ClearBridge
A Franklin Templeton Company

Global Value Improvers Strategy

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Key Takeaways

- Global value stocks led market performance as easing from central banks helped bolster cyclical and value stocks.
- The Strategy performed in line with its benchmark, as contributions from our industrials and IT holdings overcame detractors in the financials sector.
- With significant risks still present, we remain balanced in our portfolio positioning and retain the flexibility to pivot as opportunities develop.

Market Overview

Global markets rallied in the third quarter as rate cuts and monetary easing from global central banks helped spark a rotation into value sectors such as real estate, utilities and communication services. Additionally, a late-quarter surge by Chinese stocks proved helpful to more cyclical sectors including materials, industrials and consumer discretionary. The benchmark MSCI World Value Index showed positive returns across 10 of its 11 sectors, with only the energy sector declining. Value outperformed growth during the quarter, with the MSCI World Value Index returning 9.57% versus the 6.37% return of the MSCI World Index and the 3.47% of the MSCI World Growth Index.

Despite the Bank of Japan having telegraphed its intention to raise interest rates for quite some time, the size of its rate hike in August caught investors off guard, leading to a spike in market volatility on concerns that tightening of economic policy would pressure its nascent recovery. This was further exacerbated by a violent unwinding of the pervasive yen carry trade as the currency strengthened during the quarter, all of which culminated in Japan being the worst-performing region in the benchmark. Despite the increase in market volatility, we are seeing signs that Japanese businesses have become more efficient and profitable — in part due to improving corporate governance measures — and are beginning to share these gains with employees in the form of the largest wage increases in over a decade, which will hopefully translate into greater consumer confidence and spending.

Global investors were not disappointed when the Federal Reserve elected to cut rate by 50 basis points at its September meeting, sparking a strong rally in U.S. markets and a rotation into smaller value and cyclical stocks. With the first rate cut in the rear view, the question now shifts from "when" to "how much," with policymakers carefully watching as inflation appears to be coming back in line with its target and whether the U.S. economy can indeed stick a soft landing. Investors now look toward the U.S. presidential election in November, rampant with speculation as to what the permutations of political math would mean on policies surrounding international relations, trade and immigration.

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The European Central Bank (ECB) and Bank of England also cut interest rates during the quarter, the second cut in three months for the ECB and the first in four years for the BoE, as the U.K. and eurozone central banks have embarked on a more measured approach considering the slow growth rates in their respective economies. In the U.K., the snap election and landslide victory of the previously opposition Labour Party in July has resulted in a significant shift in political direction as well as economic priorities and policies. While the U.K. economy continues to hold up more strongly than those across the Channel, this new direction has spurred greater uncertainty as to the details on what these new policies would mean for the economy and markets.

While businesses and consumers continue to painfully adjust to an economy no longer tethered to property development and globalization, Chinese stocks surged late in the quarter following the announcement of an unusually broad stimulus package aimed at revitalizing the world's second-largest economy. The People's Bank of China announced that it would cut both policy interest rates and mortgage rates and, along with its existing plan to lower bank reserve ratios, set aside billions in stimulus funds for loans to brokers and insurers to purchases equities and help listed companies finance share buybacks. While the tone of Chinese government officials seems more determined than in prior iterations of policy support, there remains a considerable amount of skepticism from economists and investors that these initial efforts can translate into a durable and sustained turnaround for the broader Chinese economy.

Quarterly Performance

The ClearBridge Global Value Improvers Strategy performed in line with its benchmark in the third quarter as strong performance from our holdings in the industrials and information technology (IT) sectors overcame detractors in the energy sector.

Stock selection in the industrials sector was the leading contributor to returns, as companies in our enablers bucket continue to benefit from strong demand around long-terms sustainability trends such as electrification and the global energy transition. For example, Nexans, a French industrials company that makes cable systems for offshore wind farms, subsea interconnections, power transmission, telecom networks, fiberoptics and electrical systems, saw its share price rise as the company progressed in negotiations with the Greek and Cypriot governments on funding for its planned high-voltage direct-current

Great Sea Interconnector. Hitachi, meanwhile, continues to benefit from the demand and buildout of data centers as well as the upgrading of global electrical grids. Additionally, the Japanese company closed its acquisition of Thales' rail signaling business, which we believe will create synergies that should improve the profitability of its domestic systems integration business.

Our IT holdings also contributed to strong performance, led by Oracle, a supplier of enterprise software and cloud services. Shares rose after Oracle exceeded market expectations for quarterly earnings and reaffirmed its optimistic full-year guidance, citing a strong acceleration in revenue on its current remaining contract obligations with customers.

Stock selection in the financials sector weighed on returns, driven by weak performance from Charles Schwab and Wells Fargo. Schwab, which engages in wealth management, brokerage, banking and asset management, declined as it further reduced earnings forecasts, prompting greater concern from investors who did not anticipate elevated level of cash outflows to persist into the second quarter. Wells Fargo exceeded analyst expectations for its second-quarter earnings but came under pressure after the U.S. money center bank softened guidance for expected net interest income. A weaker overall outlook stemming from the impact of a higher-for-longer rate environment on fundings costs and continued weakness in loan demand also weighed on shares.

However, this overall weakness in financials was partially offset by a strong contribution from leading digital payments provider PayPal, which announced it would be partnering with Amazon.com to allow Prime members to like their accounts to their PayPal account beginning in 2025. We believe this partnership with the fastest-growing and strongest ecommerce platform highlights the strong value of PayPal's networks and reinforces its position as a major competitor in the financial payments industry.

Portfolio Positioning

New positions in the quarter had a cyclical focus, such as industrials company Johnson Controls International (JCI), an Irish producer of HVAC, building controls, fire and security equipment, and related services/software. JCI falls in our enablers bucket as its offerings help to make buildings more energy efficient and help its customers to reduce their own carbon emissions. Additionally, we believe JCI is a compelling turnaround story, as it has sold its residential/light commercial HVAC business and activist involvement has led to a management changeover. We believe the market is underestimating JCI's ability to improve financial performance as well as its exposure to data center tailwinds.

We also swapped our holding in Expand Energy for EQT, in the energy sector. While both are top U.S. natural gas producers, we believe EQT has a higher combination of rerating potential and has lower free cash flow breakeven costs due to its recent acquisition of Equitrans Midstream. The deal should enable EQT to generate dramatic free cash flow as U.S. liquid natural gas (LNG) demand grows over the next decade. Additionally, EQT has a viable plan to be net zero on Scope 1 and 2 GHG emissions by 2025.

We exited our position in AIA Group, the largest independent pan-Asian life insurance company, headquartered in Hong Kong. We became concerned that the return profile of AIA's insurance business would be structurally lower than in the prior decade due to the negative wealth effect of property price declines, lower consumer confidence and the risk of deflation in the greater China region.

Outlook

The two macro shocks during the quarter, Japan and China, serve as good reminders of extreme imbalances in the market today — notably the significant market concentration in a narrow sleeve of companies indexed to growth mega themes in the U.S. With the prospect of an increasing liquidity backdrop, stable economic prospects across most major international markets and the potential for Chinese policy support to remove a major drag from global growth, conditions remain supportive for a continued rotation to value and cyclical segments of the market.

In addition to increased market breadth, we also have seen the capex cycle around generative AI broaden out significantly as investors grapple with constraints around power and infrastructure. We are optimistic that this will continue to offer us opportunities to participate in this secular growth theme through stocks which remain overlooked and reasonably priced. We believe the need to balance these operational challenges with longer-term sustainability objectives will increasingly force companies and investors to consider a more pragmatic, improvement-based approach to defining the ESG field.

In recent months, political risk and policy uncertainty have become an increasing overhang on equity markets, among this uncertainty what the outcome of the U.S. election could mean for ESG areas such as renewables and energy policy. Our overall view is that concerns are overblown. Even in the most extreme case of a Republican sweep, a full repeal of the Inflation Reduction Act (IRA) would be difficult and unfavorable to many states where it has been a meaningful job creator. Even stress testing a full repeal scenario, many of the benefits to a company like U.S. renewable power producer AES, for example, already existed prior to IRA passage and would now just return to the situation before the bill, with the biggest negative impact being the need to have those tax credits extended periodically since their first expiration in 2007. As such, we have stayed balanced in our portfolio positioning and retain the flexibility to pivot as opportunities develop.

Portfolio Highlights

The ClearBridge Global Value Improvers Strategy performed in line with its MSCI World Value benchmark during the third quarter. On an absolute basis, the Strategy had gains across nine of the 10 sectors in which it was invested (out of 11 sectors total). The industrials and financials sectors were the main contributors, while the sole detractor was the materials sector.

On a relative basis, overall sector allocation effects positively contributed to performance, partially offset by stock selection. Stock selection in the industrials, IT, consumer discretionary and energy sectors, overweights to the utilities and industrials sectors and an underweight allocation to the IT sector benefited returns. Conversely, stock selection in the health care, financials, utilities and materials sectors and a lack of exposure to the real estate sector weighed on returns.

On a regional basis, stock selection in Japan and the U.K. were beneficial. Conversely, stock selection in North America detracted.

On an individual stock basis, Nexans, PayPal, Hitachi, Oracle and Compass Group were the leading contributors to absolute returns during the quarter. The largest detractors were Freeport-McMoRan, Charles Schwab, Expand Exergy, Gerresheimer and Biogen.

During the quarter, in addition to the transactions mentioned above, the Strategy initiated a new position in Teck Resources in the materials sector and exited a position in Freeport-McMoran in the materials sector.

ESG Highlights: Investing in the Energy Transition is Stock Specific

In an environment of transitory macro crosswinds, ClearBridge believes a stock-specific approach to analyzing environmental, social and governance (ESG) risks and opportunities remains all the more important. In our pursuit of positive outcomes for our clients, we are guided by research-driven stock selection as we seek to generate portfolios distinct from the market and supported by positive ESG characteristics. For example, environmental factors such as climate change remain material issues for investors to consider on a stock-by-stock basis, and the energy transition remains central to our company conversations as our holdings continue to reduce their emissions, often through cost-saving efficiency improvements, and set goals for further reductions.

As a major concern of sustainable investing, climate change and the energy transition represent large opportunities — and risks — at the company level, no matter the macroeconomic and political environment. ClearBridge continues to engage with our holdings to ensure they are building businesses with long-term viability in a lower-carbon economy.

Engaging with Part-of-the-Solution Companies

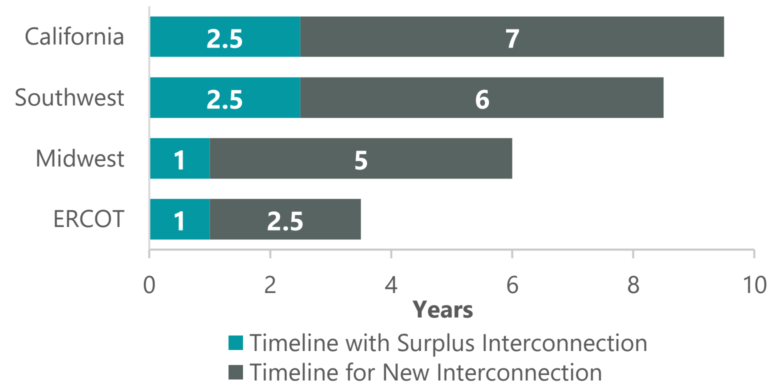
Our fundamental research process includes engaging with companies that are acknowledged leaders in the energy transition, such as ClearBridge holdings NextEra Energy (NEE) and its subsidiary NextEra Energy Partners LP (NEP), two companies accounting for 20% market share of the domestic renewable market. NextEra is still capitalizing on the Inflation Reduction Act through investing in solar and battery power, where it expects stronger growth in the near term, while wind generation additions are expected to see some catching up over the subsequent years.

As we discussed recently in engagements with NextEra's management team, growth for both entities is underpinned by a bullish power demand outlook, with a 38% increase in demand expected through 2040, driven by decarbonization and electrification.

More recently, the already strong demand for renewables is being amplified by AI and data center expansions, which are expected to double the current 4% of overall power demand currently represented by data centers. The share of AI and data center companies represents 6 GW, but growth in this customer segment will start impacting NextEra's growth estimates more significantly after 2027. Management has conveyed to us that it will take time to add incremental demand from data centers onto the grid given existent grid constraints (transmission access) are present across all power markets. For example, even in the unregulated Texas power market, where customer growth is faster and generation additions are typically easier, the regulated grid remains a big bottleneck. Adding data center customers to the grid is complicated, as it involves both grid operators and power producers.

In an environment where transmission interconnects (connections between segments of the grid that allow for the transfer of electricity from power generation sources to customers) take years (Exhibit 1), NextEra's 150 GW of interconnect queue positions become more valuable. Having surplus interconnections reduces renewable projects' timelines. In the meantime, NextEra's analytics tools have been helpful in identifying the best data center locations and putting NextEra at a competitive advantage through access to land and transmission.

Exhibit 1: Average Years for Interconnection



ERCOT stands for the Electric Reliability Council of Texas. As of June 2024. Source: NextEra Energy.

We have also discussed the favorable emissions profile at NextEra's regulated utility, Florida Power & Light (FPL), whose generation mix is dominated by natural gas (73%), along with nuclear (20%) and solar and storage (6%). The utility's cleaner generation fleet explains its favorable emissions profile, with emissions below the national average across three main pollutants (20% below the national average for carbon dioxide, 98% below for sulfur dioxide and 71% below for nitrogen oxide). FPL's plan is to expand its solar and storage footprint from the current 5 GW to 30 GW in 2033, with the utility's storage capacity growing from last year's 469 MW to 4.5 GW in 2033 (or 25% compounded annual growth), taking the solar and storage generation share of FPL's generation portfolio from 6% to 38% in 2033.

The Energy Transition Supply Chain: Environmental and Social Dimensions

Electrification, or the move to power more of society with electricity from renewable energy sources, will be reliant upon critical minerals like copper, which we know comes with environmental and social challenges. As part of PRI Advance, a collaborative initiative for investors to address human rights and social issues, ClearBridge has been engaging with holding Freeport-McMoRan (FCX) on these issues since 2022, and the copper producer has been making progress on several areas central to our engagement.

In a recent engagement we continued our discussion on the environmental and physical impact of the company's operations on Indigenous land. The company shared that it has developed an action plan to better understand its adverse impacts at several high-risk sites. On tailings, or mining waste, FCX has adopted the global tailings standard, yet its Grasberg operation in Indonesia remains a controversial asset, in particular due to its impact on water. We asked when we could expect the company's next Water Monitoring Summary report; the company said by end of 2024 was a strong possibility, both for site-level findings and broader tailings for

Grasberg. While FCX indicated it was not possible to do so at this time, we shared that we consider providing water monitoring data as a live stream for stakeholders a best practice.

FCX highlighted Grasberg as well as Sierrita, Arizona, as communities it is prioritizing from a social standpoint due to the more complex nature and higher risk profile of those operations. The company stressed how it considers the concept of its social license to be foundational and central to its operations and recognizes it can't be successful without local input and buy-in, for which community engagement is critical. The company seeks to socialize grievances to make sure all stakeholders and communities are aware of the complaint process and it reports on grievance results in quarterly meetings with community partners. We mentioned that other mines commit to address complaints in 30 days and report on the outcome; FCX shared its belief that resolving complaints in a certain time frame is not necessarily indicative of the performance of the grievance system, although it is still looking for a reliable metric for satisfaction of resolutions.

FCX also shared that it engages voluntarily with several Indigenous populations to build trust; unique to FCX, it has a Native American representation team. Several representatives are members of local impacted tribes and report directly to the company's president. This reporting structure has helped to better equip company management with a more in-depth understanding of local cultures and traditions within its Arizona operations. As a result, it will be implementing a Native American Training Program in the near future.

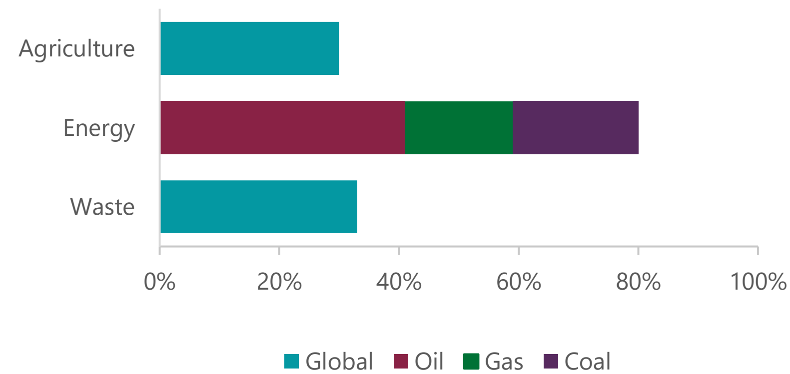
Opportunities for Change in the Energy Sector

The energy sector will also be key to the energy transition, which makes engaging with holdings all the more important as there is significant progress they can make to reduce their environmental impact. The sector is one of the more blamed but necessary industries for ClearBridge's net-zero target as part of the Net Zero Asset Managers Initiative (NZAM). ClearBridge remains on track to achieve our NZAM-related goals of having at least 66% of current in-scope assets net zero aligned or subject to engagement, aligning 100% of our assets with the pathway to net zero by 2050 and achieving net-zero emissions across all ClearBridge portfolios by 2050.

As many holdings in the energy sector have similar company-specific dynamics, we take a sector-wide approach to engagement. This enables us to use company-specific information to improve conversations, share best practices and benchmark peers. Central questions include methane and ensuring the cleanest possible natural gas.

We share with companies our view of the importance of methane emissions, which can be considered an easily attained target, but which represent a significant amount of emissions globally. The IEA estimates that production and use of fossil fuels resulted in ~120 million tons of methane emissions in 2023. While agriculture represents the main source of methane emissions, the energy sector has more abatement potential (Exhibit 2), making it a fruitful beneficiary for engagement.

Exhibit 2: Methane Abatement Potential to 2030



As of March 2024. Source: IEA.

Natural gas producer EQT is a leader among ClearBridge energy holdings, and it remains vigilant on its path to achieve net zero on a Scope 1 and 2 basis by the end of 2025, which would make it the first ClearBridge energy holding to do so. In a recent engagement with EQT's CEO and CFO we discussed how the company sees significant value in eliminating pushback on GHG emissions and wants to ensure that U.S. natural gas will be the cleanest answer to the globe's environmental and energy security goals.

While company footprints will differ, we share how a net-zero target such as EQT's is exemplary for other energy holdings and we use it as an informal benchmark in other engagements. We emphasize how EQT spent nearly $30 million to reduce its emissions, and we share how we believe shareholders and other stakeholders would be supportive of expenditures that are modestly uneconomic in the near term, like EQT's, if those expenditures are able to significantly reduce emissions.

Elsewhere in the space, we have discussed with integrated oil and gas producer ConocoPhillips how it is emphasizing its methane emissions reductions, even using autonomous drones, and eliminating routine flaring. French integrated firm TotalEnergies' methane, down 47% since 2020 nearly in line with its 50% by 2025 goal, is strong and improving, as we learned in recent engagements. Engagements with other producers like Diamondback Energy and Chesapeake Energy also emphasized the installation of continuous monitoring devices to provide real-time visibility into methane emissions performance. This practice not only boosts transparency and disclosure, but it can also support faster response times to potential leaks.

Leveraging a Long-Term Focus

As sustainability-informed investing moves in and out of the crosshairs of macroeconomic cycles and political debates dominated by shorter-term thinking, ClearBridge remains guided by the long-term fundamental arguments for incorporating ESG factors into the investment process. These ensure we're considering how companies will thrive amid environmental, social and technological changes such as the energy transition. Leveraging our long-term focus and our strong and lasting relationships with company managements, we will continue to use engagement to drive positive change in public equities as part of our investment decision making and active ownership.