



The Internal Engine of Returns

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Key Takeaways

- ▶ The goal of our valuation-disciplined process is to be an engine of returns, powered by companies generating free cash flow and allocated to attractive return opportunities or returning capital to shareholders.
- ▶ However, a valuation engine can only do so much on its own. We are always looking for opportunities to create external lift from exploiting market extremes and investor underreactions to big shifts in pricing power.
- ▶ Right now, the market is focusing investors and their precious capital on an increasingly narrow list of stocks. The result is an opportunity to buy great fundamentals at attractive valuations outside of this small subset.

Valuation Engine Drives Portfolio Lift

We have previously written about how a lifetime of being a pilot can influence how one approaches portfolio management. The basic principle of flying is to generate lift, while the basic principle of portfolio management is to generate attractive risk-adjusted returns. In both cases achieving these goals requires adapting to highly dynamic environments and making the most of opportunities that more than offset for volatility and turbulence. The key is to try and consistently execute on the investment process engine while positioning the portfolio for the big uplifts that come when extreme market positioning shifts in our favor.

The goal of our valuation-disciplined investment process is to be an engine of returns in all environments. The process is bottom up, security specific and driven by internal factors. At its core, we are looking for opportunities where market price and our estimate of business value are at least 30% apart. When we think we have identified a potential mispricing, we immediately ask ourselves what the market is getting wrong and why future fundamentals will turn out better than what is currently priced. This constitutes the engine that provides the internal lift of our portfolio: companies that can compound intrinsic business value over time by generating free cash flow and allocating that cash flow intelligently to attractive return opportunities or returning capital to shareholders. When we are correct, returns are generated as price and value converge to an increasing business value. In this environment, where most stocks outside the big index favorites are being ignored, we are finding many opportunities to put this theory into action.

One example of our internal return engine is our continued large position in American International Group (AIG), which we have owned for roughly 10 years. We originally bought AIG at a greater than 30% discount to our initial estimate of business value. This entry point assumed minimal improvements in the business but allowed us to absorb some inevitable downdrafts along the way that we took advantage of to build our position. The key, however, is that during this period AIG management dramatically improved its business. The company has compounded intrinsic business value per share at a double-digit rate by reducing risks as management overhauled their underwriting process, strengthened their balance sheet, cut expenses and operational complexity and structurally improved returns on equity. A major source of added lift came from intelligent capital allocation:

shares outstanding have been more than cut in half during this period, as management bought back roughly 5% of the company annually below intrinsic business value.

Another example was our positioning within the energy sector in the first quarter of 2024. While the market doubled down on concentration within big AI winners in the early part of the quarter, the broadening out of performance as the quarter wore on helped drive the energy sector to be the second-best performer and even outpace IT in the portfolio despite consistent investor outflows and record inflows into the IT sector. As a result, our overweight to the sector helped us pull ahead of our value index and catch up to the performance level of the mega caps dominating the S&P 500 Index.

However, this valuation-driven return engine can only create so much lift on its own. We are always looking for big opportunities to create external lift in our returns from dramatic shifts in markets. The first comes from exploiting market extremes, where the long-term probabilities are very much in our favor, while the second comes from investor underreactions to big shifts in pricing power that can be exploited through our valuation lens.

Exploiting Market Extremes

The market has been recently serving up some very notable and exploitable historic extremes. Big returns in markets are typically made when you correctly identify and exploit an outcome that the market has priced close to a zero probability. While this strategy is difficult to execute, as markets are typically the best system for pricing probabilities, sometimes markets experience diversity breakdowns that misprice the likelihood of mean reversion. We see an example of this reflected in the historic extremes in current market concentration (Exhibit 1). The market is effectively pricing an almost certain probability of continued historic concentration, yet it is easily observable that these extreme concentration levels have always reversed. The key is understanding what happens when it does reverse, and are we seeing any signs of it?

Exhibit 1: Market Concentration is Very Elevated vs. the Past Century



As of March 14, 2024. Source: Compustat, CRSP, Kenneth R. French, Goldman Sachs Global Investment Research.

Most investors assume that when market concentration reverses the market will collapse, but the historical precedent is more nuanced. In each of these seven cases of excessive market concentration identified since 1925, price momentum took off like a jet as markets reached peak concentration, only to reverse violently as concentration decreased. However, in every episode of these big momentum reversals, the previously low-momentum laggards of the S&P 500 — now showing a positive momentum factor according to the Farma-French

model in the wake of the reversal — went on to generate positive absolute returns, with an average return of 27% over the following 12 months. In other words, rather than crashing, previous concentration and related momentum reversals are an opportunity for the laggards to catch up.

Ultimately, this extreme market concentration is like a world-class magician at a kid's birthday party: through their intense focus on the magician, the kids lose sight of everything else. Right now, the market is focusing investors and their precious capital on an increasingly narrow list of stocks. The result is an opportunity to buy great fundamentals at attractive valuations in the companies beyond most investor's narrow gaze — a combination capable of generating attractive portfolio lift from our return engine, while maintaining the big external return opportunity that will come from an inevitable reversal that favors laggards.

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