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Appreciation ESG Strategy

Key Takeaways

- ▶ The market's sector performance exhibited a defensive posture in the first quarter with health care, consumer staples, utilities and real estate the top-performing industries, outside of energy.
- ▶ While our main tariff concerns could be transitory, the biggest risk is the potential for lost economic momentum. Should capital investments go from deferred to delayed or consumers from optimistic to pessimistic, reigniting the engine of economic growth and investment may prove challenging.
- ▶ 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

Despite a fast start to the year — a broad-based rally propelled the S&P 500 Index +2.8% in January — the market struggled for traction in the first quarter of 2025. Post-election animal spirits faded in February and March as investors grappled with on again/off again tariff announcements and consternation over the AI outlook. By the end of the quarter, the S&P declined -4.3%, breaking the index's streak of five consecutive quarterly advances.

Outside of energy, the best-performing sector in the quarter, the market's sector performance exhibited a defensive posture with health care, consumer staples, utilities and real estate the next-best performing industries. The energy sector outperformed as oil price stability provided air cover for stocks to recover from the deeply oversold level many shares entered the year. Within health care, investors found shelter in biotechnology and pharmaceutical shares as well as the beaten down managed care industry. Finally, regulated utilities and the real estate sector offered their usual haven status during choppy waters.

Technology bore the brunt of underperformance. Yes, the consumer discretionary sector appears as the market laggard (-13.8%), but this was primarily driven by downside in shares of Tesla and Amazon.com, which declined -36% and -13%, respectively. The information technology (IT) sector underperformed the index in each month of the quarter, the first three-month losing streak for IT since August–October 2022. Although IT underperformance was broad-based, AI-levered names bore the worst of the selling as investors fretted about the impact of Chinese advancement in AI combined with the still uncertain ROI on significant capital outlays.

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Outlook

The onset of the Trump administration's tariff shock therapy caused a sharp decline in the first week of the new quarter and shifted the market dialogue. The last time the world saw tariffs this high was during the Great Depression after the U.S. implemented the Smoot-Hawley tariffs. We caution about drawing too close a parallel to that era. The U.S. and the world were entering a serious recession in 1929, and while the tariffs added fuel to the fire, they were by no means the major cause of the depression.

As the second quarter of 2025 begins U.S. economic fundamentals are benign. Current measures of liquidity are conducive for risky assets. Credit spreads remain tight by historic standards; the yield curve is positively sloped with risk-free rates relatively stable at benign levels; bank deposits are growing at an accelerated pace while loan underwriting standards ease; M&A and IPO activity is thawing; and the Fed plans to slow balance sheet runoff. An unstable economy like in 1929 is a lot easier to knock off kilter than the stability we see now.

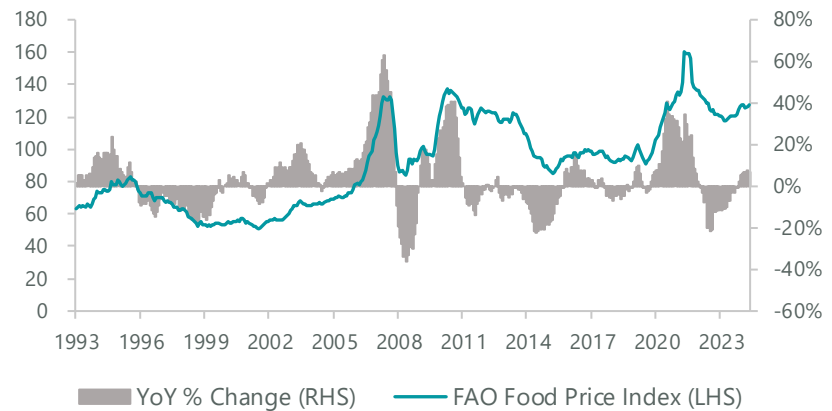
We view the tariff issue as two-pronged. First, the current lack of policy visibility creates uncertainty. While the announced tariffs are very large, their eventual level will be determined by international reaction and the Trump administration's willingness to take the pain the tariffs will create. The uncertainty seems likely to create a slowdown (or pause) in corporate capital expenditures. How can we ask our business leaders to make multiyear, growth-creating, job-generating investments in property, plants or equipment without knowing whether these investments will be impacted by broad-based tariffs? Simply put, these multiyear investments require policy stability. Markets will be volatile until we know what the tariffs will be.

The second issue with tariffs is the potential impact on inflation, Fed policy and interest rates. We view broad-based tariffs as a one-time step-up in the price of impacted goods, which could be far reaching. That said, we worry more about the potential knock-on effects of tariffs. First, with lower-income consumers already stretched by high prices, goods inflation elevates the risk of slower consumer spending (recall consumer spend accounts for two-thirds of U.S. GDP). Americans will have to budget for the rising cost of necessities such as food at the expense of discretionary items such as travel and entertainment. Second, higher consumer prices could lead to another bout of wage inflation as people fight to have income keep pace with rising costs. If realized, these two knock-on effects could significantly change the U.S. economic backdrop.

In sum, while both our tariff concerns could be considered transitory or one-time in nature, the biggest risk in our view is the potential for lost economic momentum. Should capital investments go from deferred to delayed or consumers from optimistic to

pessimistic, reigniting the engine of economic growth and investment may prove challenging.

Exhibit 1: World Food Prices



As of March 31, 2025. Source: ClearBridge Investments, United Nations, Bloomberg.

In addition to tariff uncertainties, the second potential risk we see to the markets involves the evolution of generative AI. Entering the year, expectations of the impact generative AI will have on economic growth were sky high despite lacking evidence of monetizable consumer applications. Agentic AI, a type of AI that can make decisions autonomously with limited human supervision, became a Silicon Valley buzzword but remains an efficiency tool more akin to table stakes for software services than a step function monetization opportunity.

In addition, the emergence of DeepSeek, a China-based low-cost large language model, stoked fears about the returns investors should expect from the massive investment being made in the AI ecosystem. At a minimum, the DeepSeek revelation was a trigger event that shifted investor attention from chasing an open-ended dream to a more discerning incremental investment dollar. Investors are finally asking questions like: If models can be trained on lower-cost GPUs how many Nvidia clusters does the world need? If inference can be done on CPUs, what does that imply from a hardware ecosystem standpoint? How many large language models does the world need and what is the return potential from the proliferation of these models? We view investor focus on tangible ROIs following the initial AI gold rush phase as a painful but necessary transition akin to the rationalization Internet investors experienced in the late 1990s and early 2000s.

Conclusion

Our economic and market outlook has become somewhat binary in nature and incrementally more cautious. On the one hand, we believe if policy certainty comes soon current growth concerns could prove transitory with tariff impact perhaps manageable. On the other hand, the current “on again/off again” policy environment has

meaningfully raised the risk of an economic slowdown, one that risks being concurrent with rising consumer prices, a potentially bad outcome for risky assets.

Although today the economic backdrop remains conducive for equities, we can no longer overweight this as a base case in our outlook. As such — and as risk-conscious investors focused on outperforming through a market cycle via downside protection — we believe incremental caution is warranted as we digest incoming information. Rather than trying to bet on near-term earnings trends or government policy outcomes, 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 versus what's implied in today's share price. Given rising odds of a bumpy ride, we believe our Strategy is well-suited to the current environment.

Portfolio Highlights

The ClearBridge Appreciation ESG Strategy outperformed the benchmark S&P 500 Index in the first quarter. On an absolute basis, the Strategy had positive contributions from seven of 11 sectors. The financials, health care and consumer staples sectors were the main positive contributors to performance, while IT, communication services and consumer discretionary were the main detractors.

In relative terms, stock selection in the financials and consumer discretionary sectors aided results, as did overweights to consumer staples and financials and underweights to IT and consumer discretionary. Stock selection in the IT, industrials and consumer staples sectors detracted the most.

On an individual stock basis, the biggest contributors to absolute performance during the quarter were Berkshire Hathaway, Visa, Travelers Companies, Waste Management and AbbVie. The biggest detractors were Nvidia, Microsoft, Broadcom, Apple and Amazon.com.

During the quarter, we initiated new positions in Workday in the IT sector, Tesla in the consumer discretionary sector and WEC Energy in the utilities sector. We exited Mondelez International in the consumer staples sector, Comcast in the communication services sector, Marvell Technology and Adobe in the IT sector and Sempra in the utilities sector.

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