ClearBridge Investments

Sustainability Leaders Strategy

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Key Takeaways

- Our diversified approach to portfolio construction, balancing technology names with more cyclical and defensive stocks, helped the Strategy outperform in the third quarter.
- As lockdowns eased and demand recovered, smaller manufacturers retooled to operate safely in a COVID-19 environment, making positive contributions.
- Developing the energy grid of the future will require an ecosystem of renewable energy innovators and adopters, and several ClearBridge holdings are playing a role.

Market Overview and Outlook: Diversification Is Delivering

U.S. equities overcame rising coronavirus infections, a slowing economic recovery and a sharp selloff in technology stocks in September to finish the third quarter with robust gains. Strong market returns came as the Federal Reserve increased its accommodative stance, supporting asset prices, and Congress pushed through large amounts of fiscal stimulus, which buoyed personal income and consumer spending.

The benchmark Russell 3000 Index rose 9.21%, ahead of the large cap S&P 500's 8.93%. The portfolio's exposure to renewable energy and our diversified approach to portfolio construction, balancing information technology (IT) names with more cyclical and defensive stocks, helped the Strategy outperform its benchmark and the large cap universe handily.

Economic data showed signs of a slowing recovery. Unemployment has dropped and the U.S. has brought back roughly half of the 22 million jobs lost at the beginning of the pandemic, though hiring gains have decelerated. Initial jobless claims remained over 800,000 for a fifth straight week as of September 26 and surveys are showing manufacturing expansion has slowed.

The resilient U.S. consumer, buoyed largely by stimulus, saw household income fall sharply in August as unemployment benefits were reduced. Unemployment benefits have helped prop up consumer credit as well as retail-related areas of the economy.

A confluence of work-from-home, swelling demand for renewable energy and recovering cyclicals in the industrials and materials sectors was responsible for much of the Strategy's well-balanced outperformance in the third quarter. Apple continued to thrive, driven by strong showings from its Mac and iPad businesses. The growth of wearables and software services, and the prospect of a 5G iPhone, point to further upside.

The growth of renewable energy was a common thread among many strong contributors; the portfolio has direct exposure to this theme across the IT, industrials and utilities sectors. SolarEdge Technologies, which makes power inverters and optimizers for mainly residential solar installations, was up 74% in the quarter. Enphase Energy (up 79%), a position we added earlier this year and also in IT, makes another type of inverter for residential and small commercial solar photovoltaic systems. We discuss both further, along with important trends in the renewable energy ecosystem, in this quarter's ESG Investment Program commentary.

In industrials, leading wind turbine maker Vestas Wind Systems was up 59% on strong demand, while utility Brookfield Renewable gained 39%. Through our ownership of such companies driving a global shift to renewable energy, ClearBridge is finding economic opportunity in technologies that will also help the planet. By extension, the Strategy's lack of energy holdings was a significant boon in a quarter that saw several oil majors announce investments in renewables amid depressed oil prices; the energy sector fell over 18% in the benchmark index.

Elsewhere in industrials, as lockdowns eased, demand recovered and manufacturers retooled to operate safely in a COVID-19 environment, small and mid cap names like office furniture maker Herman Miller and wood alternative decking products maker Trex had strong quarters. In materials, Ball, the largest manufacturer of recyclable aluminum beverage cans in North America, also performed well as home consumption trends stayed steady and retail stores reopened in international markets.

Vital Farms, a new addition to the portfolio via its initial public offering, was also a lead contributor. Vital Farms is an ethical food maker offering organic pasture-raised eggs. The company requires its partner farmers to allot at least 108 square feet per hen, giving the hens ample room to roam and giving the land time to rejuvenate without pesticides or herbicides.

The only area the Strategy was down in absolute terms was health care, where two biotechnology holdings saw headwinds. BioMarin Pharmaceutical had a delay for hemophilia drug valrox, one of its key pipeline programs, although we believe this product will eventually be approved and become an important growth driver. Gilead Sciences shares were down as hopes of a coronavirus treatment cure-all moderated and Gilead reported a soft second quarter. At the same time, Gilead also announced a strategic acquisition of Immunomedics, which recently launched a very promising therapy for a variety of cancer indications, and we expect the move to be a positive for the company going into 2021 and beyond.

> Improving efficiency can have a meaningful impact on GHG emissions.

One of the ways the portfolio seeks to make an impact on climate change is through companies that offer the world ways to be more energy efficient. Our other new position, Regal Beloit, designs, manufactures and sells electric motors and controls. With motors consuming 45% of global electricity production, Regal Beloit's focus on improving efficiency can have a meaningful impact on GHG emissions. Other sustainability themes driving growth in the business are electrification and digital connectivity, as Regal Beloit's products enable higher water and chemical reduction in manufacturing, and carbon dioxide and nitrogen oxide reduction versus traditional alternatives. New management is focused on improving profitability and returns on capital, which we see as a significant opportunity for shareholders.

We sold two positions during the quarter: Alexion Pharmaceuticals' main franchise is facing patent expirations and competitive threats that we believe will keep the multiple from expanding meaningfully from current levels. Attempts at diversification have had mixed results. Commercial real estate services company Jones Lang LaSalle is facing a turbulent commercial real estate landscape due to the global pandemic and we are concerned that the demand environment could be weak for an extended period.

Despite a pandemic-induced recession and myriad challenges to the economy, equity markets have on the whole recovered well, and we have found some opportunity to trim some of our better-performing stocks, in technology in particular, and reinvest in areas across the portfolio where we see better risk/reward.

Our conversations with companies on their responses to the pandemic, as well as their efforts to foster diverse and inclusive workforces, have been encouraging. The strength of the portfolio thus far through a volatile period is consistent with our experience that companies with strong balance sheets, high returns, sustainable cash flows and leading ESG profiles should perform well in periods of market turbulence. Uncertainties surrounding COVID-19 and the U.S. presidential election notwithstanding, we see plenty of positive drivers for high-quality companies with leading sustainability characteristics.

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 10 sectors in which it was invested (out of 11 sectors total). The main contributors were the IT, industrials, consumer staples 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 staples, industrials and utilities sectors contributed positively, while the Strategy's lack of exposure to the energy sector also added to relative results. Conversely, stock selection in the health care and consumer discretionary sectors detracted.

On an individual stock basis, Apple, SolarEdge Technologies, Vestas Wind Systems, Vital Farms and Enphase Energy were the largest contributors to absolute performance in the quarter. The main detractors from absolute returns were positions in BioMarin Pharmaceutical, Gilead Sciences, Automatic Data Processing, Ormat Technologies and Alexion Pharmaceuticals.

During the third quarter, portfolio holding Brookfield Renewable Partners (BEP) created a C-Corp, Brookfield Renewable Corporation (BEPC), with BEP shareholders receiving one BEPC share for every four units owned of BEP. We received and retained these shares in the portfolio.

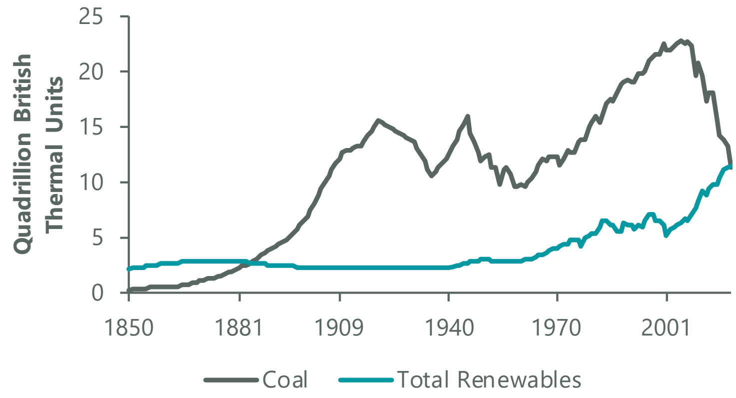
ESG Highlights: An Ecosystem of Renewable Energy Is Thriving

Recent developments in the energy and power sector suggest 2020 might be a watershed year for renewable energy and efforts to reduce carbon emissions. Forecasts for global oil demand have declined; the cost of wind and solar have fallen to levels nearly on par with fossil fuel energy sources; and investors have fled the traditional energy sector while boosting stocks tied to renewable energy.

Governments around the world also continue to raise their ambitions for carbon reduction. For example, the EU is now looking at 55% reductions by 2030 (versus 40% previously), and China set a new goal to achieve net-zero carbon emissions by 2060. Renewable energy consumption recently surpassed coal for the first time since the 19th century (Exhibit 1).

It is too early to tell if this pace of change will continue, but we expect to see a steady tide of renewable energy sourcing from several quarters. As an active owner of companies across the renewable energy ecosystem, ClearBridge is finding economic opportunity in an array of innovators and adopters that are enabling this surge and helping the world transition to a less carbon-intensive future, maybe sooner than we think.

Exhibit 1: U.S. Renewable Energy Consumption Surpasses Coal



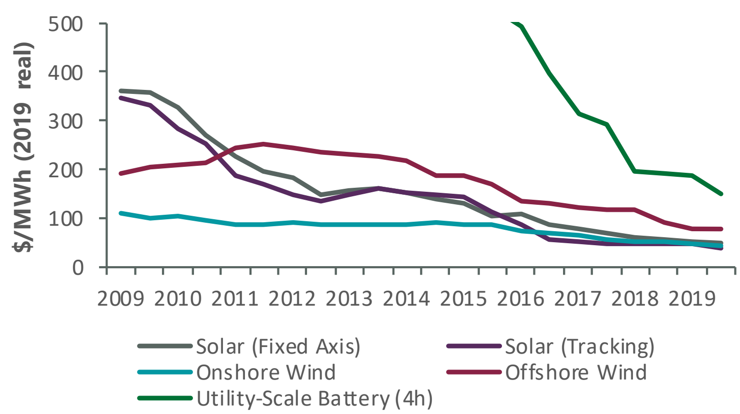
As of May 28, 2020. Source: U.S. Energy Information Administration. Renewables prior to 1890 from wood and biomass; hydroelectric added in 1890, geothermal in 1960, biofuels in 1981, wind in 1983 and solar in 1984.

Corporate Demand for Renewables Only Getting Stronger

Many companies held across ClearBridge portfolios have set aggressive targets for lowering emissions through use of renewable energy. Earlier this year, Amazon.com announced it is on track to run on 100% renewable energy by 2025, five years ahead of schedule, while Microsoft announced it expects to be carbon negative and beginning to remove the carbon it has emitted since its founding, by 2030. The ambition of these measures is made possible by falling costs of renewable energy (Exhibit 2).

Demand for renewable energy has continued to grow even through the pandemic, according to ClearBridge holding Brookfield Renewable. Brookfield Renewable's globally diversified, multi-technology renewables business, including a large hydro fleet, is well-positioned to help companies achieve decarbonization goals and makes Brookfield an attractive partner as more business and governments seek to lower their emissions.

Exhibit 2: Falling Costs of Renewable Energy Enable More Ambitious Initiatives



As of May 20, 2020. Source: Bloomberg New Energy Finance.

Commitments by large companies to increase renewable energy sourcing are felt through their supply chains, providing a competitive advantage to environmental forerunners and encouraging others to catch up. Data center provider and ClearBridge holding Equinix, for example, is a leader in renewable energy sourcing. In a recent engagement with Equinix, we discussed how several large customers that have announced their own targets around renewables and lowering carbon emissions were in some cases prioritizing Equinix data centers over competitors as it allowed them to get closer to their goals. Accordingly, we believe Equinix's goal of reaching 100% of energy sourced by renewables will be a positive for business.

Favorable Economics and Innovation Driving Solar Adoption

Brookfield Renewable has also been adding utility-scale solar in its energy mix. Solar costs have dropped in the past five years from $4 per watt to install to less than $1 per watt, according to the company, which believes solar could account for most of the its production capacity in 10 years' time (it is less than 20% today).

On the residential side, innovation by ClearBridge holdings SolarEdge Technologies and Enphase Energy, along with cheaper panels, is enabling more adoption by homeowners. SolarEdge makes solar inverters and optimizers for residential and commercial solar photovoltaic (PV) systems. SolarEdge's system combines power optimizers on the back of each solar panel on the roof (known as "module-level power electronics," or MLPE) with a string inverter on the side of the building (which converts the direct current power produced by the solar modules to usable alternating current).

Enphase was the first company to commercialize microinverters for residential and small commercial solar PV systems. A microinverter, a type of MLPE, is a small inverter placed directly on the back of each solar module, as opposed to the traditional system of one string inverter on the side of the building.

MLPEs improve the efficient energy capture of a solar PV system by performing maximum power point tracking at the module level, rather than at the array level (all modules combined). They also allow greater flexibility in how modules are installed, in terms of angle, type and number, so houses with multiple roofs at different angles can use more surface area and capture more energy from it.

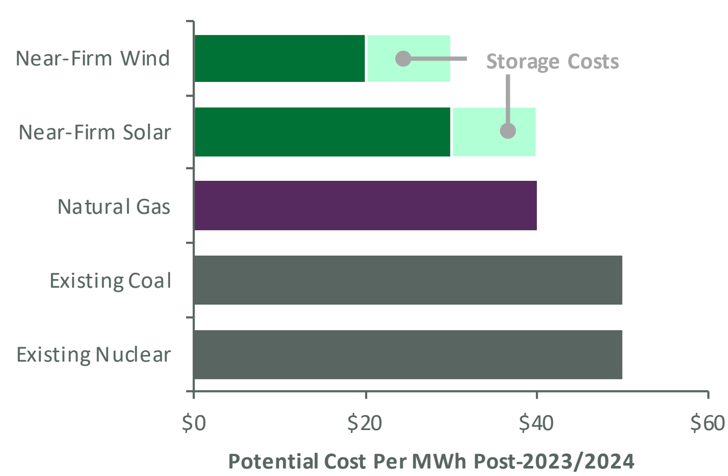
Storage Next Big Question for Renewables

While good for the planet, renewable power has two main shortcomings: an inability to "match" power consumption peaks and variability of renewable power production driven by weather dependency. California rolling blackouts in August amid record-high summer temperatures, low winds and lower imports of power from neighboring states underscore these drawbacks of renewables and highlight the importance of storage/battery capacity for a reliable power grid.

Renewable energy paired with storage is an increasingly attractive option, and one which utility companies have begun to offer. While most battery technologies today offer only a few hours of power storage, the “near-firm” renewable power resources (solar or wind plus battery that can provide power that is nearly firm, or nearly around the clock) could help alleviate some of the impacts from grid outages, especially urgent in regions currently facing generation shortages. Solar and storage is now cheap enough that it is replacing inefficient peaking units — power plants that run only when there is a high demand for electricity, in order to balance the grid.

Storage remains a focus for several ClearBridge utility holdings, such as NextEra Energy, whose unregulated NextEra Energy Resources segment has the largest battery storage capacity in the world. NextEra Energy believes near-firm renewables will be competitive with all the traditional generation technologies as of 2023–2024 (Exhibit 3). The company’s project pipeline has 2.2GW in battery storage under development and battery storage investments in 2021 are expected to exceed $1 billion. It expects the continued innovation by the automotive industry, improvements in converters and enclosures, and lower balance of system costs to drive down the cost of energy storage by ~16% CAGR between 2020 and 2023.

Exhibit 3: Even with Addition of Storage, Renewables Are Cost Competitive



As of Sept. 2020. Source: NextEra Energy. Represents projected cost per MWh for new build wind, solar, and natural gas; excludes production tax credit for wind and assumes 10% investment tax credit for solar; projected per MWh operating cost including fuel for existing nuclear and coal; based on NextEra Energy internal estimates.

Yet overall renewables remain intermittent, and while storage improves availability of renewable assets, the combination cannot beat high 90% availability of baseload gas or nuclear plants, at least in the near term. The grid of the future should have a much higher presence of renewables, although a full elimination of the traditional sources of power will likely require some major breakthroughs in storage technology.

Many Businesses Can Thrive in Transition to Renewable Energy

As efforts to combat climate change become more urgent, it is encouraging to see the increasing scale of commitments by corporations as well as state and city governments. Developing the energy grid of the future, which will have to support more cars, trucks and buses transitioning to electric motors, will require an ecosystem of renewable energy innovators and adopters. ClearBridge will continue to seek out and engage with leading companies that can thrive as we progress toward a net-zero future.