ClearBridge Investments

Large Cap Value Strategy

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Key Takeaways

- A rebound in cyclical stocks that was jumpstarted with the announcement of successful COVID-19 vaccine trials and national election results in November 2020 continued in the first quarter of 2021.
- In a stimulus-driven cyclical rebound, our quality approach to value helped the portfolio to perform well while trailing the benchmark, which was led by lower-quality and commodity-exposed companies.
- While reducing in health care and consumer staples, we increased our exposure to high-quality names in economically sensitive areas of the market that should benefit from a reopening of the economy and a financially healthy consumer eager to spend.

Market Overview and Outlook

A massive government stimulus plan, combined with the Federal Reserve's commitment to low interest rates, and encouraging developments in the fight against the COVID-19 pandemic drove a strong quarter for U.S. equities. A rebound in cyclical stocks that was jumpstarted with the announcement of successful COVID-19 vaccine trials and national election results in November 2020 continued in the first quarter of 2021. The Russell 1000 Value Index returned 11.26%, well ahead of the Russell 1000 Growth Index's 0.94% advance, making up significant ground for the one-year period.

A surprise outcome in the Georgia runoff elections in January secured the Democrats a slim majority in the Senate and control of Congress. The result was a smoother path to extraordinary stimulus under the assumption that big spending should lead to robust economic growth. Relief payments in December were followed by a $1.9 trillion package in March. The massive spending free-for-all coincided with an accelerating rollout of COVID-19 vaccines, while case counts declined after a year-end holiday travel spike. In the meantime, vaccinations in Europe continue to encounter fits and starts, further delaying reopening on the continent. Concerns also remain regarding more contagious variant strains of COVID-19 across the globe, although existing vaccines appear to be sufficiently effective to meaningfully lower hospitalization needs, all else equal.

Meanwhile, the consequences of unprecedented government spending loom over markets; growing deficits and concerns over rising inflation led to periodic drawdowns in the quarter, while a steepening yield curve resulted in many growth stocks selling off.

Amid easing business restrictions and accommodating fiscal and monetary policies, the U.S. economy picked up steam, with business confidence and new jobs numbers increasing each month. The ISM Manufacturing PMI reached 64.7 in March, driven by the strong new orders subindex of 68, the highest readings since 1983 and 2004, respectively.

In a stimulus-driven cyclical rebound, our quality approach to value helped the portfolio perform well while trailing the benchmark index, which was led by lower-quality and commodity-exposed companies.

Lead performers in the portfolio included Deere, which delivered a phenomenal first fiscal quarter ended in January and revealed impressive and previously undisclosed margins in its large equipment segment. Investors also welcomed Deere's strong pricing power and technology leadership, particularly in precision agriculture, where it has separated itself from competitors. Already strong demand for semiconductors bolstered further by Intel's announcement that it would build two new chip factories in the U.S. contributed to a sharp rally in semicap equipment companies, benefiting our holding in Lam Research during the strong quarter.

Our underweights in health care and staples contributed to relative performance during the period. As we continue to focus the portfolio on high-conviction ideas, we sold CVS and Pfizer in late 2020 and Novartis and AmerisourceBergen in the first quarter; all happen to be in the health care sector. We also prefer to act with some caution in a sector where regulatory risks persist. In consumer staples, we are broadly finding valuations uncompelling and sold Keurig Dr Pepper during the quarter. These active tilts were based on company specifics as well as our belief that an environment of substantial fiscal stimulus and easy monetary policy should be particularly supportive of more economically sensitive opportunities.

While reducing in health care and consumer staples, we increased our exposure to high-quality names in economically sensitive areas of the market. We added to low-cost, high-quality energy names Enterprise Products Partners LP, Chevron and ConocoPhillips; we are positive on these companies' strong balance sheets, competitive positions and exposure to an economic recovery. In financials, we increased our position in Capital One on the premise that a benign consumer credit environment should be sustainable in light of unprecedented government support. We also added to Charles Schwab, which continues to grow its business with impressive new account wins and should be a substantial beneficiary of higher interest rates.

New positions that should thrive in a reopening of the economy and a financially healthy consumer eager to spend include: Booking Holdings, an online travel agency with industry-leading margins and a dominant footprint in Europe; TJX, an off-brand retailer with a strong presence in the U.S. and Europe that should continue to benefit from the demise of traditional retailers, particularly as consumer spending resumes; and NXP Semiconductors, a large diversified supplier of semiconductor solutions to a variety of customers, primarily the automotive and industrial end markets, which is positively leveraged to the growth of both electric vehicles and autonomous driving.

As we actively manage holdings and position sizes, we are able to regularly recycle capital into more compelling opportunities.

We also added to Sempra Energy at what we believe to be a very attractive valuation. We view Sempra as a best-in-class utility with regulated assets in California and Texas. Both states offer attractive regulated returns and high-single-digit growth as the states transition to renewable energy sources. Sempra is also in the process of separating its infrastructure assets that include its Mexican and liquefied natural gas operations into an entity whose value was highlighted shortly after quarter end via an announced but yet to be closed sale of a 20% stake to KKR.

As we actively manage holdings and position sizes, we look to regularly recycle capital into more compelling opportunities. Maintaining our valuation discipline, we sharply reduced our position in Apple, whose shares more than doubled following our initial purchase in mid-2019 with an earnings multiple rising from the low-to-mid teens to nearly 30x. Similarly, we have materially reduced our exposure to Microsoft over recent quarters, purely based on valuation, as company fundamentals remain robust.

The portfolio's quality bias and valuation discipline have generated compelling returns over time with typically strong relative results in more challenging environments as it did through the first three quarters of 2020. However, that same quality bias tends to create a more challenging relative performance environment for the Strategy during periods of sharp economic acceleration, which tend to benefit stocks that are more commodity linked or of lower quality. This has been the case during the vaccine- and stimulus-driven rally experienced late last year and during the most recent quarter. Sectors that lagged in the quarter included communication services, where Charter and T-Mobile trailed after generating robust returns earlier in the recovery, as well as information technology (IT), where TE Connectivity performed well but trailed the sector in the first quarter after a strong 2020. Within industrials, United Parcel Service and Honeywell also lagged in the quarter after previously generating strong returns over extended periods.

Looking ahead, we are cognizant of the risks attending an environment of aggressive government stimulus and accommodative central bank policy. While it can be a challenge to find attractive opportunities in a rebound without sacrificing the quality of the portfolio, we have been able to achieve this and will continue to focus on high-quality companies that we expect will deliver superior returns over the long term.

Portfolio Highlights

The ClearBridge Large Cap Value Strategy underperformed its Russell 1000 Value Index benchmark during the first quarter. On an absolute basis, the Strategy had gains in 10 of 11 sectors in which it was invested for the quarter. The strongest contributions came from the financials, industrials, energy and IT sectors. The consumer staples and utilities sectors were the sole detractors.

On a relative basis, overall stock selection detracted from performance, while sector allocation was a positive. In particular, stock selection in the communication services, industrials, energy and IT sectors detracted from relative returns. Conversely, underweights to the health care and consumer staples sectors proved beneficial.

On an individual stock basis, the largest contributors were Deere, Bank of America, JPMorgan Chase, Lam Research and American Express. Positions in Charter, T-Mobile, Edison International, Qualcomm and Merck were the main detractors from absolute returns in the quarter.

Besides positions discussed above, during the quarter we added Cisco Systems in the IT sector and sold Suncor Energy in the energy sector.