ClearBridge Investments

All Cap Value Strategy

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Key Takeaways

- A perceived shift in monetary policy and the emergence of the Delta variant has put a pause on the cyclical and value rotation, creating an opportunity for valuation-driven strategies.
- We expect an ESG-driven value cycle as the environmental focus of ESG will marry digital technologies with capital- and resource-intensive investments in green infrastructure.
- The portfolio remains diversified among the most attractive current valuation opportunities in the market: financials, energy, consumer recovery plays and large cap biotech and drug stocks.

Market Overview

With broad U.S. indexes near all-time price highs and index valuation levels matched only by the 2000 equity bubble, one might think there is no fear in the market. This is certainly true when you look at the dramatic current excesses reflected in meme stocks, where the prevailing mantra is literally You Only Live Once (YOLO). When it comes to meme stocks, fear, along with historic artifacts like fundamentals and valuation, is reserved for losers. However, with indexes and meme stocks getting all the attention and priced for perfection, and in some cases absurdity, there is fear and disbelief priced into many traditional value stocks. Fear, especially when it is more than fully reflected in a stock's current price, can be a powerful driver of future returns. Yes, you do have to have some faith that valuation will ultimately matter again, but the greatest attribute of any disciplined investment when markets are showing extreme behavior is that it helps you avoid folly and the inevitability of future pain. In this letter we will leave the preaching on current market excesses to the always-noisy market bears and focus on the ongoing opportunity for valuation-driven strategies like ours.

In general, the biggest benefit of fear for valuation-driven investors is that it tends to lead to overreaction, with fear-driven selling driving stock prices well below business value. This behavioral response reached historic intensity over the past few years of value winter, as discussed in our previous letters. Despite the more recent rebound in favor of value, there is lingering trauma of being a value investor after such a painful market cycle. This was on full display in June as two things triggered fear-driven selling of cyclical and value stocks: a perceived shift in monetary policy to a more hawkish stance and the emergence of a much more infectious Delta COVID-19 variant. We think the market is overreacting a bit to both.

COVID-19 Variants and Fed Policy Weigh on Cyclical and Value Stocks for the Moment

To us the Delta variant is a bigger concern, as the increase in infections and lower vaccine efficacy is resulting in rising COVID-19 cases globally. However, the data shows that vaccines and prior infections do a very effective job in lowering severe cases. This effectively decouples rising infections from the rate of hospitalizations and death in areas with sufficient vaccination rates and prior infection levels. Thus, we do expect some slowing and delay in the global economic recovery from the Delta variant, but no major slowdown in big developed economies like the U.S., the U.K., the EU and China. Economic growth will still be much faster than what we experienced over the last decade, and the recovery is still very much underway while being modestly delayed in areas with lagging vaccination rates.

On the monetary front, in June the Federal Reserve acknowledged that inflation was temporarily running hot and that if inflation proved to be anything but transitory the Fed would act to cool it. No actual activity was taken: Fed bond buying wasn't tapered from its recent torrid pace, and any increase in short-term interest rates is still expected to be a late 2022 event at the earliest. Yet the change in tone had a powerful effect as interest rates tumbled across the yield curve, with real interest rates sinking to levels not seen since the European debt crisis (Exhibit 1). Ironically, rather than taking away the punch bowl, which has not even been touched, this lowering of rates will add stimulus to rate-sensitive economic activity like housing by anchoring mortgage rates at historic lows.

Exhibit 1: Real Interest Rates

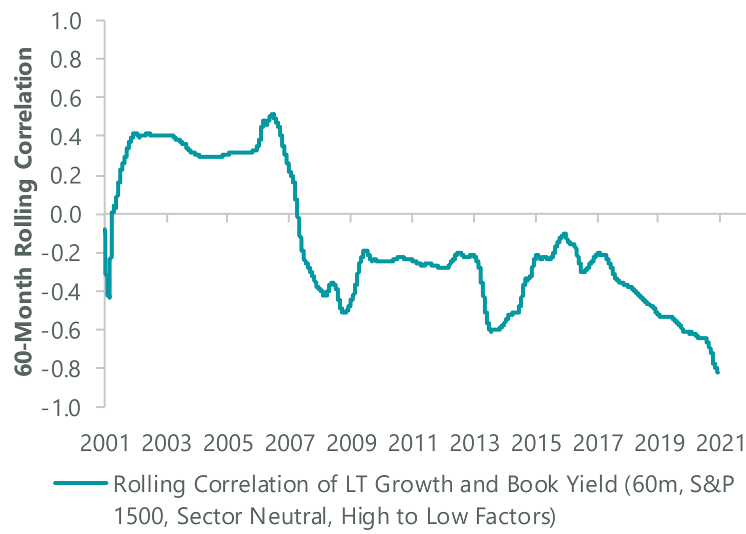
As of July 13, 2021. Source: ClearBridge Investments, Bloomberg Finance.

Interest Rates Central in Growth-Value Swings

Meanwhile, the relative performance battle between value and growth stocks rages on, with the level of interest rates being a deciding factor. In simple terms: most value stocks are highly correlated and major beneficiaries of higher interest rates, while growth stocks enjoy the opposite relationship. Currently, this performance battle is exhibiting extreme levels on two fronts:

First, the negative correlation between growth and value is at historic and almost binary levels, which explains the speed and intensity in recent shifts between the two style camps (Exhibit 2).

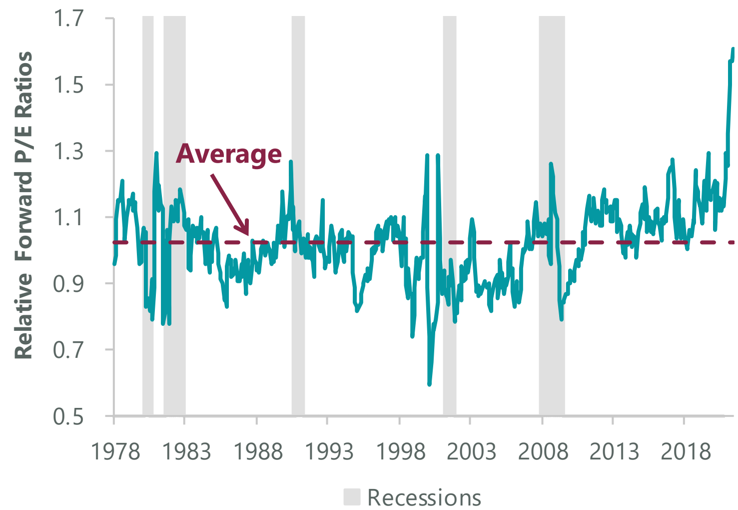
Exhibit 2: The Correlation of Value and Growth Has Never Been Lower



As of July 7, 2021. Source: Cornerstone Macro.

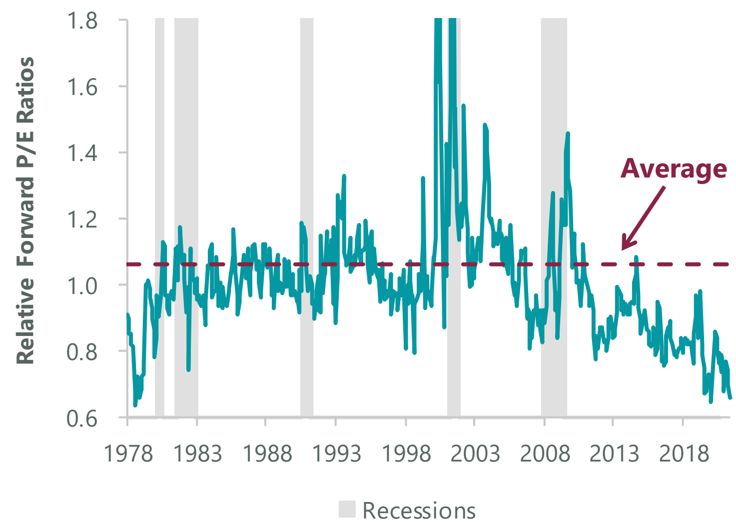
Second, the valuations of growth-tilted stocks that benefit from lower rates have spiked to bubbly levels versus history, while the rate-sensitive value camp is near the trough levels that marked the lowest relative valuation level for value in history, as we detailed last year (Exhibits 3 and 4).

Exhibit 3: Relative Valuations of Stocks Positively Correlated with Treasurys (Lower Yields)



Source: National Bureau of Economic Research, Empirical Research Partners Analysis. The chart shows the relative forward P/E ratios (cap weighted) of the quintile of large cap stocks with relative returns most correlated with 10-year U.S. Treasury bond market performance (measured over trailing 126 days). Stocks positively correlated with Treasury returns are expensive.

Exhibit 4: Relative Valuations of Stocks Negatively Correlated with Treasurys (Higher Yields)



Source: National Bureau of Economic Research, Empirical Research Partners Analysis. The chart shows the relative forward P/E ratios (cap weighted) of the quintile of large cap stocks with relative returns least correlated with 10-year U.S. Treasury bond market performance (measured over trailing 126 days). Stocks negatively correlated with Treasury returns are cheap.

Growth Stocks More Dependent on Macro Outlook

One of the benefits of investing in stocks with extremely low embedded investor expectations, which is currently the case for the value stocks we own, is that you are essentially asking very little of the future. The benefit of having modest expectations in a stock's price is that it makes a valuation-disciplined portfolio much less sensitive to forecasting an uncertain future. In addition, you can make very solid returns if the prevailing forecast turns out to be wrong, which is most often the case. After this recent reset in prices, the value stocks we own now just need an average economic recovery to continue and the Delta variant cases to crest. We expect both outcomes to occur as the current turbulence for value clears.

Conversely, with real interest rates falling to crisis-level lows and growth stock valuations spiking to historic highs, these extreme levels are highly dependent on the current forecast for low interest rates forever playing out. This arguably makes growth stocks more dependent on the macro outlook than cyclical value stocks.

If rates do indeed stay low and the COVID-19 recovery will have been just a short-term affair as the market is increasingly reflecting, than we will need to adjust the portfolio on the edges and reduce our bet on the recovery, primarily by reducing consumer discretionary recovery plays. This scenario should be welcome by most investors, as it will allow them to stay positioned for the comfortable norms of buying long-duration growth stocks and bonds at very elevated levels versus history. However, investors must recognize that this is an aggressive bet on what is familiar and leaves very little room for error if we are indeed in a new market cycle. We think investors may be underreacting to the risk that things have indeed changed, and we expect the comfortable patterns of the past growth cycle to continue to give way to something different. Why is that?

Massive Policy Shift and Pent-Up Demand Will Sustain Recovery

As discussed in previous letters, we still think investors don't fully appreciate the massive shift in policy, especially on the fiscal front, which has left U.S. consumers with over $2 trillion in excess savings. This savings is fueling pent-up demand that will sustain an economic recovery, even if it is held back at times with subsequent infection waves, and especially as these waves are much less likely to lead to widespread lockdowns, thanks to increasing vaccination rates. In addition, inventories on most critical items, like autos and housing, are at record lows versus history, and the recent decline in rates will further stimulate demand.

An ESG-Driven Value Cycle?

Beyond these immediate dynamics of pent-up consumer demand and limited inventories, which argue for at least some rise in interest rates, the ongoing shift to ESG investing will have a profound impact on how capital is allocated. We think this impact will support an ESG-driven value cycle as the environmental focus of ESG will marry digital technologies with capital- and resource-intensive investments in green infrastructure. The required capital investments will likely mount to several trillion dollars over the next decade, and will drive demand for some commodities that could rival the BRIC commodity cycle. Beyond the potential for increased resource demand, ESG is limiting the supply response to higher commodity prices. Part of this is due to real concerns of terminal demand for certain commodities, especially oil. However, even the supply of materials with increasing ESG demand like copper, used in electric vehicles and solar panels, for example, are being held back by local environmental concerns that are limiting mining activity and investment. The result is that ESG is providing an external discipline to commodity producers that has not existed in prior cycles, which should result in more sustainable returns on capital and free cash flow generation.

Current valuation opportunities in the market include financials, energy, consumer recovery plays and large cap biotech and drug stocks.

Given this expectation, our goal is to be active ESG value investors. Our goal is to engage our portfolio companies to operate as efficiently as possible in order to limit Scope 1 and 2 greenhouse gas (GHG) emissions, which lowers costs and improves execution on what management teams can control. For energy companies this means limiting flaring, recycling water and other scarce resources, and making their own processes as energy efficient and emission-free as possible. As an example, one of our largest energy investments, EQT, has a stated goal and real plan to be net-zero on Scope 1 and 2 GHG emissions by 2025. In addition, our long-standing investment in AES has benefited from the company's aggressive shift away from coal to become a major alternative-energy power producer. These capabilities allowed AES to win a contract with Google to provide continuous renewable power, including during "shoulder" hours when solar and wind may not be viable, by using its scaled industrial battery storage capabilities. The reality is that for society to achieve its goal of a major reduction of Scope 3 GHG emissions, major resource investments must be made as efficiently and cleanly as possible, as demand for energy and materials in aggregate will continue to grow.

Thus, we think this market cycle is likely to be very different than the last, given the realities of pent-up demand meeting both cyclical and structural limits on supply. Markets and economies are complex adaptive systems that often don't solve for equilibrium, but we do know that increased demand and limited supply puts upward pressure on prices. This pressure should lead to at least a modest rise in interest rates over this cycle, and we are explicitly positioned for this. Again, not solely because we think the path of least resistance for rates is higher, but also because we are being paid so much by the market to take the other side of rates staying anchored at historic lows. If they do, we will adjust as needed. If they rise, then peak valuation multiples for U.S. indexes and long-duration growth stocks will have to fall.

We see higher rates as a much bigger risk for investors to mitigate through diversification, and our goal is to use our valuation-driven investment process to help our shareholders do just that.

Portfolio Positioning

Accordingly, the portfolio remains diversified among the most attractive current valuation opportunities in the market: financials, energy, consumer recovery plays and large cap biotech and drug stocks. We have selected stocks in these sectors that are not just cheap as measured by extremely low embedded investor expectations, but that also enjoy very robust fundamentals with ample free cash flow generation and attractive returns on capital. Our energy stocks, for example, are trading at double-digit free cash flow yields, earning double-digit returns on capital and are using this cash to pay down debt and pay variable dividends to shareholders, rather than drilling too many wells. As a result, stocks like Pioneer are expected to pay a high single-digit cash dividend yield in the coming year, with cash going to shareholders rather than to excessively raising production. The financial stocks we own all have fortress-like balance sheets, with excess capital being used to increase dividends and buy back stock below business value. We have explicitly focused on financial stocks that will enjoy higher earnings and returns if rates climb higher, which is an attribute that the market may start to covet after the current growth scare abates.

During the quarter we added five new positions that met our valuation discipline with the attractive attributes we discussed above. We have raised the number of names in the portfolio to take advantage of what we think are some broad valuation opportunities, but our active share remains at normal levels well above 85%. To highlight this added diversification and our active approach, we will discuss two stocks that we added this quarter that are well-positioned for some of the changes we think are underway: Air Liquide and Quanta Services.

Air Liquide is an industrial gas company that can compound value for shareholders by taking advantage of both cyclical and secular opportunities. In general, industrial gas is a very attractive business, as it generates good cash flow and returns on capital across cycles and enjoys pricing power. This ability may be a very attractive attribute if inflation proves to be less than transitory. On the cyclical side, Air Liquide has high exposure to the economic recovery, with greater than peer exposure to the industrial and electronics end markets. On the secular side, Air Liquide has a long-term growth opportunity in clean hydrogen, where we think demand could increase 10-fold over the next 30 years. This should be a modest but sustainable growth driver that we do not think is fully reflected in the current stock price.

Quanta Services is a specialty engineering and construction company that will be a major beneficiary of the multidecade power infrastructure investment we expect to be made to support the energy transition. Based on our estimates, electric transmission capacity needs to triple or quadruple over the next 30 years to meet the demand for a net-zero economy. It is very rare to find investment runways of this length and magnitude, and we think the duration and sustainability of this growth are not reflected in Quanta's current price. Specifically, we think Quanta's revenues can triple over the next 20 years, which is well above what the stock currently embeds. This growth could be especially powerful if Quanta is able to expand profit margins as management currently expects, but any combination should allow our investment to compound at an attractive rate in one of the biggest transitions in history.

Outlook

The market thinks the risks are either the Fed tightening, causing an equity selloff, or COVID-19 variants pushing out the pandemic recovery. We think that in the first case value wins. Not only are value stocks embedding lower expectations, they are also aligned with better fundamentals: higher nominal growth, higher interest rates, ESG-created demand and ESG-inflicted supply constraints. In the second scenario, growth has an edge only if a new variant with higher vaccine resistance emerges: the current ones are still held in check in countries like the U.S. with high vaccine penetration. We remain vigilant and will adjust our portfolio to turn more defensive if a new variant emerges that causes high levels of virus breakthroughs especially with severe cases.

Meanwhile, with growth and value correlations near all-time lows, the ability to diversify away these risks with a valuation discipline like ours has never been greater. As the current growth scare gives way to a continued economic recovery, we think value's best days are still ahead in this new market cycle.

Portfolio Highlights

The ClearBridge All Cap Value Strategy had a positive return during the second quarter, outperforming the Strategy's benchmark Russell 3000 Value Index.

On an absolute basis, the Strategy had gains in nine of 11 sectors in which it was invested during the quarter. The primary contributors to the Strategy's performance were the financials, information technology (IT), energy, industrials and communication services sectors. The consumer discretionary and consumer staples sectors were the sole detractors.

In relative terms, the Strategy outperformed its benchmark due primarily to stock selection, with sector allocation also a positive.

Stock selection in the IT, communication services and industrials sectors drove most of the positive results. Conversely, stock selection in the consumer discretionary, health care and consumer staples sectors detracted.

On an individual stock basis, the greatest contributors to absolute returns during the quarter were positions in Synchrony Financial, Wells Fargo, DXC Technology, OneMain Holdings and Johnson Controls. The largest detractors from absolute performance were Biogen, Volkswagen, Lithia Motors, TreeHouse Foods and Murphy USA.

Besides portfolio activity mentioned above, during the quarter we initiated positions in Facebook in the communication services sector, Biogen in the health care sector and Unum in the financials sector. We closed positions in Allison Transmission in the industrials sector and Citigroup in the financials sector.