FRANKLIN TEMPLETON | ClearBridge

Sustainability Leaders Strategy

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Key Takeaways

- The Strategy delivered double-digit absolute returns but modestly trailed the benchmark amid the quarter's narrow rally in semiconductor stocks.
- We are maintaining overweight positions in semiconductors, industrials, utilities and materials where we are constructive on "picks and shovels" in the AI infrastructure buildout.
- Social media litigation is entering a new phase, with recent court decisions suggesting legal and regulatory risk is shifting away from user-generated content toward platform design, with claims increasingly focused on addictive features and youth mental health.

Market Overview

U.S. equities rebounded in the second quarter amid de-escalation of Middle East tensions and a rotation back into AI stocks. The benchmark Russell 3000 Index returned a robust 15.4%, driven by narrow leadership from the information technology (IT) and industrials sectors. Semiconductors surged more than 50%, led by memory and optical/networking stocks that benefited from sharply rising demand driven by AI. Industrials rose, helped by demand for electrical and cooling equipment related to data centers and renewed optimism about a broader improvement in industrial activity.

All other sectors in the benchmark trailed the overall market return, with defensive utilities and consumer staples underperforming in a risk-on market and materials feeling headwinds from lower commodity prices. The energy sector was the largest laggard in the index after being the best-performing sector in the first quarter.

Portfolio Performance

The Strategy delivered double-digit absolute returns but modestly trailed the benchmark amid the quarter's narrow rally in semiconductor stocks. Ultimately, the quarter's story was one of AI demand for computing capacity outstripping supply, benefiting many semiconductor and technology hardware stocks, including several holdings such as ASML, ASM International, Advanced Micro Devices and Flex. Areas with the tightest supply bottlenecks experienced the sharpest inflections in growth and stock prices during the quarter, with memory and related names leading the pack. In fact, more than all the Strategy's underperformance in the quarter could be accounted for by

our not owning Micron Technology, one of the big three memory chip makers globally (and the only one that is U.S.-based).

Nvidia, an overweight in the portfolio, lagged the semiconductor industry and detracted from performance. This AI bellwether was left behind as the market focused on smaller cap semiconductors and memory-related stocks. However, we remain bullish on Nvidia and believe the shares are not getting credit for the significant earnings growth driven by market dominance in logic compute for AI.

Positives came primarily from IT, meanwhile, with bright spots in other sectors like industrials. In IT, electronics manufacturing company Flex more than doubled on the strength of a recently announced spinoff of its cloud and power infrastructure business, which offers pure-play AI infrastructure exposure and a stronger than expected growth outlook. Palo Alto Networks, a leading provider of network and cloud security platforms to enterprises, inflected sharply higher, helped by continued strong operating results. The market is also appreciating that information security is unlikely to be disrupted by AI, and in fact should be a significant beneficiary as cybersecurity risks are rising dramatically. Semicap equipment companies ASML and ASM International were also strong as higher demand for memory and compute chips drove capacity expansions at chip foundries. ASML is seeing surging demand for AI chips drive order backlogs for its extreme ultraviolet (EUV) lithography machines; ASM, which sells specialized tools for making advanced AI and processor chips, gained on expectations that next-generation chips will drive higher demand for its equipment.

In industrials, equipment rental company United Rentals rose due to a combination of strong first-quarter results and a raised outlook. Shares were trading at an undeservedly low valuation given growth opportunities tied to megaprojects and data centers, which are raising demand for construction equipment. Valmont, which makes engineered steel poles and infrastructure for the power utility sector, was also up as its utility customers are investing heavily to meet AI-driven demand for electricity.

Portfolio Positioning

We are maintaining overweight positions in semiconductors, industrials, utilities and materials where we are constructive on “picks and shovels” in the AI infrastructure buildout. Within semiconductors, we are positive on semi cap equipment — manufacturing equipment for chips — as we believe the ongoing shortage of compute will continue to necessitate the buildout of further chip fab capacity. The rest of our semiconductor exposure is broad, covering GPUs, custom ASICs, as well as CPUs, memory and analog semis as demands of inference and agentic AI call for mobilization of computational resources beyond solely the GPUs used in model training that we saw in the early stages of AI buildout.

A number of stocks in the industrials, utilities and materials sectors are exposed to the data center and energy infrastructure buildout themes; we are finding quality companies in these areas at attractive valuations. At the same time, as owners of physical assets, these companies are less likely to face AI-driven disruption. This is unlike the software sector

— an underweight for the Strategy — which is seeing AI-driven headwinds to growth and terminal values.

During the quarter we added four new positions: Advanced Micro Devices, Cadence Design Systems, CF Industries, and SpaceX.

Advanced Micro Devices is a U.S. semiconductor company offering attractive exposure to the massive growth in the CPU market as CPUs have become critical to enabling agentic AI. At the same time, we are optimistic that AMD can successfully ramp up volumes of its GPU competitor chip.

Cadence Design Systems provides electronic design automation (EDA) software, hardware and IP used to design chips and electronic systems. Its chip design tools are foundational to technology innovation globally. Cadence is our preferred exposure in the attractive EDA software industry, and we exited Synopsys during the quarter: Cadence is a pure-play semi design tool company whose execution has been more consistent, and we see potential for it to gain share with Intel (a key customer) at Synopsys's expense.

CF Industries is a global producer of nitrogen-based fertilizer, which is critical for food security and some industrial applications. CF's North America-based assets are at the low end of the global cost curve, and it could command premiums for its low-carbon ammonia. Ammonia production is carbon-intensive, but CF has an aggressive roadmap to reduce absolute emissions by 25% by 2030 (versus a 2015 baseline) and achieve net-zero emissions by 2050. It is also developing the world's largest low-carbon ammonia plant, which will supply ultra-low-carbon ammonia globally.

We also initiated a position in SpaceX, a diversified aerospace and communications company that makes and operates rockets for orbital satellite deployment and develops AI models. SpaceX is a unique asset in the market with little competition in its core space-based business. It is an infrastructure provider offering the lowest cost to orbit for satellite-based communications (Starlink and its iterations for various governments) and the lowest-cost "rails" for delivery of people and materials into orbit. It is a key contractor of and enabler to NASA, and it is building out an orbital compute franchise.

SpaceX also has a path to further step changes in launch costs as it achieves rapid reusability of its Starship launch vehicle, providing substantial technology and economic moats around the core of the business. In addition, its xAI business is one of the few U.S.-based LLM providers; it is profitably offering neocloud services (a new generation of high-performance, AI-driven cloud computing) because of its cost advantage in building low-cost terrestrial compute.

The company's Starlink connectivity business could deliver meaningful social benefits by expanding access to mobile communications and broadband in underserved and remote communities. By enabling broadband connectivity in areas where terrestrial infrastructure is unavailable, unreliable or uneconomic to deploy, Starlink can contribute to broader global connectivity goals, including efforts aligned with the U.N. Sustainable Development Goals.

While we share broadly discussed concerns on governance, the potential environmental benefits of SpaceX are significant. While SpaceX uses methane as a propellant, the goal is to develop a constellation of orbital computing satellites powered by only solar energy, with no terrestrial power or water usage, which would be game-changing for the environment and for the local communities that host data centers. Orbital compute satellites would notably lower the global energy usage and emissions forecasts associated with terrestrial data centers. SpaceX is already building large-scale solar cell manufacturing capacity in the U.S. to meet its future needs.

Outlook

We see both upside and downside risks for the U.S. economy, and we have adjusted portfolio positioning where appropriate, but continued expansion remains our base case. While there remains uncertainty given elevated interest rates and inflation as well as lack of final resolution to the Strait of Hormuz crisis driving oil price volatility, energy costs have come off peaks, GDP continues to grow, money supply is expanding and the federal impulse is stimulative.

At the same time, AI spending continues to supercharge parts of the industrial and tech economy: hyperscaler capex is forecast to more than quadruple from 2023 to 2026 to greater than $700 billion. While AI adoption seems to be picking up steam and compute demand is outstripping supply, we remain vigilant on the duration of hyperscaler capex spending increases considering the major impact of this spending on the macro environment and on specific companies' outlooks.

Portfolio Highlights

The ClearBridge Sustainability Leaders Strategy modestly underperformed the benchmark Russell 3000 in the second quarter of 2026. On an absolute basis, the Strategy had positive contributions from all 10 sectors (out of 11 total; the Strategy does not own any stocks in the energy sector). The IT sector led contributors, followed by industrials, while utilities and consumer staples were the main laggards.

In relative terms, overall stock selection detracted while sector allocation helped. Stock selection in IT, health care and consumer discretionary, along with overweights to materials and utilities detracted the most. Conversely, stock selection in the financials and industrials sectors and a lack of energy holdings proved beneficial.

On an individual stock basis, the biggest relative contributors during the quarter were Flex, Palo Alto Networks, United Rentals, ASML and ASM International. The biggest detractors were Netflix, an underweight to Advanced Micro Devices, and not owning Micron Technology, Intel and Applied Materials.

In addition to portfolio activity discussed above, we exited Trane Technologies in the industrials sector.

ESG Highlights: Social Media Under Scrutiny

Social media companies are coming under increasing pressure from state attorneys general, school districts and parents arguing platforms such as Meta Platforms' Facebook and Instagram, Snapchat, TikTok and Alphabet-owned YouTube knowingly designed features that are addictive to young users and failed to adequately warn about mental health risks.

The success of recent lawsuits in California and New Mexico against Meta and YouTube could be impactful for social media broadly, raising regulatory and financial risk and creating the potential for reputational damage.

In New Mexico, a jury awarded $375 million in civil penalties against Meta for misleading the public about predator exploitation on its platforms in violation of state consumer protection law.

Not long after, a jury in Los Angeles became the first to hold social media companies responsible for contributing to a plaintiff's mental health harm via addictive design. The jury determined that Meta and YouTube were liable for negligence and failure to warn related to the plaintiff's alleged social media addiction. The plaintiff was awarded $6 million in damages.

These lawsuits are notable for not seeking action against the content featured on the platforms — for years, such attempts were unsuccessful, largely due to Section 230 of the Communications Decency Act, which protects social media companies from liability related to content posted by their users. Instead, the lawsuits attempt to find fault in the design of the products.

They also follow several milestone national regulations around the world that have involved restrictions on youth access to social media (Exhibit 1). Several U.S. states — such as Utah, Arkansas, Louisiana, Florida, Georgia, Tennessee and Nebraska — have also passed laws restricting minors' use of social media, although many of these are currently being challenged in court.

Exhibit 1: National Restrictions on Youth Access to Social Media

2023	France	Prohibits most social media accounts for children under 14 and parental consent for ages 14-15
2024	Australia	First country to enact nationwide min. age of 16 for social media
2025	Australia	Under 16 ban enters into force
2025	Malaysia	Establishes nationwide min. age of 16 for social media
2025	Portugal	Establishes nationwide min. age of 16 for social media

As of June 30, 2026. Source: ClearBridge Investments.

ClearBridge's approach focuses on the companies' risk management regardless of the source of risk.

Social Media Platforms and Active Ownership

ClearBridge owns both Meta and Alphabet in several portfolios, and we are cognizant of the risks to both society from social media and the companies via potential liability. Against this backdrop, we recently engaged with Meta to discuss youth safety. In our conversation in May, we sought to test the real-world effectiveness, credibility and trade-offs of Meta's youth safety efforts, while probing regulatory risk, reputational risk with financial penalties and competitive positioning.

Meta shared that it believes its youth safety measures such as AI-based age verification, content moderation and privacy and parental controls are best-in-class, although this could be challenged. The company also shared that it supports youth safety regulation; its requests for regulation would be for no outright bans, consistency across geographies and equal application to all social media companies.

Meta noted that its Teen Accounts enable the above safety measures by default, it employs AI to screen account content for signs that a user may have lied about his or her age and it automatically age gates as appropriate. In aggregate, these features have led to a "marked improvement" in compliance and outcomes, according to the company. In response to critics that claim these features still let through inappropriate content, the company believes these instances of algorithm failure are exceptions rather than the norm.

We advised the company to disclose the data supporting its claims that its youth initiatives are working and leading to "marked improvement," as it did not provide any during the meeting. Further, we shared our preference that, to lend greater credibility to the claims, this data should be audited by a third party.

We also explained our difficulty in locating information on these issues on Meta's websites. We noted that information difficult to find for professional investors would likely be even more challenging for everyday users — parents, for example — to locate and to inform their decisions to use the platform. We asked the company to consolidate all its statements on this subject in a single place — rather than spread it out across several different websites — to make it easier for various stakeholders to find and evaluate, similar to what the company does for its environmental disclosures. Meta was receptive to our input.

In June a trust and safety company that helps platforms and AI developers detect and prevent harmful online behavior and unsafe AI outputs published a study in cooperation with Meta that used Meta's content standards to compare the Teen Accounts content experience on Instagram versus a competitor platform. Testing was conducted from mid-December 2025 to mid-January 2026 and found that the safeguards applied to Teen Accounts on Instagram performed better than a competitor platform across several dimensions. While the period may seem short for such a study, Meta has disclosed that Teen Accounts are in the hundreds of millions; as users access the apps multiple times a day, this would aggregate to a statistically significant sample, although ideally the company could disclose time series data showing content moderation improvement over a longer horizon. Also in June, Meta rolled out its Teen Accounts protections globally to all

apps as well as parental alert notices for inappropriate content searches by teens.

Conclusion

Content responsibility remains a key component in assessing social media platforms such as those operated by Meta and Alphabet. ClearBridge's approach stresses several components of this topic: rigorous content moderation can potentially limit harmful or illegal content while seeking to maintain platform integrity, and child safety raises questions of regulatory and reputational risk.

Over the years of ClearBridge's ownership with Meta and Alphabet, we have witnessed both companies improving their content responsibility (Exhibit 2). Meta has made progress on its content policy by appointing an independent content oversight board and then growing its scope. After historically having some issues around brand safety and protecting children from sensitive content, YouTube has made significant progress in this area through staffing, technology and policy development. In 2021, YouTube became the first digital platform to receive accreditation for content-level brand safety from the Media Rating Council (MRC), following an independent audit of its content moderation, monetization and ad placement systems.

At the same time, recent litigation with social media suggests the risk profile for these companies is evolving; regulatory risk is shifting from content moderation to product design. ClearBridge's approach focuses on the companies' risk management regardless of the source of risk. As our engagement with Meta shows, we also focus on transparency, as investors need evidence that youth safety initiatives are working in practice, not only descriptions of policies or tools.

Exhibit 2: Content Responsibility Improvement Timeline

Year	Meta	Alphabet
2018	Announces Oversight Board	Expands AI moderation investments
2020	Oversight Board established	COVID-19 misinformation policies
2021	Oversight Board begins issuing decisions	First MRC content-level brand safety accreditation
2022	Updated Community Standards enforcement, explanation and review	Enhanced election misinformation measures
2023	AI content labeling initiatives launched	Generative AI safety commitments
2024–2025	Expanded AI-generated content policies	Gemini AI safeguards and synthetic media labeling

Source: ClearBridge Investments.

Social media is a fast-moving topic involving billions of participants — Meta reports 3.5 billion daily active users, while Alphabet reports over 2 billion signed-in monthly users for YouTube. We continue to educate ourselves on the sustainability factors affecting this industry as we monitor the evolution of litigation and the broader social media bans; we will continue to actively incorporate this analysis into our investment process and stewardship activity.