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Large Cap Value Strategy

Key Takeaways

- ▶ The Strategy outperformed in a higher-momentum quarter, helped by both stock selection and sector allocation, with semiconductor stocks leading the way.
- ▶ We have made concerted efforts this year to address performance challenges, neutralizing momentum exposure, reducing outsize bets in higher-volatility stocks and implementing tighter underwriting across the portfolio, with positive results so far.
- ▶ We believe the current market offers significant value opportunities as overall market breadth improves and capital flows shift away from high-flying growth stocks toward overlooked, high-quality businesses.

Market Overview

U.S. stocks kept their momentum going in the third quarter, with the S&P 500 Index and tech-heavy Nasdaq Composite setting fresh records. Confidence improved as tariffs landed better than feared, Congress passed the One Big Beautiful Bill Act in July, and the Federal Reserve delivered a 25 bps cut in September while signaling more to come. Strong earnings from mega caps in communication services, information technology (IT) and consumer discretionary sectors added fuel to the rally.

The Strategy outperformed during the period, helped by both stock selection and sector allocation. IT led the way, especially semiconductor holdings Broadcom, Intel and Taiwan Semiconductor. The massive surge in spending on artificial intelligence (AI) continues to bolster chip providers like Broadcom, whose custom-designed chips are gaining broader adoption with hyperscalers as a complement to Nvidia's dominant graphics processing units in AI buildouts. We also initiated a position in the quarter in Taiwan Semiconductor, a leader in advanced semiconductor manufacturing, with dominant market share in leading-edge nodes such as 3nm and 2nm, which are being adopted by nearly all major AI companies. While Intel is not as directly exposed to this AI spending wave, it benefited from a slew of investments and partnerships that were announced in the quarter, which shored up the company's balance sheet and provided confidence that Intel will be able to capitalize on the growing need for domestically manufactured leading edge semiconductors.

Health care stocks have been under pressure from heightened regulatory concerns as the U.S. government is pursuing tariffs on

foreign-manufactured pharmaceuticals, benefit reductions to health care service providers and potential reductions in drug prices. Despite these headwinds, the Strategy saw bright spots in the quarter with managed care provider UnitedHealth stabilizing and life sciences tools company Thermo Fisher Scientific seeing strong momentum from pharma and biotech customers. A better outlook from Johnson & Johnson, where Tremfya could be a next-gen immunology leader, and for CVS Health, on track toward recovery in its Medicare Advantage insurance book, more than offset weakness in GLP-1 maker Novo Nordisk, which we exited.

Utilities also helped. Sempra, one of our larger positions and a significant active weight versus the benchmark, saw double-digit gains in the quarter as it continued to regain investors' confidence after resetting its 2025 earnings guidance earlier in the year. In addition, its recently announced sale of a 45% stake in Sempra Infrastructure Partners at an attractive valuation eliminates a need for equity raises to fund the company's ambitious capital program in Texas. This announcement further advances Sempra's strategy to focus on its regulated U.S. utilities and strengthens its overall financial position. WEC Energy also rose, supported by AI-related energy demand driving investments for load growth combined with consistent operational execution.

Communication services was a headwind to performance, meanwhile, as a positive resolution to Alphabet's ongoing antitrust trial combined with enthusiasm for its AI offerings led to strong performance. While Alphabet has been a portfolio holding since 2020, its weighting in the Russell 1000 Value benchmark increased significantly in July, leading us to become relatively underweight. Comcast was also a detractor to Strategy performance in the quarter, as it continues to lose share of the broadband market to fiber and fixed wireless companies. We continue to hold the name, as it generates substantial free cash flow, and trades at a very attractive 16% free cash flow yield.

While financials were a small drag to performance in the quarter, we stuck to our practice of upgrading quality where we see opportunity by exiting U.S. Bancorp and initiating a new position in PNC. The two regional banks trade at comparable levels but we have greater confidence in PNC's ability to execute on both revenues and expenses, given net interest income tailwinds as its lower-yielding swaps mature and fixed-price assets continue to reinvest at higher yields. U.S. Bancorp will need to grow its expenses to support its targeted organic growth in fee revenues and market share gains.

In materials, Air Products and Chemicals was lower on demand softness in China and Europe and some continued overhang on the timing of its large hydrogen projects in Saudi Arabia and Louisiana. Cell tower REIT American Tower, meanwhile, traded down following a lighter than expected second-quarter print that indicated slower leasing growth. Industrials holding Deere performed well in the first half of the year, but tariff headwinds began to take their toll in the

farm and construction equipment maker's second-quarter earnings. In addition, persistently high rates and low grain prices continued to weigh on farmer profitability.

Portfolio Positioning

Performance of the Strategy over the past 18 months has been below our expectations, and we have made concerted efforts this year to address the challenges. First has been our neutralization of the powerful "AI trade," which has driven violent but narrow outperformance for a select number of momentum stocks since the beginning of 2024. We initiated positions in Taiwan Semiconductor and Amazon.com this quarter, while increasing our position in Alphabet, which both reduced our overall portfolio tracking error back to historical ranges and neutralized our unintentional underweight to "AI" stocks. Secondly, we've reduced outsize bets in high-volatility stocks such as Intel and Microchip Technology, which should reduce performance volatility.

Finally, we've implemented tighter underwriting across the portfolio with specific key performance indicators (KPI) that we are monitoring and acting on in a timelier fashion. For example, in the case of Novo Nordisk, we focused on three KPIs — Wegovy weekly scripts, the script recapture rate for GLP-1 compounders, and development milestones for CagriSema — and saw flat/declining weekly scripts for six weeks, which prompted our exit. We believe a tighter risk framework should help us return to our historically low volatility while staying focused on careful, company-by-company stock selection through all cycles.

Outlook

We remain cautiously optimistic about the market, focusing on high-quality companies with resilient, durable business models that can compound returns over time, regardless of short-term macro or geopolitical noise. We also see the investment landscape shifting: inflation and interest rates are structurally higher and market dynamism is increasing, especially with the rise of AI. Rather than trying to predict macro events, however, we build portfolios that can withstand volatility. We believe the current market regime offers significant value opportunities, especially as overall market breadth improves and capital flows shift away from high-flying growth stocks toward overlooked, high-quality businesses.

Portfolio Highlights

The ClearBridge Large Cap Value Strategy outperformed its Russell 1000 Value Index benchmark during the third quarter. On an absolute basis, the Strategy saw positive contributions from 10 of 11 sectors. The IT, health care and utilities sectors were the main contributors, while real estate detracted.

On a relative basis, stock selection and sector allocation were additive to outperformance. Stock selection in the IT, utilities and health care sectors along with a consumer staples underweight supported outperformance, while stock selection in the communication services, financials, real estate and industrials sectors detracted.

On an individual stock basis, the top relative contributors were Sempra, Broadcom, Intel, O'Reilly Automotive and Taiwan Semiconductor Manufacturing. Top relative detractors were Alphabet, Deere, Haleon, Microchip Technology, and Novo Nordisk.

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