Summary

Weakness in the Strategy’s consumer discretionary and technology names and underweights to several outperforming mega cap growth stocks weighed on performance relative to the benchmark.

Positioning changes remain focused on risk management with reductions in our consumer and cyclical technology exposure and an emphasis on more defensive health care and software as well as an increased weighting in financials. We are also expanding our watch list and stand ready to put cash to work.
Maintaining Conviction Through Severe Conditions

Market Overview

Rapidly tightening financial conditions and rising recession risks pressured equities in the third quarter, with tough talk from Fed Chairman Jerome Powell transforming a summer rally into the next down leg of the bear market. The S&P 500 Index fell 4.9% for the quarter and is down 23.9% year to date, its worst showing at this point in 20 years. Growth stocks held up better than value with the benchmark Russell 1000 Growth Index declining 3.6% for the quarter compared to a loss of 5.6% for the Russell 1000 Value Index. Growth, however, still trails value by nearly 1,300 basis points year to date.
The tipping point for stocks came in late August in Jackson Hole, where Powell pledged to continue raising interest rates and keep them high for a sustained period to stave off inflation. His comments all but eliminated the chance of a “Fed pivot” toward looser conditions, with the 10-year U.S. Treasury yield climbing 82 bps to finish at 3.83%, near its highest levels in over a decade.

Rising rates are particularly trying for the long-duration growth companies we target whose earnings are discounted years into the future. We are already seeing the headwinds on margins and earnings while a hawkish Fed has also contributed to a surge in the U.S. dollar, creating foreign exchange difficulties for multinational firms like Microsoft and Nike that generate significant revenue overseas.

From a sector perspective, consumer discretionary (+6.1%) and energy (+4.3%) delivered positive returns while financials (-0.8%) and industrials (-1.6%) also outperformed the Russell 1000 Growth Index. Real estate (-11.5%) and communication services (-10.6%) were the worst performers while information technology (IT, -5.4%) and the typically defensive consumer staples (-6.8%) and health care (-4.9%) sectors also underperformed.

Against this backdrop, the ClearBridge Large Cap Growth Strategy underperformed the benchmark. Weakness in consumer discretionary and IT relative to the index were the primary detractors due to a combination of stock selection with stable names Microsoft (MSFT) and Visa (V) both down over 9% for the quarter, being underweight Apple (AAPL, up 1.2% in 3Q) and not owning Tesla (TSLA, +18.2%).

Meanwhile, our communication services holdings demonstrated resilience, led by a rebound for Netflix (NFLX, +34.6%) and our not owning Alphabet (GOOG, GOOGL, -12.1%). Our health care holdings, meanwhile, saw mixed results in a turbulent period with positive performance from medical device makers DexCom (DXCM, +8.1%) and Stryker (SYK,+2.2%) offset by weakness in animal health provider Zoetis (ZTS, -13.6%) and diagnostics company Thermo Fisher Scientific (TMO, -6.6%).
2022 has been a particularly challenging year for us as active managers as focusing on diversification across different types of growth companies, favoring quality businesses and taking a defensive posture in positioning the portfolio have not generated alpha. Traditionally defensive businesses, like eye care products maker Alcon (ALC), for example, have not behaved that way through the current bear market despite maintaining solid fundamentals and execution.

We don’t take solace in the fact that we are not alone, as our mega-cap-heavy index continues to outperform most active strategies. We attribute this to the unique behavior of some of the largest constituents in the index that have outperformed in up periods and exhibited resilience during drawdowns.

Exhibit 1: Russell 1000 Growth Index Outpacing Universe

<table>
<thead>
<tr>
<th></th>
<th>One Year Ending Sept. 30, 2022</th>
<th>Percentile Rank</th>
<th>Three Years Ending Sept. 30, 2022</th>
<th>Percentile Rank</th>
<th>Five Years Ending Sept. 30, 2022</th>
<th>Percentile Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russell 1000 Growth Index</td>
<td>-22.59%</td>
<td>19</td>
<td>10.66%</td>
<td>12</td>
<td>12.16%</td>
<td>12</td>
</tr>
</tbody>
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Instead, the best approach we can take at this point is to stick with our process of fundamental, bottom-up research and stock selection with an eye on how each buy, sell, add or trim impacts the portfolio’s overall risk/reward. Through the two and half years since COVID-19 struck, we have prudently transitioned the portfolio into companies that possess what we view as the most attractive growth profiles over the next three to five years.
As a result, our active share has steadily risen, highlighted by meaningful overweights to health care, industrials, software and IT services and underweights in consumer discretionary, semiconductors and hardware in IT. We have written in past commentaries about the reasons for these moves but believe it’s important to understand why we continue to have conviction in a handful of names that have recently underperformed but still represent active overweights in the portfolio.

"Our active share has steadily risen, highlighted by meaningful overweights to health care, industrials, software and IT services."

Exhibit 2: Increasing Active Share

Meta Platforms (META), one of two overweights among the mega cap stocks, underperformed in the third quarter (-15.9%) and is the Strategy’s largest detractor year to date. Meta has also trailed mega cap advertising peer Alphabet, which we don’t own, as revenue growth has slowed due to tough comparables to a strong e-commerce environment in early 2021, negative impacts from Apple’s privacy changes and rising expenses.
While we have trimmed our position close to 20%, we remain invested as we do not think the stocks’ valuation at about 13x consensus 2023 earnings appropriately reflects its long-term earnings and free cash flow generation potential. Despite current revenue headwinds, we believe Meta is well-positioned to navigate industrywide changes to advertising targeting and its transition to the Reels short-form video format will monetize in the coming years, helping to re-accelerate revenue growth.

We also welcome Meta’s implementation of cost-cutting measures, which should help uncover the company’s high underlying profitability. Lastly, we see Meta’s investments in augmented reality as a call option for long-duration investors.

Software has been a solid long-term performer for the Strategy and a key point of differentiation versus the benchmark. But even recurring revenue businesses enabling digital transformation are not immune from the vagaries of the COVID-19 recovery. Salesforce (-12.8%) has detracted from results due to slowing revenue growth driven by a combination of factors, including pull-forward of enterprise digitization demand during COVID-19, some operational missteps, and lengthening sales cycles.

We believe the company still has ample room for revenue growth across its various platforms and should benefit from budget consolidation as customers seek control over tech spending in a weakening economy. We also see significant room for margin expansion. While we have trimmed our Salesforce (CRM) exposure, we maintain confidence that the stock will rerate to a level that reflects its growth potential.

Likewise, graphics chip maker Nvidia (NVDA, -19.9%) has struggled through the post-COVID-19 recovery but maintains dominant positions in key secular growth markets of AI and gaming. The company has significantly underperformed the index and semiconductor peers recently due to a gaming inventory correction, a decline in aggregate cryptocurrency demand and reduction in crypto mining intensity as well as concerns around the sustainability of data center sales.
We tactically trimmed our position early in 2022 due to concerns around these cycle dynamics but remain confident in the company’s long-term prospects.

**Portfolio Positioning**

Another key tenet of our approach is an emphasis on risk management. This emphasis has guided our positioning changes through the drawdown that has characterized most of the year. We started becoming more countercyclical in establishing an overweight to health care tied to procedures and in the last several quarters have complemented this activity by paring back positions in consumer discretionary and more economically exposed areas of IT.

As long-term investors, we have approached these moves in a thoughtful way, reducing positions when short-term headwinds cause us to re-examine our investment thesis and only exiting names when we believe with certainty that the reason for owning them no longer applies. This was the case with Alibaba (BABA), which we exited in the second quarter when the company suffered accelerated market share declines, in addition to the broader macro issues it was facing.

Over the last three months, we similarly exited UiPath (PATH) due to a change to our original thesis as we believe a new go-to-market strategy for its automation software could impact near-term execution. While we think process automation is a growing market, in a slowing macro environment single solutions may be more vulnerable than the platform solutions of software providers who can bundle products to meet a wide range of needs. In addition, the company has a material component of sales sourced in Europe where the economy is more vulnerable.

In addition, we continue to trim names like Adobe (ADBE) and Disney (DIS) with exposure to small and medium size businesses and consumer budgets, respectively, that are more discretionary. At the same time, we have been adding to positions in Microsoft due to cloud being more exposed to enterprise spending, which we expect to be less cyclical.
We also sold out of payments and financial software maker Fidelity National Information Services (FIS), choosing to concentrate our digital payments exposure in PayPal (PYPL), which we believe has a more attractive risk/reward at these levels and more internal levers to generate returns. We bought FIS in 2019 for its mix of offense and defense with banking software and services as a stable business and payments that could keep up with fintech. The shares outperformed the benchmark up to the sale, illustrating the resiliency of the core business; however, FIS has underperformed higher-growth payment names.

The proceeds of these actions are adding to our cash position or being directed to additions among our stable growth companies, with the newest being the purchase of Marsh & McLennan (MMC) in the financials sector. Marsh is the world’s largest insurance broker and operates two consulting businesses, Mercer and Oliver Wyman. The company benefits from attractive insurance industry dynamics, durable underlying revenue drivers and a strong margin/free cash flow profile.

It has demonstrated the ability to grow revenue in excess of GDP growth, particularly during periods of strong property and casualty commercial industry pricing like the current environment, while experiencing more modest revenue declines than overall GDP during past recessions. The insurance brokerage segment does not take underwriting risk but instead earns fees and commissions based on services provided, resulting in low capital intensity and strong free cash flow generation.

In aggregate, we believe MMC’s business will be durable during recessionary periods. Risks include a valuation on the higher end of the stock’s historical range, limited exposure to changes in GDP growth and the likelihood that shares would lag balance sheet intensive financials in a rebound.

**Outlook**
Equities are entering a period of the bear market that will be characterized by massive negative earnings revisions. We saw it early in the summer among big box retailers that held too much of the wrong inventory and it is now spreading into sectors including technology, materials, and financials. Most sectors will likely feel margin pressure, with the possible exception of energy. At this stage, with the Fed signaling a continued tightening cycle, the three factors that drive stock returns — the risk-free rate, the equity risk premium and earnings — are all headwinds.

To deliver performance in such an environment, we believe maintaining our diversified approach and risk management focus are crucial. We are also vetting a growing watch list across sectors such as financials, IT and retailing where negative sentiment and volatility should create attractive entry points into companies with dominant market positions and visible growth drivers.

We see three ways to generate returns through the bear market. The first is by owning stocks delivering high-quality organic growth via a combination of high-single-digit revenue growth, the use of free cash flow to drive buybacks and pulling levers to support earnings growth. We see a number of these opportunities in health care. The second strategy is to purchase stocks after they have derated and established a lower base for future earnings. These include companies like Netflix and PayPal where final demand is normalizing after a pull-forward during the pandemic.

The third strategy is buying growth companies with idiosyncratic or stock-specific catalysts unrelated to the direction of the market like Sherwin-Williams (SHW). The stock is an example of a company we categorize in our cyclical bucket that should experience a step change in earnings over the medium to long term with solid execution and its ability to pass through price increases.

While relative performance has been challenged by binary decisions around a handful of mega cap technology stocks, we’re entering a lower-growth period in which we’ve historically delivered strong relative results from our balanced approach.
Portfolio Highlights

The ClearBridge Large Cap Growth Strategy underperformed its benchmark in the third quarter. On an absolute basis, the Strategy posted losses across the nine sectors in which it was invested (out of 11 sectors total). The primary detractors from performance were in the IT and health care sectors.

Relative to the benchmark, overall stock selection was the primary detractor from performance. In particular, stock selection in the consumer discretionary and IT sectors hurt results the most. Selection in the financials and health care sectors as well as an underweight to consumer discretionary and a lack of exposure to energy also proved detrimental. On the positive side, stock selection in the communication services sector and underweights to consumer staples and IT contributed to performance.

On an individual stock basis, the leading absolute contributors were positions in Netflix, Amazon.com (AMZN), Uber (UBER), PayPal and W.W. Grainger (GWW). The primary detractors were Microsoft, Nvidia, Visa, Meta Platforms and Zoetis (ZTS).

Past performance is no guarantee of future results.

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Original Post

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t0587kn

ClearBridge has >1B exposure to Meta. They must be feeling the pain after last week. AMZN exposure > 1.6B.... (*edited*)

yieldhunter196

@t0587kn iam not concerned about amazons future (huge big moat) but meta? Mhnn IF metaverse flops. Bad

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