Seeking Alpha

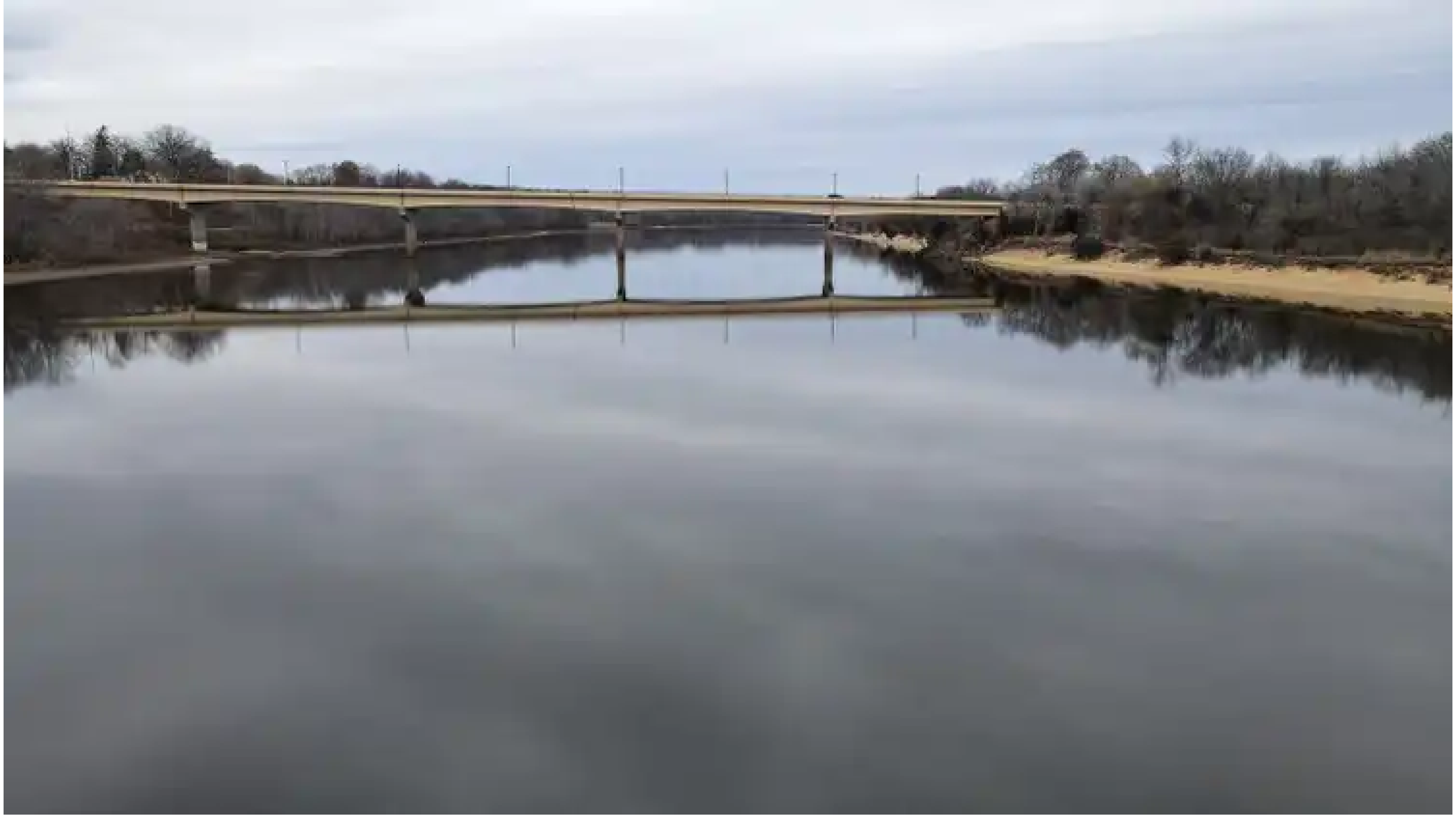
ClearBridge Select Strategy Q3 2022 Portfolio Manager Commentary

Oct. 31, 2022 11:59 PM ET | **ClearBridge Select Fund Class A A (LCLAX)**, **LCLCX** | CEM, EMO, CTR...

ClearBridge Investments
1.52K Followers

Summary

- A rebound for several disruptors in the consumer discretionary sector offset weakness in health care, enabling the Strategy to outperform through a short-lived rally and subsequent drawdown.
- We initiated two new positions in rapidly growing disruptors whose valuations have come in dramatically while culling our exposure to more consumer-oriented companies.
- The U.S. economy is holding up better than other regions and with U.S. multinationals facing foreign exchange headwinds, we believe there's a strong case to be made for owning domestic secular growth and smaller cap companies.



James Neal/iStock via Getty Images

By Aram Green

Staying Close to Home for Growth

Market Overview

After a strong rally from June through mid-summer, equity markets rolled over again following blunt hawkish remarks by Fed Chairman Powell at Jackson Hole. June market lows failed to hold and another hot inflation print in mid-September pushed markets to new cycle lows. Investor sentiment is struggling to see through a period of heightened inflation while rising rates and the end of the pandemic-induced consumer binge are producing a piercing effect on consumption globally.

The benchmark Russell 3000 Index ended 4.5% lower for the quarter and is down 24.6% year to date. In a departure from earlier in the year, growth stocks held up better than their value counterparts while smaller caps outperformed larger companies. The small and mid cap focused Russell 2500 Growth Index fell 0.1% for the quarter while the Russell Midcap Growth Index was lower by 0.7%.

For the third quarter, the performance of several of these smaller cap, growth-oriented businesses in the consumer discretionary and information technology (IT) sectors helped the ClearBridge Select Strategy outperform the benchmark. These included Latin America e-commerce marketplace MercadoLibre (MELI), which bounced off June lows after turning in another strong quarter of 40% growth with increasing levels of profitability, as well as footwear retailer Crocs (CROX).

The development of the electric vehicle (EV) market is a secular innovation we are targeting and here we saw solid contributions from ON Semiconductor (ON), which designs semiconductor components for power management with end markets in industrials and electronics that go into EVs, as well as leading EV manufacturer Tesla (TSLA).

WillScot (WSC), which falls into the evolving opportunity segment of the portfolio that includes companies with specific drivers toward operating improvement, continued to execute on its merger with Mobile Mini by driving value-added sales in a more resilient business model and generating abundant free cash flow.

The overwhelming majority of recent performance headwinds were in health care. Primary detractors Syneos Health (SYNH), Horizon Therapeutics (HZNP) and Surgery Partners (SGRY) were each hurt by distinct issues. Syneos, a leading contract research organization, experienced a slowdown in new business wins from pharmaceutical customers; Horizon saw weaker sales trends for one of its key drugs, Tepezza for thyroid eye disease, while Surgery Partners sold off on concerns that increased summer vacation for doctors would lead to lower patient procedures combined with a fair amount of leverage on its balance sheet.

Our performance in health care was disappointing as we believed this lower-multiple area of the portfolio would be more defensive, with the businesses more insulated from macro issues plaguing the broader economy. We continue to own all three stocks due to quite attractive valuations.

Portfolio Positioning

We made limited changes to the portfolio in the third quarter. New buys included embryonic positions in several rapid growers — MongoDB (MDB) and Clear Secure (YOU) — whose valuations have come in quite dramatically. MongoDB is a company we followed for many years before its 2017 IPO. The stock looks very attractive trading at a third of its recent peak in November 2021. The company's database software is growing rapidly and taking share in a $50 billion plus global market.

Clear Secure is using its innovative biometrics technology to improve how consumers go through airport security. We believe its subscription-based model, which contributes to better throughput through airports, should prove more resilient to travel trends through a downturn with more company-specific growth drivers in the years ahead, including new avenues to monetize its unique identification systems. We trimmed our Expedia (EXPE) position and rolled those proceeds into Clear Secure.

We continued to trim some of the Strategy's consumer-exposed areas with the sale of website tools provider Wix.com (WIX), gaming software developer Unity Software (U) and theme park operator Six Flags Entertainment (SIX) and a trim of discount retailer Burlington Stores (BURL). Meanwhile, we added to software names Snowflake (SNOW), which is rapidly gaining share in cloud data management, and Everbridge (EVBG), an improving growth story under new management.

Outlook

It feels like every day brings another headline detailing a historic move or level in some key macro or industry stat. This all translates in the short term to more rate hikes, more pain ahead and more patience required before investors feel comfortable buying risk assets. As a result, we believe this is an excellent time to be adding to high-conviction stocks whose businesses will likely benefit from company-specific drivers and whose valuations have already been compressed in a turbulent equity market.

We are at a point in the economic cycle characterized by shrinking money supply, quantitative tightening and a pullback in risk taking. The U.S. economy is holding up better than other regions and U.S. multinationals, which derive a large percentage of sales overseas, will see pressure from both lower international consumption as well as weaker profit translation from foreign currency. With 40% of S&P 500 Index earnings coming from international economies, we think there's a strong case to be made for owning domestic secular growth and smaller cap companies.

Relative performance for the Strategy was better in the third quarter versus earlier in the year, but we have much more ground to pick up after a rough first half. We believe the portfolio is positioned appropriately for near-term volatility while not losing sight of the long-term objective to outperform over a full market cycle.

Portfolio Highlights

The ClearBridge Select Strategy outperformed its benchmark during the third quarter. On an absolute basis, the Strategy posted losses across eight of the 10 sectors in which it was invested (out of 11 sectors total). The primary contributor was the consumer discretionary sector while the main detractors were in the IT and health care sectors.

Relative to the benchmark, overall sector allocation contributed to performance but was partially offset by negative stock selection effects. In particular, an underweight to the communication services sector, the Strategy's cash position as well as stock selection in the consumer discretionary, industrials and consumer staples sectors drove results. Conversely, stock selection in the health care and financials sectors and an overweight to real estate weighed on performance.

On an individual stock basis, the leading contributors were positions in WillScot Mobile Mini, MercadoLibre, Crocs, ON Semiconductor and Tesla. The primary detractors were Syneos Health, ServiceNow (NOW), SBA Communications (SBAC), Match Group (MTCH) and Clarivate convertible preferred shares (CLVT.PA).

Performance source: Internal. Benchmark source: Standard & Poor's.

Original Post

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

This article was written by

ClearBridge Investments

1.52K Followers

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. We convey these ideas to investors on a freque

Show More

Comments

Sort by Newest