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Large Cap Growth ESG Strategy

Key Takeaways

- ▶ In a market that continues to become more concentrated in a select few growth names seen as AI beneficiaries, the Strategy underperformed due to a combination of our mega cap allocation and stock selection.
- ▶ We upgraded our exposure to semiconductors and generative AI adoption during the quarter with three purchases and consolidated our industrials holdings, remaining vigilant for opportunities tied to a global consumer recovery.
- ▶ Many ClearBridge holdings contribute to the circular economy as they execute on best practices or make improvements in recycling, reducing or improving the sustainability of packaging and reducing landfill waste.

Market Overview

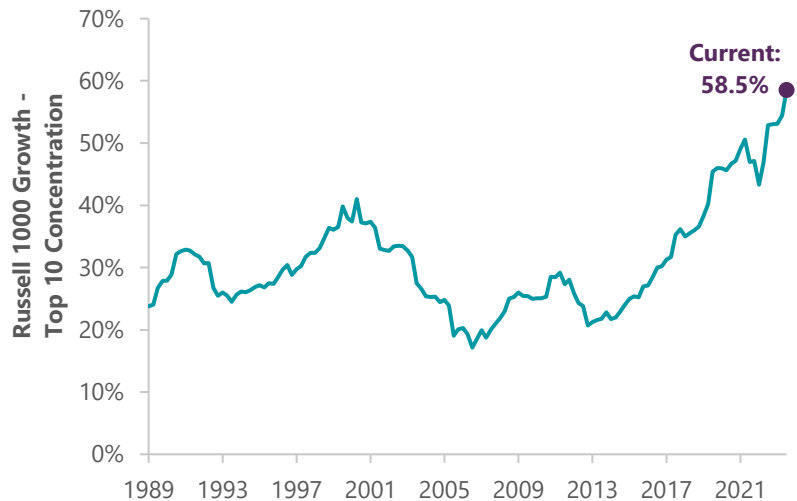
Equity leadership narrowed considerably in the second quarter, with mega cap growth stocks reasserting their influence and obscuring weakness across most of the market. The S&P 500 Index rose 4.28% for the period, while the NASDAQ Composite advanced 8.26%. By comparison, the small cap Russell 2000 Index was down 3.28% for the quarter.

Boosted by Nvidia and a handful of other semiconductor stocks riding the momentum of generative AI demand, the benchmark Russell 1000 Growth Index jumped 8.34%, outperforming the Russell 1000 Value Index by 1,050 basis points. The second quarter marked the fourth time since 2020 that quarterly style dispersion exceeded 1,000 bps in favor of growth. The Magnificent Seven contributed 8.31% of the Russell 1000 Growth's gain, led by Nvidia and Apple, meaning that seven mega caps were responsible for nearly 100% of index performance. This also increased the weighting of the group from 48% to 55% of the benchmark (compared to the ClearBridge Large Cap Growth ESG Strategy's roughly 39% weighting). Three stocks — Microsoft, Apple and Nvidia — now maintain greater than 10% positions in the benchmark (Exhibit 1).

The market's focus on AI beneficiaries further accentuated concentration risk and created near-term headwinds for diversified portfolios like ours. The Strategy underperformed the benchmark due to a combination of our mega cap allocation and stock selection. Specifically, we were hurt by underweights to Apple and Alphabet, both of which outperformed the benchmark. We took advantage of

recent price weakness to repurchase Alphabet in April, giving the Strategy exposure to all seven mega cap companies.

Exhibit 1: Market Concentration Only Worsening



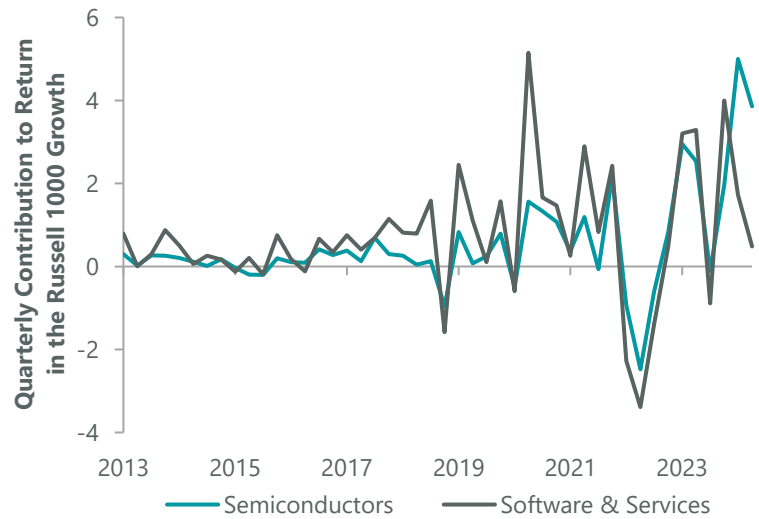
As of June 30, 2024. Source: FactSet.

Stock selection in software and consumer staples weighed on relative performance. In software, Salesforce and Workday were among a cohort of enterprise software stocks impacted by weakening software spending, partially resulting from AI-related diversions of IT budgets. Within staples, weakening spending among lower-income consumers weighed on energy drink maker Monster and mass market retailer Target while a pressured recovery in China continued to impact cosmetics and skin care company Estee Lauder.

Portfolio Positioning

While the Strategy continues to have a significant position in Nvidia, with the stock's strong price appreciation during the quarter offsetting position management trims, we are underweight semiconductors versus the benchmark. That exposure worked against us in a sentiment-driven period for chipmakers tied to AI. However, we added to our semiconductor positioning during the quarter with the purchase of Taiwan Semiconductor (TSM). TSM, an out-of-benchmark name, is the world's fabrication production provider of choice. The criticality and sophistication of the company's manufacturing footprint powers all of the leading edge fabless global semiconductor companies, including Apple, Nvidia, Qualcomm, AMD and Broadcom. While AI has driven upside in data centers, PCs and handsets are at cycle lows, positioning half of the company's business for a recovery.

Exhibit 2: Semiconductors Peaking vs. Software



As of June 30, 2024. Source: FactSet.

A new position in Accenture helped reduce the Strategy's IT underweight while also providing high-quality exposure to the generative AI buildout. Accenture is a durable business well-positioned to benefit from continued growth in overall technology spending, including migration to the cloud and the ramp of enterprise AI adoption. While AI spending thus far has been largely concentrated at the infrastructure layer, we believe that service providers like Accenture will be critical to helping enterprise users implement and integrate AI into their workflows.

The Strategy exited a position in Intel, a semiconductor manufacturer that has not been among the AI beneficiaries in the industry. While Intel has made progress in building a U.S.-based foundry business, the timing of key product launches and profit margin improvement have been pushed out. The business also faces challenges in the current spending environment with AI architecture investments crowding out traditional CPU server spend.

Other moves during the quarter included sales of United Parcel Service (UPS) and Nike. We believe our margin expansion thesis for UPS has played out, with growth now more revenue-led with macro and competitive risks increasing. This exit consolidates our positioning in the industrials sector. Nike has become overly reliant on key platforms, like Jordan, for revenue growth while innovation in areas like running has lagged. Nike could face continued revenue and profit pressure as it invests to re-invigorate innovation and re-position the business back toward wholesale outlets. As such, we are seeking out better ways to participate in the global consumer recovery in companies where earnings estimates have already reset.

We have learned to not allow short-term investor sentiment undermine our long-term theses for the companies we own.

Outlook

AI-related momentum was a key driver of performance in the second quarter, lifting the enablers in technology as well as holdings like renewable power producer NextEra that supply the increasing energy needs of data centers. Parts of the market lacking an AI connection, like our medical device holdings, underperformed despite no change to fundamentals. We have managed through several similar momentum periods over our tenure and have delivered long-term results for shareholders by staying true to an approach that emphasizes diversification across three buckets of growth companies (select, stable and cyclical) and seeks to take advantage of attractive entry points into quality growth businesses.

We have also learned to not allow short-term investor sentiment to undermine our long-term theses for the companies we choose to own. Adobe, for example, proved in raising guidance that the marketing and design solutions it offers are critical enough to customers to overcome perceived competition from generative AI. As growth investors, we will always have technology stocks as a core part of our portfolio, and we acknowledge that our 800 bps underweight to the sector has been a headwind in mega-cap-driven momentum periods. We have been carefully finding ways to close that gap with our recent IT purchases.

Exhibit 3: Large Growth Leads Following Rate Cuts

		Subsequent 12-Month Price Return				
Initial Rate Cut	Economic Outcome	Cash (3M T-Bills)	Russell 1000 Growth	Russell 1000 Value	Russell Mid Cap	Russell 2000
Apr. 1980	Recession	13.5%	39.0%	30.1%	51.41%	66.3%
June 1981	Recession	15.9%	-18.4%	-15.2%	-18.35%	-20.5%
Oct. 1984	Soft Landing	8.9%	9.5%	10.8%	11.96%	8.5%
June 1989	Recession	8.7%	17.5%	4.2%	4.50%	-1.5%
July 1995	Soft Landing	5.5%	22.5%	18.2%	17.26%	19.1%
Jan. 2001	Recession	4.4%	-15.6%	-5.7%	-3.08%	5.3%
Sept. 2007	Recession	3.2%	-17.6%	-25.4%	-19.29%	-12.8%
July 2019	Recession	1.5%	24.9%	-9.2%	-0.71%	-5.7%
Average		7.7%	7.7%	1.0%	5.5%	7.3%
Recessionary Average		7.8%	5.0%	-3.5%	2.4%	5.2%
Soft Landing Average		7.2%	16.0%	14.5%	14.6%	13.8%

Note: Rate cut cycles of at least 75 bps. Data as of June 30, 2024. Sources: FactSet, Bloomberg, S&P, Russell, ICE BofA, NBER.

Overall, we feel comfortable with our portfolio construction as the economy continues to slow. Retail sales, consumer confidence, loan growth and transport volumes are all down and the latest reading from the leading economic indicators shows signs of weakening. While higher-income consumers continue to spend, the lower end is

seeing spikes in credit card delinquencies as accumulated savings from COVID have run out and the delayed impacts of Fed tightening are finally being felt. While frequency and timing remain uncertain, we see eventual rate cuts from the Fed acting as a stabilizer for the economy. We believe our portfolio companies remain well positioned to generate consistent organic growth through economic cycles.

Portfolio Highlights

The ClearBridge Large Cap Growth ESG Strategy underperformed its Russell 1000 Growth Index benchmark in the second quarter. On an absolute basis, the Strategy delivered gains across five of the 10 sectors in which it was invested (out of 11 sectors total). The primary contributor to performance was the IT sector while the consumer staples and industrials sectors were the main detractors.

Relative to the benchmark, overall stock selection and sector allocation detracted from performance. In particular, stock selection in the consumer staples, IT and communication services sectors, overweights to industrials and financials and an underweight to IT hurt results. On the positive side, stock selection in the consumer discretionary and health care sectors and an underweight to consumer discretionary contributed to performance.

On an individual stock basis, the leading absolute contributors to performance were Nvidia, Apple, Amazon.com, Microsoft and Palo Alto Networks. The primary detractors were Estee Lauder, Salesforce, Workday, Target and Grainger.

Plastic Alchemy: Transforming Waste into Profit

The Ellen MacArthur Foundation lists three basic principles of the circular economy: eliminating waste and pollution, circulating products and materials, and regenerating nature. These principles align with some key parts of ClearBridge's fundamental ESG framework, notably factors such as resource efficiency, recycling, product life cycle management, renewable generation and land usage, which we engage on as part of ongoing company research. By reducing energy use, stress on the environment and pollution, the circular economy is also linked to mitigating climate change and conserving biodiversity.

Many ClearBridge holdings thus contribute to the circular economy as they either execute on best practices or make improvements in these areas. We have often highlighted Trex as exemplary of the circular economy. Trex is the market share leader of wood-alternative composite decking. Trex's low-maintenance and high-quality decking products are composed of 95% recycled wood fibers and plastic, making use of waste that would otherwise end up in landfills. Trex has continued to innovate and advance plastic recycling processes. Recently, as the demand for "clean streams" of plastic waste has increased in different parts of the economy, Trex has upgraded

Food waste is an avoidable crisis that has both environmental and societal costs.

technology to be able to accept “dirtier” streams of plastic waste into the manufacturing process. This allowed Trex to begin using additional quantities of waste plastic that would otherwise never be recycled, without compromising product quality standards. Trex products are more durable and have a longer life than traditional wood decking, therefore reducing overall raw material usage and end-product manufacturing. Finally, the quality and durability of the product saves consumers money through less frequent replacements and lower maintenance and upkeep costs.








Molecular Recycling Takes a Step Forward

While companies like Trex are making clear gains on plastic recycling, a circular economy that solves for plastics use remains a challenge. Regulatory bodies are stepping up requirements, such as the EU’s new rules to reduce, reuse and recycle packaging, provisionally agreed upon in March 2024. Under the new rules, plastic packaging must also include minimum recycled content. Helping companies meet these new rules will be ClearBridge holding Eastman Chemical, which makes a range of advanced materials, chemicals and fibers for everyday purposes, among them plastics for food packaging.

In a recent engagement with Eastman Chemical we discussed two different chemical recycling technologies it has developed: polyester renewal technology (PRT) and carbon renewal technology (CRT). PRT recycles polyester-based materials such as soda bottles, carpet fibers and even clothing, breaking down their basic molecules until they are indistinguishable from materials made from virgin or nonrecycled content. CRT operates in a similar way but can take a broader range of plastic types and replaces the use of coal as a feedstock to make fibers. Combining these two technologies gives Eastman a competitive advantage in molecular recycling, as it can take most types of waste plastics (Exhibit 4). Ironically, securing feedstock (i.e., waste plastic) has been a bottleneck to scaling molecular recycling as competitor technologies not using Eastman’s dual technologies often require the waste plastic to be separated purely according to grade, which waste and recycling companies do not readily offer. Eastman’s dual technology approach allows it to accept most plastic grades, making it less reliant on waste companies’ sorting.

Eastman’s first recycling plant is now operational in Tennessee, which will supply its internal Advanced Materials lines while also proving out the technology. The company is already working toward a second plant in Texas that will have Pepsi as its anchor customer. In the second plant, not only will Eastman help Pepsi meet its recycled content goals, but it is also expected to receive long-term, take-or-pay volume commitments, for doing so. This should greatly improve earnings visibility, and in turn, potentially valuation.

Exhibit 4: Eastman Chemical’s Molecular Recycling Methods

Plastic Type	Common Uses	Eastman Molecular Recycling	
		PRT	CRT
 PETE	Bottles, Textiles, Carpet, Films, Forms	Yes	Yes
 HDPE	Thicker Bottles, Containers	No	Yes
 PVC	Pipes, Wiring, Sheeting	No	Not Yet (2 nd Generation)
 LDPE	Film, Bags	No	Yes
 PP	Medical	No	Yes
 PS	Food Containers, Utensils	No	Yes
 OTHER	Baby Bottles, Water Jugs	No	Yes

Source: Eastman Chemical.

Sustainable Food Needs Sustainable Plastic

As the case of Eastman Chemical suggests, plastic is central to sustainable food. Accordingly, companies in the food industry can advance the circular economy through practices such as recycling, reducing or improving the sustainability of packaging and reducing landfill waste. Canadian grocer Loblaw can make an impact with all three of these practices.

In a recent engagement with Loblaw, we discussed its goal of making 100% of its control brand and in-store plastic packaging recyclable or reusable by 2025. This would put it in compliance with the Golden Design Rules (GDR), a set of rules established by the Consumer Goods Forum, made up of leading international retail and consumer goods companies, to benchmark packaging design, emphasizing the reduction of materials and the removal of problematic elements.

Noteworthy steps along the way have involved changes to Loblaw’s protein packaging, which used to come in polystyrene foam trays; the vast majority now are packaged in clear recycled PET trays, which are accepted in all the municipalities in which the store operates and allow for greater detectability in the recycling stream. The shift to PET trays for mushrooms led to 39.9 million trays entering the recycling stream in 2023. Removing the plastic window from 10 kg potato bags allowed 23 million bags to be more easily recycled in 2023. In

Producer responsibility incentivizes brand owners to increase the recyclability of their packaging while empowering them with control over the recycling systems.

addition, extending expiry dates for its PC Money Account and PC Mastercard physical cards should prevent more than 10,000 kgs of plastic waste in the next 12 years.

Loblaw's advances in these areas also speak to its power to use its size to change the industry, as it communicated its GDR standards to hundreds of control brands and national brand vendors, effectively dictating a new national industry standard for plastic packaging. While navigating recycling standards and practices that vary from municipality to municipality, to improve recycling rates overall Loblaw supports extending producer responsibility, a system that give brand owners responsibility of both the cost and performance of recycling systems, incentivizing them to increase the recyclability of their packaging while empowering them with control over the recycling systems themselves.

Food waste is an avoidable crisis that has both environmental and societal costs, and linking food as an organic resource in a circular economy can reduce land use and better support growing populations. Loblaw has set a goal to send zero food to landfill by 2030, a goal supportive of Sustainable Development Goal 12: Responsible Consumption and Production, in particular target 12.3, to halve global food waste by 2030. The company is currently ramping up data collection on food waste but achieved over 78,000 metric tons of diverted food waste in 2023, with most going to composting, animal feed and redistribution of food surplus to food charities.

Supplying the Auto Aftermarket

LKQ is also focused on recycling heavy materials. LKQ is the largest wholesale distributor of alternative parts for the auto aftermarket in North America and Europe. It provides "like kind and quality" (LKQ) auto parts as lower-cost alternatives to those provided by auto OEMs. It is the largest wholesale distributor of collision parts (used to repair vehicle exteriors) in the U.S. and Canada and the largest distributor of mechanical parts (used to repair internal components) in Europe. LKQ also runs its own salvage and recycling operations. As the world's largest recycler of cars at end-of-life, recovering 90%+ of the materials from scrap cars for reuse or recycling, LKQ supports resource efficiency and responsible consumption as an investable theme.

In a recent engagement with LKQ we had an extensive discussion about how it has become increasingly efficient over time at inventorying and selling more parts from its salvage vehicles, which reduces the amount of parts going for scrap and increases LKQ's margins, as it earns higher revenues from same fixed cost of goods.

Circular Economies Span All Sectors

One powerful aspect of the circular economy is how, although with differing dynamics and levels of challenges, every sector may contribute. ClearBridge will continue to share key company advances

and engagements on the topic as our holdings innovate to operate more efficiently and enable a more resilient economic system, with fewer emissions and less waste.

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