

ClearBridge Investments All Cap Growth Strategy Q1 2022 Commentary



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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.
- Growth stocks were pressured as the Federal Reserve turned hawkish, ending a historic period of accommodation, but they tend to stabilize and deliver better performance once a tightening cycle is underway.
- Recent underperformance was driven by stock selection, where earnings shortfalls impacted several names in communication services and technology.
- During periods of market transition such as the current one, our experience has taught us that bearish investor sentiment often overlooks business fundamentals, creating opportunity for us as long-term investors.



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Market Overview

Volatility spiked to 12-month highs in the first quarter as Russia's invasion of Ukraine combined with monetary tightening, stubbornly high inflation and lingering effects of the COVID-19 Omicron variant to pressure equities. The S&P 500 Index suffered a 10% correction mid-quarter before recovering to finish down 4.60%, while the NASDAQ (-9.10%) flirted with a bear market before paring losses. Growth stocks bore the brunt of the selling, with the benchmark Russell 3000 Growth Index declining 9.25% compared to a loss of 0.85% for the Russell 3000 Value Index.

The Federal Reserve raised short-term interest rates 25 basis points in March, ending a period of unprecedented accommodation, and projected at least six more rate increases through year end. We believe the rate cycle could last through 2023 with the neutral interest rate approaching 3%. Yields were volatile, declining in a flight to safety during the early days of the invasion before resuming their climb, with the 10-year U.S. Treasury rising over 80 bps in aggregate to end the period at 2.3%.

Growth stocks have historically been pressured leading into a tightening cycle and the past three months have tracked that pattern. What's different this time is the speed of the Fed's shift from a gradual withdrawal of liquidity in the second half of 2021 to an aggressive program to attack the highest U.S. inflation in 40 years. Growth equities tend to stabilize and deliver better performance once a tightening cycle is underway and we view the ClearBridge All Cap Growth Strategy as well-positioned to participate in this potential leadership shift.

The Russian invasion drew an immediate and united response from Western democracies in the form of economic sanctions on one of the world's largest commodity producers. Beyond the wrenching humanitarian toll of the conflict, the cutoff of Russian oil, natural gas and raw materials for such high-demand applications as semiconductor manufacturing and electric vehicle production has exacerbated global inflation and further complicated supply chain bottlenecks. While the Strategy has no direct exposure to Russia or Ukraine, the secondary effects of rising input costs and constrained raw material availability could further blur already challenged corporate earnings visibility. In the current market, companies are being punished for being conservative in their guidance.

While the Strategy underperformed the benchmark Russell 3000 Growth Index during the quarter, we were encouraged by the resilience of the steadily growing, highly free-cash-flow- generative and moderately valued companies we target. We continue to see these types of stable compounders as the foundation of the portfolio, though we believe that complementary exposure to select, faster growing disruptors as well as cyclical and improving growth companies, should position the Strategy to perform well in a variety of market and economic environments.

While portfolio construction hurt relative returns when a narrow band of mega cap growth names dominated performance, first- quarter underperformance was due to lackluster stock selection. Earnings shortfalls impacted several names, including Netflix and Facebook (now Meta Platforms).

After being a prime beneficiary of increased viewing patterns during the stay-at-home period of COVID-19, Netflix is recalibrating what a normal growth trajectory will look like as global economies fully reopen. The stock fell sharply after the company modestly reduced its net subscriber additions for the current quarter, calling into question its ability to continue to deliver double-digit subscriber growth.

We believe one of our edges as active managers is our long-term orientation and willingness to be both early and patient with additions to the portfolio. With Netflix, we remain convinced that our thesis for owning the stock is intact. While some fear the U.S. streaming market is becoming saturated, Netflix's penetration of global broadband homes is still less than 50%, a figure that doesn't even include the opportunity to attract more mobile-only smartphone users.

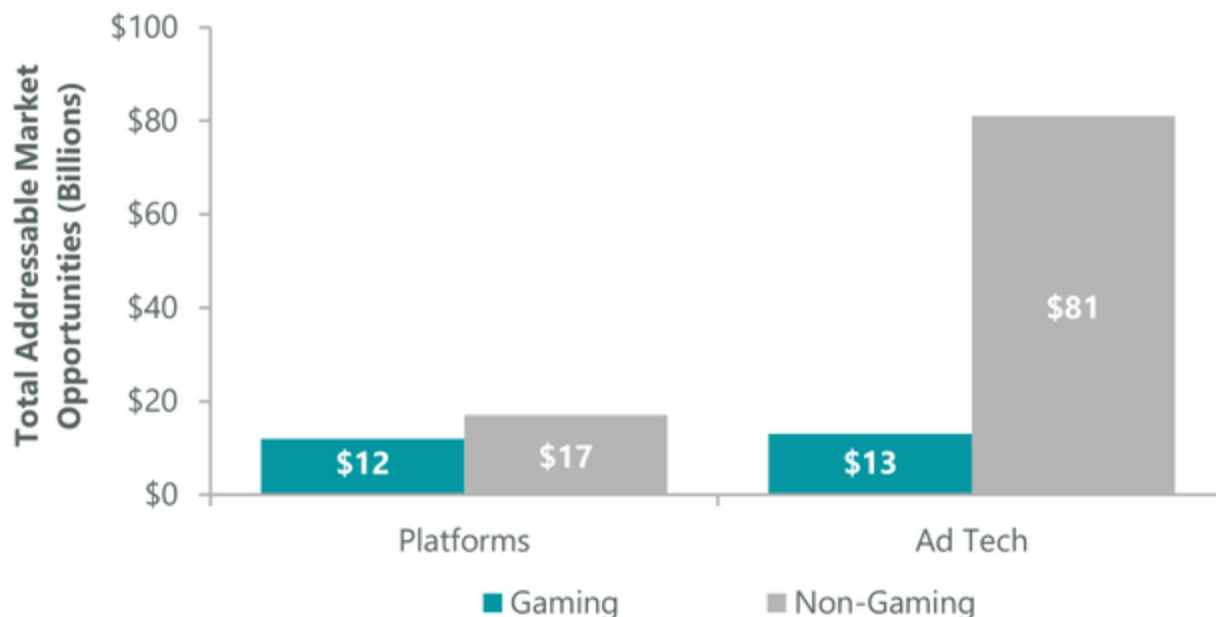
Facebook shares derated following fourth-quarter earnings results and first-quarter revenue guidance that was weaker than expected. We knew going into Facebook's latest reporting period that Apple's ([AAPL](#)) iOS14 privacy changes (measurement, loss of signal) would have a near-term impact on earnings, but competition in the social media space (primarily from TikTok) further catalyzed multiple compression in the stock. While TikTok is a competitive threat and Apple's privacy changes have impacted the industry, we believe these risks are manageable and Facebook retains a number of advantages around user scale, advertiser scale, new product development and sophistication of its digital advertising technology that are not being valued at current levels.

Portfolio Positioning

Short-term price inefficiencies created by recent market volatility have allowed us to ramp up our repositioning efforts. While our initial purchases are usually small, we have been patiently building our exposures by dollar cost averaging into market or security-specific weakness. During periods of market transition such as the current one, our experience has taught us that bearish investor sentiment often overlooks business fundamentals, creating opportunity for us as long-term investors.

We took advantage of a correction in higher-multiple stocks early in the first quarter to purchase shares of Unity Software ([U](#)), a leading platform to create, run and monetize 3D content. With about 1.6 million monthly active creators versus roughly 15 million potential content creators in gaming alone, we believe the company's Create Engine is still underpenetrated relative to its core addressable market. We similarly see a long runway for growth in Unity's Operate Solutions segment given its advertising network commands single-digit share of the \$60 billion mobile app install ad market today. Furthermore, we believe Unity is well-positioned to expand its addressable market to include industries beyond gaming, on both the operate and create sides of their business (Exhibit 1). The company is not yet free cash flow positive but given strong net expansion rates and high gross margins, we see a path to improving profitability over time, with management notably targeting positive free cash flow this fiscal year.

Exhibit 1: Growth Potential Outside Gaming is Growing



Source: ClearBridge Investments, Unity Software SEC Form S-1 2020 and Applovin Corporation SEC Form S-1 2021.

Health care has always been a core foundation of the portfolio and we have been diversifying our health care exposure to include services and solutions beyond our traditional overweight to biopharmaceuticals and managed care. New addition Insulet ([PODD](#)), a leading provider of insulin pumps for diabetes patients, is currently the only meaningful manufacturer of patch pumps, the preferred form factor for many patients as compared to traditional tubed pumps. We believe Insulet has a long runway for growth given its large and underpenetrated market, which is only one-third penetrated in Type 1 diabetes and low-single-digit penetrated in the insulin-intensive Type 2 diabetes population.

Additionally, we see the launch of the company's next generation offering, Omnipod 5, which received FDA clearance in January, as an accelerant to growth. Insulet has strong gross margins and is profitable today, though we still see room for significant operating margin expansion ahead.

Doximity ([DOCS](#)), another new purchase, operates the largest professional social network for physicians. We believe Doximity is poised to gain share within its core addressable market for medical professional marketing, hiring and telehealth solutions. We also see significant opportunity for growth beyond this initial target market, driven by the potential for the company to add new member types, broaden its customer base, expand internationally and offer direct-to-consumer applications. Doximity has a profitable financial model, though we see room for further margin expansion ahead, particularly as growth matures.

Intel rounded out our purchases for the quarter. The world's largest manufacturer of semiconductors, especially CPUs for computers and mobile devices, had been mismanaged in the past, hurting its competitive position. CEO Pat Gelsinger has completely revamped the organizational structure and burned down technology sharing between its owned product and fabrication customers to better compete in this latter area. Intel has differentiated technologies and a roadmap to achieve product leadership in its core PC and data center markets and is using operating leverage to reinvest in new business opportunities such as chip production and GPUs. Chip production has become a bipartisan national security and intellectual property issue due to geopolitical tensions and Intel is expected to be a prime beneficiary of U.S. and European government subsidies to develop new leading-edge fabrication capacity outside of Asia.

Other actions included the sale of Home Depot, a move based on where we are in the consumer and housing cycle as we come out of a period of nesting and dedensification and as government stimulus related to COVID-19 expires. The company has effectively pulled forward demand over the last two years and taken share because of in-stock inventory availability relative to peers. Many of those tailwinds are now turning neutral to negative and our thesis for Home Depot of optimizing the business in terms of merchandising/inventory, omnichannel, PRO/DIY mix, labor and distribution centers has played out. The exit is part of our efforts to reduce consumer discretionary exposure and provide better downside protection if volatility persists.

Outlook

We are entering a period of policy reversal that should lead to a normalization of capital market returns and economic growth from a peak everything environment (liquidity, profit margins, global growth). This is the type of environment where GDP growth is likely to slow and liquidity becomes less abundant and our diversified approach to portfolio construction and focus on quality growth should thrive. Heightening levels of volatility should also be an advantage, allowing us to be opportunistic given our longer-duration growth horizon for the companies we target and own in the portfolio. We did not deliver on our objective this quarter to have better down capture in a volatile market due to consequential poor performance in a select few names.

We still have high conviction in the benefits of our diversified approach and will not waver from our mandate in pursuit of alpha. Instead, we will continue to apply the learnings of the last several years, both the decisions we got right as well as the situations where we misjudged the timing of improvement stories, the competitive risks of specific industries or the growth drivers of certain mega caps that maintain significant weightings in our benchmark. We will remain patient when our business case for owning a company is unchanged by near-term pressures.

However, we have been and will continue to be more disciplined sellers if we see fundamental issues or anticipate such issues on the horizon.

Positioning moves through the pandemic were focused on improving our up capture in strong markets through increasing our weighting to disruptive growth companies in technology and shadow tech. More recently, we have been adding more differentiated return streams to the portfolio with our additions in health care.

We are also committed to participating in the most powerful secular growth trends our research efforts have identified. These include cloud computing/software-as-a-service, gaming, digital payments as well as electrification. A new trend that has emerged with rising geopolitical tensions between the West and China and now Russia is the need for reshoring of production and fortifying supply chains. We have exposure to this theme which we believe will involve a multiyear, if not longer, commitment by most multinational companies.

Portfolio Highlights

The ClearBridge All Cap Growth Strategy underperformed its Russell 3000 Growth Index benchmark in the first quarter. On an absolute basis, the Strategy had losses across seven of the eight sectors in which it was invested (out of 11 sectors total). The primary detractors from performance were the IT and communication services sectors while the sole contributor was the financials sector.

Relative to the benchmark, overall stock selection and sector allocation detracted from performance. In particular, stock selection in the communication services, IT and industrials sectors, an overweight to communication services and underweights to the consumer staples and energy sectors were the primary drags on results. On the positive side, stock selection in the health care sector contributed to relative performance.

On an individual stock basis, positions in Vertex Pharmaceuticals ([VRTX](#)), Palo Alto Networks ([PANW](#)), Splunk ([SPLK](#)), CrowdStrike Holdings ([CRWD](#)) and AbbVie ([ABBV](#)) were the leading contributors to absolute returns during the period. The primary detractors were Facebook ([FB](#)), Netflix ([NFLX](#)), Autodesk ([ADSK](#)), Home Depot ([HD](#)) and Seagate Technology ([STX](#)).

In addition to the transactions mentioned above, we closed positions in Cerence ([CRNC](#)) and Citrix Systems ([CTXS](#)) in the IT sector.

Additionally, the Strategy gained shares of S&P Global ([SPGI](#)) in the financials sector following its acquisition of existing holding IHS Markit.

REITs to the rescue! Investing during a rate hiking cycle

The Fed has finally admitted how hot inflation is running - and we could now be looking at multiple rate hikes over the next several months, at a *minimum*. This means a rough go for certain groups such as technology.

However, there's one asset class which has been shown to outperform during rate hiking cycles - real estate investment trusts (REITs). Over a 2.5 year stretch the Fed raised rates seventeen times. During that time, **REITs outperformed the S&P 500 by more than double**.

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

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