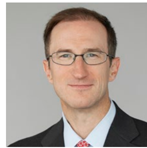
ClearBridge Investments

Value Equity Strategy



Sam Peters CFA
Managing Director, Portfolio Manager

Jean Yu CFA, PhD
Managing Director, Portfolio Manager

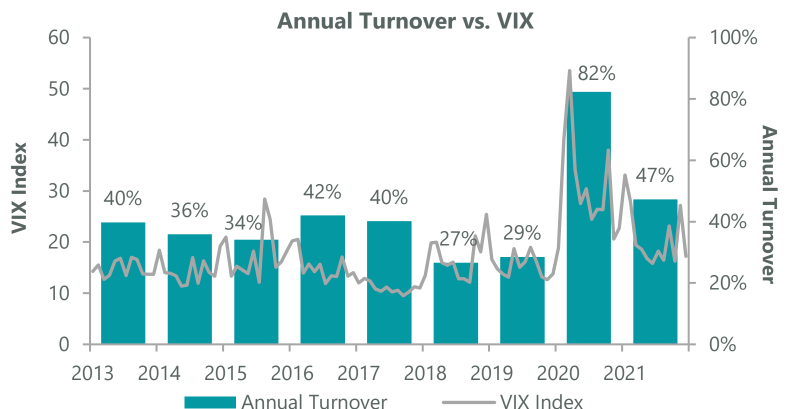
Key Takeaways

- We believe the shift from pandemic to endemic, and resulting recovery in services and travel, will be the next big event of this new market cycle; the valuation upside in select recovery stocks is still extremely compelling.
- Fundamental improvements in our holdings drove returns, rather than valuation expansion, with energy and financials as key examples.
- Despite the positive returns, the valuation of the portfolio is more attractive entering 2022 than it was last year.

Market Overview

A critical goal of our investment process is effectively reacting to market surprises, which we broadly define as information not reflected in market prices and which triggers price volatility. When we observe a surprise, our investment process requires us to decide if we should act, and if so, how quickly. In a world full of noise, achieving a well-calibrated reaction is always challenging. However, while not always perfectly executed, a passion for dynamic adaption and decisive decision making is a cultivated strength of our investment team and process. One of the byproducts of this flexibility is that our turnover is not constant. This is most evident when comparing our annual turnover against market volatility (Exhibit 1). The onset of the COVID-19 pandemic was arguably the biggest volatility event of our careers and triggered a cascade of changes that are still being processed by financial markets, resulting in our turnover being elevated during the pandemic.

Exhibit 1: Turnover Tracks Market Turmoil



As of Dec. 31, 2021. Source: ClearBridge Investments, Bloomberg Finance LP.

While the level of general turnover abated as we progressed through 2021, it remained high in one area: post-COVID-19 recovery plays. The concept behind this investment thesis was, and still is, straightforward: with the advent of effective vaccines, the path from pandemic to endemic is just a matter of time. As this transition occurs, the estimated excess savings of over $2 trillion built up on U.S. consumer balance sheets will unlock dramatic pent-up demand for experiences, especially global travel. This investment case seemed especially compelling when the Pfizer vaccine positively surprised markets in November 2020. As a result, we made post-COVID-19 stocks (which were trading well below our estimate of recovery value) a sizable theme within the portfolio. We understood this to be a more aggressive tilt in positioning because it required a major improvement in demand to catalyze fundamentals and drive price toward higher business values. While we accepted that recovery would not be smooth and that it would take time to deploy vaccines both domestically and globally, we decided that recovery was the logical path of least resistance and we were being well compensated for these risks.

What we did not account for, however, was vaccine hesitancy and the risk of further infection waves. As a result, the first variant wave, Delta, was a negative surprise to both the market and our team. When the risk surfaced, we immediately updated our probability-driven models and debated how we should react. The resulting conclusion was that the recovery would be delayed and that we should reduce our exposure quickly, subsequently targeting the most aggressive recovery stocks such as cruise lines. We again acted swiftly and decisively to the positive surprise that Pfizer had delivered a high-efficacy antiviral COVID-19 pill. This pill should greatly reduce COVID-19 severity risks globally, increasing the probability of a global travel recovery in 2022. While this is still true, the emergence of the highly mutated Omicron variant set off another infection wave which spurred us to again act quickly and further reduce our risk exposure. This back-and-forth may sound exhausting, but it highlights our compulsion to act if we determine a surprise has a large enough impact on the probabilities that power our valuation-driven investment cases.

We believe the shift from pandemic to endemic, and the resulting recovery in services and travel, will be the next big event of this still-new economic and market cycle, and the valuation upside in select recovery stocks is still extremely compelling. However, the underlying risks must still be managed with an eye toward the timing, and ebb and flow, of COVID-19 waves. We expect to remain active in this area and apply our process to help drive positive active returns in 2022.

Despite these challenges, we did get two major things right in 2021: we were materially overweight the best- and third-best

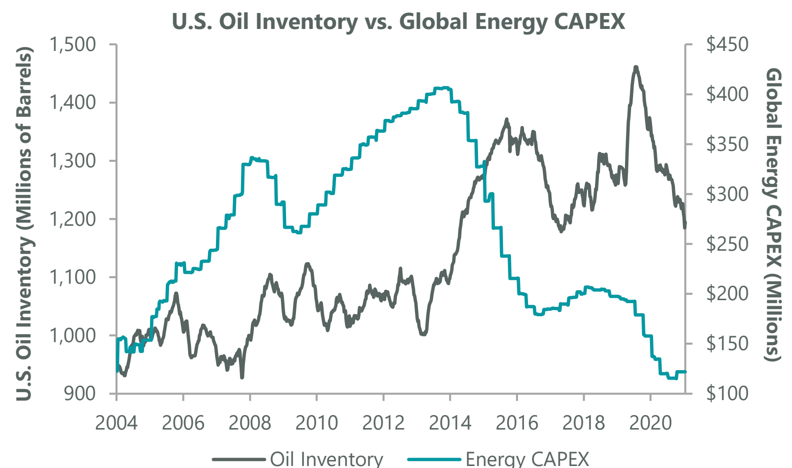
performing market sectors in energy and financials. We held our conviction in the sectors, even as we debated the risks from Delta and Omicron, as our investment cases remained well supported despite COVID-19 headwinds. Even considering the big price moves in 2021, we feel the outlook for our energy and financial stocks is even stronger in 2022. How so?

Even considering the big price moves in 2021, we feel the outlook for our energy and financial stocks is even stronger in 2022.

Strong Fundamentals Fuel Energy Outlook

Our broad investment case on energy stocks is simple: commodity cycles are driven by the supply side. Every down cycle lays the seeds for the next up cycle, as low prices kill animal spirits. The resulting collapse in capital investments ultimately leads to a tight market and higher prices. From there, the cycle begins anew: wash, rinse, repeat. The COVID-19 down cycle was especially acute as the collapse in demand and oversupply from short-cycle shale resulted in one of the biggest surprises ever: negative oil prices. Adding to the record depths of the last cycle was the mounting narrative and real risks of declining terminal oil demand from decarbonization efforts and the global energy transition. The result has been an absolute collapse in capital spending, despite historically low inventories and a 60% increase in the price of oil in 2020 (Exhibit 2).

Exhibit 2: Disciplined Spending Despite Declining Inventories



As of Dec. 31, 2021. Source: ClearBridge Investments, Bloomberg Finance LP, IEA.

These dynamics have driven a massive improvement in the fundamentals of U.S. oil and gas producers, as free cash flow generation has exploded and returns on capital have skyrocketed well above the cost of capital. Most importantly, producers are signaling continued discipline by returning record amounts of capital to shareholders, rather than drilling to grow production. Despite the metamorphosis from capital-destroying caterpillars to free-cash-flowing butterflies, energy stocks are in the loneliest bull market in history due to the extreme starting point and ESG concerns greatly limiting interest and participation. As a result,

their market-leading performance in 2021 was completely driven by the overwhelming strength of fundamentals as earnings increased over 300%, while earnings multiples compressed over 60%. Our energy holdings are collectively now selling at 10x forward earnings and generating double-digit free cash yields. This is a record discount to the market despite historically strong current fundamentals, and cheaper than last year despite the market-leading move.

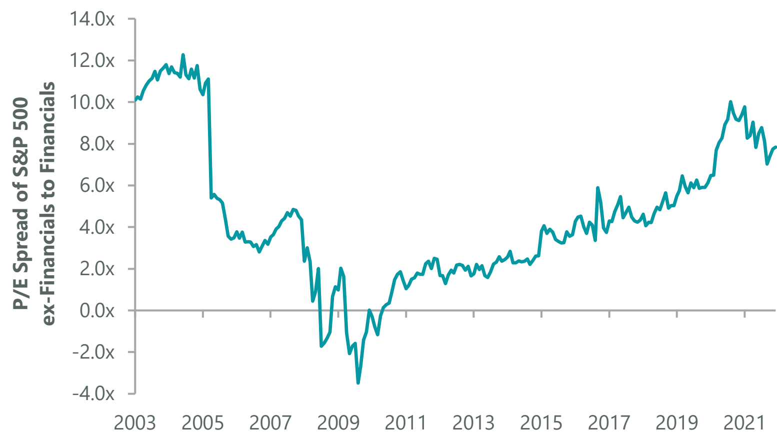
Time is on the side of this energy bull market, as the longer capital spending stays depressed the more likely demand will exceed supply over the next several years. J.P. Morgan estimates that matching supply and demand will require an increase in capital spending of roughly $750 billion. We struggle to see this happening given ESG hesitancy, as well as the need for over $1 trillion in additional capital spending directed toward alternative energy and the broader energy transition. Additionally, we are concerned that energy prices could skyrocket higher once global travel recovers, as jet fuel demand is still roughly 25% below pre-COVID-19 levels. This would push OPEC surplus capacity to historically low levels, all while global inventories are also depressed.

Despite the combination of strong stock performance, robust energy fundamentals and risks of much higher prices, the energy sector's weighting in the overall market remains historically depressed considering its market-leading free cash flow yields and record low valuations. As such, the energy sector remains our largest active weight in the portfolio.

Prospect of Rising Rates Favors Financials

The financials sector's strong fundamentals also received recognition in 2021: earnings grew over 30%, exceeding the overall market, while financial stock earnings multiples stayed roughly flat. Despite holding its valuation ground, the financials sector is trading at very depressed multiples relative to the market (Exhibit 3). We think this is a very attractive setup for 2022 as the financials stocks we own, mostly lenders and insurance, will enjoy improving fundamentals and higher valuations if interest rates rise as expected over the next several quarters. This is counter to the overall market, which is selling near historic valuation highs and will almost certainly see valuation multiples decline as interest rates rise.

Exhibit 3: Current Earnings Show Cheap Financials



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

Additionally, bank loan growth has started to accelerate. We have been strong proponents of the view that loan growth would be a key macro factor as this new economic and market cycle progressed. If loan growth continues, and we expect it will, it would be another powerful tailwind to the post-COVID-19 recovery and support higher interest rates across the yield curve. Like energy, our financial stocks have robust current fundamentals, well above market shareholder returns via dividends and buybacks, are well-positioned for what we think comes next and are selling at roughly 9x forward earnings. As a result, the financials sector remains our second-largest active weight in the portfolio.

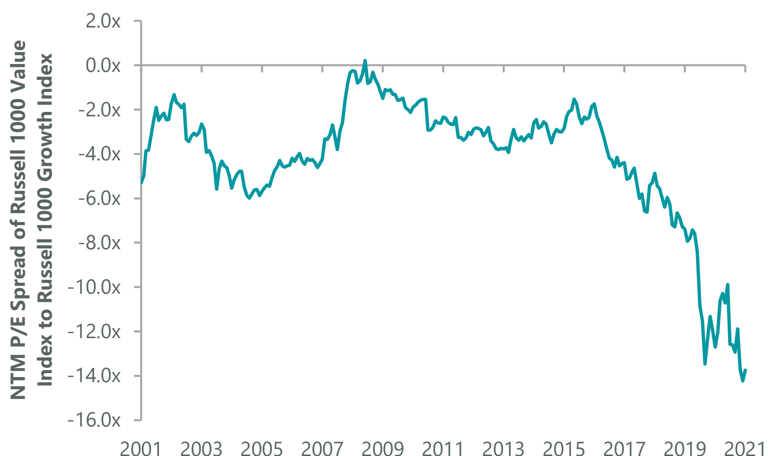
Value Poised for Strong Performance

Beyond energy and financials, we are encouraged by how the portfolio as a whole is positioned for 2022. Despite the positive absolute and relative returns this year, the valuation of the portfolio is more attractive entering 2022 than it was entering 2021. The fundamental improvement in our holdings is what drove returns in 2021, with energy and financials as key examples, rather than relying on valuation expansion. Currently, the portfolio sells at a more than 20% discount on its estimated 2022 earnings relative to its value index but with stronger expected growth in earnings and free cash flows.

A more robust metric that is a better reflection of our valuation process is our estimates of the intrinsic business value of our aggregated portfolio holdings versus current market prices, which is higher now than it was one year ago. This improvement is very unusual after a year with such strong returns but speaks to the fundamental robustness of our holdings. The current value opportunity does not require betting on bad business fundamentals and weak balance sheets, rather it’s the opposite.

From a broader perspective, we still think value is positioned to lead over the next market cycle. After valuations of value hit their cheapest level ever in 2020, the style has made progress rebounding from extremely depressed levels relative to growth. However, by most measures, the valuation of value is still locked in the cheapest decile versus history (Exhibit 4). We think value will make further progress in 2022 as COVID-19 continues to transition from pandemic to endemic, interest rates move higher, and more investors accept that we have entered a new market cycle with faster nominal economic growth and reflationary tailwinds.

Exhibit 4: Value's Valuation Hits All-Time Low



As of Dec. 31, 2021. Source: ClearBridge Investments, Bloomberg Finance LP.

Portfolio Activity

During the quarter we participated in the initial public offering of Fluence Energy, one of the market leaders in the rapidly growing electricity storage market. Energy storage is set to become one of the key areas of investment for energy transition given the intermittency of renewables. Current estimates project spending on energy storage will grow from roughly $5 billion per year currently to $50 billion annually over the coming decades. As this spending ramps up, we expect Fluence's revenues to grow well above 20% over the next several years and allow the business to scale profitably. Based on the IPO price, Fluence was valued at roughly 2x forward revenues and less than market multiples on cash flow and earnings by mid-decade in our base case scenario. With over 20% market share the stock is well-positioned to follow growth higher, especially if Fluence can enhance its business model with services revenues and a software offering to handle the growing complexity of an increasingly digital grid.

One of the enduring strategies of our valuation-disciplined investment process is buying when price falls dramatically below business value due to an overreaction, such as the disruption risk posed to legacy value stocks from up-and-coming competitors.

We found this to be the case in legacy payment companies, whose valuations collapsed in 2021 as concerns increased that new payment intermediaries and disruptors like Square would drive market share losses and pricing pressure. While the threat of disruption risk to these established payment companies should not be taken lightly, it is important to note that many of these emerging disruptors are small relative to the massive global payments network and heavily reliant on the very payment infrastructure they are trying to disrupt. This led us to initiate a position in Fiserv, whose stock dropped to a level that embedded projections for negative long-term growth despite no current evidence of disruption. We think Fiserv will continue to grow despite perceived disruption risks given its scale and efficiency. Fiserv also owns cloud-based payments hardware and software system Clover, which is both bigger and faster growing than Square; this provides an additional degree of protection against further disruption risk.

Outlook

While the coming year is certain to bring its own surprises and challenges, we will continue to cultivate the dynamic adaption and decisive decision making that is a hallmark of our investment process. We are confident that our portfolio is exceptionally well-positioned with robust fundamentals and attractive valuations that will allow us to navigate from strength-to-strength as this new market cycle evolves.

Portfolio Highlights

The ClearBridge Value Equity Strategy underperformed the benchmark Russell 1000 Value Index in the fourth quarter. On an absolute basis, the Strategy posted gains in 10 of 11 sectors in which it was invested during the quarter. The sole detractor from the Strategy's performance was the communication services sector, while positive contributors included the financials and health care sectors.

In relative terms, the Strategy underperformed its benchmark during the quarter primarily due to sector allocation effects, which was mildly offset by a positive contribution from security selection. In particular, stock selection in the industrials and consumer discretionary sectors, and underweight allocations to the health care and real estate sectors weighed on relative performance. Conversely, stock selection in the communication services, materials and consumer staples sectors were positive contributors.

On an individual stock basis, the greatest contributors to absolute returns during the quarter included positions in ON Semiconductor, Freeport-McMoRan, AbbVie, UnitedHealth Group

and Signature Bank. The largest detractors from absolute performance were positions in Southwest Airlines, Medtronic, General Electric, Activision Blizzard and Splunk.

Besides portfolio activity discussed above, we initiated new positions in TripAdvisor in the communication services sector and Zimmer Biomet in the health care sector. We exited our positions in Toll Brothers and Darden Restaurants in the consumer discretionary sector, ViacomCBS in the communication services sector, Anheuser-Busch InBev in the consumer staples sector, Eli Lilly in the health care sector, Fidelity National Information Services in the information technology sector and Southwest Airlines in the industrials sector.

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