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## Large Cap Value ESG Strategy

### Key Takeaways

- ▶ Despite initial signs of market broadening following Donald Trump's election victory and further interest rate cuts from the Federal Reserve, the market reverted to the narrow mega cap growth leadership that characterized most of 2024.
- ▶ Against the backdrop of a challenging year of narrow market breadth, the Strategy outperformed in the quarter, demonstrating resilience and potential for recovery as the market began to normalize and our quality bias in materials and utilities stood out.
- ▶ Sustainability issues on which ClearBridge has been engaging holdings and seeing improvements span environmental topics such as reducing emissions and packaging waste, improving efficiency among small businesses and comprehensive auditing of far-flung supply chains.

### Market Overview

Despite initial signs of market broadening following Donald Trump's election victory and further interest rate cuts from the Federal Reserve, the market reverted to the narrow mega cap growth leadership that characterized most of 2024. Outside this group, market action was more subdued, with the benchmark Russell 1000 Value Index returning -1.98%, about 900 basis points behind its growth counterpart. Potentially reflationary policies from the Trump administration, such as tariffs, and slight upticks in inflation put upward pressure on longer-term interest rates, causing weakness in economically sensitive and rate-sensitive sectors.

2024 presented a number of challenges for the Strategy due to the narrow market breadth, the strong performance of specific thematic growth stocks and the sluggish economy. Our diversified, valuation-sensitive approach struggled in this environment. Stock selection, typically a strong point for our strategy, was weaker than we'd hoped due to certain technology and health care stocks like Intel, Microchip Technology and CVS.

Despite these setbacks, we remain confident in our long-term process of investing in high-quality franchises within durable, growing markets at reasonable valuations. We believe this approach will drive sustained outperformance over time. Notably, the Strategy showed improvement in the fourth quarter, outperforming and demonstrating resilience and potential for recovery as the market began to normalize.

Our quality bias in materials and utilities stood out the most in a quarter that saw a reversal of some of 2024's themes. Materials was the worst performer in the benchmark, though we tend to avoid the highly commoditized businesses that led the selloff. Relative outperformance among utilities came from not owning AI-levered power companies, which sold off, and by our large active weight in Sempra, a well-positioned diversified utility likely to benefit from a Republican energy policy and growing LNG demand, both for export and domestic production.

Our overweight in financials, with a focus on payments and consumer finance companies like Visa, Capital One and American Express, proved beneficial. These firms, along with banks such as JPMorgan Chase and Bank of America, gained from economic resilience, robust consumer spending, yield curve normalization, and the anticipated reduction in regulatory pressures from the incoming administration. Adhering to our valuation discipline, we trimmed positions in American Express and JPMorgan Chase, primarily due to their strong performance.

Detractors came mainly from the health care sector. Elevated utilization trends, lower Medicare Advantage (MA) rates, and more generous MA benefits broadly across the industry materially pressured profitability of CVS and, to a lesser extent, UnitedHealth Group. Ongoing Medicaid redeterminations resulted in increased acuity of remaining Medicaid members, leading to increased pressure on Medicaid profitability, with Elevance Health being the most exposed among our holdings. Potential regulatory pressures on pharmacy benefit managers also weighed on CVS Health and UnitedHealth Group, while the latter's managed care business, along with that of Elevance, was pressured by increased medical care ratio increases. We elected to exit our marginal position in Elevance in the quarter, given relatively higher exposure to Medicaid, typically a target for Republican administrations, and redeployed some of the proceeds in CVS and UnitedHealth.

The largest relative detractor in terms of selection was the information technology (IT) sector, particularly Microchip Technology. The company announced a change in CEO, lowered its revenue guidance and revealed manufacturing restructuring plans, which collectively pressured the stock at year-end. The embedded semiconductor industry is experiencing a significant cyclical downturn as customers deplete inventories they had stockpiled during the COVID-era chip shortages. While this has negatively impacted Microchip's near-term financials, we believe that its large and fragmented customer base (~120,000 customers and several thousand SKUs) and sticky products will allow it to maintain pricing and market share once a recovery materializes. We took advantage of the weakness to add to our position, confident that Microchip is a well-positioned, scaled player in the analog/microcontroller market with the potential for higher margins in the long term.

### Portfolio Positioning

In a very skewed market in 2024, we saw a large valuation divergence that provided opportunities for our process as high-quality companies simply weren't attracting capital. In the fourth quarter, we added to out-of-favor defensive holdings such as PepsiCo and Becton Dickinson, appreciating their lower economic sensitivity and reasonable valuations. We also added to Deere, which we had trimmed aggressively in 2023 as the agriculture cycle was in its later stages. We added to it during the period at what we view as very reasonable valuations based on what look like trough earnings. Deere's competitive advantages, such as distribution scale and tech stack, continue to manifest in sustainably higher profitability through the cycle, relative to peers and its own history. At the same time, we maintained our valuation discipline and reduced exposure to Oracle and Broadcom. Both companies benefited from robust AI spending, Oracle on the infrastructure side and Broadcom on the custom silicon side, as well as a well-executed VMware acquisition.

### Outlook

As the U.S. political landscape shifts, we are reminded why we try to own resilient, durable franchises that can withstand various uncertainties and generate attractive risk-adjusted returns over the long term. We anticipate a potentially more business-friendly environment under the new administration in the coming four years, which would support economic growth and a broadening of the market. The ISM Manufacturing PMI has been in contraction territory for some time; should that trend reverse, capital that has been on the sidelines may find more incentive to enter the market. We believe there are pockets that would benefit, perhaps those overlooked in the narrow market of 2023 and 2024, more than others. Given already-stretched investor optimism amid a variety of indeterminate risks, volatility is likely to create opportunities for disciplined investors with an eye on long-term value creation.

### Portfolio Highlights

The ClearBridge Large Cap Value ESG Strategy outperformed its Russell 1000 Value Index benchmark during the fourth quarter. On an absolute basis, the Strategy had positive contributions from four of the 11 sectors in which it was invested for the quarter. The financials and energy sectors contributed the most, while the health care and consumer staples sectors were the main detractors.

On a relative basis, overall stock selection and sector allocation effects contributed to outperformance. In particular, stock selection in the materials, energy, utilities and financials sectors helped relative returns. Conversely, stock selection in the IT, consumer staples, health care and real estate sectors and a materials overweight detracted.

On an individual stock basis, the largest contributors were JPMorgan Chase, Broadcom, Williams Companies, XPO and McKesson. Positions in Microchip Technology, CVS Health, Danaher, Thermo Fisher Scientific and UnitedHealth Group were the main detractors.

### **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.

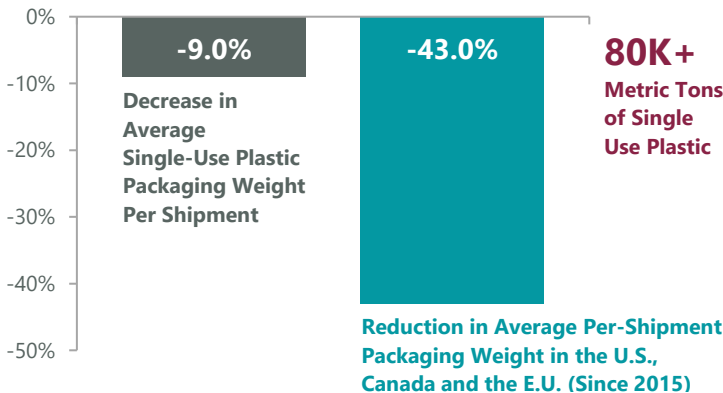
A mega cap company like Amazon is a complex and very large company that may seem difficult to own in sustainable portfolios, as investors might be concerned about its overall carbon footprint and environmental impact, as well as working conditions, given the size and speed of the workforce. Amazon has 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 1). 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 1: 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 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

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

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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