ClearBridge Investments Sustainability Leaders Strategy Q1 2022 Commentary

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ClearBridge Investments

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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 energy rally proved a headwind for the Strategy in the first quarter, although the urgency of energy security has accelerated spending on renewable energy, helping solar companies despite threats from higher interest rates.
- We repositioned our industrials exposure to benefit from inflation trends, particularly from higher agricultural commodities prices.
- Holdings across ClearBridge driving the shift to renewable energy continue to lead the way with new technologies and projects that are finding both legislative andmarket support.

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Market Overview

High inflation sparked a hawkish turn for the Federal Reserve that, along with challenged supply chains, soaring commodities prices and Russia's invasion of Ukraine in February, made for a volatile first quarter of 2022. The benchmark Russell 3000 Index retreated 5.28%, with growth stocks selling off on the prospect of aggressive interest rate hikes. The Russell 3000 Growth Index declined 9.25%, while value held relative ground, with the Russell 3000 Value Index edging down 0.85%, supported by commodities-driven sectors such as energy and utilities.

In the benchmark the energy sector (+39%) led by a large margin, with utilities (+4%) the only other positive performer. The quarter saw skyrocketing prices for oil and gas as a supply-driven energy crisis in Europe was made worse by Russia's invasion of Ukraine, which underscored a sudden need to diversify away from the 40% of natural gas supplies Russia currently provides Europe. This is not the type of quarter in which the Strategy, which by prospectus does not own fossil fuel companies, will outperform, and our lack of energy holdings was a significant headwind in the quarter.

At the same time, higher oil and gas prices, and the pressure the invasion put on Europe to diversify its energy sources, increased the relative attractiveness of renewable energy. The urgency of obtaining energy security has accelerated spending on renewable energy, with the EU commission proposing new measures to reduce European dependence on Russian natural gas. In addition to diversifying gas supplies, REPowerEU, Europe's energy security plan, emphasizes more rapidly reducing fossil fuel use by boosting energy efficiency while increasing renewables and electrification. Many renewable energy projects will accelerate with easier permitting and financing.

We are well-exposed to this secular shift. Portfolio holding Brookfield Renewable (BEP), which owns hydro, wind and solar assets across the globe, was the top performer in the quarter. SolarEdge Technologies (SEDG) and Enphase Energy (ENPH) are two key solar holdings that should be able to take advantage of greater incentives for solar installations in many geographies. Both were also strong contributors for the quarter, overcoming pressures of a higher discount rate on their strong projected future earnings, raw material inflation and supply chain challenges as their long-term value was reaffirmed.

The Strategy has long been focused on energy efficiency as a means of boosting bottom lines and lowering global carbon emissions, with names such as Regal Rexnord (RRX), which helps customers achieve their energy efficiency objectives with engineered couplings that are critical components in wind farm turbines, integrated compressors that make HVAC systems more energy efficient, and dry running conveyor solutions that reduce water and chemical usage.

Trane Technologies (TT), another energy efficiency play in the industrials sector that should benefit from trends highlighted in the REPowerEU energy security plan, was a top detractor for the quarter, mainly due to continued supply chain headwinds raising costs. We think there is a strong secular tailwind for the cost and emissions savings Trane provides: the company makes products that help reduce energy consumption and emissions for residential and commercial HVAC and transport refrigeration, the minimization of food waste and other perishable goods and the increased productivity for Trane's customers. Trane estimates ~15%-25% of all greenhouse gas emissions in the world are emitted through HVAC systems and buildings.

The acceleration in electrification of transport should support electric vehicle (EV)-related stocks like TE Connectivity (TEL) and Aptiv (APTV), which came under pressure in the quarter on concerns the auto cycle is past its peak. TE Connectivity makes connectors for a wide range of uses, from automobiles to data centers and medical devices. Aptiv provides a range of solutions for the auto industry, including autonomous driving technologies, safety technologies, components, and wiring. The large exposure of both to EVs should lead to long-term value as EVs continue their growth, boosted by their relative attractiveness as prices at the pump hit near-historic highs.

Meanwhile, housing-related stocks such as Trex, which makes decking and railings from recycled materials, and home improvement retailer Home Depot were weaker in sympathy with rising mortgage rates and commodity costs.

Portfolio Positioning

We were active in taking advantage of opportunities presented in a volatile quarter, especially in the industrials sector where we shifted our exposure to benefit more from inflation trends.

Despite attractive secular growth in end markets for both companies, supply chain challenges led us to exit home electronics company Resideo Technologies (REZI) and Shoals Technologies (SHLS), which makes electric balance of systems (EBOS) components for ground-mounted solar projects.

We used the proceeds to fund a new position in Deere (DE), a leading manufacturer of farm and construction equipment and a leader in precision agriculture, which applies new technologies in planting, spraying and irrigation tasks to improve yields while reducing the use of water and harmful pesticides and herbicides. Deere offers a steering system that reads the soil and steers planters to nearly eliminate overlapping passes on the field, reducing fuel consumption and associated emissions, as well as seed and chemical use. We like the long-term setup for Deere, as well as the near-term environment that made the stock a top contributor in the quarter. With agricultural commodities prices rising, boosting the outlook for farm revenues and demand for Deere's equipment, and low inventories at dealerships, Deere looks well positioned.

We also added to Eaton (ETN), a market leader in the electrical equipment industry and a position begun late in 2021. Eaton's products enable the electrification of the power grid and, importantly, EV charging infrastructure. Share prices should benefit as EVs grow and investments increase to improve grid efficiency and resilience.

We took advantage of the selloff in technology stocks early in the quarter to initiate a new position in semiconductor company Intel. We are positive on Intel's new management's plan of regaining technological leadership and becoming a major global foundry player, coupled with Intel's strategic importance to computing in the U.S. as Russia's invasion of Ukraine brought home the importance of local supply chains to critical industries. With over 90% of the most advanced chips currently coming from Taiwan, there is need to onshore supply. Intel's policies and disclosures around its environmental footprint and impact, diversity and inclusion and supply chain auditing are best in class and the gold standard for the broader technology hardware industry.

Outlook

While the U.S. economy continues to feel the effects of inflation, and rising energy prices stemming from the Russia/Ukraine conflict should exacerbate this, we are bottom-up, fundamental investors and focus on companies that have sustainable competitive advantages and pricing power, i.e., they can price their products to keep up with cost inflation and avoid severe margin compression. There is no change to our belief that owning high-quality companies with excellent sustainability profiles will generate outperformance through a full market cycle.

Portfolio Highlights

The ClearBridge Sustainability Leaders Strategy underperformed its Russell 3000 Index benchmark during the first quarter. On an absolute basis, the Strategy had gains in one of 10 sectors in which it was invested (out of 11 sectors total) - the utilities sector. The main detractors were the information technology (IT), consumer discretionary and industrials sectors.

On a relative basis, overall stock selection and sector allocation detracted from performance. Stock selection in the industrials, financials, materials and consumer discretionary sectors and a lack of exposure to the energy sector were the main detractors from relative results. Conversely, stock selection in the IT sector and an underweight to the communication services sector contributed positively.

On an individual stock basis, Brookfield Renewable, Progressive (PGR), Deere, SolarEdge Technologies and Enphase Energy were the largest contributors to absolute performance in the quarter. The main detractors from absolute returns were positions in Trex Company, Home Depot (HD), Microsoft (MSFT), Trane Technologies and Keysight Technologies (KEYS).

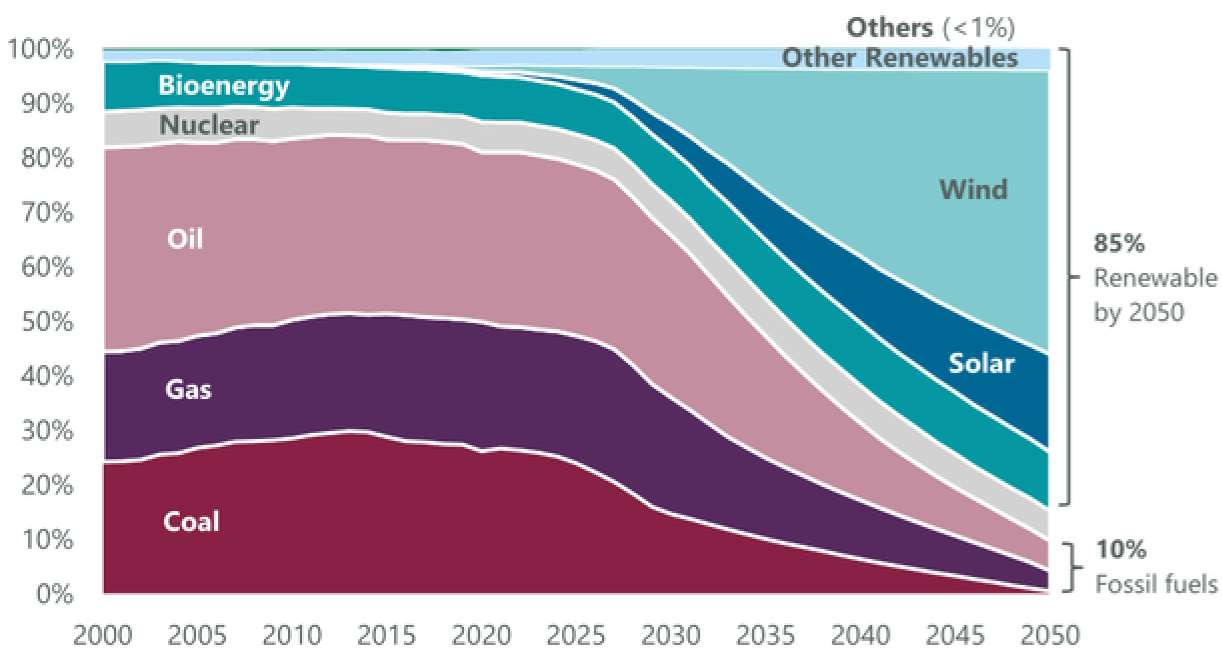
ESG Highlights: Push for Energy Security Will Help Energy Transition

Along with the immense toll it has taken so far on human life, the Russian invasion of Ukraine has highlighted afresh the role of energy security in national security. Roughly 40% of Europe's natural gas is provided by Russia, a vulnerability that speaks to a broader dependence on fossil fuels that could complicate the timeline of many commitments for net-zero emissions. Europe had already been facing an energy crisis since the summer of 2021, with low gas storage levels contributing to record energy prices in late 2021 and public backlash leading governments to subsidize energy costs.

Yet energy security and the energy transition are not inconsistent. While in some ways today's energy crises add to the challenges facing net-zero by 2050 ambitions, they are also spurring more aggressive actions to reach those goals that affirm the long-term opportunity presented by the energy transition (Exhibit 1).

Holdings across ClearBridge driving the shift to renewable energy continue to lead the way with new technologies and projects that are finding both legislative and market support.

Exhibit 1: Primary Energy and Renewable Energy Sources in Green Scenario



As of Sept. 13, 2021. Source: International Energy Agency, BloombergNEF.

The Key to Energy Security is Diversity of Supply

Rather than slow the move to net-zero by retrenching into more oil and gas production, current energy crises should accelerate trends that can propel the energy transition, such as Europe's need for domestic energy production and the improving economics of renewable energy relative to fossil fuels.

The war in Ukraine underscores that energy security is national security, and the key to energy security is diversity of supply. It should bring forward spending on global energy infrastructure in several areas, given the Herculean task of fundamentally rethinking the source of Europe's energy supply on a condensed timeline. Europe must shore up natural gas supply locally, but sources are limited. Instead, it will import more natural gas from a range of sources - the U.S., Southeast Asia, Australia and Qatar. To support this, the REPowerEU plan, released by the European Commission in February following the start of the war, designates gas storage as critical infrastructure and allows incentives for refilling. Germany announced construction of two LNG re- gasification terminals. We expect Europe to contract for new LNG capacity globally over the next several years.

Yet the desire to have energy independence will also increase demand for energy derived from sources other than fossil fuels. The REPowerEU plan accelerates the clean energy transition by enabling more investment in renewables and in effect links the need for energy security with decarbonization. Seeking to reduce Europe's dependence on natural gas and coal in different sectors of the economy - in homes, buildings, industry and power systems - the plan prioritizes:

- Reduction of natural gas consumption in all sectors, including energy, housing and industry.
- More rooftop solar panels, heat pumps and energy savings to reduce EU dependence on fossil fuels, making homes and other buildings more energy efficient.
- Speeding up renewables permitting.
- Doubling the EU ambition for biomethane for 2030, in particular from agricultural waste and residues.
- Replacing demand for Russian gas with 15 megatons of renewable hydrogen, both imported and domestic.

The residential sector in Europe accounts for roughly 40% of natural gas usage, so replacing gas in the home with electricity, electric pumps and heating is on the agenda. Likely increases in tax incentives for charging infrastructure and electric vehicles (EV) will speed up the electrification of transport.

ClearBridge holding Legrand is a significant beneficiary of energy efficiency and electrification trends. Its low-voltage products, sensors and smart thermostats are essential to reducing energy use in commercial and residential buildings. Legrand products also support the growth in EV charging stations infrastructure.

ClearBridge is a top 20 owner of Eaton, whose electrical equipment products also enable the electrification of the power grid as well as EV charging infrastructure.

The key issue with renewables is intermittency, and battery energy storage is the clear solution. We are seeing increased penetration of utility-scale storage in the U.S. where wholesale prices average around $0.09 per kilowatt hour (kwh). However, with Europe paying up to $0.35/kwh and as much as $0.45/kwh in Germany, which gets 55% of its gas from Russia, we would expect to see increased adoption of storage systems to accommodate a ramp- up in renewables.

High and rising utility costs combined with policy support are driving increased penetration of residential solar plus storage systems in Europe. Portfolio companies Enphase Energy and SolarEdge Technologies expect to see significant growth in solar installations in this market, led by Germany and Italy. Consumers are demanding not only solar on the roof but also a complete system solution, including batteries. This phenomenon is accelerating revenue growth for these companies.

The replacement of demand for Russian gas with green hydrogen positions ClearBridge holdings Air Products and Chemicals (APD) and Linde (LIN) well. Green hydrogen, made by using renewable energy to split water into its basic elements, hydrogen and oxygen, and subsequently cleanly burn the hydrogen as fuel, is seen as key to lowering emissions in hard-to-decarbonize industries such as steel and cement, as well as transport. APD's major green hydrogen project in Saudi Arabia, Neom, where hydrogen is generated with the use of renewable energy, should benefit from accelerating demand in Europe. The project is slated to be operational by 2026. In 2021 Linde announced a long-term agreement to provide European semiconductor maker Infineon (IFX) with onsite production and storage of green hydrogen for the company's site in Villach, Austria. The facilities are expected to be operational in 2022.

Securing a clean, domestic source of energy for semiconductor manufacturing appears strategic today amid heightened concerns of reliable supply from Taiwan.

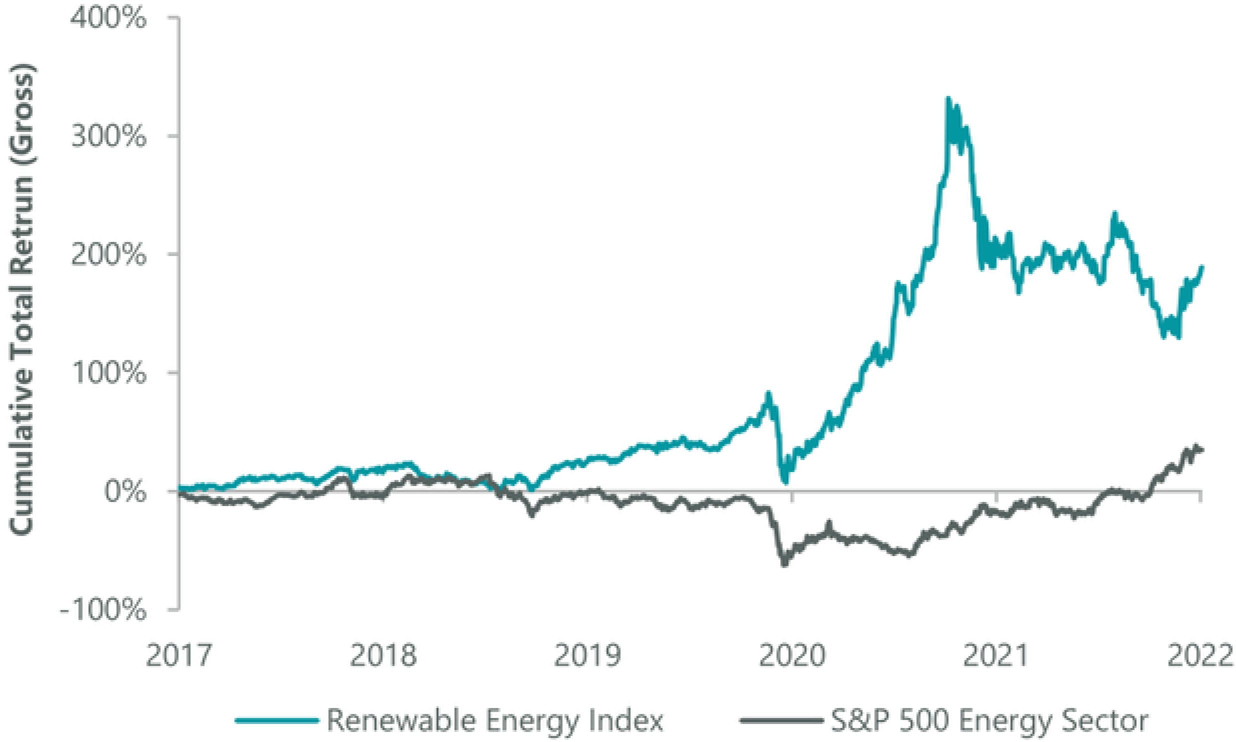
Higher Fossil Fuel Prices Drive Demand for Renewables, Energy Efficiency

While higher oil prices have been a boon to the energy sector in recent quarters and a challenge for renewable energy stocks, it is important to remember that fossil-fuel-based energy and renewable energy are in essence substitute goods, albeit imperfect; the higher cost of one increases the relative attractiveness of the other.

While higher natural gas prices boost short-term returns for the traditional energy sector, they also drive demand for renewable energy, lifting those stocks (Exhibit 2). This will include commercial and residential solar, in which SolarEdge, which makes power inverters and optimizers for solar installations, is an industry leader. Improved commerciality of new higher-power inverters, increasing sustainability goals of businesses and rising power prices resulting from increased fossil fuel costs and carbon prices are driving demand for commercial and industrial (C&I) solar in the U.S. as well as in Europe, Asia and the Middle East.

This is concurrent with secular growth in home rooftop solar both in Europe and in the rest of the world. SolarEdge is also expanding its storage capacity for residential and C&I energy storage with the ability to ramp up capacity significantly should it be needed to meet demand.

Exhibit 2: Recent Energy Run Leaves Long-Term Renewable Leadership Intact



As of Apr. 4, 2022. Source: ClearBridge Investments, Bloomberg LP. Measures cumulative total return of the iShares Global Clean Energy ETF and the S&P 500 energy sector.

Reducing energy use through energy efficiency is another key value driver, and ClearBridge holdings helping make progress in this area will benefit from the world's need to reduce energy consumption. For example, Atlas Copco (OTCPK:ATLCY), a Swedish company, makes energy-efficient compressors and vacuum pumps that adapt their speed to production needs. Current high energy prices should drive demand for highly energy-efficient compressors from Atlas as the majority of the life cost of a compressor is energy costs. Investment in a new compressor can yield significant energy savings. In addition, Atlas manufactures large compressors used in the power industry. The call for energy independence and the diversification of natural gas sourcing could prompt investments in the distribution network (gas pipelines) and regasification (LNG) terminals in Europe. This in turn will increase the demand for large gas and process solutions offered by Atlas.

Utilities Add Hydrogen, Carbon Capture to Portfolios

Utilities continue to enable the energy transition. As infrastructure monopolies, both electric and gas utilities have been actively involved in pushing for more efficient use of the existent systems through various demand management and energy efficiency programs. At the same time, these companies have been investing heavily into adding renewable energy to their asset mix. Gas utilities have started adding renewable natural gas (RNG) into their streams while trying to determine an optimal percentage of hydrogen that could be mixed in. On the electric side, several companies have announced early retirements of their coal-fueled power plants and their replacement with solar and wind capacity.

The share of renewable power in the U.S. has been increasing steadily: the Department of Energy's data indicate that power produced by solar and wind generation increased by 25% and 12%, respectively, over the course of 2021 relative to 2020. The recent increase in natural gas prices should not derail the renewable buildout. On the contrary, the increase in natural gas and electricity produced with natural-gas-fueled power plants make the relative economics of renewables more attractive. Similarly, higher oil and gasoline prices make a stronger case for the adoption of EVs.

Outside of renewables, the energy transition will require massive investments by utilities in their infrastructure. For example, some industry executives estimate a $4 trillion investment will be needed for buildout of the country's transmission infrastructure alone.

In addition to benefiting from robust demand for U.S.-sourced LNG, ClearBridge holding Sempra Energy is at the forefront of the industry's transition to clean energy. The company recently announced a green hydrogen project, the Angeles Link, supporting the Los Angeles manufacturing hub. The interstate pipeline system would bring green hydrogen (hydrogen sourced from solar and wind power) as an alternative fuel for hard-to- electrify industrial processes.

The size and breadth of decarbonization opportunities is also growing for ClearBridge holding Brookfield Renewable, with early opportunities in newer technologies like carbon capture and storage (CCS) factoring into the renewable power company's energy transition strategy. In March 2022 Brookfield announced its first CCS deal, a convertible debenture with Canadian CCS developer Entropy. While CCS is not economic in most places yet, the Entropy deal provides high-single-digit returns on the downside and fully supported returns at carbon pricing well below the Canadian government rate. Over the long term, Brookfield could offer CCS to its renewables off-takers who have large Scope 1 emissions to capture.

Energy Alpha Across Economic Sectors

While in the coming decades there will be moments of strong performance from the traditional energy sector as global oil supply and demand dynamics change, the urgency of lowering global carbon emissions remains a key secular trend supporting opportunities for alpha in several sectors. Energy efficiency and innovations in renewable energy technologies such as solar panels, energy storage, green hydrogen and carbon capture remain key long-term growth stories to watch, offering energy-related value creation potential in the industrials, utilities and information technology sectors that can keep the energy transition on track.

Limit risk while still seeing solid long-term growth

When the whole world was down in March 2020, Eric Basmajian's portfolio was up. How did he do it? By mastering two powerful macroeconomic forces.

First are the secular trends like debt and demographics that create a long-term gravitational pull on the market. Second are the cyclical peaks and valleys that drive most of the gains and losses.

By understanding how these forces interact, you can capture equity-like returns with bond-like risk. Even in today's world of higher inflation, rising rates and falling growth.

What's more, for a limited time only, Eric is welcoming new members for **53% off the first year**.

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