ClearBridge Investments

Mid Cap Strategy

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Key Takeaways

- Lower cyclical exposure proved beneficial as we manage through a manufacturing recession and elevated volatility.
- The portfolio's consumer exposure was a leading contributor during the quarter as our companies have been successful in targeting long-term growth markets.
- We remained active in repositioning the portfolio, adjusting existing positions while adding several new names.

Market Overview and Outlook

Stock performance was mixed in the third quarter as rising risks sparked more volatility and turned investor sentiment decidedly defensive. The S&P 500 Index advanced 1.70% during the quarter while the benchmark Russell Midcap Index rose 0.48% to hold onto a 21.93% return year-to-date. Value stocks ended a long streak of dominance for growth, with the Russell Midcap Value Index (+1.22%) outperforming its growth counterpart by 189 basis points for the quarter.

From a sector standpoint, real estate (+8.22%), utilities (+7.30%) and consumer staples (+6.79%) were the strongest performers, reflecting a rotation into defensive stocks. Health care (-6.42%) and energy (-12.27%), meanwhile, were the worst overall performers.

Volatility spiked over the last three months on the ebbs and flows of U.S.-China trade tensions, attacks on Saudi Arabia's energy infrastructure and increasing signs of a global economic slowdown. Mindful of these risks and the potential impact of a U.S. manufacturing recession, the Federal Reserve cut short-term interest rates 0.25% at both its July and September meetings. Following the September move, Fed Chairman Jerome Powell noted that a still-strong economy and low unemployment are being offset by heightened uncertainty that has hurt business spending.

We have always managed the Strategy with a bias toward companies with high-quality fundamentals. Over the last several years, however, we have realized that solid companies may run into difficulties that can quickly worsen or may take longer than anticipated to implement improvements beneficial to their share price. This wisdom has led us to be more proactive in managing downside risk and quicker to trim or eliminate positions from the portfolio that no longer work. Such increased diligence, in addition to reseeding much of the portfolio with new mid cap companies such as precision test and measurement equipment manufacturer Keysight Technologies, Vail Resorts and data storage provider Western Digital, has supported solid recent performance that continued in the third quarter.

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The companies we own in the consumer discretionary sector in particular have seen a resurgence. The sector was the leading contributor to performance over the last three months, boosted by names like Hasbro. The company has successfully transformed itself from a maker of traditional toys and games into a branded entertainment company by investing in digital games and winning product licenses for many of the leading movie franchises including Star Wars, Disney princesses and Marvel. The new Hasbro is seeing revenues accelerate and benefiting from a better mix of higher-margin products. The portfolio has also seen strong contributions year-to-date from Carvana, whose online platform is disrupting the way consumers buy and sell used cars.

Despite growing recession concerns stemming from a yield curve inversion during the quarter and contraction in manufacturing activity in August and September as measured by the ISM surveys, the portfolio's industrials holdings have also been solid contributors. We have chosen to own a handful of industrials companies that tend to be less cyclical than the sector as a whole. Defense supplier L3Harris Technologies, for example, is enjoying synergies from the completion of its merger of portfolio holdings L3 Technologies and Harris Corp., while Teledyne Technologies and Ametek manufacture critical components in highly specialized markets with high barriers to entry.

Banks could see their lending margins contract with the Fed now cutting interest rates, yet parts of the financials sector, like insurance, are well-positioned. Portfolio holding Arch Capital is benefiting from the first good pricing market for reinsurance in a decade while diversified insurer Hartford Financial has also done well. In a low rate environment where attractive yields are scarce, we also see good opportunities for REITs, including Starwood Property Trust and life sciences-oriented office and lab space owner and operator Alexandria Real Estate.

Health care was the primary headwind for the portfolio in the quarter as negative sentiment continued to weigh on the sector. In addition to pressure on prescription drug prices, concerns are mounting regarding potentially changing policies. This is particularly true with several Democrat candidates advocating either a single payor or government option as an alternative to private health insurance, and is a primary reason why we don't have any health insurance exposure in the portfolio. Alexion Pharmaceuticals was additionally hurt by patent challenges to its Soliris treatment for rare blood diseases. While valuations have become compelling for many companies in the sector, we expect the overhang to remain until there is more clarity on the outcome of the 2020 elections.

Wellcare Health Plans has been a strong long-term performer in health care, but we exited the position in the quarter ahead of its acquisition by rival Centene. In addition to meaningful trims and adds of our existing holdings, we also established two new positions. DXC Technology, in the IT sector, is a consultant and service provider helping companies transition to the cloud and handle related technology operations. The stock had derated to an unsustainable valuation after its latest results and we see it as a grower of free cash flow once the company gets through a slower period of growth. NCR, also in IT, manufactures ATMs and software in a duopoly market where its chief competitor is financially weakened. We believe the expectations for NCR are too low and see promise as it reinvests healthy cash flows in new businesses running point-of-sale equipment for retailers and hotels.

As we enter the fourth quarter, the uncertainties with potential to negatively impact stock prices are only increasing. We are already 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 these companies directly so any resolution of the U.S.-China trade standoff would relieve pressure. This is no time to be taking on undue risk and we feel good about our portfolio of less cyclical companies with greater visibility to end demand and better balance sheets compared to the mid cap market overall.

Portfolio Highlights

The ClearBridge Mid Cap Strategy outperformed its Russell Midcap Index during the third quarter. On an absolute basis, the Strategy had gains in seven of the 11 sectors in which it was invested during the quarter. The largest contributors were the industrials and consumer discretionary sectors.

On a relative basis, overall stock selection contributed to performance. Strong stock selection in the consumer discretionary, industrials and financials drove relative performance. On the negative side, stock selection in the health care, materials and real estate sectors as well as an underweight to real estate detracted from relative results.

On an individual stock basis, Lam Research, Teledyne Technologies, Eversource Energy, L3Harris Technologies and Western Digital were the largest contributors to absolute performance in the quarter. The primary detractors from absolute returns were positions in DXC Technology, Xilinx, Alexion Pharmaceuticals, BioMarin Pharmaceutical and Pioneer Natural Resources.

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