



Sustainability Leaders Strategy



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Key Takeaways

- ▶ After a very strong 2023 and 2024, the U.S. equity markets were lower in the first quarter of 2025 as a result of an escalating trade war, slowing economic growth and a rotation out of AI-related stocks that dominated 2024.
- ▶ The Strategy saw strong contributions from defensive health care and utilities holdings, although this was offset by negative contributions from select AI exposures in industrials, IT and communication services.
- ▶ 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

After a very strong 2023 and 2024, the U.S. equity markets were lower in the first quarter of 2025 as a result of an escalating trade war, slowing economic growth and a rotation out of AI-related stocks that dominated 2024. Following highs in recent weeks, the S&P 500 Index and Nasdaq Composite entered correction territory in March. The benchmark Russell 3000 Index returned -4.72% for the quarter.

Against this backdrop the Strategy trailed its benchmark due largely to select AI exposures: following the DeepSeek announcement in late January, which called into question the potential returns on AI investments, the AI value chain has traded down. In the portfolio this led to weakness in blue chip hyperscalers Microsoft, Amazon and Alphabet as well as semiconductor makers Broadcom and Nvidia. Eaton, whose electrical components are used in AI data centers, also pulled back. The AI rotation, as well as concerns over a slowing macro environment amid highly touted cuts to government departments, also weighed on enterprise software companies such as Salesforce, ServiceNow and Adobe. We trimmed several of these holdings to reflect elevated risk, adding to more defensive health care and consumer staples names such as McKesson, Danaher, Colgate-Palmolive and Procter & Gamble.

In health care, top contributor CVS Health rallied on the expected benefit to its managed care segment following an announcement by the U.S. Centers for Medicare and Medicaid Services of a proposed 4.3% average increase in government payments to Medicare Advantage plans in 2026. CVS also provided a positive update on its health costs relative to depressed expectations along with strong

quarterly results. Drug distributor McKesson, meanwhile, benefited from strong U.S. pharma and specialty distribution fundamentals.

The Strategy also saw a strong quarter from American Water Works, a higher-quality defensive name enjoying structural support for higher capital investments (aging water infrastructure, new environmental regulations) and continued consolidation of the fragmented water utility industry.

Portfolio Positioning

We continue to believe that quality businesses with strong free cash flow generation and competitive moats will outperform over time.

We were active in seizing on opportunities a volatile market provided in the first quarter to initiate four new positions and exit three.

United Rentals, in the industrials sector, is the largest construction equipment rental company in North America, with a fleet of equipment, such as scissor lifts, forklifts, loaders, excavators, hoists and cranes. It serves a diverse set of end markets and an overall expanding total addressable market due to the shift to renting versus owning and increased product offerings. The rental model is also inherently more resource efficient as it enables higher utilization of equipment. Within the industry, United Rentals is competitively advantaged as its lower cost of capital and scale drive lower procurement costs. Expected investments in U.S. infrastructure, grid and manufacturing capabilities should drive a longer demand cycle.

Argenx is a commercial-stage biotech company with a focus on rare autoimmune diseases; its leading drug Vyvgart is currently approved for two severe autoimmune diseases, and with its successful launch, Argenx is transitioning to meaningful profitability.

US Foods is the second-largest food distributor in the U.S., serving restaurant, hospitality and health care industries. It takes share due to its high service quality, its well-trained sales force and its ability to offer private label products, which save customers money. The company's fleet efficiency efforts should have the dual impact of enhancing margins and of reducing emissions – US Foods has an ambitious emission reduction target of 32% reduction in Scope 1 and 2 emissions between 2019 and 2032. It also has low exposure to tariffs in general due to its reliance and support for domestic suppliers.

Finally, Flowserve is a pump and valve manufacturer serving energy, power, chemicals, water and general industries and is positioned for meaningful margin expansion as revenue growth has resumed following several years of declines after the peak of the energy cycle in 2014. Revenue strength has been due to recoveries in energy, mega projects, decarbonization spending and power projects. We believe Flowserve's leverage to the new power generation buildout may be underappreciated.

Meanwhile, we exited Veralto and Williams-Sonoma on strength, recycling capital into fresh ideas. We also exited Ball, as overall beverage consumption volumes are being pressured by both cyclical and secular headwinds. At the same time, while the shift from plastic

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bottles to aluminum cans remains in place, it is slowing in some key markets for Ball, such as mass-market beer, where penetration levels are starting to plateau in the high 70% range. These factors give us less confidence in Ball's ability to meet earnings growth expectations.

Also, on the margin, we took some money off the table with trims to strong contributors Republic Services, a waste disposal company that has been growing margins well amid better landfill pricing, and Gilead Sciences, which rallied on strong earnings driven by robust performance across HIV, oncology and liver disease portfolios.

Outlook

New tariffs announced by the U.S. significantly alter the global economic picture, as the Trump administration seeks to restructure global trade. Odds of a recession have risen and the policy response from the U.S. and other countries will be the main determinants of the path forward for the economy.

As various stocks decline and multiples rationalize, we expect there to be attractive opportunities for long-term investors looking to own quality businesses over the business cycle. In the near-term, investors are weighing the impacts of elevated economic, trade and geopolitical uncertainty. However, we continue to believe that quality businesses with strong free cash flow generation and competitive moats will outperform over time. While the U.S. market is underperforming global indexes to start the year, we believe the long-term economic outlook for the U.S. is positive given relatively attractive demographics, a healthy labor market, leadership in innovation and access to capital.

Portfolio Highlights

The ClearBridge Sustainability Leaders Strategy underperformed its Russell 3000 Index benchmark in the first quarter. On an absolute basis, the Strategy had gains in four of 10 sectors in which it was invested (out of 11 sectors total). The main contributors were the health care, utilities and financials sectors, while the IT, consumer discretionary and communication services sectors were the main detractors.

On a relative basis, overall stock selection and sector allocation detracted. In particular, stock selection in industrials, IT and communication services and a lack of energy holdings detracted from relative results. Conversely, stock selection in the consumer discretionary, health care and utilities sectors, as well as a health care overweight, proved beneficial.

On an individual stock basis, CVS Health, Republic Services, American Water Works, McKesson and Visa were the largest contributors to absolute performance. The main detractors from absolute returns were positions in Broadcom, Microsoft, Nvidia, Apple and Amazon.com.

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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