ClearBridge Dividend Strategy Portfolio Manager Commentary Q1 2022

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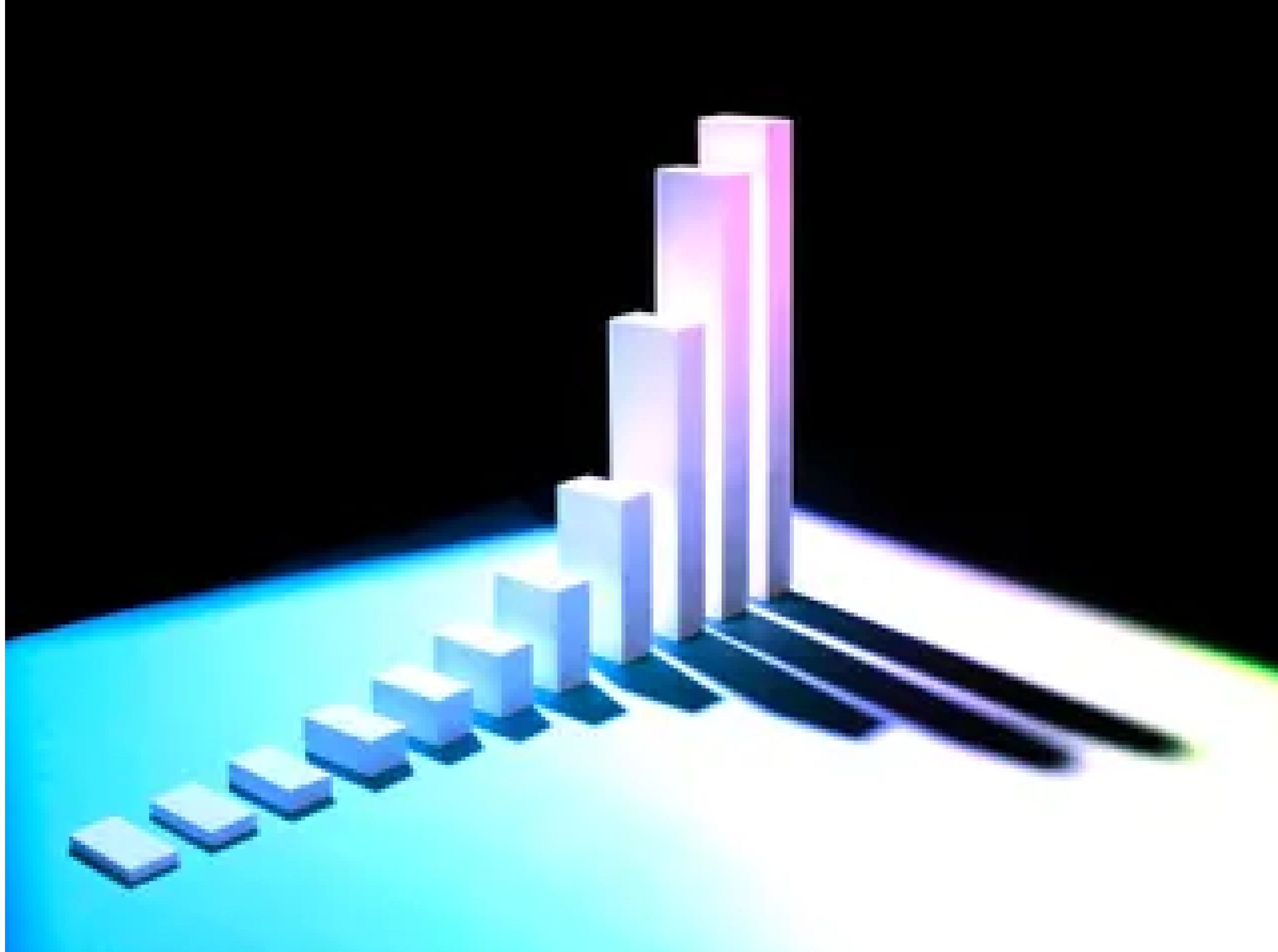
Summary

- ClearBridge is a leading global asset manager committed to active management. Research-based stock selection guides our investment approach, with our strategies reflecting the highest-conviction ideas of our portfolio managers.
- The Strategy was well-positioned for inflationary pressures which accelerated following the invasion of Ukraine, outperforming in a volatile quarter.
- Russia's attack revealed the fragility of the international order, changed global energy flows and drove home the importance of local manufacturing for critical industries.
- Our performance benefited from overweights to energy as well as aerospace and defense, and from our underweight to high-multiple stocks whose multiples compressed as interest rates rose.



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Market Overview

The first quarter of 2022 was a volatile one for the capital markets. The S&P 500 Index finished down 4.6% — quite good considering it was down 12% year to date through early March. The ClearBridge Dividend Strategy meaningfully outperformed the market during the quarter, driven by:

1. our overweight to energy stocks
2. our underweight to high-multiple stocks (whose multiples compressed as interest rates rose)
3. and our significant overweight to aerospace and defense stocks

The seeds of these broader market dynamics were planted two years ago in the early months of COVID-19. Companies ratcheted back production as demand cratered. The federal government injected trillions of dollars of fiscal stimulus to soften the blow of lockdowns and reduced economic activity. Additionally, for reasons that are still unclear, many workers permanently left the labor force. As the economy recovered, demand outstripped supply. Flush consumers bid up the price of the limited goods they could get their hands on. Workers, finding themselves with the upper hand, extracted higher wages.

Throughout most of 2021, the Federal Reserve maintained that these inflationary pressures were "transitory" and did little to contain them. In the last several months, however, the Fed pivoted and embraced a more hawkish stance.

High-Quality Dividend Growers Provide Offset to Inflation

While we never expected war in Ukraine, our portfolio was well- positioned for the further inflationary jolt it gave to prices.

Between February 23 and March 8 global oil prices rose 27% and electricity prices in Europe soared 400%! Our considerable overweight to energy, which we have discussed many times before, benefited us meaningfully as commodity prices soared and investors reappraised the value of North American resources. Our investments in infrastructure, Enbridge (ENB) and Williams (WMB), and in oil production, Pioneer Resources (PXD), performed well. At the same time, higher commodity prices were headwinds for our materials companies. PPG Industries (PPG), a paint and coatings maker, and Ecolab (ECL), a specialty chemicals and hygiene company, both use petrochemical products as feedstocks. As oil prices rise, these input costs increase and squeeze profit margins.

As raw material prices skyrocketed, inflation expectations and interest rates soared. During the quarter the 10-year U.S. Treasury yield rose 45% to 2.3%. The 30-year mortgage rate rose 50% to 4.7%. Rising rates lifted our insurance holdings and weighed on high-multiple stocks — such as mega cap tech companies in the information technology (IT), consumer discretionary and communication services sectors — which we are significantly underweight.

Our material overweight to aerospace and defense (~5% in Dividend Strategy vs ~1.5% in the index) was another large contributor to performance in the quarter. Both Raytheon (RTX) and Northrop Grumman (NOC) performed well. Our investment in these companies was obviously not predicated on war breaking out in Europe. Rather, they both embody many of the core attributes we look for in all our companies. Both have favorable long-term growth outlooks that should enable them to compound earnings and dividends for years to come. Raytheon has been a long-term holding and benefits from solid positions in both defense and commercial aerospace. The defense business provides a stable and predictable foundation of recurring revenues while the commercial aerospace business offers leverage to recovering travel as the world bounces back from COVID-19.

Northrop Grumman is a more recent addition to the portfolio. We started following it closely in late 2019 based on the strength of its product portfolio. While we immediately liked the company and the story, the valuation did not initially screen well. Defense stocks sold off around the 2020 election as investors worried that a Democratic administration would result in weaker defense spending. We found that interpretation misguided and took advantage of the selloff to build a position. Last month, as defense stocks surged post Russia's attack, we trimmed our Northrop position. While we continue to like the company, we believe the recent run in the shares appropriately discounts the higher level of defense spending we now expect to see.

Portfolio Positioning

We are long-term investors underwriting investments in high- quality companies where we can compound returns at superior rates. As our companies' earnings compound, so do their dividends. Our emphasis on companies with pricing power and robust competitive advantages results in a portfolio well suited to navigate the ups and downs of the uncertain world we live in.

In the early days of the invasion, we made two measured changes to the portfolio based on longer-term fallout we anticipate from Russia's invasion of Ukraine. First, we initiated small positions in U.S. natural gas producers Chesapeake (CHK) and EQT (EQT). Second, we initiated a position in Intel (INTC).

Given its superior environmental profile compared to other fossil fuels, we have long favored natural gas in our energy holdings. Combustion of natural gas releases 50% less CO2 than coal, 25% less CO2 than gasoline and dramatically less particulate and pollution, per the U.S. Energy Information Administration. With the advances in shale production this century, the U.S. has become a natural gas powerhouse with some of the lowest-cost and largest reserves in the world. But because natural gas is difficult to ship across the ocean (it must be liquefied, which requires expensive infrastructure on both ends of the voyage), America's gas bounty has ironically proved a burden for U.S. producers.

The surplus of natural gas in North America has resulted in low prices and weak earnings for gas-focused producers. Exports, while growing, are restrained by the high cost of building export infrastructure. Europe, in a Faustian bargain, has relied on abundant, inexpensive Russian gas transported by pipeline.

Despite the abundance of low-cost resources and a superior environmental profile, the investment case for U.S. natural gas producers was previously unfavorable due to oversupply in the domestic market.

In the days preceding the invasion, we were quick to realize the war would change global energy flows. Europe is shifting away from Russia and toward new sources of imported liquified natural gas. We purchased our stakes in Chesapeake and EQT to capitalize on these trends. The recently announced energy pact between the U.S. and Europe represents an early positive datapoint in support of this investment thesis. We funded these purchases, in part, with a trim of Pioneer. While we continue to like Pioneer, the risk/reward outlook for the stock is more balanced following recent gains in the shares.

Over the last year, Pat Gelsinger, Intel's new CEO, has devised a bold and aggressive strategy shift for the company. Gelsinger wants to open Intel's factories to manufacture chips for competitors and thereby increase the utilization of Intel's machinery. Doing so could increase the company's returns and profits and bolster its competitive moat. While we admired these moves and saw their potential merit, we sat on the sidelines.

Intel's repositioning requires tens of billions of dollars of increased investment and entails more risk than we are usually comfortable with. Russia's invasion of Ukraine, however, changed our calculus. It revealed the fragility of the international order and drove home the importance of local manufacturing for critical industries like semiconductors.

Over several decades Taiwan has become the leading source for cutting-edge computer chips. With China determined to control Taiwan, this poses a critical strategic risk for the U.S. and the West. Concern over this threat has simmered for years but the war in Ukraine marks a boiling point. Indeed, just two weeks after Russia invaded Ukraine, Germany offered Intel over €5 billion in subsidies to build a plant in-country. We expect the U.S. will soon do the same. As Intel embarks on this new course, there is significant, long-term upside potential for the shares. This strategy entails meaningful risks, but at the $45 price we paid for our shares, we believe the risk/reward was asymmetrically skewed in our favor. We partially funded our acquisition of Intel with trims of semiconductor holdings Broadcom (AVGO) and Texas Instruments (TXN).

Outlook

As we enter the second quarter, we like our positioning. We were surprised by the strength of the market's recovery at the end of the first quarter. We believe investors are being complacent in the face of the myriad risks we see: inflation at its highest level in decades, interest rates rising sharply, elevated asset values and continued speculative excess in the form of cryptocurrencies and NFTs, for example.

We continue to stick to our discipline. We are free-cash-flow- focused investors concentrated on building a diversified portfolio of businesses with strong balance sheets; recurring, predictable revenues; robust competitive advantages; low risk of secular disintermediation; reasonable valuations and attractive dividend growth profiles. We believe this type of portfolio is well-suited to thrive amid elevated global challenges.

Portfolio Highlights

The ClearBridge Dividend Strategy outperformed its S&P 500 Index benchmark during the first quarter. On an absolute basis, the Strategy had gains in three of 11 sectors in which it was invested for the quarter. The main contributors to Strategy performance were the energy, industrials and utilities sectors. The materials, IT and consumer discretionary sectors, meanwhile, were the main detractors.

On a relative basis, sector allocation and stock selection contributed positively to performance for the quarter. In particular, an overweight to the energy sector and underweights to the consumer discretionary, IT and communication services sectors helped relative results. Stock selection in the industrials and IT sectors also contributed positively. Conversely, stock selection in the materials, consumer discretionary and energy sectors weighed on relative results.

On an individual stock basis, the main positive contributors were Williams Companies, Pioneer Natural Resources, Sempra Energy (SRE), Raytheon Technologies and Enbridge. Positions in Home Depot (HD), PPG Industries, Ecolab (ECL), Microsoft (MSFT) and Apollo Global Management (APO) were the main detractors from absolute returns in the quarter.

Editor's Note: The summary bullets for this article were chosen by Seeking Alpha editors.

This article was written by

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