

ClearBridge

Investments

Select Strategy



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Key Takeaways

- ▶ Intra-quarter volatility provided ample opportunity to enter new positions across the different asset classes we target in the Strategy.
- ▶ Weakness in disruptive companies that were beneficiaries during the initial COVID-19 lockdowns and faced tough comparisons in the latest earnings period weighed on Strategy performance.
- ▶ Resilience among IT and communications holdings serving the enterprise market, as well as companies with pricing power, provided ballast as inflation became a more prominent risk.

Market Overview

Equities experienced significant swings in the third quarter, impacted by flare-ups of the COVID-19 Delta variant and a spike in yields that offset robust earnings results, with all but the largest growth companies finishing the period lower. The S&P 500 Index managed a gain of 0.58% for the quarter while smaller cap stocks suffered losses for the full three months. The benchmark Russell 3000 Index fell by 0.10% with growth stocks holding up better than value as the Russell 3000 Growth Index rose 0.69%, outperforming the Russell 3000 Value Index by 162 basis points.

On a sector basis, financials (+2.83%) was the best performer in the benchmark while information technology (IT, +0.94%), real estate (+0.72%) and health care (+0.23%) also outperformed. Meanwhile, industrials (-4.30%), the Strategy's largest overweight, consumer discretionary (-1.03%), the second-largest overweight, as well as consumer staples (-0.88%) and communication services (-0.33%), lagged.

The Select Strategy was down in absolute terms for the quarter and trailed the benchmark by about 100 basis points, primarily due to weakness in companies that were beneficiaries during the initial COVID-19 lockdowns.

A handful of our rapid growers hit tough earnings comparisons in the summer reporting period after experiencing a surge in demand in the second quarter of 2020 as companies moved to remote work and consumers were confined to their homes. Zynga, which develops games played on social and mobile platforms, experienced a significant uptick in new customers last year but

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has not seen as much retention and gaming usage as the economy has reopened. For Pinterest, whose social bulletin boards were popular as consumers focused on home renovation and redecorating during the pandemic, recent results have yet to establish a clear base of customers and we are holding our position until the company has a better line of sight into future growth. E-commerce platforms such as Vroom and enablement providers like Wix.com and Shopify have also faced headwinds as consumers become more active outside the home.

We are less concerned about any product weakness or competitive positioning risks among these companies but are instead closely watching to determine at what levels their businesses will normalize post-COVID-19. In instances where we have noticed a meaningful slowdown due to growing competitive threats or our thesis has not played out as expected, we have been disciplined in trimming or eliminating exposures. These concerns motivated our sale of telehealth provider Teladoc and real estate brokerage Compass.

Offsetting the consumer slowdown, the Strategy benefited from resilience among its disruptive IT and communications holdings serving the enterprise market. Fortinet was a leading contributor for the quarter on growing demand for cybersecurity services amid an increase in ransomware and similar data attacks. ServiceNow and HubSpot were also strong performers in helping businesses streamline their workflows and enhance customer relationships and marketing.

Portfolio Positioning

Volatility during the quarter provided us ample opportunity to enter new positions across the different areas we target in the Strategy.

We took advantage of alternative asset classes to establish exposure in health care analytics firm Clarivate and cloud data analytics provider DataBricks. Clarivate sells a range of analytics and data packages to biopharmaceutical and medical technology customers. The common stock had come under pressure due to disappointing medium-term growth guidance and a large secondary offering of convertible securities. We purchased the mandatory convertible shares, which pay an attractive yield, as we wait for the company to rebuild its credibility with investors and convert to common equity in the low \$30s. DataBricks, where we made a private placement investment, offers data engineers and scientists a platform to run high-powered analytics on data housed in warehouses run by firms like Snowflake. The business is growing rapidly as customers adopt more modern architecture for data analytics.

Also within the disruptors segment, we initiated a position in VTEX, an e-commerce and customer engagement software provider serving the higher end of the market in Latin America. VTEX enables large LatAm commerce companies and brands to establish an omnichannel selling presence and helps multinational brands such as Carrefour, L'Oreal, Motorola and Mondelez reach the LatAm market. VTEX expands the portfolio's exposure to fast-growing LatAm, supplementing existing holding MercadoLibre, which operates more as a marketplace in the region.

We added to our durable compounders with the purchase of CME Group. The global exchange operator maintains a dominant presence in interest rate options and futures trading. Depressed interest rates over the last 18 months have slowed volumes and pressured the stock. As we return to a more normalized environment for rate hedging, CME offers interest rate exposure without taking on the credit risk of traditional financial institutions.

In addition to these new buys, we took advantage of near-term price weakness to add to disruptors Insulet, Twilio and Match Group, evolving opportunities Uber and Pioneer Natural Resources as well as durable compounder WillScot Mobile Mini.

The Strategy views the new issue market as an attractive source of new ideas, but we have become choosier, vetting more IPOs than we ultimately commit to. As the market cycle has progressed, the discount to fair value for IPOs of high-quality growth businesses has shrunk. We have also been disciplined in managing our SPAC exposure and sold out of two SPACs, Dragoneer Growth Opportunities and the first SPAC from Altimeter Growth, where we did not like either the businesses they acquired or the valuations paid.

Outlook

Despite progress on reopening and improving global GDP growth, supply chain challenges remain pervasive. From logistics to scarcity of labor and product, supply chain delays are hitting almost every single business we cover. This is fomenting inflation and forcing companies to raise prices or spend more on hiring and transport to meet revenue targets. We are carefully monitoring these developments to discern the duration and severity of impacts on margins and profitability.

Aware of these inflation risks, since the spring we have begun navigating to companies that can take price and maintain flexibility in their business. Enterprise software companies, for example, avoid many of the inflationary issues facing companies with a physical product or service. Digital platforms like Match are also well-positioned to execute through a period of broad economic pricing headwinds. We also strive to own companies with strong physical pricing power such as Pioneer, one of the most

fundamentally sound operators in oil and gas exploration and production, and MSC Industrial Direct, which has been able to push price increases through its distribution channels.

The other key factor we continue to watch is how the U.S. addresses the path of COVID-19 as we enter a higher-risk period in the fall and winter.

Portfolio Highlights

The ClearBridge Select Strategy underperformed its Russell 3000 Index benchmark in the third quarter. On an absolute basis, the Strategy had gains in four of the 10 sectors in which it was invested during the quarter (out of 11 sectors total). The IT and real estate sectors were the primary contributors to performance while the communication services and consumer discretionary sectors were the main detractors.

In relative terms, overall stock selection detracted from performance. Specifically, stock selection in the communication services, health care, consumer discretionary and consumer staples sectors and an overweight to the industrials sector negatively impacted results. On the positive side, stock selection in the industrials and real estate sectors contributed to performance.

On an individual stock basis, the largest contributors to absolute returns during the third quarter were Fortinet, ServiceNow, Crocs, Sprout Social and HubSpot. Surgery Partners, Wix.com, American Eagle Outfitters, Pinterest and Zynga were the most significant individual detractors from absolute returns.

In addition to the transactions mentioned earlier, the Strategy initiated positions in Cricut in the consumer discretionary sector and Definitive Healthcare in the health care sector and gained shares in GXO Logistics following its spinoff from portfolio holding XPO Logistics. We also closed positions in Regal Beloit and Bloom Energy in the industrials sector, Vertex Pharmaceuticals in the health care sector, Bumble in the communication services sector and Universal Display in the IT sector.

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