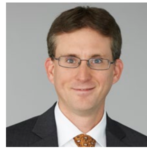
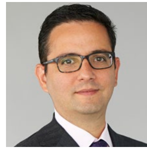
ClearBridge Investments

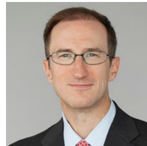
All Cap Value Strategy



Reed Cassady CFA
Director, Portfolio Manager



Albert Grosman
Managing Director, Portfolio Manager



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Managing Director, Portfolio Manager

Key Takeaways

- The catalyst of Vaccine Monday, valuation extremes between growth and value stocks and a rotation in market leadership into traditional value sectors are all indicative that we are transitioning into a new market cycle.
- The global energy transition will require substantial amounts of natural gas, a reality that remains mispriced in the market.
- We are refining our portfolio positioning and composition to reflect more historical levels after using our valuation discipline to take advantage of record high volatility during parts of the last year.

Market Overview and Outlook

We have a Big Bang framework for market cycles. Every market cycle begins and ends with valuation extremes and a change event, typically a crisis. In the beginning, some group of stocks has gotten compressed to extremely depressed valuation levels that are unsustainable. As the old market regime ends this depressed group starts to explode higher in fits and starts and is ultimately the source of new winners as a new market cycle is born.

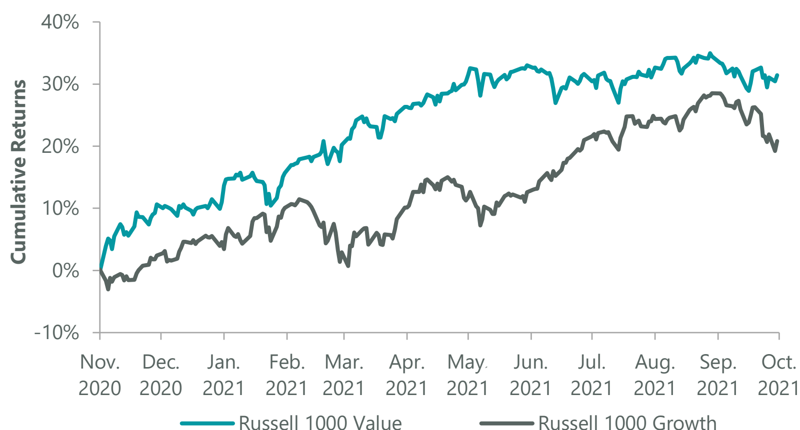
This argument for the primacy of initial conditions is simple and we believe a constant in market cycle arcs between fear and greed. However, markets are a complex adaptive system where simple changes lead to major surprises that make investing so difficult. It is hard to change your mind when hated stocks are hated for good reasons. Typically, the fundamental drivers of hated stocks are extremely challenged, often by an existential threat, and valuations chase these bad fundamentals to historic lows. The added challenge is that hated stocks often start off at the other extreme, having expanded to historic valuation highs in previous market cycles. As a result, the journey between loved and hated status is often a long and painful one. At the beginning of the last market cycle, as a recent example, commodity stocks were loved, and U.S. tech stocks were historically depressed.

Signs of a New Market Cycle Are Increasingly Evident

Just as the real Big Bang has signatures physicists use to observe the origins of the universe, our Big Bang market cycle framework also has distinct signatures. A new market cycle requires a big event that ends the previous market cycle, a catalyst that sparks the new market cycle, valuation extremes that can power returns in both directions, losing stocks that start leading after successfully adapting to change, and a long-term driver of change. We think we are observing all the above, and that it is still early. Our framework observations follow:

- The obvious ending event of the last market cycle was the COVID-19 pandemic and the historic policy response. Few would dispute this, but investors always cling to the comfort of the known past market cycle and resist change. As a result, most investors typically think that once the crisis fully clears, we will get a repeat of the last cycle. This is always possible, but we have never observed a repeat and think it is highly unlikely this time.
- We think the observed spark was "Vaccine Monday": November 9, 2020, when Pfizer announced a dramatic positive surprise on COVID-19 vaccine efficacy results. This catalyst removed a huge amount of uncertainty from the market and restored confidence in an economic recovery and the potential for rapid economic growth as pent-up demand was unleashed on the U.S. economy. Since then, the value index has outperformed growth by over 10%, even with the pause during the recent Delta mutation wave (Exhibit 1).

Exhibit 1: Value Index vs. Growth Index Returns Over the Last Year



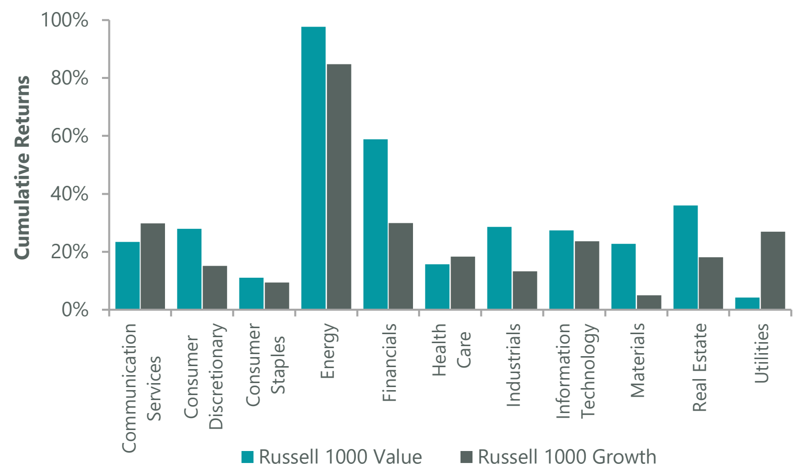
Data shows daily cumulative returns from Nov. 6, 2020 through Oct. 5, 2021.
Source: ClearBridge Investments, Bloomberg Finance.

- We can also see valuations at extremes, which we have examined in previous commentaries. The last market cycle was the worst relative performance period for value stocks relative to growth stocks, with the relative valuation of value reaching an all-time low at the 100th percentile. Even after value's

bounce from Vaccine Monday, the correction from Delta headwinds brought value back close to all-time relative valuation lows. Based on updated work by AQR (we referenced the original AQR research in last year's third-quarter commentary), large cap U.S. value stocks are back to the 94th percentile. In other words, value relative to growth stocks have only been cheaper 6% of the time over the past 40 years, and that 6% took place all in the last year before Vaccine Monday. Inverting this argument, growth and value stocks are priced as if nothing has changed. As a result, you are getting paid an historic amount by value stocks to bet on change, while growth stocks are making an equally extreme bet that nothing has changed. This is possible, but not probable.

- Perhaps the simplest observation is that deeply depressed, losing stocks are starting to lead the market since the catalyst spark. The clear losers from the last market cycle were traditional cyclical value stocks: energy and financials. Since Vaccine Monday the energy sector is leading the market, and financials are also ahead (Exhibit 2). We argue that companies from these two sectors are, in many cases, successfully adapting to change.

Exhibit 2: Value vs. Growth Sector Returns



Data shows cumulative returns from Nov. 6, 2020 through Oct. 5, 2021.
Source: ClearBridge Investments, FactSet. Sector classification based on GICS.

- Finally, we think the big driver of change over the next market cycle will be the trillions of dollars spent on the global energy transition. This will shift the economy from investing primarily in digital investments, like the cloud, to building out physical networks, primarily an intelligent and updated electric grid that can handle the added complexity of renewable energy sources. These projects will be extremely material and labor intensive, driving cyclical growth well above what we experienced in the last market cycle. This will also be one of the biggest investment cycles and transitions in history. The risks and opportunities are massive and underappreciated in our opinion.

Simple changes can lead to major surprises when complex adaptive systems are involved: shifts in supply and demand, the simplest concept in economics, are colliding with the complex system dynamics within the economy and markets. If the dominant macroeconomic risk of the last market cycle was managing deflationary risks from demand shocks, the new market cycle is being challenged by pent-up demand and a severely dislocated global supply chain leading to shortages. The COVID-19 Delta wave slowed the demand recovery but had a much bigger impact on supply. As the Delta wave crests, we expect supply chain issues to start resolving, but pressures will remain well into 2022. The result should hasten economic growth post Delta, as both supply and demand reaccelerate. We think this will put upward pressure on interest rates, which will allow the new market cycle to keep emerging in favor of value.

This brings us back to the energy transition. The focus is on shifting the incredibly complex power supply curve from thermal-based sources of energy to renewable energy, while still allowing demand for energy to keep growing. The complexity of this transition is being underestimated, as evidenced by increasing power shortages and the potential for a full-blown energy crisis this winter. The challenge is that thermal energy supply is being cut back much faster than renewable energy can be delivered, coupled with short-cycle capital discipline and long-cycle underinvestment from oil and gas companies. With demand recovering cyclically, especially post Delta wave, inventories are getting to historic lows and spare capacity is declining. The result is a classic supply cycle for energy, without the usual supply response.

An Active Bet on Emissions Reductions in the Energy Sector

As active ESG value investors, we play a role in supporting the adaption to these massive changes. On the policy front we fully support a global carbon tax, which would provide a vital price signal to markets to generate lower carbon supply and curtail demand and Scope 3 emissions — the real goal. A carbon tax would also generate revenues that will be sorely needed to fund the transition. We have extensively stress tested the portfolio assuming a $150 global carbon tax, which will guide us moving forward on this topic.

We are also actively dialoguing and supporting our portfolio companies to reduce Scope 1 and 2 emissions, while still supplying markets with much-needed, but clean-as-possible thermal energy supply. For example, methane emissions (CH_4) can be directly monitored and minimized and can have an outsized and much faster impact: CH_4 can trap over 100x more atmospheric heat than CO_2, and it dissipates roughly 10x faster.

Cutting methane emissions in half by 2030 could avoid an estimated quarter degree of warming by 2050 and a half degree by 2100.

Complex problems need many adaptions.

One of our main stock picking principles is focusing on companies that can successfully adapt to change. Besides minimizing Scope 1 and 2 emissions, the key adaption for energy companies has been the shift to free cash flow generation, allowing the companies to pay down debt and return capital to shareholders. As this is the first time shale energy companies have ever made money, the irony is that the incredible shale technological breakthrough was a near-death experience for these companies, which burned through over $200 billion in investor capital. Conversely, ESG could be the best thing that ever happened to the shale companies as it restricts investor capital, supports company discipline and forces companies to prepare for terminal demand. The result is that our energy company investments should generate the highest free cash flow and cash dividend yields in the market in 2022. Our largest energy holding, Pioneer Natural Resources, will pay a cash dividend of over 10% while achieving a fortress-like balance sheet that will allow stock buybacks. The ideal market solution is higher energy prices while we transition from disciplined supply, as it will incentivize innovation and smart transition. However, underinvestment could result in energy spikes that derail or delay transition. Complex problems need many adaptions.

The transition will also require substantial amounts of natural gas, a reality that remains mispriced in the market. The most levered to this dynamic in the portfolio is EQT — the largest natural gas producer in North America — which is poised to generate 50% of its market cap in free cash flow by the end of 2023, based on current forward prices. While much of that will go toward debt reduction, a fortress-like balance sheet is in sight, meaning a substantial portion of that 50% will return to shareholders in dividends and share repurchases. Further down the value chain is natural gas pipeline company Kinder Morgan. We expect the company's pipes will remain fuller for longer than currently embedded by the market, as gas plays a vital role in displacing coal power production and in backstopping variable power generation from renewables. Similar to Pioneer, Kinder boasts the fourth-best dividend yield in the S&P 500. Looking forward, the company has a medium-term upside from energy transition initiatives as its assets transport and sequester carbon and longer-term from hydrogen transportation if that fuel takes off as a hydrocarbon alternative.

The result is that the energy sector remains our largest overweight, as we think we are witnessing adaptive change and are getting rewarded for it. Energy transition is effectively driving free cash flow yields that support much higher business values if

they persist beyond the very short term, which we think is much more likely than what market prices currently embed.

The energy transition is also creating long-term options from companies directly involved in rebuilding the grid, electrification and renewables. Our goal is to invest in companies that are already generating earnings and free cash flow that supports current business values and getting the long-term option at an attractive price. Examples include AES in battery storage, Quanta in rebuilding the grid and Eaton in electrification.

Focusing the Portfolio for a New Market Cycle

As the transition to a new market cycle has come into clearer focus, our portfolio turnover has fallen to more normal levels after a historically elevated period. High turnover is to be expected as our valuation discipline allows us to take advantage of volatility, which was at record-high levels during parts of the last year. We also had concentrated turnover in the period after Vaccine Monday as we quickly reacted to the positive surprise. We are also slowly trimming back the number of names as the new market cycle takes shape and uncertainty comes down. Shareholders should expect to see 50 core positions, with active weights from 1% to 4%, and an R&D list of roughly 30 stocks that will either be increased or sold after we get confirmation or falsification of our investment case.

Despite the lower turnover, we still invested in three new names during the quarter where we think price is attractively below our assessment of value: Cisco Systems, General Electric (GE) and Olin.

Cisco is legacy and value tech, which is often a tough combination for stock performance. However, Cisco has been improving its business model dramatically over the last several years as it transitions to a larger mix of software and recurring service revenue. This improvement is working its way into a higher stock price, but the business value is also increasing and remains above the current price. We think revenue growth will accelerate in 2022, unlike many technology companies, as pent-up demand from enterprise customers is unleashed and a new product cycle in 400G accelerates at hyperscaler customers. This combination of an improving business model and faster cyclical growth should further close the price-to-value gap.

GE is an example of an incredibly talented agent, CEO Larry Culp, leading a successful turnaround as he addresses legacy issues and adapts GE to compete over the next market cycle and beyond. The key to adaption in the case of GE entailed fixing the balance sheet, changing incentives from hiding problems to directly addressing them, and driving down costs through Six Sigma improvement. The result should be a dramatic improvement in free cash flow as GE focuses on three major themes: Future of

Flight, Precision Health, and Energy Transition. The key is that GE will continually improve under Mr. Culp, and price should inevitably converge with a rising business value as the turnaround is more fully appreciated.

Olin is another turnaround by a capable CEO, Scott Sutton, but in the chemical space: an industry with a very favorable record of successful turnarounds. The key to success is simply shifting from chasing volume to pursuing profits and free cash flow, specifically in the chlorine derivatives market. Olin's free cash flow has increased roughly five-fold over the past year, and though the pace will slow, we expect further increases in the coming years that are not fully reflected in the price.

Outlook

We think we are observing one of the biggest periods of transition and change in our investment careers. This is resulting in many surprises characteristic of complex systems like markets, but our biggest surprise is that the broad market is still pricing assets as if nothing has changed. This is a huge opportunity for valuation-disciplined investors, like us, who are already being rewarded from the early shift to a new market cycle.

Portfolio Highlights

The ClearBridge All Cap Value Strategy had a negative absolute return for the third quarter and underperformed the benchmark Russell 3000 Value Index. On an absolute basis, the Strategy posted losses in nine of 11 sectors in which it was invested during the quarter. The main detractors from the Strategy's performance were the health care and IT sectors. Positive contributors included the financials and consumer discretionary sectors.

In relative terms, the Strategy underperformed its benchmark during the quarter due to stock selection and sector allocation. In particular, stock selection in the health care, consumer staples, utilities and energy sectors weighed on relative performance. Conversely, stock selection in the consumer discretionary, industrials and financials sectors were positive contributors.

On an individual stock basis, the greatest contributors to absolute returns during the quarter included positions in American International Group, Murphy USA, Quanta Services, Signature Bank and Oracle. The largest detractors from absolute performance were positions in DXC Technology, Covetrus, AES, Western Digital and Suncor Energy.

Besides portfolio activity discussed above, the Strategy exited positions in Arista Networks in the IT sector and KeyCorp in the financials sector.

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