sectors. The aforementioned competitive challenges in the Canadian communication services sector follow a two-year approval process for the Rogers/Shaw combination and Quebecor/Freedom transactions that closed in the spring of 2023. Fears surrounding intense competitive pressures continue with further meaningful weakness in holdings Telus and BCE in the first quarter. With these concerns, as well as lingering regulatory and macro fears, valuations have significantly re-rated. Furthermore, both businesses have been pursuing cost efficiencies to help navigate a tougher near-term revenue environment. While undoubtedly challenged in the short term, we expect both businesses to deliver modest overall growth with improving free cash flow profiles in the coming years — especially for BCE, whose payout ratio is currently strained — as they both de-lever, moderate capital expenditures and leverage their respective fiber footprints and overall asset base.

Portfolio Positioning

Trading activity in the first quarter of 2024 was broad based as market strength presented several opportunities to trim dearly priced holdings on our terms, while weakness in interest-rate sensitives, as well as more surgical situations, provided opportunities to add. Transactions included trimming a number of value/cyclical and more growth-oriented names in industrials (RTX, SNC-Lavalin, Waste Connections), the consumer groups (Dollarama, Alimentation Couche-Tard, Loblaw), and IT (CGI Group) on strength as the market hit new all-time highs. Meanwhile, we added to materials holdings Agnico Eagle Mines and Nutrien on weakness early in the quarter. In the case of Nutrien, we capitalized on meaningful share price weakness as agriculture/fertilizer markets search for stability, including potash markets that started the year soft. Interest-rate-sensitive holdings in

communication services and utilities have been steadily growing in prominence in the portfolio in recent quarters with the higher interest rate environment pressuring these securities to the point that we believe the risk/reward is excellent. The first quarter of 2024 continued this trend with additions to BCE, Fortis and the introduction of Brookfield Renewable (BEPC) and DTE Energy. While the Strategy is typically low turnover, we will continue to be decisive when warranted and as further opportunities arise.

BEPC was briefly held in the portfolio in 2020, and again in 2022-2023, but in each case was subsequently exited due to strong share price appreciation. Recent price weakness, reflective of a challenging environment for entities with levered balance sheets, was further pressured by diminished prospects for capital recycling, which has historically augmented BEPC's targeted returns. This pessimism was amplified by tempered growth expectations due to lingering inflation, creating an opportunity to own shares at a reasonable valuation. BEPC owns and operates a globally diversified portfolio of high-quality, long-life renewable power assets. The portfolio consists of more than 19,000 MW of renewable capacity spanning diverse technologies across North America, South America, Europe and Asia. This diverse asset base combined with contracted revenue streams provide visibility to stable cash flow generation. BEPC operates under a Master Service Agreement with Brookfield Asset Management (BAM), which leverages BAM's global reach, as well as its deep expertise and strong capabilities across key areas of operation. This arrangement has also provided BEPC the opportunity to co-invest in compelling, high-quality assets of material size and scale alongside BAM and its institutional partners, shaping the company's strong track record of delivering attractive returns over time. Although we acknowledge near-term challenges for BEPC, this competitive advantage positions the company to further capitalize on attractive investment opportunities as the push for decarbonization accelerates over the foreseeable future.

We exited our longstanding position in Duke Energy during the period and replaced it with Michigan-based utility DTE Energy in which we see superior risk-adjusted return prospects. Operating in a favorable regulatory framework which includes significant potential renewables buildouts, DTE offers a high-single-digit EPS growth trajectory at an attractive valuation combined with a well-covered dividend. The company is also in a strong financial position with minimal equity requirements to fund its growth in the near term.

At quarter end, the Strategy's largest sector exposures were financials, IT, industrials and consumer staples. Relative to the benchmark, the Strategy is overweight the generally defensive/non-cyclical consumer staples and utilities sectors, as well as industrials and communication services. The Strategy is most underweight the typically value/cyclical-oriented financials, energy and materials sectors.

Outlook

With the equity market discounting an ideal scenario including rate cuts, continued economic growth and a solid corporate earnings profile, there appears to be little margin for error. Accordingly, our bottom-up approach continued to drive the Strategy toward more defensive positioning than is typical.

The continued strength in equity markets to start 2024 merits a reminder that the Strategy continues to target a trailing beta of 0.8 to 0.9 — beta being a measure of the volatility, or systematic risk, of the Strategy relative to the benchmark. In the specific circumstance of a strong market over a short period of time, such as what we saw yet again in the first quarter of 2024, this generally makes for a challenging environment for the Strategy to keep pace. However, we believe the Strategy performed well in the quarter given the market's strength and our lower-beta approach.

Throughout a full market cycle, superior risk-adjusted returns can be achieved in various ways, but generally they require a combination of both offense and defense. At peaks, investors tend to be focused on the thrill of the ride and fear of missing out, with risk considerations secondary; however, downside protection has proven to be crucial through a cycle. Ultimately, the compounding of returns over time is heavily influenced by how resilient a portfolio of equities is on the downside. The current strength of the equity market may cause investors to become complacent to the value of downside protection, however we believe our experience through many market regimes has proven the case for prioritizing risk management throughout the cycle.

We manage the Strategy with a distinctive growth at a reasonable price (GARP) investment style with a particular focus on sustainable and visible high profitability, secular growth and strong capital allocation. In addition, the Strategy maintains a much better valuation profile than its benchmark based on our free cash flow valuation approach — a feature that remains critically important to our success. At any point in time, there are equities that we find fundamentally attractive, yet the valuations simply don't make sense.

We believe our defensive positioning serves as dry powder that we will deploy when better opportunities arise. We look forward to a market environment whereby our portfolio benefits from our patient and deliberate positioning. We would welcome the opportunity, on our terms, to shift toward a more aggressive stance and transition the Strategy's beta profile from the current lower end of our targeted range (0.8) to the upper end (0.9).

With this approach, the ClearBridge Canadian Plus Equity Strategy has successfully navigated various market conditions characterized by both strong and weak sentiment, as well as shifts in sector leadership and economic landscapes. Our bottom-up approach prioritizes identifying and capitalizing on market inefficiencies. With

the current equity market landscape presenting risks and uncertainties, we expect the future will present both challenges and excellent opportunities. We will seize on opportunities as they arise, leveraging our extensive track record of delivering superior absolute, relative and risk-adjusted returns over the long term.

Portfolio Highlights

During the first quarter, the ClearBridge Canadian Plus Equity Strategy underperformed its custom benchmark, comprising a 60% allocation to the S&P/TSX Composite Total Return Index and a 40% allocation to the S&P 500 Total Return Index. On an absolute basis, the Strategy generated gains in 10 of the 11 sectors in which it was invested. The primary contributors were the financials and industrials sectors while the sole detractor was the real estate sector.

On a country basis, security selection in both U.S. and Canadian equities was detrimental to relative performance.

Relative to the benchmark, security selection and sector allocation detracted from performance. In particular, selection in the IT sector was the primary headwind to results, while selection in the communication services, health care and industrials sectors as well as an overweight to the utilities sector weighed on performance. Stock selection in the consumer staples, financials and materials sectors and underweights to materials and real estate contributed to performance.

On an individual stock basis, leading absolute contributors included JPMorgan Chase, Microsoft, Canadian Pacific Kansas City, Wells Fargo and Waste Connections. Top absolute detractors included Apple, Intel, BCE, Open Text and Toronto-Dominion Bank.

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