ClearBridge Investments

Large Cap Value Strategy

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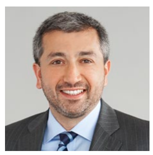

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Key Takeaways

- U.S. equities overcame a new COVID-19 variant, sharply higher inflation data and a decidedly more hawkish Fed outlook to make strong gains in the fourth quarter and year.
- The Strategy outperformed for the year, driven in part by long-term holdings within the technology sector that are not household names.
- The pandemic created opportunities for us to be more aggressive in a variety of areas of the market, including travel- and payments-related companies and more defensive areas.

Market Overview

U.S. equities overcame a new COVID-19 variant, sharply higher inflation data and a decidedly more hawkish Fed outlook to make strong gains in the fourth quarter and year. The benchmark Russell 1000 Value Index returned 7.77% for the quarter and 25.16% for the year. It was a robust year, marked by spikes in interest rates and commodity prices during the first quarter amid the post-vaccine reopening rally, followed by stabilization as these surges leveled out. Supportive monetary and fiscal policies resulted in a robust economic recovery and strong market performance broadly. Unemployment declined substantially throughout the year, approaching pre-COVID-19 levels; meanwhile, business confidence remained elevated. Markets were led by energy and financials, with real estate also recouping 2020 losses. Cyclical sectors dominated the year; higher-multiple information technology (IT) stocks felt crosswinds from waves of the pandemic (tailwinds) and higher inflation and interest rates (headwinds), while consumer staples and utilities lagged in the rally.

The ClearBridge Large Cap Value Strategy outperformed for the year, driven in part by long-term holdings within the IT sector such as Motorola Solutions and TE Connectivity. While neither is a household name, both companies are strong competitively advantaged franchises within their respective markets. Motorola Solutions (MSI), a leading provider of mission-critical communications products and services with more than 100,000 public safety and commercial customers in 100 countries, continues to execute at a very high level. It is leveraging its strong competitive position to expand its addressable market through targeted tuck-in acquisitions in areas such as video and command-to-control centers. TE Connectivity (TEL) is a leading global manufacturer of engineered components, particularly connectors and sensors used in a wide variety of applications including automotive, health care, communications and industrial. TEL's automotive business represents over 40% of sales and is a major beneficiary and enabler of the accelerating transition to vehicle electrification, including hybrid and battery electric.

Our energy and financials holdings kept pace in the 2021 rally. Within energy, ConocoPhillips continues to leverage its strong balance sheet and cost-advantaged acreage position in the prolific Permian Basin by making an opportunistic acquisition of assets from Royal Dutch Shell, further solidifying its strong Permian footprint. In financials, Bank of America, JPMorgan Chase and Charles Schwab benefited from strong economic growth, a rise in Treasury yields and a benign credit environment.

Defensive sectors such as utilities underperformed the broader market, with our California-based utilities, Sempra Energy and Edison International, generating modestly below-sector returns on continuing wildfire concerns, despite significantly improved financial exposure due to the 2019 legislation AB 1054. The legislation was a major positive step toward reducing wildfire risk to California public utilities, which we expect to be reflected in improved valuations over time.

Market strength continued in the fourth quarter, with only the communication services sector down in the Russell 1000 Value Index. In addition to continued strength from Motorola and TE Connectivity within the IT sector, portfolio returns benefited from the strong performance of semiconductor maker Qualcomm, which has executed exceptionally well in pursuing the transition to 5G, growing both content and share due to its leadership position in cellular technology. The chipmaker recently outlined a number of peripheral growth opportunities outside of mobile markets, including automotive (where it hopes to leverage its strong presence in the automotive infotainment space into advanced driver assistance systems), Internet of Things (including opportunities in the PC market, VR/AR market and factory automation) and radio frequency (where mmWave adoption globally, including China, would drive substantial upside).

The quarter also saw strong showings from UnitedHealth and Anthem; both have been operating well and are key players in the evolution of health care insurance and delivery, providing more integrated and cost-effective solutions and receiving a tailwind from an aging population. Both stocks tend to be volatile based on changes in medical loss ratios (MLR), though we view this volatility as short term for business models that are able to reprice policies relatively quickly. We added significantly to both positions during the year.

The communication services sector was a weak spot in both the value benchmark and the Strategy in the fourth quarter. We mitigated this somewhat by trimming our positions in Comcast, T-Mobile and Charter earlier in the year as we grew more concerned about increasing competition in wireless, where aggressive handset promotions have cut into margins, and broadband, where subscriber growth slowed down due to fewer households moving and switching providers and where exceptionally robust growth at the height of the pandemic in 2020 and the first half of 2021 should present tough comps going forward.

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Portfolio Positioning

The pandemic created opportunities for us to be more aggressive in a variety of areas of the market. We were opportunistic throughout the year, for example, in positioning the portfolio to benefit from a flush consumer eager to return to spending and traveling. New positions included Booking Holdings, an online travel agency with industry-leading margins and a dominant footprint in Europe and TJX, an off-brand retailer with a large presence in the U.S. and Europe that should continue to benefit from the contraction of many traditional retailers, particularly as consumer spending resumes.

In the fourth quarter we added Visa to our stable of companies in the growing payments space, alongside American Express and Capital One. Visa had underperformed significantly in 2021 and continues to face near-term earnings pressure from reduced cross-border travel due to COVID-19. We believe the weakness created an opportunity for us to invest in an exceptionally high-quality payments franchise with an attractive growth and free cash flow profile and little credit or interest rate exposure.

After a strong year for equities we sought to bolster more defensive areas of the portfolio and added to PepsiCo, increasing our exposure to a high-quality and stable name. To help better navigate an inflationary environment, we added to PPG Industries, a high-quality cyclical coatings company we find attractively valued. The company has implemented aggressive pricing to offset raw material inflation, and should also benefit from recovery in miles driven and air travel, which should support its most profitable segments, aerospace and automotive refinish coatings.

Outlook

Looking ahead, with aggressive fiscal and monetary policies contributing to a strong economy and robust markets, we anticipate some normalization is likely over time. We continue to focus our bottom-up process on high-quality franchises, with a slight tilt to benefit from higher rates and general economic recovery through overweights to financials and industrials. That said, we seek balanced exposure to the market over the long term and focus on compounding returns over time; we believe this is appropriate in a market environment that proves, time and again, to be unpredictable.

Portfolio Highlights

The ClearBridge Large Cap Value Strategy outperformed its Russell 1000 Value Index benchmark during the fourth 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 IT, health care, industrials and materials sectors. The communication services sector was the sole detractor.

On a relative basis, overall stock selection contributed to performance, while sector allocation detracted. In particular, stock selection in the IT, materials and health care sectors added to relative returns. Conversely, stock selection in the communication services and financials sectors weighed on relative results.

On an individual stock basis, the largest contributors were UnitedHealth Group, TE Connectivity, Qualcomm, Home Depot and Cisco Systems. Positions in DISH Network, Comcast, Charter Communications, Capital One and T-Mobile were the main detractors.