ClearBridge Investments

Small Cap Value Strategy

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Key Takeaways

- The U.S. equities market rebounded in the first quarter of 2019 after the factors that pressured stocks in the fourth quarter mostly reversed.
- Our communication services and energy holdings performed well in the first quarter, while some health care names lagged the market.
- We have tilted our positioning toward companies with stronger balance sheets, more resilient business models and, on balance, less cyclical sensitivity.

Market Overview and Outlook

The U.S. equities market rebounded in the first quarter of 2019 after the factors that pressured stocks in the fourth quarter mostly reversed. Fears of a slowing economy and rising interest rates abated, and sentiment toward economic growth improved, driven by positive signs from U.S.-China trade negotiations and a more dovish stance from the Federal Reserve. Investors shrugged off a 35-day U.S. government partial shutdown and a brief inversion of the 3-month/10-year yield curve, to push stocks higher. The benchmark Russell 2000 Value Index rose 11.93%, lagging its growth counterpart's 17.14% rise. The broader market, as measured by the S&P 500 Index, made its largest quarterly gain since 2009, rising 13.65%.

The Small Cap Value Strategy delivered good results in a period that saw strong performance across the market. Performance was driven by a number of stock-specific drivers, along with broader industry trends. Digital editing software maker Avid was the largest contributor to performance as it delivered solid fourth-quarter earnings and issued strong guidance for 2019 earnings, driven by execution on cost initiatives and improving visibility on cash flows. It has been a year since Jeff Rosica took over as CEO, and the company looks to be on a positive track. Its software is used in the creation of many Hollywood blockbusters, and was used in every best picture nominee at the 2019 Oscars.

Our holdings in communication services also performed well in the first quarter. Gray Television posted solid fourth-quarter results and more importantly gave more details on the expected results of the Raycom acquisition (which closed January 2, 2019). The higher than expected free cash flow generation from faster realization of deal synergies will help Gray Television de-lever its balance sheet quicker than the market previously expected. Gray Television’s station footprint spans multiple competitive states and there is some early excitement about the revenue potential of the 2020 election cycle.

Also in the communication services sector, Iridium operates a global system of satellites for voice and data communications and counts among its clients the U.S. Department of Defense. In February, Iridium completed a period of large capital expenditures — more than $3 billion over almost 10 years — and successfully completed launching its next-generation satellite network. The new network positions Iridium in a growing Internet of Things market and completing the upgrade has allowed Iridium to begin generating meaningful cash flow from its operations, which are driven by mostly recurring and predictable service revenues, and de-levering its balance sheet.

Oil prices recovered after plummeting in the fourth quarter as the trade outlook improved and OPEC maintained previously announced temporary production cuts, boosting energy stocks such as our holdings Apergy, which makes pumps and related equipment for drilling companies, and onshore oil well drilling contractor Patterson-UTI.

Dana, a position we added to in the fourth-quarter and trimmed on strength in the first quarter, was also a top contributor. Dana provides drivetrain, sealing, and thermal-management technologies to the trucking industry; it has a significant exposure to heavy duty and off-road vehicles, which run on different cycles than passenger light trucks, and less exposure to China than its peers. These characteristics should provide for relatively resilient results among auto suppliers in a more uncertain economic environment.

During the quarter we initiated a position in Carter’s, the largest branded marketer in North America of apparel and related products exclusively for babies and young children. Following a tough year in 2018 due to what we believe to be transitory issues, we found valuation to be attractive and earnings growth expectations to be sufficiently reset.

We also initiated a position in Newpark Resources, an oil drilling equipment supplier that focuses on drilling fluids and mats used for temporary access roads. We believe that the company’s differentiated products and potential to expand its market outside the energy sector offers material upside in the stock.

We added to utility company NorthWestern, which provides electricity and natural gas in South Dakota, Nebraska and Montana, as we continue to gain confidence in an improving regulatory environment in Montana as a result of a positive interim rate case ruling in February. We trimmed our position in Weis Markets as we grew more concerned about the competitive

We don't believe a recession is imminent, but we do expect growth to slow in 2019.

environment and resulting impact to margins following the company's strategy to lower prices on broad swaths of its product offering.

Looking ahead, we remain of the opinion that while a recession is not imminent, growth should slow in 2019 as we reach the later stages of the economic cycle and the economy absorbs the benefits of tax cuts. Over the course of the last several months, we have tilted the portfolio's positioning toward companies with stronger balance sheets, more resilient business models and, on balance, less cyclical sensitivity.

Portfolio Highlights

The ClearBridge Small Cap Value Strategy outperformed its Russell 2000 Value Index benchmark during the first quarter. On an absolute basis, the Strategy had gains in all 11 sectors in which it was invested for the quarter. The primary contributors to positive performance were the information technology (IT), financials and real estate sectors. The consumer staples and utilities sectors were the main laggards.

On a relative basis, the Strategy outperformed its benchmark due to stock selection decisions. Stock selection in the communication services, consumer discretionary, IT, energy and materials sectors added the most to relative returns. Meanwhile, stock selection in the industrials sector detracted from relative performance.

On an individual stock basis, Avid Technology, Gray Television, Iridium Communications, Surgery Partners and Dana were the largest contributors to absolute performance in the quarter. The greatest detractors included positions in Hansa Biopharma, Weis Markets, Briggs & Stratton and Heartland Financial.

During the quarter, we established positions Carter's in the consumer discretionary sector and Newpark Resources in the energy sector.