



## Value Strategy



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### Key Takeaways

- ▶ The biggest tail risk we are facing is a full-on trade war, which is why the market reacted so negatively to the so-called Liberation Day tariffs.
- ▶ The Strategy underperformed for the quarter as stock selection, driven by detractors in the energy and financials, overcame contributions from our overweight to energy and underweight to IT.
- ▶ Our “team of rivals” philosophy drove our returns coming out of the COVID crisis five years ago, and it will help guide us through and capitalize on current tariff turmoil.

### Market Overview

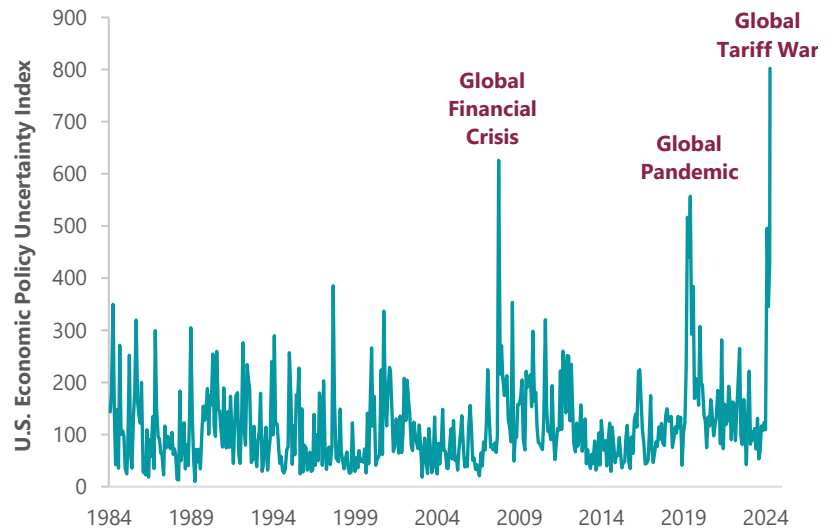
Wanderers on a rocky precipice above a sea of fog — like the subject of Caspar David Friedrich’s wonderful 19th-century painting *Wanderer above the Sea of Fog* — might aptly describe investors today, navigating complex landscapes with limited visibility and irreducible uncertainty. In many ways, our key task as an investment team is to process and reduce as much of this uncertainty as possible as we observe events and to discover real opportunities where asset values do not fully reflect fundamentals. Achieving this is immensely challenging right now as for most of our careers the primary goal of government policy has been to offset negative exogenous shocks and to stabilize excesses. This stabilization has been reversed completely with the recent negative surprise of the highest tariffs in almost a century. Policy has morphed into a destabilizing shock and a source of immense uncertainty. Despite this extremely foggy market landscape, our task remains unchanged.

One of the main ways we look to reduce uncertainty is with theoretical models that help frame key economic and market dynamics. One of the most robust models we apply is the concept of positive and negative feedback loops in dynamic systems — positive feedback loops amplify and reinforce change in a system, leading to system instability, while negative feedback counteracts change in a system, bringing it back toward stability.

One of Trump’s primary goals of his second term was to remove all negative feedback from within his administration. The goal was to ensure that the President’s decisions would be unquestioned and executed accordingly without delay — the opposite of President Lincoln’s “Team of Rivals” approach that helped guide him through the Civil War. Adding to this dynamic is that Trump, on many

occasions, has stated that he likes to be unpredictable. The result is that the current administration is a positive feedback loop of policy uncertainty (Exhibit 1).

Exhibit 1: Trump Has Plunged the Economy into Chaos



Data as of April 6, 2025. Source: Baker, Bloom & Davis; Bloomberg L.P.

Even with an enforced positive feedback loop within his own administration, there will be tremendous external negative feedback as Trump's policies are unleashed on the economy and markets. The ultimate negative feedback could come from dramatic shifts in future elections. While we are not trying to handicap these impacts directly, we are merely observing that Trump is acting as an extremely aggressive political poker player playing an incredibly risky hand.

The obvious event to address is the massive shift in trade policy from the recent "Liberation Day," with announced tariffs estimated in the 22% to 24% range, which can only be compared to the Tariff of 1828 and Smoot-Hawley in 1930. The former is considered one of the early economic sparks leading up to the Civil War and labelled the "Tariff of Abominations" by the South, while the latter helped cement the Great Depression as a full-on trade war ensued. A tariff is effectively an import tax that results in a stagflationary shock, as both demand and supply are negatively impacted simultaneously, resulting in higher prices and lower growth. The biggest tail risk is that we end up in a full-on trade war, which is why the market reacted so negatively to China's retaliatory tariff announcement. There are no winners in a trade war.

As investment managers, our priority is to try to evaluate the immediate impact of what is effectively the largest tax increase in U.S. history. Unfortunately, things are likely to get a lot worse economically and fundamentally in the immediate future. In evaluating corporate earnings, it is hard to evaluate the downside with great precision. However, Goldman Sachs and other leading

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market makers estimate that S&P 500 earnings could drop approximately 1% to 2% for every 5% increase in the tariff rate. This suggests an immediate earnings hit of 4% to 8%, which would effectively wipe out any expected earnings growth in 2025. This also assumes that most of the price increase would be passed on to consumers, which we think is unlikely and doesn't account for the negative impact that ongoing uncertainty will have on economic growth more broadly.

This suggests we should treat the Liberation Day tariff like we would a recession shock. During recessions following World War II, S&P 500 earnings declined 13% on average, while the market typically declined by 20% to 30%. So far, as of April 6<sup>th</sup>, the Russell 1000 Value Index is down 15% from its recent peak, while the S&P 500 is down a little over 17%. Accordingly, we are assuming the market will likely have more downside of 10% to 15% in the immediate future, especially as hard data around earnings and economic growth start to catch up with the collapse in consumer, business and investor sentiment.

We came into Liberation Day with the most defensively positioned portfolio in our history and have lost over 3% relative to our index since its late November peak. With the benefit of hindsight, we should have been even more defensive. Given what we currently observe, we are adapting the portfolio to be even more defensive by trimming cyclical exposure where the investment case has weakened and we will be running ongoing stress tests of each holding to adapt to whatever unfolds from the ongoing tariff damage. Our goal is to play defense now so that we are positioned to take advantage of the opportunities that ultimately arise from every market crisis.

This begs the question, what opportunities could arise from all this uncertainty?

1. **Tactical positioning:** Coming out of the election the market's wall of worry collapsed, but it is now being rapidly rebuilt. The CBOE Volatility Index (VIX) has climbed from near-record-low levels in December to roughly three standard deviations above historic averages. From current VIX levels, which the index has reached 12 times since 1990, the market return was positive three to six months later 80% to 90% of the time—the exception being during the Global Financial Crisis — but it clearly takes a lot of negative news to maintain these levels of panic.
2. **The Fed put:** The Fed is in a bit of tough spot given the stagflation risks from the Liberation Day tariffs. Accordingly, the Fed has stated it will monitor tariff-related inflation risks, but we expect deflationary pressures to mount as growth slows, aided by the recent 20% collapse in oil prices. Lower long-term interest rates and commodity prices are key negative feedback cushions to slowing growth and give the Fed more room to maneuver. A general heuristic is that investors can quit panicking when policy

makers start panicking, and our guess is the Fed put will come into play if we see another 10% downside in the equity market.

3. **The Trump put:** President Trump is, by nature, unpredictable, and we don't expect him to fold his tariff hand soon or on his own. However, we suspect that panic will increase as election risks mount, and we are already seeing some early counter moves within the Republican party. Ultimately, we think there will be some give in initial tariff levels as the ongoing damage from tariffs and policy uncertainty become more evident and fully priced into markets.

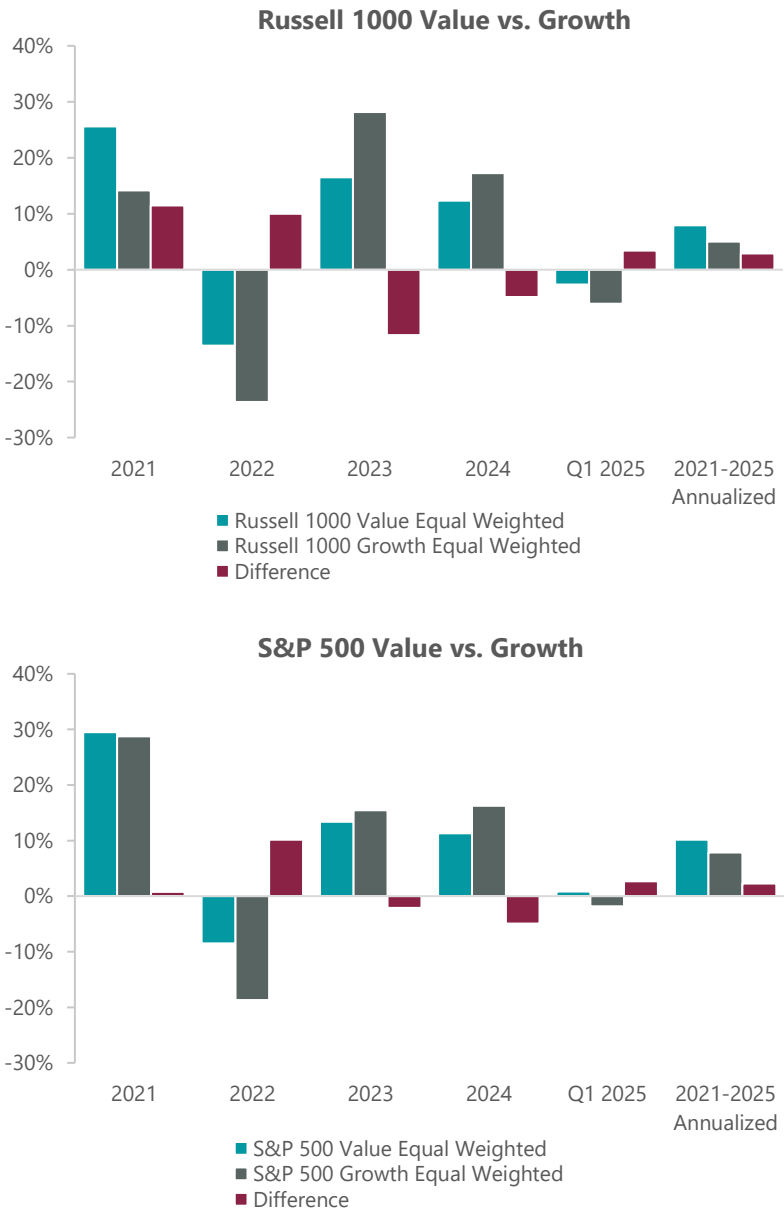
### Value Still at an Extreme Discount Despite Outperformance

Every market panic brings on some level of regime change and a new set of opportunities. We have frequently shared how the value of value relative to growth is still at historic extremes in the cheapest 10% versus history. However, despite the relative value of value persisting near extreme levels, value has led growth during the post-COVID market cycle (Exhibit 2). This has been driven by value offense coming out of the COVID market lows and is now being led by value defense during the recent tariff turmoil. We think the tariff shock, along with Joseph Schumpeter's "creative disruptions" from the emergence of AI, could more fully set value free from its current extreme levels. Especially if the ongoing decline in market concentration from extreme levels continues, allowing capital to flow into other areas that have been largely ignored until recently — something we expect to continue.

The key to benefiting from this shift toward value is in finding absolute value opportunities. Specifically, in businesses that can continue to generate free cash flow, earn attractive long-term returns on capital, and have fortress-like balance sheets that will allow them to deploy capital countercyclically even as tariff pain gets absorbed by the economy. During market crises, equity prices of these types of durable businesses are typically much more volatile than underlying business value. Thus, lower stock prices and compounding business values are the engine of attractive forward return potential coming out of bear markets.

On a related note, there will also be opportunities to buy durable growth on sale, as forced selling and market panic often drives select growth stocks to levels that discount very little or no long-term growth. For examples, we do not expect advances in AI and related investments to stop, and yet we are seeing AI-enabling stocks decline to free cash flow yield levels of roughly 10%, levels that discount little if any long-term growth. In addition, we continue to monitor the stocks of businesses that will be clear beneficiaries of AI adoption, where stock prices are falling materially below our estimate of long-term value. To the degree that tariffs raise costs and hurt profit margins broadly, AI-driven productivity gains could be a critical source of negative feedback in offsetting margin pain.

Exhibit 2: Value Leads Growth Post-COVID



Data as of April 6, 2025. Source: FactSet, ClearBridge Investments.

### Quarterly Performance

The Strategy underperformed its Russell 1000 Value benchmark during the first quarter, as stock selection in the energy and financials sectors overcame positive contributions from our overweight to energy and underweight to IT.

Health care stocks populated our top performers for the quarter. Our top contributor was CVS Health, which posted strong fourth-quarter results exceeding analyst expectations thanks to positive contributions from its Aetna insurance and pharmacy network. Additionally, the company received a tailwind from the perceived

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benefit to its managed care segment following a proposed increase in government payments to Medicare Advantage plans in 2026. Biopharmaceutical company Gilead Sciences announced strong fourth-quarter earnings growth and also rose both on news that its HIV prevention treatment drug Lenacapavir had been filed for U.S. approval, with an anticipated launch scheduled for mid-2025, and on positive reception to its cirrhosis of the liver treatment Livdelzi in its first full quarter.

Conversely, holdings in the energy sector, led by Venture Global and Noble, weighed on relative performance. We participated in the IPO for the natural gas liquefaction and export construction company Venture Global but saw its share price decline after management reduced their valuation expectations. However, we believe that the company's disruptive modular LNG technology — which they are deploying at massive scale and at attractive returns — represents a truly attractive opportunity for long-term growth in natural gas. Meanwhile, Noble, which provides offshore drilling services for energy E&P companies, continues to decline as contracting opportunities have failed to materialize. With our thesis that consolidation and rationalization would drive a meaningful up pricing cycle evaporating, we ultimately elected to exit the position to redeploy the proceeds into other, more compelling opportunities.

### Portfolio Positioning

While we had already begun to shift toward a more defensive positioning entering the quarter, we made a number of adjustments in response to the rapid-fire developments in both economic and political policy. Among our largest new positions during the period was Walt Disney, as we believe that it has turned a corner on building out its streaming service, which should help margins inflect higher and help drive better earnings than the market currently anticipates. The shift in management's strategy, from "market share growth at all costs" to a more focused approach on improving pricing should also help to improve both profitability and margins, and we believe that there remains meaningful upside compared to other streaming service providers at similar scale.

Our largest sell was Goldman Sachs relatively early in the quarter, as expectations for an increased capital market cycle under the new Trump administration brought its share price in line with our assessment of fair value. We also exited enterprise software and cloud services company Oracle as its strong performance in 2024 had rerated its stock higher and narrowed the gap between our assessment of share price and intrinsic business value. This, combined with the company's relatively high correlation to other AI holdings that we have high conviction in led us to seize the opportunity to capture gains in the stock reinvest in other areas we feel have superior risk/return profiles.

## Outlook

Inspired by President Abraham Lincoln, we run a “Team of Rivals” approach within our investment team. This is not easy, as it forces us to manage our egos and pride as we navigate uncertainty collectively and make inevitable mistakes along the way. However, the challenge of constant and intense debates in the pursuit of better judgment and the surfacing of hidden truth within an always foggy market landscape is worth it. It helps us dynamically manage the intense tactical risks of a bear market so that we can pursue long-term valuation opportunities that are the silver lining of every market crisis. This team process is what drove our strong returns coming out of the COVID crisis five years ago, and it will help guide us through and capitalize on current tariff turmoil.

## Portfolio Highlights

The ClearBridge Value Strategy underperformed its Russell 1000 Value Index during the first quarter. On an absolute basis, the Strategy had positive contributions from three of the 11 sectors in which it was invested. The leading contributor was the health care sector, while the IT and financials sectors detracted the most.

On a relative basis, overall stock selection weighed on returns, while sector allocation effects were positive. Stock selection in the health care sector, an overweight to the energy sector and underweights to the IT and consumer discretionary sectors benefited performance. Conversely, stock selection in the energy, financials, consumer staples, utilities and IT sectors weighed on performance.

On an individual stock basis, the biggest contributors to absolute returns were CVS Health, Gilead Sciences, Nestle, EQT and Johnson & Johnson. The largest detractors from absolute returns were Venture Global, Block, PayPal, Noble and Skyworks Solutions.

During the period, in addition to the transactions listed above, we initiated new positions in DraftKings and Genuine Parts in the consumer discretionary sector, Jones Lang LaSalle in the real estate sector, Ryan Specialty in the financials sector, PepsiCo in the consumer staples sector, MicroChip Technology and Intel in the IT sector and BP in the energy sector. We exited positions in Capital One Financial in the financials sector, Target, Lamb Weston and Coty in the consumer staples sector, Skyworks Solutions and Marvell Technology in the IT sector, AES in the utilities sector and Fluence Energy in the industrials sector.

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