ClearBridge
A Franklin Templeton Company

Value Strategy

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Key Takeaways

- The Strategy mildly underperformed its benchmark in a quarter that broadly favored value over growth, as declines in health care overcame strength from technology and materials stocks.
- Valuation discipline was challenged in 2025 by the economy's unexpected resilience and the market's rapid dismissal of volatility shocks, but the process has sharpened our portfolio positioning heading into 2026.
- With value spreads near historic extremes and AI adoption poised to broaden economic benefits, we see an attractive probability gap that creates meaningful upside potential for valuation-driven investors.

Market Overview

Warren Buffett once said, "Investing is simple, but not easy" — a mantra that fits how adhering to our valuation-disciplined process felt, both in the fourth quarter and 2025. The advantage of our process is that it is rooted in a similarly simple, but not easy, exercise: unpacking the embedded expectations that the market has priced into stocks and identifying where our team's probabilities are different. We win when the outcome turns out better than expected, or when we are underweight areas where market expectations prove too optimistic; we lose when we get the probabilities wrong, which inevitably happens some percentage of the time. Most years we get enough probabilities right, on both a broad and a stock level, to overcome where we get them wrong, resulting in decent risk-adjusted returns across a wide variety of market environments. Why, then, was 2025 such a challenge?

A Look Back at 2025

At a broad level we underestimated the resilience of the market and the economy to the year's two big volatility events: the reveal of Chinese AI model DeepSeek and President Trump's Liberation Day. Both caused volatility to spike and relative performance pain despite ultimately proving incredibly short lived.

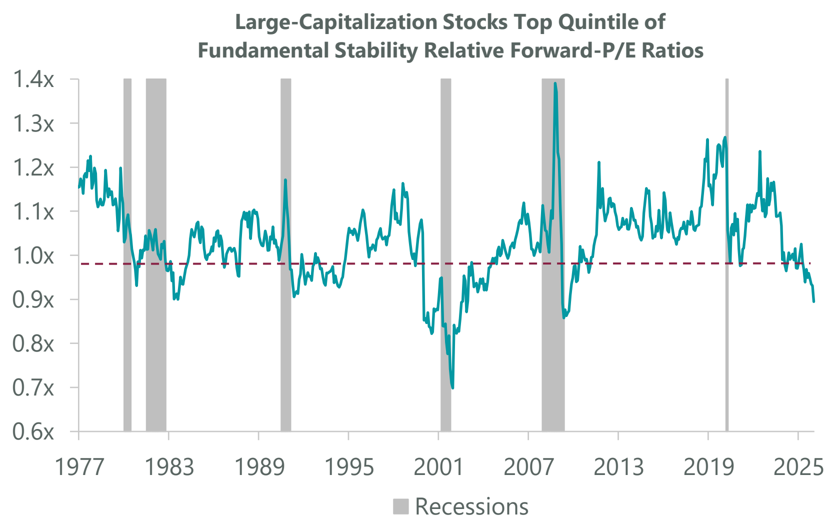
In the case of DeepSeek, capital spending shrugged off the prospects of a less infrastructure- and capital-intensive AI model and continued to accelerate throughout the year. As a result, AI-exposed stocks, especially the picks-and-shovels we own, were some of the best-performing investments in the market. We remained overweight AI against our index but reduced exposure given the spike in volatility, which proved to be good risk management but costly on a performance basis.

Secondly, we expected Liberation Day to negatively impact economic and earnings growth in 2025. This was initially supported by an over three-standard-deviation jump in market volatility — an extreme enough event that one would expect it to raise market risk premiums and create ample valuation opportunities. The big surprise, however, was that volatility had a historically fast collapse back to normal without impacting risk premiums.

We like growth, we just don't like to pay for it.

The key driver of this was the resiliency of the U.S. economy, whose real economic growth translated into the earnings growth that powered the year's returns. With hindsight, the best course of action following Liberation Day was to add risk aggressively, as low-quality and high-volatility stocks led the market following the storm. Conversely, stocks with the highest quality fundamentals, which form a key segment of our investment universe, have seen their multiples compress.

Exhibit 1: Stable Stocks Are Out of Favor



As of Dec. 31, 2025. Source: National Bureau of Economic Research, Empirical Research Partners Analysis.

The commonality in both is that we underestimated the structural resilience of the U.S. economy and the operating leverage that continues to support best-in-the-world free cash flow (FCF) margins for U.S. companies. This FCF generation is largely funding the massive capital spending on AI infrastructure, where the U.S. already has a dominant lead. The market clearly believes that AI will further support U.S. leading profit margins and productivity, but proving this will be a key determination for the market in 2026.

On a stock-specific level, we had several good outcomes where our better-than-embedded outcomes came to fruition in 2025. Micron Technology and Newmont Mining benefited from much higher prices for memory chips and gold, respectively, than were reflected in their stock prices. In each case we were right for the right reasons: we expected AI to drive memory demand well above supply growth, creating a memory price spike, and we have been long-term bulls on gold as supply is fairly limited in any given year and any source of new demand able to push prices higher. Even before 2025's spike in prices, miners like Newmont had greatly lagged the underlying price increase in gold, giving us an opportunity to buy a high-probability event at a low-probability price.

Conversely, we got the fundamentals wrong in payments stocks, especially Fiserv, which experienced a dramatic decline in earnings expectations following its aggressive price increases and inflated, but undisclosed, earnings from Argentina. While we had reduced our exposure to payment stocks — including Fiserv — earlier in 2025, we underestimated the probability and magnitude of a bad outcome.

A Look Forward to 2026

New year market forecasts typically suffer from recency bias as the previous year's performance simply gets extrapolated. We believe this is very much the case, as current forecasts and embedded expectations contend that 2026 will simply be a slightly improved version of 2025. This is not an unreasonable starting point, but it suggests the market could be roughly in line with earnings growth, assuming no help from multiple expansion, as indexes are currently at historically elevated valuation extremes. This seems reflected in consensus forecasts for an average return of 10.5% in 2026, with an extremely narrow standard deviation of 3.5%. This narrow clustering is very interesting as it does not reflect that the S&P 500 Index is a 15% volatility index, which creates opportunities for us as valuation-disciplined, probability-driven active investors.

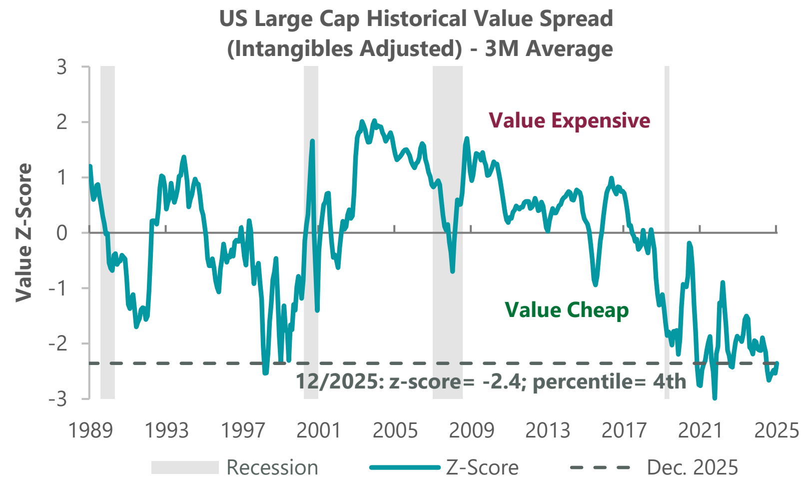
2026 will be the year that AI has to justify the immense and accelerating capital investment.

If the forecast is correct, we have a compounding advantage by owning faster-growth companies than the index at lower valuations. Current 2026 earnings growth expectations for our holdings are roughly 20% versus high single digits for the Russell 1000 Value Index (RLV), yet the portfolio is selling for less than 15x forward earnings versus over 18x for the RLV. If a benign scenario plays out, this growth advantage is a tailwind even if the relative multiple discount remains constant. To put it simply: we like growth, we just don't like to pay for it.

The greatest opportunities, however, come when valuation is extreme enough that it implies an incredibly low probability of an outcome we think is likely — creating a true investment edge and potential source of significant alpha generation. On a broad level, the market continues to price value stocks relative to growth at a level that implies value has little chance of leading. Despite a couple of good years, value spreads have remained trapped at the cheapest 10% of their history (Exhibit 2).

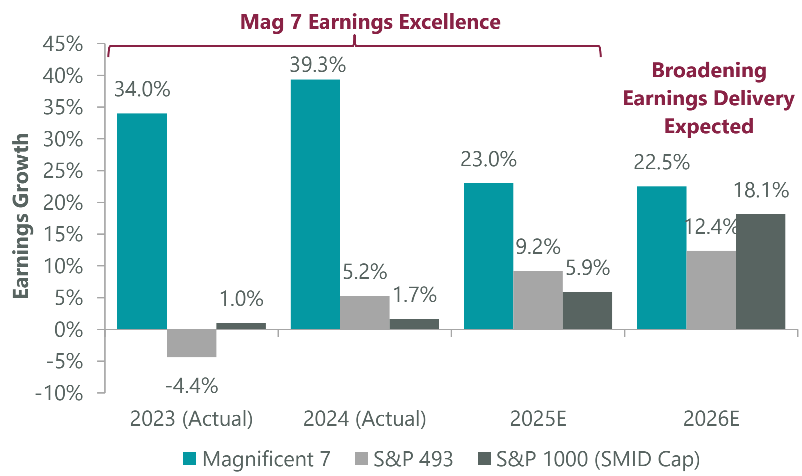
We think the catalyst for value's escape will, ironically, come from AI adoption. 2026 will be the year that AI has to justify the immense and accelerating capital investment. To do this, it will need to be diffused more broadly across the economy, driving material productivity gains and higher profit margins. If this occurs, it could narrow the margin, return and earnings growth gap between tech stocks and AI adopters, including value stocks not priced for this structural upside. Even without this upside potential, the relative gap between tech earnings growth and the rest of the market is set to narrow dramatically, without any structural boost from AI beyond this incorporated into relative valuation spreads (Exhibit 3).

Exhibit 2: Value Remains Trapped at Extremes



As of Dec. 31, 2025. Source: AQR, ClearBridge Investments analysis.

Exhibit 3: Closing the Gap



Data as of Dec. 31, 2025. Sources: FactSet, S&P. 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).

The key is to look for a broadening market and actual cases of AI adoption driving higher margins; we see emerging evidence of both. The potential from the setting-value-free probability gap could drive an upside scenario that is even more bullish than expectations.

Quarterly Performance

Stock selection in the health care sector was the greatest detractor from relative returns in the fourth quarter, largely owing to the decline in drug developer Corcept Therapeutics, whose stock fell following the release of a FDA Response Letter for its relacorilant program, citing the need for additional evidence to support approval. With the prospect of the company having to lean more heavily on its legacy products, which are under pressure from greater generic competition, we elected to exit the position.

Our top performer was Micron Technology, which continued to extend its strong 2025 performance following attractive earnings results and upbeat guidance due to accelerating AI-driven demand, tightening memory supply and improving pricing dynamics across DRAM and high-bandwidth memory markets. Performance was also bolstered by copper miner Freeport McMoRan, whose shares advanced alongside the commodity price on improving global growth expectations, a weaker U.S. dollar and continued optimism around long-term demand tied to electrification and energy transition trends.

Portfolio Positioning

In the fourth quarter, we made several changes within our financials holdings. For example, we swapped our exposure within regional banks by replacing M&T Bank with Fifth Third Bancorp. We believe that Fifth Third is poised to accelerate its growth by combining its best-in-class digital strengths with recently acquired Comerica's middle-market franchise in fast-growing, attractive regions in the Southeast, Texas and California, ultimately upgrading our overall return profile.

We also exited our position in payments company PayPal. While we had thought that stronger leadership could help reaccelerate growth within PayPal's core franchise, performance has suggested that this may be a more daunting task than we anticipated given the company's exposure to structurally slower growth areas of e-commerce. With a growing probability that the company could fail to break out from mid-single-digit growth rates for the foreseeable future, we decided to sell the stock.

Ultimately, we believe that the crucible of 2025 has helped sharpen our positioning for 2026. We are actively focused on finding AI adoption in sectors and industries where it is not currently priced, giving us exposure to the upside scenarios as we compound higher growth in a value wrapper. For the downside, we are focused on companies generating free cash flow and with strong balance sheets. We have also continued to decrease individual stock volatility where we cannot reduce it as part of our portfolio construction. Finally, we are overweight real asset sectors such as energy and materials, which should do well in an inflation scenario while also compounding business value from robust ongoing free cash flow generation.

Outlook

Our main goal is to get back to making active valuation-disciplined investing look simple again, even if it isn't easy. While we approach every new year with humility and a focus on process discipline, we think positioning for many possible futures is critical in a market priced for a narrow set of outcomes — especially when the alternatives have much higher probabilities than what the market has priced. In an increasingly passive world crowded into the same few stocks and sectors, we think that this is a key source of differentiated returns for active, probability-driven managers like us.

Portfolio Highlights

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

On a relative basis, overall stock selection detracted from performance. Stock selection in the health care, financials, communication services and utilities sectors as well as an underweight to the IT sector weighed on performance. Conversely, stock selection in the materials, IT and industrials sectors and an overweight to the health care sector proved beneficial.

On an individual stock basis, the biggest contributors to relative returns were Micron Technology, Freeport-McMoRan, Onemain, Newmont and Argenx. The largest detractors from relative returns were Corcept Therapeutics, Fiserv, Charter Communications, Talen Energy and Meta Platforms.

During the period, in addition to the transactions listed above, we initiated new positions in Celsius in the consumer staples sector, Global Payments, Intercontinental Exchange and Webster Financial in the financials sector and Contemporary Amperex Technology in the industrials sector. We exited positions in Silgan in the materials sector, DraftKings in the consumer discretionary sector, TG Therapeutics and ICON in the health care sector, Fiserv and American International Group in the financials sector and Charter Communications and Meta Platforms in the communication services sector.