ClearBridge Investments

Dividend Strategy

John Baldi
Managing Director, Portfolio Manager

Michael Clarfeld CFA
Managing Director, Portfolio Manager

Scott Glasser
Managing Director, Co-Chief Investment Officer, Portfolio Manager

Peter Vanderlee CFA
Managing Director, Portfolio Manager

Key Takeaways

- The second quarter was another strong quarter for the stock market and the portfolio, with cyclical sectors dominating year to date.
- While a more hawkish Fed posture may justify a flatter yield curve, we still think the entire curve is likely to move higher.
- On the margin we increased our exposure to sectors poised to benefit from higher prices and rising rates, funding it with trims from recent strong performers.

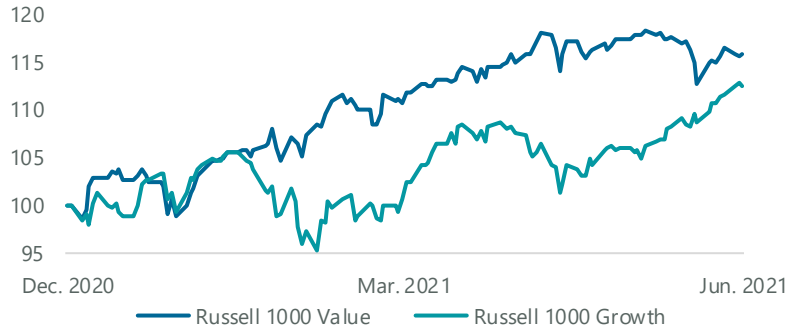
Market Overview and Outlook

The second quarter was another strong quarter for the stock market and for the ClearBridge Dividend Strategy. With the economy emerging from COVID-19-induced shutdowns, GDP is expected to have grown 10% for the quarter and corporate earnings 60%. For the year, GDP is now expected to rise 6.6% and corporate earnings are expected to be up 36%. Strong economic growth and earnings growth should drive robust dividend growth.

The S&P 500 Index was up 8.6% in the quarter and is now up 15.3% for the year. Cyclical sectors like energy and financials, the best performers in the first quarter, continue to be the best performers year to date. During the second quarter, however, the growth-oriented sectors of information technology (IT) and communication services — which dominated in 2020 but lagged in the first quarter of 2021 — outperformed the market and recouped much of their earlier underperformance.

While the market trend in 2021 has been solidly upward, beneath the surface a tug-of-war rages. Most of the year the dominant theme has been that rising inflation will lead to rising rates, which will benefit cyclicals, financials and value stocks and weigh on the valuation multiples of growth stocks. Beginning in early June, however, this trade reversed. While value continues to lead growth in 2021, growth has narrowed the gap significantly.

Exhibit 1: A Narrowing Gap Between Value and Growth

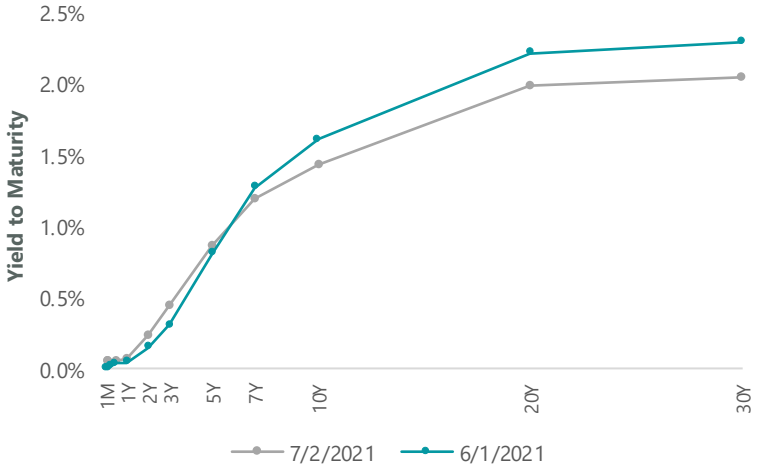


As of June 30, 2021. Source: ClearBridge Investments, Bloomberg Finance.

There is no single factor that fully explains this trend reversal, but it predominantly results from more hawkish Fed commentary. While pundits have warned of rising inflation since late 2020, until recently the Fed pooh-poohed that concern and maintained that COVID-19-driven economic impacts necessitated ultra-low rates for years to come. At its June meeting, however, the Fed struck a decidedly different tone and acknowledged the accelerating economic recovery would likely mean a quicker end to crisis-era accommodations.

The interest rate curve responded to this change by flattening, as shorter-term interest rates rose and longer-term interest rates declined.

Exhibit 2: A Flattening Yield Curve



As of July 2, 2021. Source: ClearBridge Investments, Bloomberg Finance.

The decline in long-term rates caught many off guard but was subsequently explained as the logical result of a Fed no longer asleep at the wheel with respect to inflation. All else equal, it makes sense that a more hawkish Fed would calm inflation fears

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and lead to a flatter curve. But with a 10-year Treasury yield of just 1.6% going into the Fed meeting, it is clear that all else is not equal. Starting points matter, and while this new Fed posture may justify a flatter curve, we still think the entire curve is likely to move higher.

Our portfolio positioning reflects our robust economic outlook married with our concern regarding the potential for higher rates. Of course, we continue to maintain a broadly diversified portfolio of high-quality companies capable of compounding earnings and dividends at attractive rates over time. On the margin, however, we increased our exposure to banks and energy — sectors poised to benefit from higher prices and rising rates.

We funded the shift primarily with trims in Blackstone, Comcast and United Parcel Service following big gains in those names. Blackstone, Comcast and UPS are three long-term holdings that have been and remain core holdings. During the quarter, however, we took gains in these names and resized the positions to reflect their current risk-reward post strong increases in the stocks.

Blackstone has delivered phenomenal performance for many years but until the last year or two its success went unrewarded by investors. This began to change when it converted from a partnership to a C-corp and was turbocharged in the second quarter as the stock became eligible for inclusion in broad market indexes, which will drive greater structural demand for the shares. While we continue to be very constructive on the company and anticipate remaining significant holders for years to come, considering the 50% year-to-date rise in the shares, we shaved down the position.

Comcast, like Blackstone, has been a meaningful long-term holding whose stock performance has at times lagged its robust fundamental performance. Over the last nine months the stock price caught up some with the fundamentals and looked like it had more room to run. Our thesis on the name evolved, however, following the May 17 announcement that competitor Discovery was merging its operations with Time Warner. This deal positions the new company as a credible competitor to Netflix, Amazon Prime, Hulu and Disney, and results in Comcast being left without the proverbial dance partner in the evolving pay TV/DTC landscape. While we continue to believe Comcast's cable systems business is well-positioned and that NBCUniversal remains valuable, the competitive dynamic for NBCUniversal has stiffened. Our reduced position size reflects both our continued enthusiasm for many parts of the franchise and emerging concerns given the evolving pay TV/DTC landscape.

UPS too has been a core, long-term holding. For many years its stock languished alongside fundamental performance that was both uneven and often uninspiring. Since Carol Tomé took the

reins last summer and capitalized on COVID-19-related freight disruptions, UPS's earnings have soared, and the stock has followed suit. We trimmed the position toward the end of the quarter despite continued near-term momentum and an undemanding valuation multiple. This trim reflects the longer-term risk, though hard to quantify, that Amazon may become a full-fledged competitor and meaningfully disrupt the dynamics of the industry. While not our base case, this risk cannot be disproven. We continue to be very bullish on UPS's near-term outlook and optimistic about its longer-term outlook, while also continually looking over our shoulder to make sure Amazon is not on our heels.

Over the last year we have increased our exposure to utilities and during the quarter we continued to build out our position in Sempra. We added to utilities during the depths of the pandemic as their stocks sold off despite the defensive nature of their businesses. In a world of uncertainty, utilities offered predictable results with an attractive entry point. Our investment thesis in utilities, however, is not merely defensive; we believe utilities are one of the best ways to capitalize on the energy transition as the world decarbonizes and electrifies. As we move to electric vehicles and renewable power, the world will see tremendous investment in electric infrastructure. Utilities will build the grids of the future and this investment should drive attractive earnings growth for decades. We have focused our utilities investments in states with aggressive green policy initiatives that will drive strong growth.

With concerns over rising interest rates dominating the broader market dynamics over the last several months, utilities have predictably languished. That said, we believe the attractive yields and undemanding valuations of most of our utility holdings more than offset the headwinds from rising rates. More fundamentally, we believe the societal imperative for decarbonization and electrification will drive long-term growth that will ultimately overwhelm any impact from rising rates.

Looking ahead, we expect strong dividend growth. At the onset of the pandemic, we thought the Global Financial Crisis would be the best proxy for the path of dividend growth, i.e., a deceleration from the high single digits to low single digits. Instead, our holdings generated 7% dividend growth over the pandemic thus far. This year we expect to see an acceleration back to the high single digits. This should be powered by broad-based economic strength. Financial services companies executed well on recent stress tests and will return more capital to shareholders. While inflationary pressures currently challenge many companies and industries, we favor companies with pricing power that should help to offset rising cost pressures.

Portfolio Highlights

The ClearBridge Dividend Strategy underperformed its S&P 500 Index benchmark during the second quarter. On an absolute basis, the Strategy had gains in 10 of 11 sectors in which it was invested for the quarter. The main contributors to Strategy performance were the IT, financials and industrials sectors. The utilities, communication services and consumer discretionary sectors, meanwhile, were the main laggards.

On a relative basis, stock selection contributed positively to performance for the quarter, while sector allocation detracted. In particular, stock selection in the industrials, financials and consumer staples sectors aided relative returns. Conversely, stock selection in the consumer discretionary and IT sectors as well as overweights to the utilities and materials sectors detracted.

On an individual stock basis, the main positive contributors were Microsoft, Blackstone Group, Apollo Global Management, Apple and UPS. Positions in Walt Disney, WEC Energy, Ecolab, Verizon Communications and NextEra Energy were the main detractors from absolute returns in the quarter.

During the quarter we initiated a new position in Cisco Systems in the IT sector and closed positions in Cognizant in the IT sector and Walmart in the consumer staples sector.