ClearBridge Investments

Sustainability Leaders Strategy

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Key Takeaways

- The U.S. equity market delivered modest gains in the third quarter, overcoming trade tensions and concerns about slowing global growth with a little help from the Federal Reserve.
- The market was led by the more defensive utilities sector, in which the portfolio's relative outperformance was driven by our focus on renewable energy companies.
- Our engagements across the food supply chain seek to reduce greenhouse gas emissions, improve efficient use of herbicides in agricultural production, scale sustainable packaging and smooth labor tensions and delivery logistics.

Market Overview and Outlook

The U.S. equity market delivered modest gains in the third quarter, overcoming trade tensions and concerns about slowing global growth with a little help from the Federal Reserve. A lack of resolution in U.S.-China trade talks continued to weigh on sentiment. Slowing economies in Europe and China and weaker manufacturing in the U.S. as businesses await clarity on a trade deal were also a headwind. In its efforts to calm the markets and sustain economic growth, the Fed reversed its course and cut the federal funds target rate for the first time in a decade. The benchmark Russell 3000 Index rose 1.16%.

Despite trade tensions and some signs of slowing economic activity, the U.S. economy is holding up relatively well. GDP grew at 2.0% in the second quarter, well ahead of other developed countries. Unemployment remains low, wages are rising, and credit conditions remain strong. Manufacturing has slowed, yet the U.S. consumer appears to be standing on solid ground. Tariffs are weakening confidence, according to the University of Michigan Survey of Consumers, but not enough to prevent growing retail spending, as of August data. Volatility picked up in August as recession fears drove bond yields lower.

With two rate cuts and a strong dip in long-term yields occurring in the quarter, more defensive stocks in the utilities, real estate and consumer staples led the benchmark. As active managers, we seek to deliver differentiated performance from the market, and the Strategy's strong relative performance in the utilities sector, where we are focused on renewables, generated a gain of 16%+ versus the sector's 8% return.

Ormat Technologies, a market leader in the geothermal energy industry, delivered another solid quarter of gross margin expansion driven by streamlining operations. Geothermal is a low carbon alternative that consumes less land and water while exerting much lower impacts on the environment, compared with conventional fossil fuel combustion. Ormat's proprietary technology is proving valuable as geothermal grows as a source of base load renewable energy around the world.

Brookfield Renewable Partners, which owns a portfolio of hydroelectric, wind, solar power and storage facilities across the world, was another strong contributor. Brookfield's recent acquisition of 50% of Spanish solar power provider X-Elio added another growth lever for the company, which also maintains an attractive dividend.

Economically sensitive sectors made more modest gains. The Strategy maintains an underweight to the consumer discretionary sector, yet all three holdings in the sector were strong positive contributors to performance. Nike's geographic diversity and strong brand momentum helped it withstand tariff-related pressure felt by many wholesale apparel companies and apparel retailers, and it delivered excellent second-quarter results. A robust employment picture and continued strength in the housing market helped Home Depot maintain its robust financial performance. Meanwhile, Starbucks also rose on strong results and is seeing success moving away from sugary drinks and into its innovative line of premium iced coffees.

The Strategy's information technology (IT) holdings were also strong performers, led by Apple, which revealed three new phones and several other new products in September and announced the monthly price for its video streaming service. We expect Apple to leverage its strong iPhone franchise and benefit from the transition to 5G over the coming years. SolarEdge Technologies, which makes power inverters and optimizers for solar installations, delivered record second-quarter results, driven by European demand, and raised guidance. The company looks to have moved past 2018 choppiness with two consecutive quarters of stellar growth. Lam Research, whose technologies are crucial to the miniaturization of semiconductor technology, which reduces device size and energy consumption for chips, also had a very strong quarter as the current memory cycle looks to be near bottom.

The Strategy's lack of energy exposure was a positive for relative performance during the quarter as the energy sector was under pressure despite a temporary surge in oil prices as conflicts rose in the Middle East.

Health care sentiment has remained challenged due to the political rhetoric over potential changes to the U.S. health care system. The 2020 presidential election is an overhang for the sector and the improving poll numbers for Democratic candidates pushing a "Medicare for All" system specifically hurt UnitedHealth, the nation's largest managed care provider. While UnitedHealth would be hurt by such an overhaul, we believe such a scenario is unlikely. The service innovations the company has put in place are part of the solution to managing health care costs. In fact, government agencies lack the expertise and infrastructure to implement significant changes to health care and would be reliant on providers like UnitedHealth to do so.

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Biotechnology companies such as BioMarin and Alexion have also been pressured by the risk of prescription drug pricing controls. Based on its portfolio and pricing policy, BioMarin has little exposure to many of the proposals floated by politicians. Alexion Pharmaceuticals was additionally hurt by European regulators' failure to approve new patents for its Soliris treatment while a competitor has challenged additional U.S. patents for the drug that addresses rare blood disorders.

Rideshare company Lyft also declined in the quarter as competition in rideshare remains high and a California bill that would require companies like Lyft to reclassify contract workers as employees added another uncertainty on Lyft's path to profitability.

As we enter the fourth quarter, we will continue to monitor the economic developments that have the potential to negatively impact stock prices and growth. We are in a manufacturing recession and are keeping a close eye on how companies are managing through the slowdown to keep it from spreading to other parts of the economy. Tariffs are hitting many companies directly, so any resolution of the U.S.-China trade standoff would relieve pressure.

We continue to integrate sector-specific ESG considerations into our fundamental research process. We believe this integration helps us identify high-quality companies with sustainable business models that will prove resilient over the long term, even in the event of a downturn.

Portfolio Highlights

The ClearBridge Sustainability Leaders Strategy outperformed its Russell 3000 Index benchmark during the third quarter. On an absolute basis, the Strategy had gains in nine of the 10 sectors in which it was invested (out of 11 sectors total). The primary contributors were the information technology, utilities and consumer discretionary sectors. The health care sector was the sole detractor.

On a relative basis, overall stock selection and sector allocation contributed positively to performance. Stock selection in the IT, consumer discretionary and utilities sectors helped relative results the most. In terms of sector allocation, a lack of energy exposure also proved beneficial.

On an individual stock basis, Trex, SolarEdge Technologies, Apple Alphabet and Lam Research were the largest contributors to absolute performance in the quarter. The main detractors from absolute returns were positions in Lyft, BioMarin Pharmaceutical, Alexion Pharmaceuticals, Vestas Wind Systems and Autodesk.

ESG Highlights: Disruption in the Food Industry

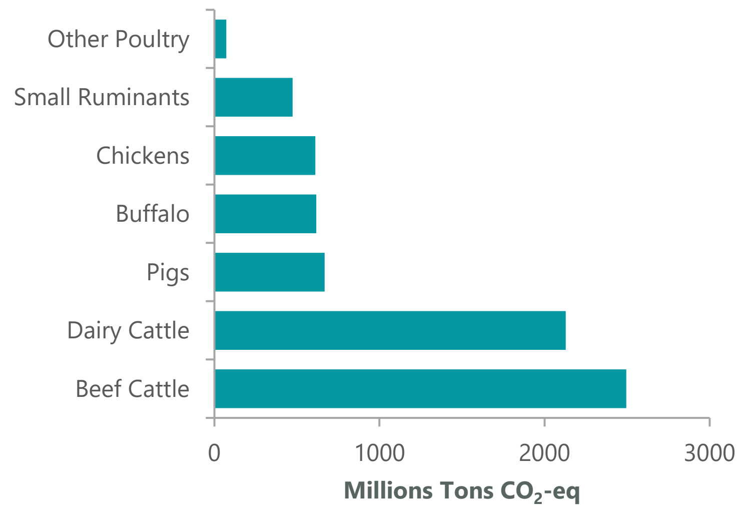
As recent growth of plant-based protein products suggests, there is an appetite for change in the food industry. Many consumers are seeking to reduce the environmental effects of meat production, or just eat less meat, and newly available burgers, hardly distinguishable from real meat but made with pea, soy or potato proteins, are proving to be a popular solution. But the development of plant-based proteins is just one example of how the food industry is being disrupted by innovation that may have environmental and social consequences.

From the field to the table, and increasingly from the restaurant counter to your door, the changing ways we produce, distribute and consume food are creating opportunities and presenting challenges for investors to consider. As an active owner of companies across the food supply chain, ClearBridge is finding economic opportunity in food industry innovation as companies seek to reduce greenhouse gas (GHG) emissions, improve efficient use of herbicides in agricultural production, scale sustainable packaging and smooth labor tensions and delivery logistics. At the same time, it is important to understand these dynamics in a balanced manner and to scrutinize evidence as it arises.

Changing Consumption Habits May Have Environmental Benefits

Arguments against the current amount of meat production focus on the role livestock plays in GHG emissions. One estimate — from a vast 2013 United Nations study and therefore potentially a conservative figure — puts the amount of carbon dioxide equivalent per year produced by livestock globally at 7.1 gigatons, or 15% of all human-produced GHG emissions (Exhibit 1). In addition to the release of GHG emissions, industrialized animal agriculture can also have other environmental impacts such as water contamination from waste (bacteria, chemicals, hormones and antibiotics). Concerns about environmental impact, negative health consequences, high resource use and animal welfare have even encouraged some countries to consider meat taxes, similar to taxes on alcohol and tobacco.

Exhibit 1: Global Estimates of Emissions by Species



Source: Tackling Climate Change Through Livestock, a report by the Food and Agriculture Organization of the United Nations, 2013.

The environmental benefits of plant-based meat products could be significant. A study by Beyond Meat and the Center for Sustainable Systems at the University of Michigan suggests a Beyond Burger generates 90% less GHG emissions, requires 46% less energy, has 99% less impact on water scarcity and uses 93% less land than an equivalent quarter pound of ground beef.

The excitement about plant-based proteins has encouraged traditional packaged food companies to take another look at reinvesting in their somewhat neglected veggie burger brands. Kraft Heinz has reformulated and rebranded its Boca Burger and Kellogg has updated its portfolio of plant-based protein products with the introduction of Incogmeato. ClearBridge holding Nestle is adding its own Awesome Burger to the lineup. Given Nestle's scale and infrastructure as arguably the largest food company in the world, the impact of a plant-based meat product from the company could be considerable.

Additionally, several restaurants have been launching successful limited-time offerings in partnership with Impossible Foods (currently privately owned) and Beyond Meat. In another opportunity to scale plant-based protein, McDonald's recently announced it will offer the P.L.T. (plant, lettuce and tomato) burger with Beyond Burgers.

At the same time, it's important to acknowledge the environmental impacts of large-scale switching to plant-based proteins. These include deforestation, runoff of herbicides and pesticides into ground water and the dangers of monoculture farming, all of which should be considered before accepting meatless "meat" products as a panacea and monitored by investors for risks as plant-based protein businesses grow.

Similarly, the health benefits of switching to meatless burgers may not be so clear cut, as most meatless burgers are heavily processed and high in saturated fat and sodium. At the same time, part of the disruption in plant-based proteins is their increased ability to substitute for meats in vegetarian diets through the addition of vitamins and minerals, such as B12 and zinc (in the Impossible Burger), often found in animal proteins.

Greater internet connectivity on the farm better enables technology-enhanced solutions and, ultimately, more efficient and sustainable agriculture.

Precision Agriculture Reduces Herbicide Use

In a recent engagement with the management of ClearBridge holding John Deere, we discussed how companies in the agricultural supply chain are using technology to improve food production. Deere is a leader in precision agriculture, which applies new technologies in planting, spraying and irrigation tasks to yield more harvest and use less water and pesticides. Its AutoTrac steering system, for example, reads the soil and steers planters to nearly eliminate overlapping passes on the field, reducing unnecessary fuel, seed and chemical use. Similarly, Deere has a technology that improves spraying precision and reduces double-spraying. Its ExactEmerge planter is designed to increase the accuracy of spacing, depth and population of seeds, making for larger and more efficient yields.

In 2017 Deere acquired Blue River Technology, a small company applying machine learning, computer vision and robotics to agriculture. Blue River's precision sprayer, currently in development, uses computer vision and artificial intelligence to precisely spray herbicides only where they are needed. The sprayer is expected to reduce herbicide application rates by over 30% for all major crops, including a 90% reduction for cotton — in our meeting we learned of one field trial for cotton in which herbicide consumption costs declined to $25,000 compared to $250k the previous year. It is slated for a potential 2021 launch.

Since some of Deere's farm equipment innovation relies on connectivity, the lack of broadband coverage in rural areas has been a challenge. ClearBridge holding Microsoft's FarmBeats program is offering one solution in this regard by helping farmers improve their digital technology. FarmBeats is an Internet of Things (IoT) platform that uses unused TV white spaces to create broadband links between a farmer's home internet connections and a solar/battery-powered IoT station on the farm. Greater internet connectivity on the farm better enables technology-enhanced solutions and, ultimately, more efficient and sustainable agriculture.

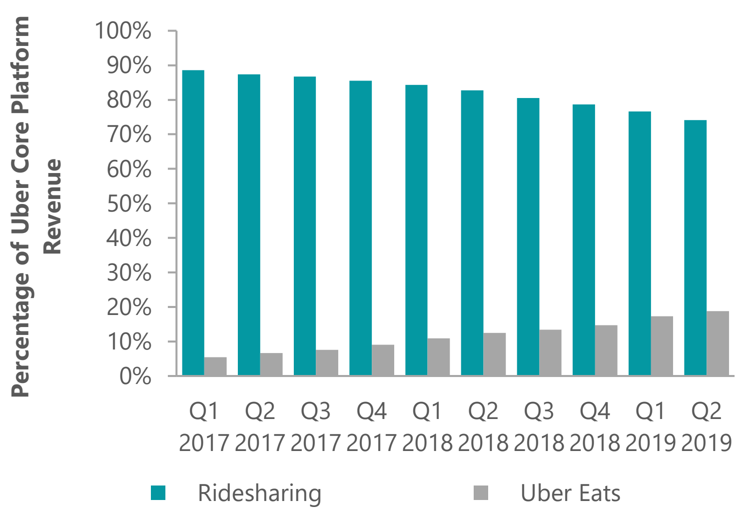
Big Things Could Come in Small Packages

Adapting to fast-changing tastes has typically been difficult for larger, more established players in the food industry, but some are becoming nimbler to better compete with startups and are adding the power of scale to innovation. Nestle's Yes Bar, for example, is a vegan-focused snack bar with plant-based protein designed to appeal to health- and environment-conscious consumers. To meet this market, Nestle developed a sustainably sourced recyclable paper wrapper, the first of its kind that can be used in the high-speed flow wrap machines necessary to produce the product at scale. The paper wrapper also guarantees product quality and freshness over its shelf life. The push from smaller disruptive forces helped enable a confectionary packaging innovation that greatly reduces plastic use in the food industry.

Food Along the Last Mile

The technological disruption that brought us rideshare companies like ClearBridge holding Uber is also enabling a large platform for online food delivery aggregators. For companies with both rideshare and food delivery businesses, the proportionate role of food delivery is increasing (Exhibit 2).

Exhibit 2: Food Delivery Increasingly on the Menu



Source: ClearBridge Investments, Bloomberg LP.

This is not surprising: food delivery sales in the U.S. for online aggregators are taking off. We are now at $20 billion in gross annual sales, just counting DoorDash, Uber Eats, Grubhub and Postmates, to name four of the larger players (Exhibit 3). Sales through these platforms are growing at around 60% year over year. While this is small compared to overall U.S. restaurant sales (which are an estimated $800 billion a year, including delivery, dine in and drive through), the total pie of digital-enabled delivery is slated to grow.

Exhibit 3: U.S. Online Food Delivery Is Growing Steadily

Source: YipitData. YipitData provides informational services for institutional investors and other corporations and entities and is not registered as an investment advisor in any jurisdiction.

At the same time, as online food delivery aggregators are offering enhanced convenience and expanded food selection to consumers, new questions have arisen about food safety and protection for drivers and couriers in the gig economy. Food safety questions run the gamut from whether drivers can maintain correct hot or cold temperatures for food in their cars to concerns around food tampering from couriers. Labor questions surround benefits and pay for delivery drivers and couriers, most of whom are working part-time.

Ultimate success of online delivery companies may depend on the strength of partnerships with restaurants, in effect bringing drivers' incentives into closer alignment with those of the restauranteurs, and the ability to leverage technology to reduce food safety incidents and improve delivery efficiency. ClearBridge holding Grubhub looks to be well-positioned in both regards. Through our regular engagements with Grubhub, we remain in active dialogue on best practices with regards to both food safety and labor relations.

Consumers Are Playing an Increasing Role

The role of the consumer in these changing dynamics should not be forgotten. Consumers voting with their wallets have been successful at changing, or at least helping steer, a whole industry, and this has occurred largely only in the past few years. While a common criticism is that more sustainably sourced foods are usually more expensive and more available to affluent consumers, this situation may be changing, if slowly. ClearBridge holding Costco, is both the largest warehouse food retailer in the U.S. and a top organic food retailer. Given its scale, Costco is making organic and natural food products more price competitive, helping to overcome some cost barriers. At the same time, shopping for organic or sustainably sourced products can be confusing. For example, little consensus and few useful laws regarding organics labelling make determining which products are truly organic a challenge.

From production to consumption, food covers many industries and offers ClearBridge many avenues for understanding and engaging with companies we own both on best practices and on disruptive innovations that are both offering economic opportunities and potential solutions to pressing environmental problems. We continue to work with our portfolio companies to create more ways in which consumers and investors can truly change the food landscape.