ClearBridge Investments

Small Cap Value Strategy

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Key Takeaways

- Concerns about slowing global growth sent equities lower, while small cap value stocks fared better than their growth counterparts.
- Financials sold off generally and banks in particular, largely on concerns around funding costs and widening credit spreads.
- Our portfolio's current positioning is toward companies with stronger balance sheets, more resilient business models and, on balance, less cyclical sensitivity relative to the start of 2018.

Market Overview and Outlook

Equity markets rallied the first three quarters of 2018, riding a wave of favorable economic and corporate earnings reports, boosted in part by the tax cut stimulus. In the fourth quarter, concerns about slowing global growth, exacerbated by escalating trade tensions with China, sent equities lower. Smaller companies underperformed larger ones as the Russell 2000 Index declined -20.20% for the quarter. Value stocks outperformed growth stocks, with the benchmark Russell 2000 Value Index falling -18.67%, compared to the Russell 2000 Growth Index falling -21.65%.

U.S. economic news started the quarter very strong but ended more mixed. While the U.S. consumer did well, manufacturing experienced some softness to close out 2018. Retail sales were robust, posting one of the best Christmas seasons in years. Car sales were steady above 17 million (seasonally adjusted annual rate), although results were boosted by high fleet sales. Housing slowed slightly but continued to grow. Unemployment claims bottomed for the cycle in September at 205,000 before rising to 231,000 by December — still a very low number. Job creation was strong in December at 312,000 and average hourly wage growth picked up to 3.2%. Employment is one of the best indicators of the health of the U.S. economy but tends to lag at the onset of a recession.

The best performers in the fourth quarter were low-risk or defensive stocks. Meanwhile, as concerns about global growth grew, cyclical and economically sensitive areas traded down across the market. Oil prices peaked north of $75 in early October but cratered to the mid-$40s by year-end, bringing energy stocks with them. Coming into the fourth quarter, oil markets had been anticipating shortages caused by new Iranian sanctions. Instead, the sanctions were overshadowed by weaker global economic data that resulted in reduced expectations for oil demand.

Rising interest rates and suggestions that the Federal Reserve would continue unwinding its multi-trillion-dollar balance sheet pressured the stocks of leveraged companies. The small cap value universe tends to be more cyclically exposed with a high percentage of financials increasing its overall economic sensitivity. Financials sold off generally and banks in particular, largely on concerns around funding costs and widening credit spreads. Two portfolio holdings that got caught up in the selling were regional banks that were vulnerable on each of these factors, respectively. Texas Capital traded down on fears of rising deposit costs, while Western Alliance shares were down on credit concerns.

As investors fled to more stable areas of the market, our underweight to the utilities sector was a detractor. We are underweight utilities because we believe they currently trade at high valuations despite limited revenue upside and deteriorating allowed returns. Nevertheless, the market bought up utilities, regardless of price, in its search for safety. Accordingly, cyclical consumer discretionary and industrials sectors bore the brunt of investor fears; the portfolio has a sizable overweight to auto suppliers and housing related distributers. Given the concerns about the economy, these consumer-linked industries were a drag on performance in the quarter.

TreeHouse Foods, a food processing company producing private label packaged foods in the consumer staples sector, was a significant contributor. The stock was helped along by enthusiasm for consumer staples names, but on a fundamental level Treehouse represents a good turnaround story as its restructuring brings free cash flow growth increasingly into view.

Portfolio activity undertaken in the fourth quarter improved the overall balance sheet of the portfolio as we favored businesses with lower leverage. We also sought broadly to reduce cyclicality in the portfolio by channeling funds to companies with more resilient business models.

In the energy sector we sold the more commoditized and higher-levered oil services company Forum Energy and added Cactus, which has differentiated products and virtually no debt. We also added three utilities names, aiding our defensive positioning in an uncertain economic and interest rate environment and reducing but not eliminating our underweight to the utilities sector. IDACORP, NorthWestern and El Paso

Electric are all solid franchises that trade at a discount to their peer groups.

We took advantage of volatility in the fourth quarter to add opportunistically in areas we found oversold. In financials, we increased our positions in Western Alliance and Affiliated Managers, finding the skepticism embedded in the fallen stock prices unjustified. We also added to Wintrust Financial on weakness; Wintrust benefits from a strong geographical franchise and dependable execution. Adding to these names served to partially offset the reduction in financials exposure from two regional banks we sold in the quarter, Bank7 and F.N.B.

Portfolio activity undertaken in the quarter improved the overall balance sheet of the portfolio.

In the consumer discretionary sector, we added to truck and auto systems supplier Dana. Dana's attractive balance sheet and promising end markets providing drivetrain, sealing, and thermal-management technologies to the trucking industry should continue to provide value in a more uncertain economic environment. The increase in Dana was funded partly with the sale of Superior Industries, whose higher leverage, weaker passenger vehicle end markets and lackluster execution represented a departure from our original investment theses.

While the fourth quarter revealed signs of a slowdown, we believe the market reaction was disproportionate to the underlying economic data. We do not believe a recession is imminent, but we do expect growth to slow in 2019 as we reach the later stages of the up-cycle and the economy absorbs the benefits of tax cuts. Our portfolio's current positioning is toward companies with stronger balance sheets, more resilient business models and, on balance, less cyclical sensitivity relative to the start of 2018.

Portfolio Highlights

The ClearBridge Small Cap Value Strategy underperformed its Russell 2000 Value Index benchmark during the fourth quarter. On an absolute basis, the Strategy had gains in one of the sectors in which it was invested for the quarter (out of 11 sectors total). The sole contributor to positive performance was the consumer staples sector. The financials, energy and industrials sectors were the main detractors from returns during the quarter.

On a relative basis, the Strategy underperformed its benchmark impacted primarily by stock selection decisions. Stock selection in the financials, consumer discretionary and information technology (IT) sectors detracted the most from relative returns. Meanwhile, stock selection in the consumer staples and real estate sectors were the main contributors to relative performance.

On an individual stock basis, Weis Markets, TreeHouse Foods, Avid Technology, Moog and Crawford were the largest contributors to absolute performance in the quarter. The greatest detractors included positions in Surgery Partners, Superior Industries, Western Alliance, Belden and Texas Capital.

During the quarter, besides new positions mentioned above, we established positions EnPro Industries and Moog in the industrials sector. In addition to sales previously mentioned, we closed a position in Tutor Perini, ACCO Brands and Triumph in the industrials sector, McDermott and Extraction Oil & Gas in the energy sector and PC Connection in the IT sector.