ClearBridge Investments

Mid Cap Growth Strategy

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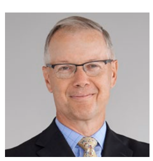

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Key Takeaways

- A host of negative considerations largely overlooked earlier in the year caught up with stocks in the fourth quarter with smaller growth companies bearing the brunt of a sharp decline.
- Defensive consumer staples and similar companies were the leading performers in a difficult market environment.
- We have yet to hear of a material slowdown in economic velocity from our companies. Opportunities remain abundant.

Market Overview and Outlook

Volatility spiked in the fourth quarter, sending U.S. stocks to broad losses as investors fretted over risks related to slowing global growth, China trade relations, rising interest rates and peak corporate earnings. The S&P 500 Index suffered its second-worst December on record (-9.03%) to finish down 13.52% for the fourth quarter and register its first annual loss (-4.38%) since the global financial crisis.

The Russell Midcap Index declined 15.37% for the quarter to finish down 9.06% for the year. Growth stocks were hurt more than value stocks, with the Russell Midcap Value Index falling 14.95% for the quarter compared to a loss of 15.99% for the benchmark Russell Midcap Growth Index. All 11 sectors in the benchmark were lower, with energy (-25.0%), health care (-19.8%) and industrials (-17.9%) stocks underperforming.

The Mid Cap Growth Strategy was not immune from the selling pressure that erased market gains accumulated in the first three quarters of the year. We seek to stay diversified across all sectors and that broad exposure provided a measure of balance during the quarter as our consumer staples companies managed gains while our materials and health care names held up better than similar companies in the benchmark.

Consumer discretionary stocks presented the most significant headwind to performance during the quarter. Online food delivery platform Grubhub was a leading detractor in the sector. Despite better than expected revenue in the latest quarter, additional investment on marketing and expansion caused the company to lower EBITDA forecasts, pressuring a stock that has been a strong performer over the last two years.

Energy also negatively impacted relative performance as lower demand from slowing global growth and oversupply from U.S. shale drillers, Saudi Arabia and Russia contributed to a more than 35% decline in crude oil prices. Both exploration & production and oil service companies suffer in this type of environment with the market only rewarding cash flow positive energy companies that manage capital expenditures.

We believe the investments in the portfolio will continue to demonstrate above-industry growth dynamics.

We believe recent market action reflects a transition to normalized valuations and earnings growth rates as monetary and fiscal stimulus measures are simultaneously removed from the economy. The Federal Reserve raised short-term interest rates for the fourth time in 2018 in December as it continued a path of tightening. Meanwhile, the boost to corporate earnings from late 2017 tax reform is starting to wear off as EPS growth is forecast to decelerate and companies face tougher quarterly comparisons. The uncertainty over trade and tariffs, which is causing corporate managements to delay capex, was another driver of elevated volatility.

Selling pressure provided opportunities to purchase WorldPay, and WellCare Health Plans. WorldPay, in the IT sector, provides credit card and e-commerce payment processing services globally for merchants and financial institutions. We expect WorldPay to continue to benefit from the growth in e-commerce, cross-border transactions and its merger with Vantiv. WellCare, in the health care sector, provides managed care services for government-sponsored health insurance programs including Medicare and Medicaid. We are attracted to the company's valuation and earnings visibility and expect growth to reaccelerate in the years to come.

While inflation has yet to stick at the Fed's target 2% rate, a strong labor market is starting to see wage pressures that could broaden across the economy. Hourly wages rose 3.2% in a very strong December jobs report – the highest rate since 2009 – that saw 312,000 new jobs created, well above expectations. A recovery in stocks could also cause inflation expectations to rise. A recent report from researcher ISI Evercore cites the importance of pricing power should the trade war escalate and add to inflation pressures.

Just as we seek opportunities to add dynamic mid cap companies to the portfolio, the same attention is applied to monitoring the execution and investment theses of our existing holdings. We have been very active over the last several quarters in analyzing our thesis for owning every company in the portfolio and have been disciplined in selling names that no longer work. We closed a position in Affiliated Managers Group in the fourth quarter. The asset manager is facing fundamental challenges to its business that were highlighted by outflows from one its largest affiliates.

The euphoria of earlier this year has vanished, supplanted by investor pessimism about decelerating economic growth. Interest rates are higher (modestly) and for the first time in a long while, cash equivalents provide a nominal return worth considering. Equities have experienced a sharp downward price adjustment, with valuations appearing quite attractive in aggregate for growth businesses. Yet we would caution those valuations are framed by the unknowable, whether trade frictions and slowdowns in major economies are the pause that refreshes or the glissade into 2019 recession.

We have yet to hear of a material slowdown in economic velocity from our companies. Opportunities remain abundant. While there have been some dislocations to a variety of items (such as labor constraints, hurricane disruptions) we believe the investments in the portfolio will continue to demonstrate above-industry growth dynamics.

Portfolio Highlights

The ClearBridge Mid Cap Growth Strategy underperformed its Russell Midcap Growth Index benchmark during the fourth quarter. On an absolute basis, the Strategy had gains in one of ten sectors in which it was invested during the fourth quarter (out of 11 sectors total), consumer staples. The consumer discretionary, information technology and industrials sectors were the primary detractors from returns during the quarter.

In relative terms, overall stock selection detracted from performance but was partially offset by positive sector allocation. Stock selection in the consumer discretionary sector detracted the most from relative returns. The industrials and energy sectors also negatively impacted relative performance driven by stock selection. Conversely, stock selection in the health care sector contributed the most to relative results. Stock selection in materials also contributed to relative performance. In addition, both an overweight allocation and stock selection in the real estate sector added to relative gains.

On an individual stock basis, positions in Grubhub, Fortinet, Aspen Technology, Core Laboratories and United Rentals were the greatest detractors from absolute returns during the fourth quarter. Workday, US Foods Holding, Varian Medical Systems and SBA Communications Corp were the largest contributors to absolute returns.

During the fourth quarter, we initiated positions in Worldpay in the IT sector and WellCare Health Plans in the health care sector and closed a position in Affiliated Managers Group in the financials sector.