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Dividend Strategy

Key Takeaways

- ▶ The market's meteoric rise has been powered by a small handful of technology juggernauts that have come to dominate critical aspects of the modern economy: AI compute, the cloud, e-commerce, electric cars, mobile phones, search and social.
- ▶ As the S&P 500 Index has become increasingly concentrated, the investment industry has lost sight of the importance of diversification, the most basic principle of risk management.
- ▶ With the market at all-time highs, valuations on the fuller side and interest rate expectations becoming less dovish, we have redoubled our discipline on valuation and remain focused on high-quality dividend payers that possess three key attributes critical for times like these: downside protection, current income and growth.

Market Overview

2024 was a terrific year for the stock market and for the ClearBridge Dividend Strategy. For the second year in a row, the S&P 500 Index rose around 25% or more. Dividend Strategy rose less than the market but was still up strongly, with relative performance improving dramatically as the market broadened out in the second half of the year. The Strategy trailed from January to June, when market returns were dominated by Nvidia and Meta Platforms, then outperformed the rest of the year as market participation evened out.

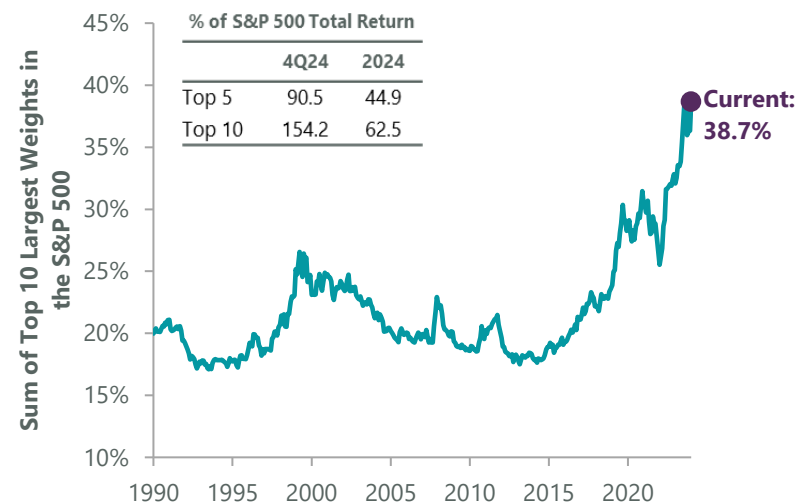
Thematically, much of 2024 was a continuation of the AI-driven surge that began in late 2022 when OpenAI unveiled ChatGPT. Nvidia, whose chips are the brains for AI computations, has been the standout stock of this cycle; its shares are up over 800% in the last two years. Nvidia now represents 6.6% of the S&P 500, up from 1.1% at year-end 2022.

But the story of the last two years is not just about Nvidia. The market's meteoric rise has been powered by a small handful of technology juggernauts that have come to dominate critical aspects of the modern economy: AI compute, the cloud, e-commerce, electric cars, mobile phones, search and social. The absolute dominance of these companies in their respective domains (Alphabet in search, Meta in social, Apple in mobile, etc.) is unlike anything the U.S. economy has seen since the trust era of the late 1800s. Collectively, the top 10 names in the stock market represent 39% of the S&P 500 and are up 155% in the last two years. Apple and Microsoft, among

the “worst” performers of this bunch, are up 95% and 79% over the last 24 months, respectively.

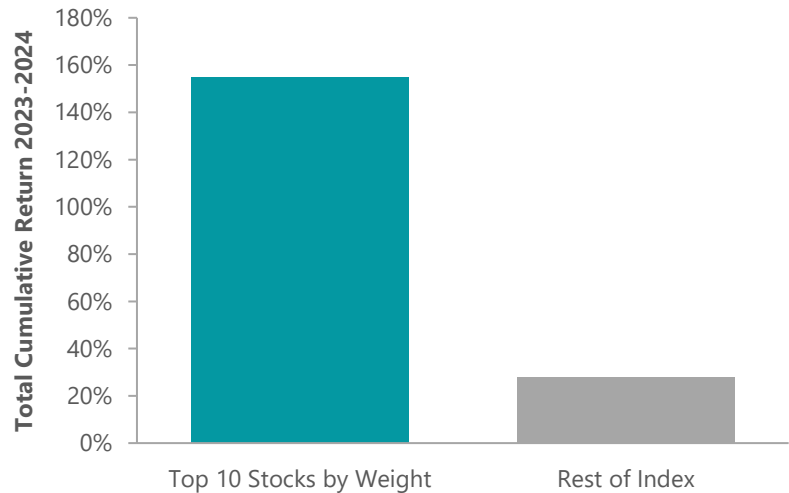
It would be difficult to overstate the uniqueness of this market period. At no other time in history has such a small handful of stocks been responsible for such a staggering proportion of the market’s capitalization and returns (Exhibits 1 and 2). As we have discussed previously, this phenomenon presents challenges for investment managers using the cap weighted S&P 500 as their benchmark. With such a small number of names driving performance of the index, active managers must take huge positions in these few winners to keep pace.

Exhibit 1: S&P 500 Remains Concentrated



As of Dec. 31, 2024. Source: S&P, FactSet, and Bloomberg.

Exhibit 2: And Returns Remain Skewed



As of Dec. 31, 2024. Source: ClearBridge Investments, FactSet. Top 10 stocks by ending weight.

Two years into this powerful and unique market cycle, we find ourselves reflecting on routine performance reports and analyses whose touchstone is the benchmark. Benchmark-based reporting is the industry's equivalent of breathing or brushing our teeth: we do it instinctively, almost by rote, and without question. It is generally unremarkable and uncontroversial.

Today, however, we find ourselves questioning the foundations of this exercise. Instead of focusing on *relative performance* of investment products versus the S&P 500, we wonder if the industry should be focusing on the *absolute risks* embedded in the S&P 500. The S&P 500 has historically been a diversified index, but today it is not. For diversified money managers, it looks like the S&P 500 is wearing a "temporarily out of order" sign.

Officially, the information technology (IT) sector represents a little north of 30% of the S&P 500. If we add back firms previously categorized in the IT sector but subsequently re-categorized into other sectors, the S&P 500 is over 40% technology.¹ There is nothing wrong with using a highly concentrated index for a benchmark, but we typically think of funds with concentrated indexes as sector funds. And there is nothing wrong with investors allocating *a portion* of their money to a highly concentrated investment program. Today, however, society has made *large* allocations to funds benchmarked to a highly concentrated S&P 500, under the false pretense that the S&P 500 represents a diversified bogey.

As long as the Fateful Eight stocks — adding Broadcom to the Magnificent Seven² — continue to rise, the fragility of the current system will remain obscured. But if a handful of large stocks at the heart of our markets ever drop significantly, the impact on investors, society and the financial system could be profound.

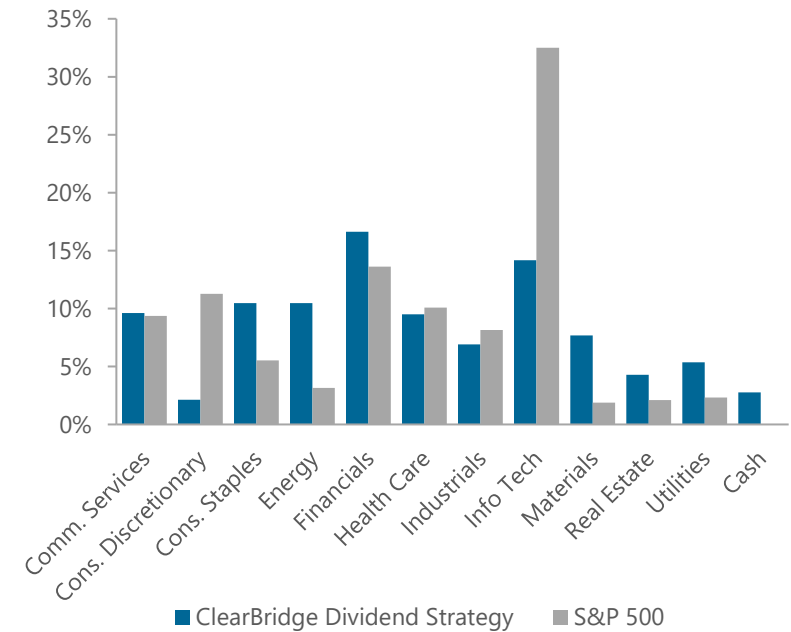
Given its extreme concentration now, the S&P 500 seems like an irrelevant yardstick for diversified, risk-averse investors. It clearly measures something, but not what it was originally supposed to measure. Risk-averse investors seeking diversification might rethink the emphasis they put on its use for appraisals: today, the S&P 500 and these investors are not playing the same game.

The ClearBridge Dividend Strategy, however, has not drifted off course. We remain resolute in adhering to our founding risk principles: we maintain broad exposure to all sectors while staying strongly diversified (Exhibit 3). We have meaningful exposure to AI through investments in Apple, Broadcom, Microsoft and Oracle, but we have not gone "all-in" on AI investments because no thoughtful investor should ever go "all-in" on anything.

¹ During the last 10 years, the S&P 500 has moved several companies out of the IT sector to prevent it from appearing too big relative to other sectors. Most notably, it has moved Visa and Mastercard to financials and Meta and Alphabet to communication services.

² Alphabet, Amazon.com, Apple, Meta Platforms, Microsoft, Nvidia and Tesla.

Exhibit 3: ClearBridge Dividend Strategy Remains Broadly Diversified

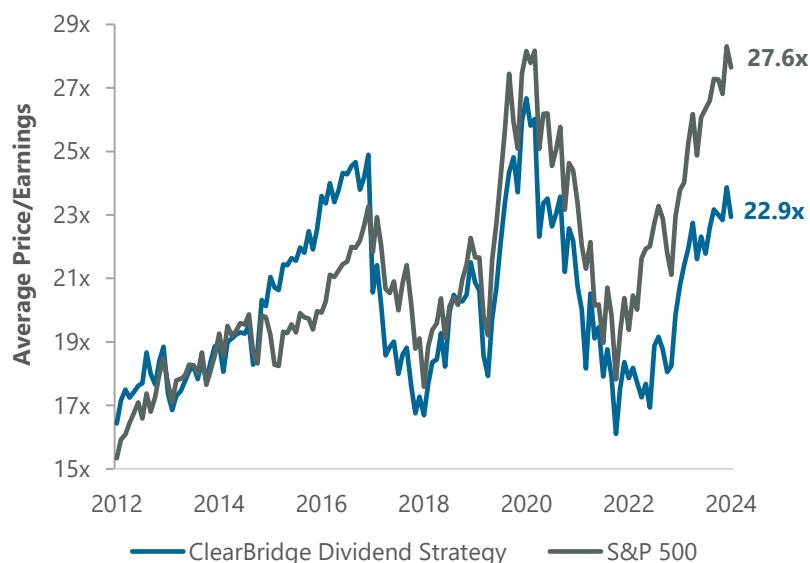


As of Dec. 31, 2024. Source: ClearBridge Investments, FactSet.

Our commonsense approach to diversification and risk management is hardly rocket science, but it distinguishes us in the current investment environment. In its efforts to institute rigorous and systematic risk controls, the investment industry has come to define risk as tracking error, the measure of performance disparity between a portfolio and its benchmark index. Portfolio managers are encouraged to size their positions in relation to their weight in the index, rather than in absolute terms. So, as the S&P 500 has become increasingly concentrated, portfolio managers have followed along. The industry has lost sight of the most basic principle of risk management: do not put all your eggs in one basket!

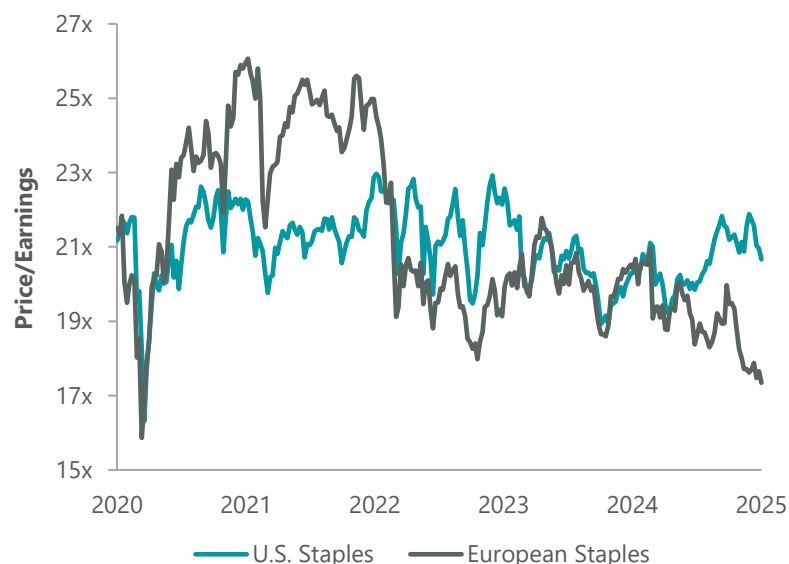
In a market approaching all-time valuation extremes, we have redoubled our discipline on valuation (Exhibit 4). Throughout 2024 we increased our exposure to consumer staples, which we view as being attractively priced and defensive. We were early in increasing our allocation there: despite compelling valuations, the stocks underperformed due to challenging fundamentals and continued investor preference for high-momentum stocks. Yet we remain constructive on global staples companies based in Europe, such as Diageo, Haleon and Nestle, to which we have added. These companies have similar geographic footprints to their U.S. peers but offer significantly more attractive valuations (Exhibit 5).

Exhibit 4: ClearBridge Dividend Strategy Trading at a Meaningful Discount



As of Dec. 31, 2024. Source: ClearBridge Investments, FactSet.

Exhibit 5: European Staples Trading at Discounts to U.S. Peers



As of Jan. 3, 2025. Source: ClearBridge Investments, Bloomberg Finance.

Early in the year we also significantly increased our exposure to communication services, initiating positions in both Alphabet and Meta when each announced regular dividend policies. Our rigorous but flexible approach to dividends enabled us to move quickly when these companies announced dividends. Many other dividend-focused products have rigid rules regarding dividend histories that have precluded them from participating in and profiting from these dynamic growth companies.

During the fourth quarter, as both inflation expectations and interest rates rose, we increased exposure to natural gas through our stake in

EQT and increased our position in MetLife. With the current boom in energy demand for AI and data centers, and with the expected resumption of LNG export permitting under the incoming administration, we anticipate robust growth in natural gas demand in the years ahead. Rising interest rates make MetLife's retirement products both more attractive and more profitable.

We exited our long-held position in Mondelez over concerns about the impact of soaring cocoa prices on the company's profitability. We sold United Parcel Service after a prolonged period of lackluster performance in its operations and its share price. Lastly, we exited a profitable investment in Kenvue and used the proceeds to consolidate our position in Haleon, the leading consumer health company, in our view.

Outlook

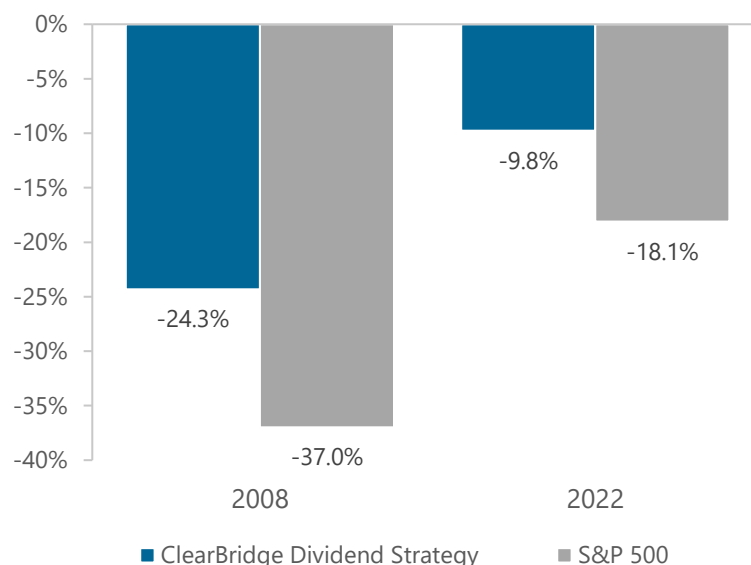
With the market at all-time highs, valuations on the fuller side and interest rate expectations becoming less dovish, investor positioning must become more nuanced. The economy is healthy, and the incoming Republican government should ease the burdens of both taxes and regulation. Consequently, corporate earnings in 2025 should remain healthy. But security analysis requires more than just forecasting earnings; investors must also decide how to value that stream of earnings.

Parsing the net impact of a Trump presidency is complicated. On the positive side for investors, Trump's policies on tariffs and immigration should result in higher wages. Middle class workers have a high propensity to spend, so as their earnings go up, consumer spending and nominal growth could benefit. On the less positive side for investors, high tariffs and restrictive immigration policies would lead to lower margins, higher inflation and higher interest rates.

As we look to 2025 and position for this brave new world, the case for high-quality dividend payers — companies that are typically leaders in their sectors, with strong balance sheets, low debt, recurrent predictable revenues and economic moats — has almost never seemed stronger. High-quality dividend payers possess three key attributes critical for times like these: downside protection, current income and growth.

Downside protection: After a two-year period in which the market has soared nearly 60%, stocks may be extended. Dividend payers, such as those targeted by the ClearBridge Dividend Strategy, tend to outperform during turbulent periods as investors gravitate toward the safety of their healthy payouts (Exhibit 6).

Exhibit 6: Dividend Focus Consistent with Lower Down Market Capture



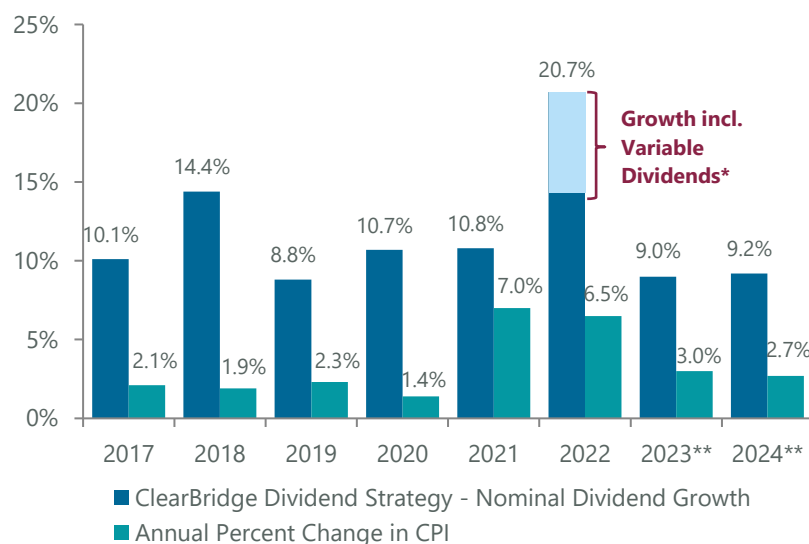
Source: ClearBridge Investments. Shows two largest calendar year drawdowns of the S&P 500 Index since inception of strategy.

Current income: In big bull markets people tend to overlook dividends. When a handful of mega cap growth stocks drive the preponderance of equity market performance, people predictably focus on capital appreciation. But bear markets remind us that dividends — albeit prosaic — are responsible for 40% of total return over the long term. In flat-to-down markets, meanwhile, dividends provide a cash flow return to investors that offsets share price stagnation or depreciation.

Growth: While strong upfront yield is attractive, the real power of equity is in its long-term compounding and growth. Unlike bonds, which typically offer fixed coupons, dividends have the potential to offer rising cash flow streams over time. Dividend growth is great in regular periods, but absolutely critical during inflationary periods. As inflation erodes the value of a dollar, growing dividends help to maintain purchasing power despite the increasing cost of living (Exhibit 7).

As we turn the page on 2024, and on a phenomenal two-year run for the equity markets, we strive to remain grounded in our expectations. A healthy economy provides a backdrop for continued growth in earnings, but the elevated starting point for asset values keeps a lid on potential upside. Recent gains have us all feeling good, but it is important to keep our expectations in check. Given the tremendous recent run, our expectations for 2025 are restrained. We believe our portfolio of high-quality dividend growers is the right place to be in the year ahead.

Exhibit 7: Dividend Growers Combat Inflation Out of the Pandemic



As of Dec. 31, 2024. Source: FactSet, BLS, St. Louis Fed (FRED), Federal Reserve Bank of Minneapolis.

*Includes variable dividends from PXD, CHK. **2023 and 2024 Nominal Dividend Growth calculated using 2022 dividend growth excluding PXD, CHK; 2024 CPI as of Nov. 2024.

Portfolio Highlights

The ClearBridge Dividend Strategy trailed its S&P 500 Index benchmark during the fourth quarter. On an absolute basis, the Strategy saw positive contributions from six of 11 sectors in which it was invested for the quarter. The financials, IT and energy sectors were the main positive contributors, while the consumer staples and health care sectors detracted the most.

On a relative basis, stock selection contributed to performance but was offset by negative effects of sector allocation.

In particular, stock selection in the financials, energy, IT, materials, utilities and health care sectors proved beneficial, while stock selection in consumer staples, communication services, industrials, consumer discretionary and real estate detracted. Main detractors in terms of sector allocation were overweights to materials and energy and underweights to consumer discretionary and IT.

On an individual stock basis, the main positive contributors were Apollo Global Management, Broadcom, Williams Companies, JPMorgan Chase and Capital One. Positions in Nestle, American Tower, Linde, Coca-Cola and Comcast were the main detractors from absolute returns in the quarter.

In addition to the transactions mentioned above, we initiated a new position in Unilever in the consumer staples sector.

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