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Large Cap Growth ESG Strategy

Key Takeaways

- ▶ Most growth indexes entered correction territory during the quarter, pressured by the chaotic introduction of tariffs as well as fears of a slowing U.S. economy and higher inflation.
- ▶ The Strategy outperformed through this reversal, aided by strong, diversified stock selection and an underweight to the Magnificent Seven.
- ▶ 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

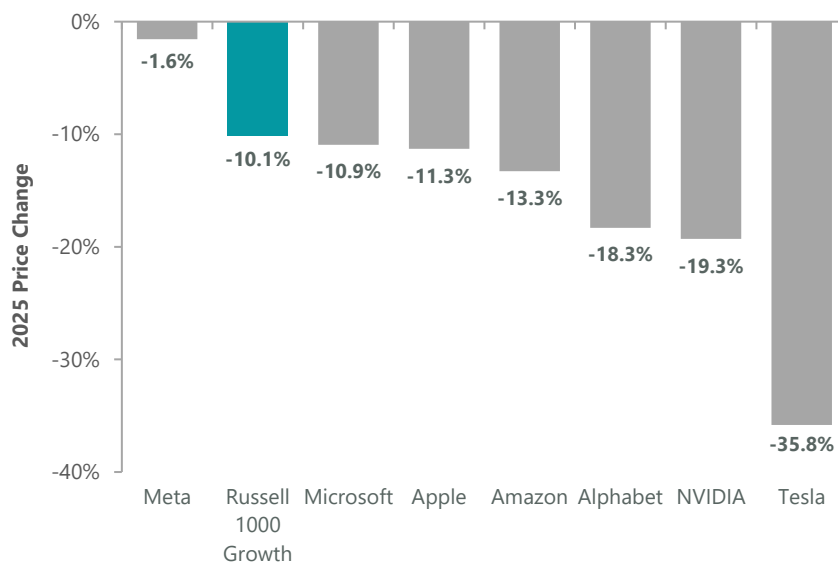
A stall in the mega cap growth trade occurred in the first quarter as the chaotic introduction of tariffs accompanied by fears of a slowing U.S. economy and higher inflation sent stocks to their worst quarterly showing since the 2022 bear market. The S&P 500 Index declined 4.27% while the growth-laden NASDAQ Composite tumbled 10.42% and the benchmark Russell 1000 Growth Index (RLG) fell 9.97%.

Trump's actions to reorder global trade dominated headlines in his first three months in office, sending the S&P 500 and most U.S. growth indexes into correction territory. The RLG underperformed the Russell 1000 Value Index by over 1,200 basis points. Through March, the U.S. had imposed 25% steel and aluminum tariffs, an additional 20% tariff on China, plus 25% tariffs on most goods from Canada and Mexico not covered by a previous trade deal, with more sweeping levies expected to start the second quarter.

Tariffs were just one of the headwinds impacting the Magnificent Seven as all except Meta Platforms underperformed the index. The surprise emergence in January of DeepSeek, a Chinese large language model (LLM), with capabilities similar to the best LLMs but built with inferior chips and at a lower cost, caused investors to question whether the massive capex being devoted to Gen AI would continue. Shares of Nvidia, supplier of the most advanced GPU chips to power AI applications, fell sharply despite Nvidia continuing to deliver record financial results amid a strong rollout for its newest Blackwell GPU system.

The ClearBridge Large Cap Growth ESG Strategy held up better than the benchmark through this reversal (on a gross basis), aided not only by its underweight to the Magnificent Seven and the information technology (IT) sector but also strong stock selection across IT, communication services and financials.

Exhibit 1: The Divergent Seven



Price returns as of March 31, 2025. Source: FactSet.

Semiconductors are a foundational technology for sustainable development.

Our active underweight to the Magnificent Seven added more than 100 basis points to relative returns for the quarter, with underweights to EV maker Tesla and Google parent Alphabet being among the largest relative contributors. We added to both positions, taking advantage of what we view as short-term weakness as Alphabet missed high expectations for cloud revenue growth in its latest quarter, while Tesla worked through negative sentiment over CEO Elon Musk’s role in the Trump administration.

An important but often overlooked component of our diversified approach is adding what we view as “insurance” to the portfolio through the ownership of lower-beta names that tend to hold up well in downturns. In this category, commercial insurance broker Marsh & McLennan, exchange and financial data provider S&P Global and paint and coatings maker Sherwin-Williams delivered positive returns during the quarter.

Portfolio Positioning

We continued our “moving to the middle” approach to portfolio construction by taking some profits to reduce our health care overweight and leveraging recent volatility to deploy the proceeds into IT, where the Strategy remains underweight the benchmark by ~1,000 bps. We believe these actions leave the portfolio well positioned as economic growth is expected to slow and earnings growth broadens across the spectrum of growth companies we target.

The purchase of Synopsys, a leader in electronic design automation (EDA) software and custom chip designs, was the most significant change to our IT holdings. Synopsys is a software provider that operates in a duopoly market with multiple avenues of growth driven by increased complexity of semiconductor chips. The company’s EDA

software and tools are mission critical and difficult to replicate, providing defense to its high-margin business model. The stock has lagged over the past year as the recent wave of AI infrastructure spending has not yet accelerated its revenue growth. We think this is driven largely by softness in the cyclical portions of the semiconductor market and that Synopsys remains well positioned to benefit from AI infrastructure spending and increasingly complex chip design. Also in IT, we added to tax and accounting software maker Intuit.

To help fund these additions, we exited our position in Alcon, a medical device company focused on eye care products and solutions for surgical procedures and consumer use, and Intercontinental Exchange (ICE), an operator of securities exchanges and provider of fixed income, data services and mortgage technology solutions. We purchased Alcon in 2020 after surgical disruptions due to COVID-19 created a unique buying opportunity. At the time, Alcon had major positive cycles in both of its core businesses as well as the opportunity to expand margins by investing in new manufacturing and leveraging its commercial investment. We sold down the position gradually as the stock approached what we viewed as fair value. Similarly, we sold ICE as the stock has re-rated higher due to expectations for positive change in housing fundamentals supporting its mortgage business.

Outlook

As a large cap manager, the multinational exposure of many of our holdings makes tariffs a key risk we are monitoring. Tariffs could be a headwind to GDP growth with the size of that headwind in the short-term depending on substitutes, ease of shifting production and consumer elasticity of demand. We have examined what happened in 2018 when tariffs were put in place as a guide. In certain sectors like the auto parts, costs were passed on to the consumer and the auto parts retailers did just fine. In other cases, tariffs put in place on China caused companies to shift production to other parts of Asia.

One way that we have evaluated current tariff risks is by gauging our exposure compared to our peer group and the RLG. Generally, the Strategy has lower tariff exposure than the benchmark.

Drilling further down, we have been engaging with management teams of portfolio companies with production outside the U.S. to understand supply change fungibility and the ability to pass through costs to end customers. We are specifically monitoring risks to the consumer sector from tariffs because consumers have already borne the burden of several years of cost inflation pressuring wallets and some areas of spending, like dining outside the home, have easy substitutes. That said, beverage holdings Starbucks and Monster both held up well during the quarter. Starbucks is undergoing an earnings reset under new CEO Brian Nicoll that is being well received by investors. Monster, meanwhile, benefited from price increases and strength in its international business.

We see companies like these and our other holdings outside the Magnificent Seven starting to deliver better earnings growth. We have positioned the portfolio in anticipation of this broadening out in the market. Barring a recession, in 2025 we expect to see earnings growth from industrials and health care companies narrowing the gap to earnings growth compared with the technology universe. While we have entered a period of heightened uncertainty, the general health of the economy entering this phase of the cycle is strong. We are moving into an environment where we expect to lean on growth from multiple angles, not just the rapid revenue growth we have seen out of the mega caps but also companies inflecting higher due to better margins or improved earnings.

Portfolio Highlights

The ClearBridge Large Cap Growth ESG Strategy outperformed its Russell 1000 Growth Index benchmark in the first quarter. On an absolute basis, the Strategy delivered positive contributions in two of the nine sectors in which it was invested (out of 11 sectors total). The primary contributor to performance was the financials sector while the IT and consumer discretionary sectors were the main detractors.

Relative to the benchmark, overall sector allocation contributed to performance. From a sector allocation perspective, overweights to health care, industrials and financials and an underweight to IT supported results. From a stock selection perspective, strength in communication services, IT and financials offset weakness in health care, real estate, industrials and consumer staples.

On an individual stock basis, the leading absolute contributors to performance were Visa, Uber, Marsh & McLennan, Netflix and Monster Beverage. The primary absolute detractors were Nvidia, Amazon.com, Microsoft, Tesla and Apple.

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 holding ServiceNow, Strategy holdings Microsoft and Salesforce are key for enhancing economic productivity. IT services companies such as Strategy holding 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 an 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 Strategy holding 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)
- Strategy holding ASML and Lam Research (which make tools that produce semiconductor chips)
- Strategy holding 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 Strategy holding 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 Strategy holding 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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