ClearBridge Investments Small Cap Value 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.
- Value has outperformed growth by a substantial margin over the last 12 months but is still making up ground compared to the head-start growth has had over the last 12 years.
- The process of ending a decade of cheap and available capital has begun, creating headwinds that pose a challenge for the market as a whole.
- Our charge of constructing a portfolio of high-quality companies at attractive valuations is a never-ending process, and we remain vigilant in searching for outstanding value.

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Market Overview and Outlook

Small cap stocks had a rough ride during the first quarter, as increases in market volatility and investor uncertainty from major macro catalysts weighed on performance. However, the Strategy's focus on high-quality companies and flexible active management helped it to outperform the Russell 2000 Value Index, which fell 2.40% compared to the Strategy's decline of 0.84%. We continued to see the rotation in investor preference for value drive the difference between the Russell 2000 Value index, which returned - 2.40% but outperformed the Russell 2000 Growth index, which returned -12.63%. The Russell 2000 Value Index has now outperformed the Russell 2000 Growth Index by over 1,750 basis points over the last 12 months but is still making up ground compared to the head-start growth has had over the last 12 years.

From 2000 to 2010, small cap stocks saw a much more moderate annual appreciation that favored growth over value. That was an unusual period, with markets subjected to events of the dot-com bubble and the Great Financial Crisis (GFC). However, the last 12 years have also been unusual, with markets experiencing highly stimulative monetary policy and very stimulative fiscal policy, first as a response to the GFC and, more recently, COVID-19. Prior to 2008, the 10-year Treasury rate essentially never broke 4% and the federal-funds rate rarely dipped below 3%. In contrast, since 2008 the 10-year rate has averaged 2.3% and federal-funds rate 0.5%.

We view this unusually low cost of capital as one, if not the, primary reason equity markets have experienced this incredible run. The relative unattractiveness of returns on cash and fixed income securities spurred investors to seek out higher returns in growth stocks, venture capital, private equity, etc. Investing styles based around long-term improvements in fundamentals and returning capital to shareholders via dividends took a back seat to the quest for growth because of minimal reinvestment opportunities outside of equities. This search for higher returns also devolved into investor speculation in non-productive assets, such as cryptocurrencies or non-fungible tokens, hoping someone would pay a higher price for those assets in the future. In retrospect, we find it unsurprising that 12 years of access to cheap and abundant capital would lead to a lot of unproductive investments.

This period appears to be coming to an end. The sharp rise of inflation over the past year has catalyzed the Fed to respond and initiate a rate hiking cycle that is ratcheting up the cost of capital. The result is that the cost of holding assets that generate no yield - such as commodities, pseudo-currencies and highly ambitious but low-quality growth stocks - is rising. We believe that this dynamic, reflected in investor fears that 10-year rates may again rise to 3% or 4%, has only just begun. If this is indeed the case, it will likely become less popular for public companies to chase growth potential at the expense of profitability.

While companies with immature business models and no profits exist throughout the market, there are certain sectors where they congregate more easily, such as health care. As access to cheap capital recedes, however, many of these specialty drug and biotech companies will likely find it challenging to dismiss long periods of unprofitability and we have had limited exposure in the sector. This benefited our performance during the period, as our underweight allocation to the health care sector yielded positive results.

However, this transition to a higher cost of capital has not been universally beneficial. Our biggest detractor in the quarter was Century Communities (CCS), a home builder whose stock price was subjected to inflation from labor and raw materials as well as concerns over whether the strong current demand for homes will persist as mortgage rates rise. While inflation is certainly a concern, the fact that home prices are at historic highs affords homebuilders the latitude to pass these increases through to homebuyers. We also believe demand from those looking to buy a home and obtain a mortgage will continue to persist despite rising rates, especially as inflation results in rising rents. We believe the housing cycle is far from over and have strong conviction in Century Communities.

Portfolio Positioning

We continue to be active in refining our portfolio positioning as we navigate through these periods of heightened uncertainty and volatility. Our charge of constructing a portfolio of high-quality companies at attractive valuations to achieve the strongest risk-return profile is a never-ending process, and we remain vigilant in searching for outstanding value. To that end, we made a number of adjustments during the quarter to better reflect where we see the greatest opportunities.

We initiated a new position in Itron, in the information technology (IT) sector. Itron (ITRI) is an industrial technology company that makes meters, networking equipment and software for utility infrastructure. Continued global supply chain disruptions proved a headwind to the company's ability to fulfill orders during the fourth quarter, leading to disappointing earnings results, which weighed on the stock's price but created a compelling entry point. We believe supply constraints will prove transitory and recognize the company has a strong backlog and ample new order bookings. Additionally, Itron is a key player in modernizing grid technology and energy efficiency initiatives, which we suspect will support demand over the long term. As such, we expect Itron to deliver revenue and margins well ahead of those embedded in the stock.

We also initiated a new position in Group 1 Automotive (GPI), in the consumer discretionary sector. Group 1 Automotive is one of the leading auto dealership groups in the U.S. and the U.K. Through our analysis, we believe the current stock price already discounts a considerable decline in revenue and profits due to concerns about elevated used car prices and high gross margins per unit. However, we believe this does not reflect the underlying strength of the company's diversified business line and flexible cost structure. Ultimately, we believe the company will prove more durable than the market expects and be a long-term value creator for the portfolio.

We exited our position in CSG Systems (CSGS), in the IT sector. CSG provides revenue management and digital monetization, customer engagement and payment solutions primarily to the communications industry. We decided to exit the position as a result of our updated assessment of the company's perceived value range, and we determined that the company's current share price and prospects offered less upside potential than some of the potential new inclusions to the portfolio.

Outlook

We believe we are at the precipice of significant shifts in long- term market trends. The process of ending a decade of cheap and available capital has begun, creating headwinds that pose a challenging appreciation period for the market as a whole. In the face of such uncertainty, our foundation of using fundamental analysis to invest in high-quality companies should leave us well-positioned to persevere through these challenges. We have strong conviction in our portfolio companies and positioning, and we believe that rising rates and the shifting trends we currently see in the market will work to our advantage to find even greater opportunities.

Portfolio Highlights

The ClearBridge Small Cap Value Strategy outperformed its Russell 2000 Value Index benchmark during the first quarter. On an absolute basis, the Strategy had losses across seven of the 11 sectors in which it was invested during the quarter. The leading detractors were the consumer discretionary, IT and health care sectors, while the leading contributor was the energy sector.

On a relative basis, overall stock selection contributed to performance. Specifically, stock selection in the financials and real estate sectors and an underweight allocation to the health care sector contributed to returns. Conversely, stock selection in the IT and communication services sector and an overweight allocation to the consumer discretionary sector detracted.

On an individual stock basis, the biggest contributors to absolute returns in the quarter were Helmerich & Payne (HP), CNX Resources (CNX), First Horizon (FHN), Matador Resources (MTDR) and Magnolia Oil & Gas (MGY). The largest detractors from absolute returns were Century Communities, SMART Global (SGH), Quotient (QTNT), Goodyear Tire & Rubber (GT) and PROG (PRG).

In addition to the transactions listed above, we initiated new positions in Webster Financial (WBS), First Busey (BUSE) and Simmons First National (SFNC) in the financials sector, Meritage Homes (MTH) and Stoneridge (SRI) in the consumer discretionary sector, UTZ Brands (UTZ) in the consumer staples sector, Green Plains (GPRE) in the energy sector, Maxar Technologies (MAXR) in the industrials sector, NorthWestern (NWE) in the utilities sector, Real Matters (OTCPK:RLLMF) in the real estate sector and Mirum Pharmaceuticals (MIRM) in the health care sector. We also exited positions in Wintrust Financial (WTFC), Home BancShares (HOMB), OneMain (OMF) and First Horizon (FHN) in the financials sector, Stride and American Axel & Manufacturing (AXL) in the consumer discretionary section and Avient (AVNT) in the materials sector.

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.

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

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