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Large Cap Value ESG Strategy

Key Takeaways

- ▶ Following recent highs, both the S&P 500 and the Nasdaq Composite entered correction territory in March, while the benchmark Russell 1000 Value Index, with a positive quarterly return, handily outperformed its growth counterpart.
- ▶ Over the past few quarters, we've taken advantage of the run-up in expensive, momentum-driven stocks to reallocate capital into areas of the market where valuations are more reasonable, yet fundamentals remain stable and defensive.
- ▶ SDGs 8 and 9 emphasize the importance of sustainable development and are a focus for ClearBridge as they are among the SDGs most reliant on the private sector for progress.

Market Overview

An escalating tariff war and a rotation out of the AI-related tech stocks that dominated 2024 sent markets lower in the first quarter of 2025, with the S&P 500 Index declining -4.3% and ending its five-quarter streak of positive gains. Following recent highs, both the S&P 500 and the Nasdaq Composite entered correction territory in March. Amid a tech-led selloff, the benchmark Russell 1000 Value Index (+2.1%) handily outperformed its growth counterpart (-10.0%) in the quarter.

Over the past few quarters, we've taken advantage of the run-up in expensive, momentum-driven stocks to reallocate capital into areas of the market where valuations are more reasonable, yet fundamentals remain stable and defensive. While this positioning helped us outperform the S&P 500 in the quarter, some of our more defensive holdings faced idiosyncratic challenges that caused us to lag the value benchmark.

One area where we've increased exposure in recent years is the utilities sector, where the combination of rising electricity demand, highly stable cash flows and attractive valuations has made the space overlooked relative to higher-flying AI plays. While utilities typically perform well in volatile markets, our holdings in Edison International and Sempra were negatively impacted by the tragic wildfires in Southern California, which caused billions of dollars in damages. In particular, Edison materially de-rated on concerns about future liabilities, as one of the fires overlapped with its service footprint. However, we remain confident that California's Wildfire Fund and protective legislation will be sufficient to mitigate long-term financial impacts. Sempra's issues were compounded by a large earnings reset due to unexpected regulatory changes in California and the

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company's shift of capital toward Texas, where, while it is a higher-growth market, profitability is being pressured in the short term due to higher costs. While this negatively affects near-term earnings, we believe the decision is right for the long term. We maintained positions in both companies, as we believe their valuations have been overly discounted for businesses with defensive characteristics and high-single-digit earnings growth.

Weakness in communication services was driven primarily by Alphabet, which traded lower as the market rotated out of AI leaders. Part of the decline followed the unveiling of Chinese AI startup DeepSeek, whose new foundational and reasoning models — reportedly offering similar performance to leading U.S. models at lower compute costs — triggered a broader selloff in the AI ecosystem. Additionally, concerns are rising that Alphabet's dominance in search could be challenged by startups like OpenAI or large platforms like Meta Platforms, which may leverage their AI capabilities to enter the search market. While Alphabet remains a highly cash-generative business trading at a reasonable multiple, we reduced our position during the quarter due to the increasing competition in its core business.

We remain very selective with our AI exposures, as we believe some of the market froth is likely to fade. Oracle's core database business remains highly resilient and has shown impressive cloud growth in recent years — particularly in its Oracle Cloud Infrastructure offering with clients like TikTok and OpenAI. However, stretched valuations and exposure to unprofitable AI startups present risks if capital markets tighten. As a result, we exited our position in Oracle during the quarter. Conversely, despite a selloff in Broadcom, we maintained our position, as we believe the company is well-positioned to gain share with its AI-focused custom application-specific integrated circuit (ASIC) solutions for customers like Alphabet and Meta. These exposures should remain more resilient even if overall AI spending moderates.

Stock selection in financials and consumer discretionary, meanwhile, contributed meaningfully.

In financials, property and casualty insurers have historically passed through inflation via higher premiums and tend to be less economically sensitive. Holdings in Progressive, Travelers and Berkshire Hathaway performed defensively, as expected, during the volatile period.

In consumer discretionary, tariffs on auto imports created a favorable backdrop for the auto repair market. This benefited auto parts retailers like O'Reilly, given its leadership position and the relatively inelastic demand for its products. The company should also benefit from weakened competitors like Advance Auto Parts and Napa, both of which have much less margin to absorb cost inflation if O'Reilly decides to be more aggressive in the marketplace.

In health care, CVS Health was a top contributor. The stock rallied on the perceived benefit to its managed care segment following an

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announcement by the Centers for Medicare and Medicaid Services of a proposed 4.3% average increase in government payments to Medicare Advantage plans in 2026. CVS also beat both revenue and earnings expectations for the fourth quarter, supporting hopes for a turnaround in its Aetna insurance segment and stabilizing profits in its pharmacy operations. Drug distributor McKesson also outperformed, benefiting from strong U.S. pharmaceutical and specialty distribution trends.

We initiated a new position in Novo Nordisk, the global leader in diabetes care and one of two dominant players in the fast-growing GLP-1 diabetes and obesity drug market. A slowdown in prescriptions for Novo's GLP-1 drugs, combined with confusion surrounding a clinical trial of its next-generation candidate, CagriSema, caused a significant pullback in the stock. We saw this as a buying opportunity. We believe the GLP-1 market remains vast and that Novo (alongside Eli Lilly) is well-positioned to maintain a duopolistic structure for years to come, given the complexity of manufacturing, differentiated intellectual property and brand strength. We also expect growth to reaccelerate as supply ramps up following its acquisition of Catalent and as regulators crack down on unlicensed compounders.

Outlook

While 2024 was defined by a narrow market dominated by a small set of momentum stocks, 2025 has ushered in a much more diversified environment. The valuation gap between growth and value had reached historically extreme levels, making a reversion long overdue. Combined with recent market volatility, this sets the stage for high-quality, value-oriented portfolios like ours to outperform. We expect continued volatility in the face of geopolitical and policy uncertainty, but that volatility should create opportunities for best-in-class franchises trading at overly discounted valuations that can offer compelling, risk-adjusted returns over the long haul.

Portfolio Highlights

The ClearBridge Large Cap Value ESG Strategy underperformed its Russell 1000 Value Index benchmark during the first quarter. On an absolute basis, the Strategy had positive contributions from six of the 11 sectors in which it was invested for the quarter. The health care and financials sectors contributed the most, while the utilities and information technology (IT) sectors were the main detractors.

On a relative basis, stock selection in the utilities, communication services, IT and industrials sectors detracted the most, while stock selection in the financials, consumer discretionary and real estate sectors proved beneficial.

On an individual stock basis, the largest contributors were CVS Health, Berkshire Hathaway, McKesson, Williams and Progressive.

Positions in Sempra, Edison International, Broadcom, Eaton and Microchip Technology were the main detractors.

ESG Highlights: SDGs Key for Productivity and Growth

While some of the United Nations Sustainable Development Goals, or SDGs, consider elemental topics such as water, hunger, poverty, good health and education, and are therefore easier to understand and discuss, SDGs such as Decent Work and Economic Growth (SDG 8) and Industry, Innovation and Infrastructure (SDG 9) may be lesser known or understood. These emphasize the importance of sustainable development and are a focus for ClearBridge as they are among the SDGs most reliant on the private sector for progress.

Investing in Decent Work and Economic Growth

SDG 8 aims for decent work and economic growth, and includes promoting inclusive and sustainable economic growth, with employment and decent work for all. Among its targets (8.2) is achieving higher levels of economic productivity through diversification, technological upgrading and innovation, including a focus on high-value-added and labor-intensive sectors. Enterprise software aids in this goal, as the products and services of companies like ClearBridge holdings ServiceNow, Microsoft and Salesforce are key for enhancing economic productivity. IT services companies such as Accenture help companies implement technology upgrades.

Other examples of technology upgrading across industries include Amazon's robotics-enabled warehouses, which are delivering speed increases that do not come at the expense of employee health, as we discussed in a recent engagement with the company. Amazon's fulfillment center (FC) recordable injury rate (injuries considered exceeding first aid) is down 34% from 2019 to 2024 and 6% year over year and now stands at 4.4%. Lost-time injuries are down 65% over five years and 13% year over year, showing that safety investments are paying off. With 750,000 robots across fulfillment centers, FCs equipped with next-gen robotics have approximately 20% lower injury rates and lost-time injury rates than FCs without.

Amazon compares favorably to peers on its lost time incident rate (LTIR) and its recordable incident rate (RIR), with a LTIR better than the general warehousing and storage industry and courier and express delivery services industry averages and a RIR better than courier and express and that is quickly catching up to the general warehousing and storage average. Amazon has also implemented more shift types to offer flexibility, including an "anytime shift" where employees can block out a certain day of the week.

Other examples of technology upgrading include Deere's precision agriculture offerings and connected combines, which are upgrading the technological capabilities of the agricultural sector, and Ecolab's digital service offerings for remote monitoring and analytics to improve operational efficiency of its customers.

Enabling Resilient Infrastructure and Advancing Research

SDG 9 supports industry, innovation and infrastructure through building resilient infrastructure, promoting sustainable industrialization and fostering innovation. Among its targets (9.1) is developing quality, reliable, sustainable and resilient infrastructure to support economic development and human well-being, with a focus on affordable and equitable access for all. Helping this target are ClearBridge holdings Vulcan Materials, which makes aggregates (such as gravel) for roads and other infrastructure, and United Rentals, which provides construction equipment such as scissor lifts, forklifts, loaders, excavators, hoists and cranes in a resource-efficient rental model that increases equipment utilization and reduces wasted capacity.

Resilient infrastructure may be supported by green building practices of real estate investment trusts like AvalonBay Communities, which owns and develops apartment properties. In a recent engagement with the company, we discussed AvalonBay's submission to the Science-Based Targets initiative of a new emissions reduction target aligned to 1.5°C climate science, rather than its current 2°C target. This change, along with goals of 60% declines in Scope 1, 2 and 3 emissions off a 2017 baseline by 2030, help ensure AvalonBay is bringing high sustainability standards to the ~300 communities and 91,000 homes it owns and develops. Other highlights of AvalonBay's sustainable development include the use of embodied carbon emissions tracking (embodied emissions are those associated with the production stages of a product's life), biodiversity and climate risk assessments, construction waste recycling and drought-tolerant and native plantings in its new development communities.

Electrification is also a key component of this target of SDG 9, and is supported by Eaton, whose electrical equipment enables the electrification of the power grid and, importantly, electrical vehicle charging infrastructure.

SDG 9 also includes a target (9.5) to enhance scientific research and upgrade the technological capabilities of industrial sectors in all countries and to increase the number of research and development workers per 1 million people. Semiconductors are a foundational technology for sustainable development. Almost every technology development in every sector is reliant on the development of better and better semiconductors, and many businesses ClearBridge owns and engages with are essential parts of that ecosystem:

- Synopsys (which makes semiconductor design software)
- ASML and Lam Research (which make tools that produce semiconductor chips)
- Nvidia and Broadcom (which design semiconductor chips)

These are also some of the most R&D-intensive businesses outside of health care. For example, every year Synopsys re-invests more

than 30% of its revenue back into R&D to improve its next generation of chip design software. Also on this note, companies like Alphabet are innovating with research across multiple fields, including long-term research into areas like quantum computing.

The list could go on, but it is worth mentioning SDG 9's target (9.c) to increase access to information and communications technology and strive to provide universal and affordable access to the Internet in least developed countries. Serving this goal too, then, is Amazon's Project Kuiper, an initiative to use a network of low Earth orbit satellites to give affordable broadband access to underserved areas of the world without reliable connectivity.

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