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Portfolio Strategy

ClearBridge Multi Cap Growth Strategy Portfolio Manager Commentary Q2 2022

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Summary

The equity correction has brought stock prices and sentiment closer to levels where risk/reward becomes asymmetric to the upside. We believe a pickup in merger & acquisition activity would be an early signal that undervalued assets are becoming monetized.

Steadily growing, highly free-cash-flow-generative and more moderately valued companies enabled the Strategy to outperform through a sharp market pullback.

Heightened volatility provided opportunities to purchase shares in growth companies on our watchlist, as well as add to existing positions at attractive levels. This activity has put us in the later innings of the overall portfolio transition we embarked on in early 2021.

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Entering Later Innings of Portfolio Evolution

Market Overview

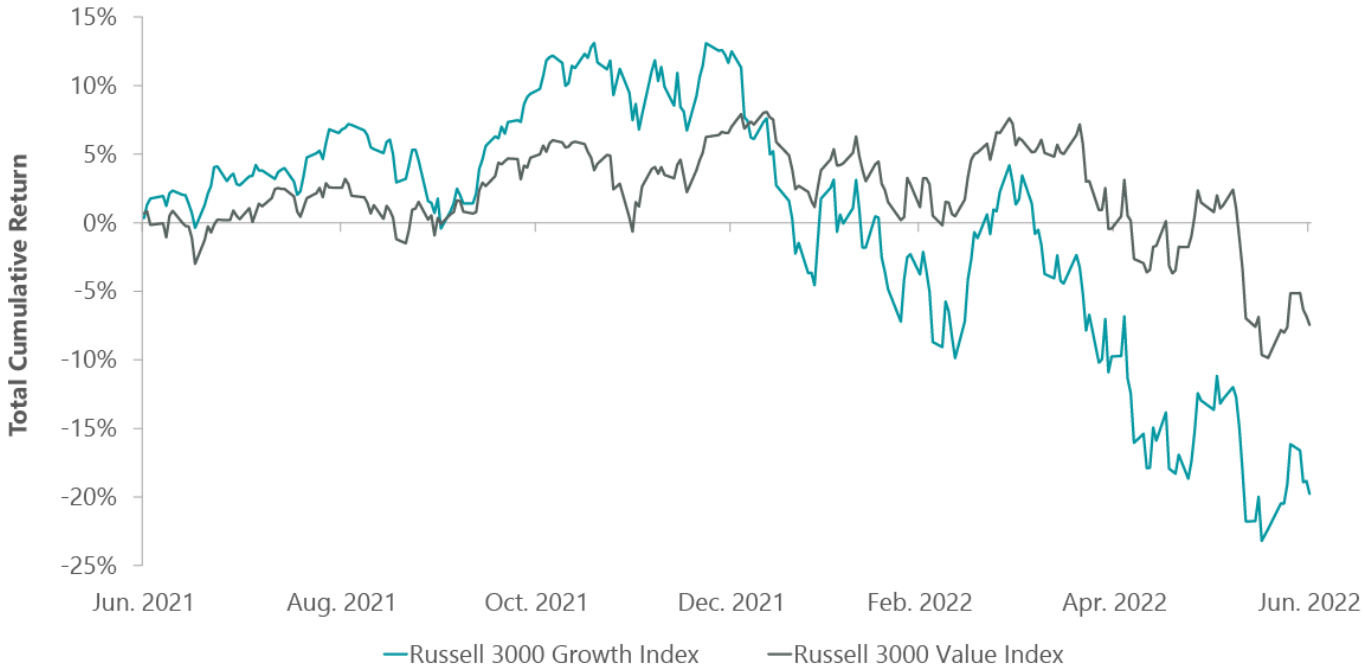
Growth equities entered a bear market in the second quarter as worsening inflation and aggressive actions from the Federal Reserve weighed on corporate results and investor sentiment. Persistent price pressures, global supply chain disruptions and rising recession risks drove the S&P 500 Index down 16.10% for the quarter, capping its worst start to the year (-19.96%) since 1970.

Rising interest rates continued to weigh most heavily on growth stocks, whose future earnings are discounted, with the benchmark Russell 3000 Growth Index falling 20.83% for the quarter and underperforming the Russell 3000 Value Index by 842 basis points. Growth trails value by 1,500 bps year-to-date. To put this in perspective, the underperformance of growth compared to value over the trailing three and six months is among the most severe in the Russell 3000 indices dating back to 1995.

A worse than expected 8.6% Consumer Price Index reading for May pressured the Federal Reserve to raise rates 75 bps in June, the largest hike since 1994, and project ambitious tightening through the rest of the year. The 10-year Treasury yield surged to a four-year high of 3.5% in mid-June, eventually finishing 67 bps higher for the quarter at 3.01%.

Though not immune to the broader market pullback, the ClearBridge Multi Cap Growth Strategy outperformed the benchmark during the second quarter and remains ahead year-to-date. As we discussed last quarter, steadily growing, highly free-cash-flow-generative and more moderately valued companies that form the foundation of the Strategy have supported results through the rout for growth stocks (Exhibit 1). We consider these businesses to be durable compounders, with strong leadership positions and effective management teams able to successfully execute through this challenging macro environment. Additionally, balance sheet strength provides support to shareholder returns through actions such as buybacks, dividends and business development activities. We believe such companies should emerge even stronger on the other side of the downturn.

Exhibit 1: Growth/Value Gap Continues to Widen



As of June 30, 2022. Source: FactSet.

Just as important, heightened levels of volatility provided opportunities for the Strategy to purchase shares in growth companies on our watchlist, as well as add to existing positions at attractive levels. These actions reinforce the balance we have sought to achieve as our portfolio construction process has evolved over the last 18 months and help position the Strategy to outperform over the long term.

Portfolio Positioning

The continued selloff in the market in the second quarter offered entry points into a number of pipeline ideas that were significantly more expensive months ago but are now becoming more appropriately valued for the portfolio. We took advantage by adding three new names to the Strategy: Diageo (DEO) in the consumer staples sector, Snowflake (SNOW) in the information technology (IT) sector and Airbnb (ABNB) in the consumer discretionary sector.

Diageo is a leading global distiller and brewer which addresses the large ($500 billion-plus) and fragmented market for spirits. With its portfolio of premium products, we see Diageo as a steady compounder poised for sustained, above industry growth. The company's margins remain below pre-COVID levels in a number of geographies and should continue to recover as channels reopen, though we also see opportunities for consistent margin expansion beyond this period of rebound. The spirits category is not immune to weaker consumer spending nor inflation; however the majority of Diageo's profits are from the U.S. market, which has historically been more resilient. Additionally, the company has a number of margin levers to help combat rising input costs.

Snowflake operates a cloud-based data platform for small and medium-sized businesses and enterprise customers. The company is a key beneficiary of software spending moving to the cloud, as well as the increasing strategic importance of data. With the potential to address the large and growing market for data cloud, a roughly $250 billion plus opportunity by 2026, we see a long runway for growth ahead. Although the company is already profitable, we believe Snowflake still has significant room for free cash flow margin expansion.

Airbnb is the leading online platform for alternative accommodations globally. We believe the company is well-positioned to capitalize on the large and growing market for travel and experiences, with the potential for growth in e-travel to be higher post pandemic due to pent-up demand and increased work from anywhere flexibility. Airbnb is highly profitable today, though we see room for further margin expansion ahead. Furthermore, secular underpinnings to growth, a more variable cost structure and strong balance sheet should help the company drive better through-cycle performance as compared to its consumer discretionary peers.

The severity of the current selloff, exacerbated by extreme negative investor sentiment, especially toward growth stocks, has compressed the multiples of a number of portfolio companies despite strong fundamentals and led us to add to several existing positions. One example is cybersecurity software provider, CrowdStrike (CRWD), which continues to execute well against a robust demand environment for its endpoint security solutions with quarterly results and forward guidance outperforming expectations. We similarly added to disruptive growth companies HubSpot (HUBS) and Doximity (DOCS) during the quarter.

Outlook

With our more recent transactions, we are in the later innings of the overall portfolio transition that we embarked on in early 2021. The result of the repositioning is a more balanced and diversified portfolio of companies with a stronger growth profile while maintaining a valuation discount as compared to the benchmark.

As fear continues to rise in the markets, owning industry leaders with balance sheet strength and flexibility is essential. Sturdy businesses with tailwinds have seen their share prices correct along with more speculative companies and a recession is becoming the consensus view. After the sharp correction, we feel we are getting closer to levels for stock prices and sentiment where risk/reward becomes asymmetric to the upside. We believe a pickup in merger & acquisition activity would be an early signal that undervalued assets are becoming monetized. The collapse of growth valuations has been painful but establishes a strong base for long-term investors like us who are able to look out five to ten years.

We have brought down financial leverage in the portfolio and are confident in the seasoned management teams running the companies we own. Going forward, we will continue to apply a high conviction, business owner's approach while seeking to maintain balance and be opportunistic with portfolio additions. We believe this philosophy should deliver a high active share strategy that is well-positioned to drive outperformance for investors over the long term.

Portfolio Highlights

The ClearBridge Multi Cap Growth Strategy outperformed its Russell 3000 Growth Index benchmark in the second quarter. On an absolute basis, the Strategy had losses across the seven sectors in which it was invested (out of 11 sectors total). The primary detractors were in the IT, industrials and communication services sectors.

Relative to the benchmark, overall stock selection and sector allocation contributed to performance. In particular, stock selection in the health care and communication services sectors, an overweight to health care and an underweight to consumer discretionary drove results. Conversely, stock selection in the IT, materials, industrials and consumer discretionary sectors, an overweight to communication services and an underweight to consumer staples weighed on performance.

On an individual stock basis, positions in Vertex Pharmaceuticals (VRTX), UnitedHealth Group (UNH), Twitter (TWTR) and Ionis Pharmaceuticals (IONS) were the leading contributors to absolute returns during the period. The primary detractors were Broadcom (AVGO), Wolfspeed (WOLF), Johnson Controls (JCI), HubSpot (HUBS) and Lyft (LYFT).

In addition to the transactions mentioned above, we exited a position in Pentair (PNR) in the industrials sector.

Original Post

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

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