



Value Strategy



Reed Cassady CFA
Managing Director,
Portfolio Manager



Sam Peters CFA
Managing Director,
Portfolio Manager



Jean Yu CFA, PhD
Managing Director,
Portfolio Manager

Key Takeaways

- ▶ The Strategy outperformed its benchmark during a volatile quarter, as strong contributions from our financials and energy holdings overcame detractors in consumer staples.
- ▶ As they age, bull markets often find investor confidence increasing while valuation excesses remain hidden, but these excesses and related risks are quickly growing too large to ignore.
- ▶ We do not position the portfolio for any one future scenario or outcome but have identified three possibilities for 2025: Continued Goldilocks, Increased Inflation and Recession.

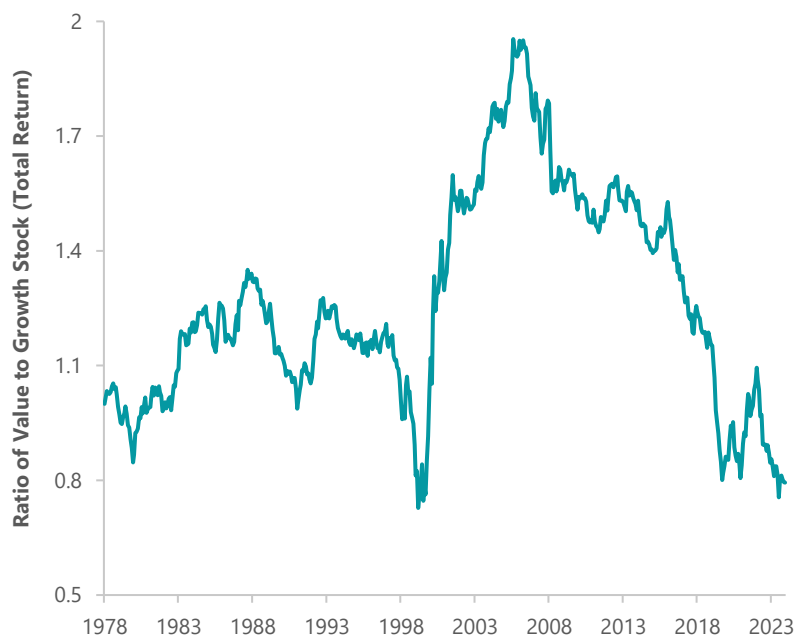
Market Overview

Reflecting on 2024 and the state of value entering 2025, we are reminded of the titular character from Oscar Wilde's *The Picture of Dorian Gray*. Much like Dorian, whose portrait would grow old and ugly while he stayed young and lived a life free of consequences, bull markets often grow divided, with investor confidence increasing on the surface while the market cycle ages and ugly valuation excesses remain hidden and are increasingly ignored. That is until, much like the portrait confronting Dorian, the valuation excesses become too much to ignore. If this is again the case, we believe that 2025 may be the year that exposes the market's portrait, revealing to investors the historic valuation levels and growing risk factors that can no longer be ignored.

There is a very good reason that valuation is being ignored by investors: despite an absolute return for the Russell 1000 Value Index (RLV) of approximately 19% over the last two years, the Russell 1000 Growth Index (RLG) outperformed this by more than 4x for an absolute return of 87%. That would make this the worst two-year relative period for value in 45 years, comparable only to the two-year periods that ended with growth bubbles arguably bursting in 2020 and 1999.

The fourth quarter of 2024 certainly didn't help value managers, as growth beat value by another 9%, helped by a drop for the RLV of almost 7% in December alone. This resulted in the total return ratio of value relative to growth dropping to 40-year lows.

Exhibit 1: Value to Growth Drops to 40-Year Lows

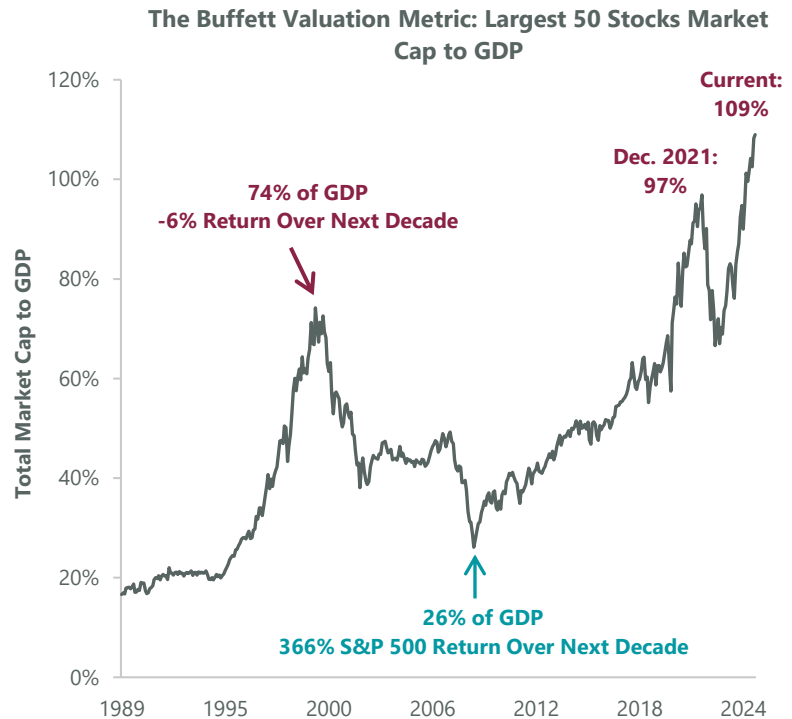


As of Dec. 27, 2024. Source: ClearBridge Investments, FactSet.

While relative extremes are one thing, the bigger risk is that absolute valuation measures of the market have also risen to historic extremes. One of our favorite measures of long-term valuation comes from Warren Buffett, who argued that the total value of equity market capitalization relative to the overall economy was “the best single measure of where valuations stand at any given moment.” That measure climbed to historic highs of 230% in 2024 and may explain why Mr. Buffett has built Berkshire Hathaway cash levels to a record \$325 billion. However, given the extreme concentration of U.S. markets in mega cap stocks, an arguably better measure narrows the Buffett indicator to just the 50 largest U.S. stocks. By this measure, valuation extremes tower above the 2000 internet mega cap bubble and the growth liftoff during COVID (Exhibit 2).

When valuations have historically achieved extremes even below current levels, they have weighed heavily on forward long-term returns. If history is any guide, the next decade should generate passive U.S. equity returns ranging from negative to low single digits — well below rising investor expectations of sustained double-digit returns from passive equity beta.

Exhibit 2: Buffett Ratio Highlights Extreme Concentration



-6% total return includes dividends reinvested in the index for the period March 31, 2000 to March 31, 2010. 336% total return includes dividends reinvested in the index for the period Feb. 27, 2009 to Feb. 28, 2019. As of Dec. 31, 2024. Source: Kailash Capital Research, LLC.

Competitive Advantages Capture Opportunity

The opportunity for valuation-disciplined active managers, like us, is to deliver on the basic drivers of long-term returns that indexes increasingly lack by combining attractive absolute valuations with strong fundamentals in a truly diversified portfolio.

Perhaps the best way to demonstrate how the current market is playing to our comparative advantage as active managers is to compare our portfolio to our respective index on key metrics:

1. **Valuation:** On a forward price/earnings ratio, our portfolio is selling at just over 13.5x forward earnings versus almost 17x for the RLV and over 30x for the RLG — a level that puts the RLV at the top quintile of its market history on an absolute basis, but close to a record discount to the RLG. Yes, the value of value relative to growth is at historic extremes, but maintaining attractive absolute valuation levels is not a passive proposition at this point and requires being active and disciplined.
2. **Fundamentals:** One of our main long-term goals is to own stocks that are mispriced, but that also compound intrinsic business value. Business value compounds when companies can grow by deploying capital at returns above their respective cost of capital. This captures a key discipline of our investment process, as we not only want mispriced stocks, but we must also

A mispriced stock, with high volatility and low correlation to the rest of our portfolio, adds to our risk budget.

get the fundamentals right. This keeps time on our side and surfaces the power of long-term compounding in driving returns. In 2024 portfolio earnings and cash flow compounded at a high-single-digit rate, while our holdings also enjoyed positive earnings estimate revisions above 8%. By comparison, RLV earnings growth was essentially flat with positive estimate revisions of roughly 5%. In 2025, the portfolio's compounding growth advantage is expected to expand materially with sales and earnings growth more than double what is expected for the RLV. The key is that one must be truly active versus the index and go where your investment process takes you. This typically leads to modestly higher tracking error than peers, but where we are getting paid for this relative risk while managing absolute risks through portfolio diversification.

3. **Diversification:** Another comparative advantage of our investment process is that we use an absolute value lens to look across the market for opportunities. This allows us to broadly capture absolute valuation opportunities that support portfolio construction through combinations with low pair-wise correlations. Many of our peers are increasingly focused on stocks that closely correlate with the index regardless of valuation. Our active inversion is that a mispriced stock with high volatility and low correlation to the rest of our portfolio adds to our risk budget, as it lowers portfolio level volatility. These risk-reducing combinations allow us to invest in great fundamental and valuation opportunities that most managers wouldn't even consider. Despite sometimes higher stock-level volatility, our portfolio holdings are generating positive earnings and cash flows with strong balance sheets, adding resilience in a world increasingly anchored to passive risks and ignoring mounting absolute risks.

We also think we have a sustained comparative advantage in how we adapt to an always uncertain future, beginning with the absolute valuation advantage we always try to maintain. Very simply, low valuations embed a poor-to-average future outcome in their prices, providing a healthy margin of safety against the unknown, while high valuations require good-to-great things to materialize. With indexes trading at record valuations, markets are banking on the certainty of good-to-great outcomes.

Quarterly Performance

The Strategy outperformed its Russell 1000 Value benchmark during the fourth quarter, as both positive contributions from stock selection and sector allocation effects contributed to relative performance. Six of our top 10 individual contributors came from the financials sector, which rallied on the prospect of deregulation and an increase in M&A stemming from Donald Trump's victory in the presidential election and a Republican sweep. These included Apollo

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Global Management, a private equity manager, First Horizon, a bank, and Block, an electronic payments manager that also saw robust merchant payment activity surrounding the holiday season. Stock selection in energy was largely driven by strong performance from EQT, North America's largest natural gas producer, on expectations for colder winter weather and increased demand.

Conversely, stock selection in the consumer staples sector weighed on overall performance, where Nestle, a Swiss-based food and beverage company, retreated after it reported a decline in total sales and guided down guidance for its full-year sales growth and margins, citing a softer consumer demand environment globally.

Portfolio Positioning

We added several new positions during the quarter and updated our utilities and energy exposure. In utilities, we bought Talen Energy, an independent power producer which sells electricity, capacity, and ancillary services into wholesale power markets, which we funded by exiting our position in Constellation Energy. Although both companies are merchant power producers that stand to benefit from higher power prices as AI data centers are brought online, we believe that Talen's stock price has milder embedded expectations than does the more optimistic Constellation. As a result, we believe that Talen represents a much more attractive risk/reward tradeoff that still capitalizes on the strong, long-term trend toward higher power prices.

Our largest sell was Baker Hughes, which we made to fund our new position in oilfield service provider peer Schlumberger. While we acknowledge that Baker Hughes has stronger near-term tailwinds, its strong performance has resulted in a historically wide valuation gap to Schlumberger. Schlumberger has similar exposure to the oil and gas industry, but also has an improving portfolio of assets and greater digital initiatives that we believe will lead it to outperform Baker Hughes over the long run.

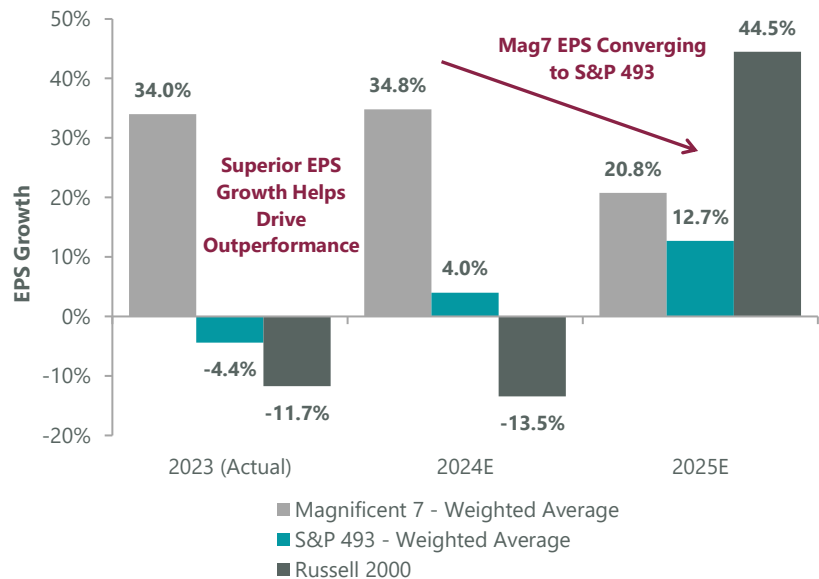
Outlook

We think 2025 will be full of surprises, with the contradictory nature of Trump policies likely at the center of them. Overall, we see three main scenarios for 2025: continued Goldilocks/soft landing, cyclical inflation upside and a recession. The first appears to be what the market is pricing, yet the others are both distinct possibilities.

- **Continued Goldilocks:** This is supported by a continuation of lower inflation and Fed easing and combined with a pro-business Trump agenda from tax cuts and lower regulation. We do think we will see increasing deal activity and that the animal spirits of optimism will continue. Look no further than the massive investment spending around AI. We are also seeing signs that bank loan growth is accelerating, which would further support growth. The true silver lining of this scenario is that we would

expect the market to sustainably broaden out as the relative earnings growth of the market outside of the Magnificent Seven is positioned to accelerate meaningfully. This is also where our own material earnings and free cash flow growth advantage versus our index could really matter in driving absolute and relative returns.

Exhibit 3: Earnings for the S&P 493 Are Set to Accelerate



Magnificent 7 data refers to the following set of stocks: Microsoft (MSFT), Amazon (AMZN), Meta (META), Apple (AAPL), Google parent Alphabet (GOOGL), Nvidia (NVDA), and Tesla (TSLA). Data as of Dec. 31, 2024. Sources: FactSet, Russell, S&P.

- Inflation Upside:** It wouldn't take much for the economy to run too hot. Inflation seems to have bottomed well above the 2% Fed target and, in addition to its already moderately rising, many of Trump's policies including tariffs and immigration are directly inflationary. Additionally, we think it will be very difficult to contain the fiscal largesse that a dysfunctional political system has become addicted to. In addition, the animal spirits and accelerating loan growth mentioned above are both inflationary impulses that have been missing over the last few years. The market is not positioned for inflation risk, and we are concerned that higher long-term Treasury yields in this scenario would start to weigh heavily on market valuations. Our insurance against this scenario is our overweight to commodity sectors, with energy being our biggest overweight, and why we own names that are beneficiaries of higher rates, like life insurance.
- Recession:** A recession seems like a low near-term probability given current observation. However, the main paradox in Trump policies is if the Department of Government Efficiency (DOGE) has any success in cutting the \$2 trillion in government spending they are targeting, the economy would slow dramatically from much lower fiscal spending. The ability to meaningfully cut

deficits and withstand resulting political pain seems quite remote, but how much are you willing to bet against Elon Musk if his support from Trump holds up? Fortunately, we do not have to make a major bet against Musk's efforts as defensive sectors and low-volatility stocks have all fallen out of favor given the recent jump in animal spirits. Many defensive sectors, as highlighted by health care being the worst performing sector in 2024, have surfaced good absolute value that we are taking advantage of. Adding to defensive names on sale accounted for most of our portfolio activity in the fourth quarter.

While we consider these scenarios in our process, we do not position the portfolio for any one of them. Our goal is resilience at every level, starting with low absolute valuations and good compounding fundamentals that ask little of the future. We then add a critical layer of diversification by owning companies that would thrive in different macro and market environments. This positions us well to adapt to the inevitable surprises that 2025 will surface.

Portfolio Highlights

The ClearBridge Value Equity Strategy outperformed its Russell 1000 Value Index during the fourth quarter. On an absolute basis, the Strategy had positive contributions across five of the 11 sectors in which it was invested. The leading contributors were the financials and energy sectors, while the health care and materials sectors detracted the most.

On a relative basis, overall stock selection and sector allocation effects positively contributed to returns. Stock selection in the financials, energy, utilities and health care sectors and an overweight to financials benefited performance. Conversely, stock selection in the consumer staples, industrials, materials and real estate sectors weighed on performance.

On an individual stock basis, the biggest contributors to absolute returns were Marvell Technology, EQT, GE Vernova, Vistra and Apollo Global Management. The largest detractors from absolute returns were AES, Freeport-McMoRan, Novo Nordisk, UnitedHealth and Micron Technology.

During the period, in addition to the transactions listed above, we initiated new positions in CVS Health in the health care sector, Fortune Brands Innovations in the industrials sector as well as Charles Schwab in the financials sector. We exited positions in GE Vernova and Boeing in the industrials sector, Apollo Global Management, Fairfax Financial and Everest in the financials sector, Gen Digital in the IT sector, Haleon in the consumer staples sector, Vulcan Materials in the materials sector, TotalEnergies in the energy sector and Howard Hughes in the real estate sector.

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