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## Appreciation ESG Strategy

### Key Takeaways

- ▶ Although conditions today remain conducive for risk assets, we see high expectations and sticky inflation as risks to the 2025 outlook.
- ▶ Despite robust GDP growth, there remain many anemic areas in our economy, a dynamic we see as difficult to improve should rates remain at current levels.
- ▶ The importance of scale represents a key tenet of ClearBridge's approach to ESG integration, as companies can make a positive impact simply because of their global reach, their deep supply chains and the depth of their involvement in the communities in which they operate.

### Market Overview

A powerful post-election rally propelled the S&P 500 Index up 2.4% in the fourth quarter, the S&P 500's fifth consecutive quarterly advance (and eighth over the past nine quarters). The index's 25% total return for calendar 2024 marked back-to-back years of at least 25% returns, an ascent only achieved four times since 1929 (1936, 1955, 1998, and today). At this point, we're running out of superlatives to describe the market's relentless advance over the past two years.

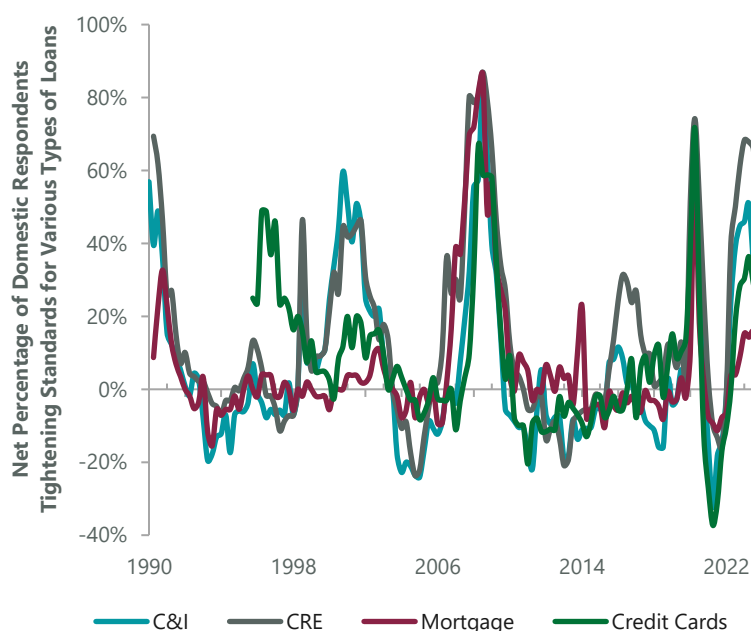
Consumer discretionary stocks led the advance in the quarter (+14.3%), the only sector to post a double-digit quarterly return. This was almost exclusively driven by Tesla, which rose 52% as investors chased the open-ended optionality of an Elon Musk/Donald Trump alliance. Travel and consumer stocks (including Amazon) also fared well with investors optimistic that robust consumer spending would continue beyond the holiday shopping season. Communication services and information technology (IT) also outperformed on continued optimism around artificial intelligence. Finally, financials performed well as investors looked forward to a lighter regulatory touch for banks and credit card issuers under a Republican administration.

Materials and health care stocks were the worst-performing sectors in the quarter, declining -12.4% and -10.3%, respectively. Metals, mining and chemicals stocks lagged as the industrial economy remains sluggish and investors feared stubbornly high mortgage rates would keep a lid on real estate activity. Within health care, large managed care companies trailed as investors fretted about the industry's claims-paying practices following the tragic murder of Brian Thompson, a UnitedHealth executive. Drug stocks were weak as

anemic current growth collided with worries about the potential impact RFK Jr. could have on the industry should he be appointed as head of Health and Human Services.

Liquidity, the primary driver of bull and bear markets in our view, remains plentiful, with credit spreads at 20-year lows suggesting little fear of a corporate credit cycle. Bank loan officers — as measured by the Senior Loan Officer Opinion Survey (SLOOS) — are normalizing underwriting criteria following the largest non-recessionary tightening in credit standards in survey history, a tailwind for credit availability (Exhibit 1). Finally, expectations for capital markets activity (IPOs, debt issuance, M&A) are high as investors expect the Trump administration and Republican majority to lessen scrutiny on corporate deal making. However, it is not all blue skies as we start 2025. A year-end market swoon brought a spike in volatility sending nearly 80% of S&P 500 stocks below their 50-day moving average.

Exhibit 1: Credit Availability Is Increasing



As of December 31, 2024. Source: ClearBridge Investments, Barclays Research and Federal Reserve.

## Outlook

Although conditions today remain conducive for risk assets, we see high expectations and sticky inflation as risks to the 2025 outlook. As evidenced by the post-election rally, markets expect Trump's policies will unleash a capital investment cycle while technological innovation will drive a rise in productivity. However, inflation remains stubbornly close to 3%, versus the Fed's 2% target, while wage inflation remains above 4%. A data-dependent Fed is likely done reducing interest

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Investor expectations  
or lower interest rates  
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market returns.

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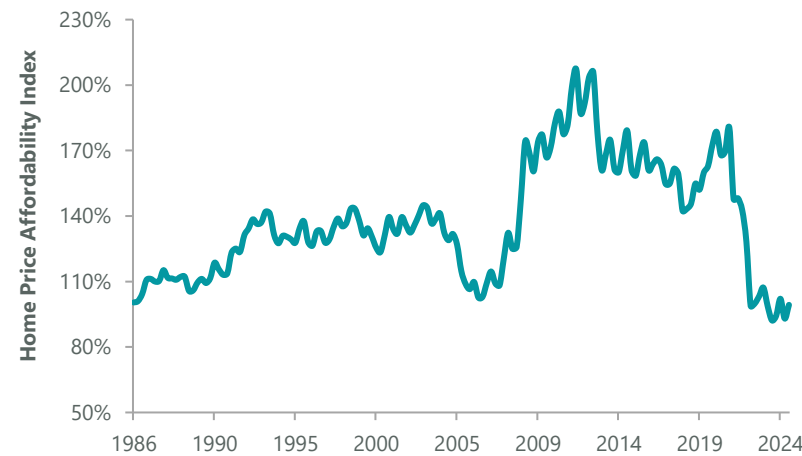
rates given relatively easy current financial conditions and GDP growth trending around 2.5%.

Interest rates are a key medium-term risk, in our view. Investor expectations for lower interest rates remain too aggressive and could act as a ceiling to materially higher stock market returns. We believe that real interest rates in the future are more likely to be in line with longer-term historical levels, not the post-Global Financial Crisis era to which many equity investors are anchored (especially considering the likelihood for higher deficit spending). While equity markets have been willing to absorb higher discount rates to date, the gradual acceptance of a “back to the future” rate regime, as well as the indeterminable effect of future government policy actions, will likely play a greater role in equity returns in 2025.

Expectations of the impact generative AI will have on capital investment and economic growth remain sky high. Agentic AI, a type of artificial intelligence that can make decisions autonomously with limited human supervision, has replaced copilots as the buzzword in Silicon Valley. However, despite the changing terminology we see this as a “copilot 2.0” efficiency tool more akin to table stakes for software services than a step function monetization opportunity. With America’s largest technology companies committed to AI infrastructure capex, we remain focused on investor willingness to fund this massive outlay in the absence of a tangible returns on investments. With power costs and compute intensity increasing, the investment required to chase artificial general intelligence (AGI), the ability of a machine to understand or learn any intellectual task that a human being can, continues to march higher. In our view, we remain many iterations away from having humanoid robots doing our cooking or cleaning or fully autonomous driving.

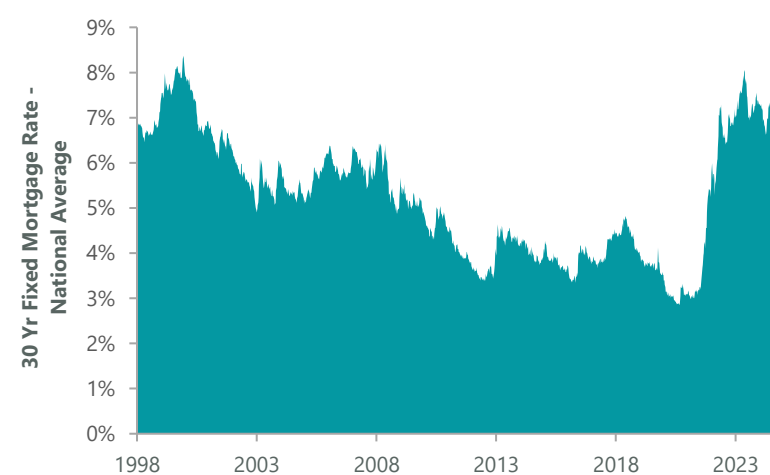
Despite robust GDP growth, there remain many anemic areas in our economy, a dynamic we see as difficult to improve should rates remain at current levels. Housing remains unaffordable (Exhibit 2) and with mortgage rates sticky at ~7% (Exhibit 3); it is hard to see activity pickup without price concessions or better financing rates (or both). Manufacturing remains in a slump with the ISM Manufacturing PMI highlighting contracting activity in 25 of the past 26 months. Forward-looking demand indicators continue to suggest sluggish activity. Finally, despite currently robust consumer spending and near-full employment, the rise in credit card delinquency rates should be monitored for consumer stress at the lower-end of the income curve.

Exhibit 2: Home Affordability Is Low



As of December 31, 2024. Source: ClearBridge Investments, National Association of Realtors, Bloomberg Finance.

Exhibit 3: And Mortgage Rates Are High



As of December 31, 2024. Source: ClearBridge Investments, Bankrate.com, Bloomberg Finance.

In sum, we believe that the economy will continue its expansion in 2025 driven by incremental fiscal support, productivity gains and stable employment trends, with wage growth sustaining consumer spending. However, we feel the effect on economic growth that potential policy changes floated by the Trump administration will have — be they tax extensions, tariffs, immigration or a change in government size — are largely factored into today's market valuations. We do expect reduced regulatory scrutiny to unlock investment and drive an M&A upcycle, which would be positive for capital markets, all else equal.

Shorter term, we worry that current expectations have become too complacent or, said more plainly, too bullish. While we agree the

impact of generative AI is likely to create game-changing technologies and opportunities for investors over the next decade, we feel that this cohort of companies, which have been market leaders and where expectations are sky high, could face some volatility while digesting recent gains. They also face risks from the reality of non-linear adoption rates for new technologies, changing business models and unanticipated bottlenecks (particularly power availability and cost).

Our longer-term worry relates to the sustainability of government debt and the burden of debt service on the budget deficit. At some point the U.S. will need to increase taxes or cut spending to prevent debt costs from spiraling out of control. Deficit spending at current levels cannot last forever. Current presidential plans offer an impractical budget that would greatly increase the deficit, an outlook that worries us further. Should investors require a greater risk premium (yield) to own a risk-free Treasury, the next administration and Congress will face stark choices not in anyone's current playbook. By no means is the U.S. dollars status as reserve currency our birthright.

### **Conclusion**

Our expectation is that 2025 will be a more subdued, but positive, year in terms of overall equity returns, but we admit this is not a bold prediction given the excess returns the past two years and the currently benign backdrop. Overall longer-term fundamentals remain on a solid footing. We expect small and mid cap companies, as well as more cyclical businesses, to benefit from continued growth of the U.S. economy. We believe the current backdrop has heightened the risk to the investment landscape should there be any stall in the disinflationary trend, disappointment in AI-driven capex, or government policy hiccups. We believe when everyone is bullish there is more risk to markets, not less.

We are long-term investors focused on the risk-adjusted returns a diversified portfolio can deliver through a market cycle. Rather than trying to bet on near-term earnings trends or government policy speculation, we believe it is better to look out two to three years and make investment decisions based upon our assessment of a company's longer-term, sustainable growth rate relative to what is implied in today's share price.

### **Portfolio Highlights**

The ClearBridge Appreciation ESG Strategy outperformed the benchmark S&P 500 Index in the fourth quarter. On an absolute basis, the Strategy had positive contributions from six of 11 sectors. The IT and financials sectors were the main positive contributors to performance, while health care was the main detractor.

In relative terms, stock selection in the industrials, consumer staples, energy and materials sectors aided results, while stock selection in the health care sector, a consumer discretionary underweight and materials and consumer staples overweights detracted.

On an individual stock basis, the biggest contributors to absolute performance during the quarter were Amazon.com, Nvidia, Broadcom, Alphabet and Visa. The biggest detractors were Eli Lilly, American Tower, Thermo Fisher Scientific, ASML and Adobe.

During the quarter, we initiated new positions in BJ's Wholesale Club in consumer staples and Starbucks in consumer discretionary, and we exited Nestle in consumer staples, PPG Industries in materials and ICON in health care.

### **ESG Highlights: Public Equities Amplifying Positive Impact**

Large companies with complex global operations may sometimes present challenges for sustainability-minded investors. In some cases, because a larger company's business is more complex than smaller, pure play companies focused on one particular sustainability need (addressing unmet medical needs or enabling renewable energy, for example), its sustainability contributions might be misunderstood or overlooked. Yet some well-known companies can have lesser known sustainability strengths, and these may be all the more impactful due to their large scale. The importance of scale represents a key tenet of ClearBridge's approach to ESG integration, as companies can make a positive impact simply because of their global reach, their deep supply chains and the depth of their involvement in the communities in which they operate.

A mega cap company like Amazon is a complex and very large company that may seem difficult to own in sustainable portfolios, as investors might be concerned about its overall carbon footprint and environmental impact, as well as working conditions, given the size and speed of the workforce. Amazon has drastically improved its capital allocation and profitability since 2022 under new CEO Andy Jassy; much of this has been driven by ongoing efforts at margin improvement through retail regionalization, scaling its advertising business and improving costs. Complementing these fundamental and governance improvements is Amazon's growth as company for which sustainable improvements strengthen the business case, with potential for positive change that benefits multiple stakeholders (employees, customers and shareholders).

Since 2019, ClearBridge's sector analysts have been engaging Amazon on the most material and relevant activities that could pose risk to the company in terms of operations and societal impact. These areas include climate change and climate targets; labor topics such as worker health and safety and unionization; packaging and materials; responsible AI; and disclosure. During our multiyear engagements, Amazon has agreed to disclose more data around each of these

issues. In addition, Amazon reaches out to us throughout the year (and vice versa) to consult us on its sustainability progress and goals. Our most recent engagement, in September 2024, was on climate strategy and covered science-based targets, last-miles-driven, renewables and EV investments and AI power needs.

Sustainability disclosures are significant for shareholders as they help benefit the bottom line over the long term, and Amazon's progress on several sustainability initiatives, such as reducing and innovating on packaging materials and increasing their circularity, are meaningful considering the scale of its operations. Amazon is the second-largest private employer in the U.S., with over 1.5 million employees: increasing wages, providing immediate family benefits and free tuition, and focusing on worker safety at these volumes positively impacts their many employees. The company delivers over 600 million packages per year with less materials and filling. It uses machine learning algorithms to determine the most efficient packaging for each order and so it can minimize empty space in boxes and optimize shipments to require less space in vehicles, reducing the number of vehicles on the road (Exhibit 4). AWS, meanwhile, is the largest cloud provider in the world, and is designing the latest protocols on addressing responsible AI. We believe progress made on these sustainability topics will have a material positive impact.

Exhibit 4: Amazon Reductions in Single-Use Plastic and Packaging Weight



Source: "How Amazon is improving packaging and boosting sustainability," Oct. 2024, Amazon.

#### More Than a New Coat of Paint

As the world's largest paint and coating company, Sherwin-Williams may suffer from negative sustainability perceptions due to their paint products being derivatives of petrochemicals like propylene. The industry has, however, been increasingly replacing hydrocarbon-based solvents with water-based ones, which have no harmful volatile organic compounds (VOCs) — in particular architectural

paints, which are two-thirds of Sherwin-Williams's business. Some waterborne solvent products made by Sherwin-Williams and others include air-purifying and sanitizing paints that reduce VOC levels from sources such as carpeting, cabinetry and fabrics in addition to fighting bacteria.

Sherwin-Williams further distinguishes itself with a sustainability-forward salesforce that helps its customers become more efficient. It stands out as an engaged supplier to its customers, providing education and recommendations on best practices using its products that can help its customers overcome labor shortages with paints that require fewer passes, for example, and use less material. In a recent engagement with the company, we also learned how it supports new accounts (small business owners) with consulting resources such as the digital infrastructure, invoices and accounting basics needed for new contracting businesses to succeed long term.

In terms of how to recycle or properly dispose of excess paint, Sherwin Williams volunteers many of its stores across the U.S. as drop-off locations for unwanted or leftover paint through its partnership with PaintCare, a nonprofit organization.

While the company's execution on its stated sustainability goals such as carbon emission reductions has been slower than might be hoped, we recognize such large goals take time. Upgrading LED lighting kits for all paint store color displays, investing in renewable energy to power its facilities and growing its paint recycling program are positive signposts for Sherwin-Williams, as its recently appointed CEO — a woman (only 6% of CEOs at the companies in the S&P 500 are women),<sup>1</sup> — continues to foster a winning culture of product innovation and service excellence with positive environmental and social impacts.

#### Change Should Start with Industry Leaders

Modern clothing manufacturing and retail is often considered riddled with environmental and social problems such as resources use, waste, pollution, overwhelmed landfills, child labor and unfair labor practices. However, a clothing manufacturer leader like Inditex is actually an agent of change and improvement in a problematic industry. We believe change should start with industry leaders rather than with fringe or marginal players, and ClearBridge is following how a clothing behemoth like Spain-based Inditex, best known for its Zara brand, is using its leadership to improve its ESG rankings among its peers and benefit the entire industry.

Examples of Inditex's environmental leadership include its use of sustainable fibers with low impact on the environment, its innovation in next-generation fibers and its use of recycling. Among its short-term goals are 100% responsibly sourced linen (it reached 100% for cotton in 2023) and a 25% reduction in water use by 2025. For 2030

<sup>1</sup> <https://research.com/careers/female-ceos-of-the-sp-500>



it aims to improve biodiversity across 5 million hectares, reduce emissions by 50% across total product life from design to recycling (and by 90% by 2040), and move to 100% fibers with low impact on the environment.

Social leadership is equally important: Inditex is dedicated to remedying the poor social image of the industry with a comprehensive audit of all external suppliers. This will affect millions of people. The company is already a recognized leader for its internal human resources credentials for talent development, diversity and engagement of its 170,000 employees. It is now turning its focus outward on the entire ecosystem for responsible clothing manufacturing. Its "Workers at the Centre" program for supply chain management involves due diligence on all 1,700 suppliers, inspecting human rights, living wages, respect, and health and safety. It has spoken with 1.5 million people so far with the goal to reach 3 million people by 2025. Monitoring visits improved from 540 in 2022 to 820 in 2023.

While these improvements are laudable, we recognize there is still a lot of progress to be made, and some commitments could be made more credible with more detail provided on how they'll be met. Yet given the extreme fragmentation of the fashion industry, we believe Inditex's scale and forceful implementation of better sourcing and manufacturing should have an amplified positive impact on the whole industry's supply chain.

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