

ClearBridge Mid Cap Strategy Q3 2022 Portfolio Manager Commentary



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Summary

- Equities continued their slide during the third quarter, as investors grew increasingly anxious over the combination of aggressive interest rate increases and a growing likelihood of recession.
- Health care proved an impediment to relative performance, as the evaporation of capital market financing activity weighed on investor sentiment towards biotech stocks and their vendors.
- We believe that constructing a portfolio of high-quality companies with strong balance sheets at attractive valuations remains the best way to generate attractive long-term returns.



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Market Overview and Outlook

Equity markets continued their downward slide during the third quarter, as investors grew increasingly anxious over the combination of aggressive interest rate increases from the Federal Reserve and the growing likelihood of a recession. The S&P 500 Index declined 4.88% over the three-month period, slowing, extending its decline to 23.87% year to date.

Despite their reputation as more defensive, value stocks failed to maintain favor due to their greater ties to the economy, resulting in the Russell Midcap Value Index falling 4.93% compared to the 0.65% decline of the Russell Midcap Growth Index. However, value continues to outperform on a year-to-date basis by over 1,100 basis points.

Investors hoping that a policy-engineered recession would spur a reversal in central bankers' hawkishness were sorely disappointed as the U.S. economy proved just healthy enough for the Fed to continue aggressively raising rates by another 75 basis points in September as part of its war on persistent inflationary pressures. Candid statements by Fed Chair Powell and other policymakers signaling their intent to continue raising rates beyond previous targets, regardless of the economic consequences, caused equities to retreat further.

Hawkish monetary policy, combined with continued supply chain disruptions stemming from COVID-19 lockdowns in China, war in Ukraine, critically low levels of energy and other commodities and multi-decade high inflation sent investors looking for stability in the most defensive market sectors.

Hard questions about companies' ability to sustain growth rates, margins and earnings guidance in the event of a recession continued to largely favor price-taking companies with undifferentiated products in sectors such as energy and consumer staples. Amidst such headwinds it is no wonder that even the highest quality companies have struggled to rise above the noise and pessimism.

"Amidst significant headwinds, it is no wonder that even the highest quality companies have struggled to rise above the noise."

While we have high conviction in our portfolio of companies with strong balance sheets and economic resiliency, sturdy fundamentals have been overshadowed by extremely negative sentiment. This disconnect contributed to the ClearBridge Mid Cap Strategy's underperformance versus its benchmark for the quarter.

From a sector standpoint, energy (+1.23%) was the only sector of the benchmark to generate positive returns during the quarter. The industrials (-0.01%), information technology (IT, -1.61%), financials (-1.97%) and consumer discretionary (-2.75%) sectors managed to outperform the Russell Midcap Index. Meanwhile the interest rate sensitive real estate (-9.19%) sector was the worst performer for the period, followed by the health care (-6.76%), consumer staples (-6.41%), materials (-5.65%), utilities (-5.53%) and communication services (-5.49%).

Stock selection within the health care sector was the main impediment to relative performance. The evaporation of capital market financing activity negatively impacted biotechnology stocks, which tend to be more reliant on capital markets for funding, and their vendors. This was further compounded by extended sales cycles as clients have become more conservative in light of greater economic uncertainty. Such was the case for Syneos Health ([SYNH](#)), a clinical research organization that suffered as customers delayed scheduling new drug and treatment trials.

However, we believe the market has overreacted to the news, partially due to a new CEO poorly communicating that these scheduling clusters are not unusual even in the best bull market. We believe the new management team can improve Syneos' go-to-market strategy and expect clients can only delay clinical trials for so long before it becomes an impediment to their own businesses.

Vaccine-related companies suffered as the market saw dwindling COVID-19 revenues. Catalent ([CTLT](#)), which develops and manufactures drugs, biologics, cell and gene therapies and consumer health products, saw its shares derate after the company missed earnings expectations partially due to a drop-off in its COVID-focused biologics business.

Catalent is responding by reshuffling internal assets to increase synergies and focus on its strong non-biologic franchises, such as its high-growth and high-quality gummy vitamin business. The company has begun correcting its supply chain issues and has thus far successfully navigated inflationary pressures, setting up an improving margin picture over the next few years.

Our exposure to industrials generated positive performance during the quarter due to strong idiosyncratic drivers and greater earnings clarity. The lead contributor to performance was WillScot Mobile Mini ([WSC](#)), a North American leader in turnkey modular space and portable storage solutions.

The company has been able to drive increases in margins and market share through its value-added products and initiatives, including fully furnished spaces, modular customization abilities to suit different client purposes and improvements in logistics and supply chain management. Additionally, WillScot's long-term contracts and pricing power as an industry leader have allowed it to pass through cost increases on contract renewals.

Our IT holdings also positively contributed to relative performance versus the benchmark. Aspen Technology ([AZPN](#)), which develops software to optimize manufacturing operations and supply chain functions particularly within the energy industry, benefited from strong global energy demand, particularly in Europe. ON Semiconductor ([ON](#)) was boosted during the quarter by high demand for auto semiconductors used in sensing and power management modules amid global chip shortages and tight supply chains.

The company's new leadership have divested underperforming manufacturing facilities and redirected the company's focus towards higher margin products. Additionally, the company's acquisition of GT Advanced Technologies, which specializes in silicon carbide-based products, leaves ON well-positioned to extend its long-term growth runway as electric vehicles transition to more energy-efficient silicon carbide auto inverters.

Portfolio Positioning

Rather than abandon our discipline to chase short-term returns, we remain diligent in seeking opportunities to improve our overall positioning. We continue to build an extensive watchlist of candidates, and continually review our existing holdings to ensure our thesis for owning them remains compelling. This approach led to the initiation of two new positions and exits from three others during the quarter.

New holding Everbridge ([EVBG](#)) is a leader in critical event management software used to coordinate and disseminate information to keep employees safe in the event of an emergency. The stock has struggled over the last year in digesting what we view as too many acquisitions. However, the company's new CEO is refocusing the business on its flagship product by divesting ancillary product lines.

We also added natural gas company EQT ([EQT](#)) in the energy sector. As one of the lowest-cost domestic producers, EQT stands to benefit from its position as a leading supplier of natural gas to a world suffering from critically low energy reserves. The Russian invasion of Ukraine and threats to hold natural gas exports hostage have spurred a surge in European energy prices, generating long-term agreements by European countries to purchase U.S. natural gas.

This strong demand and elevated prices have helped EQT strengthen its balance sheet and position it to take advantage as opportunities emerge for natural gas to plug the gaps in the global energy transition from fossil fuels to renewables.

We exited our position in theme park operator Six Flags Entertainment ([SIX](#)) during the quarter. While we continue to believe that Six Flags' new CEO is on the right path in directing assets and efforts towards greater premiumization of the parks, the lingering legacy of COVID-19 and a highly inflationary environment present formidable headwinds to these efforts.

Outlook

We believe owning a portfolio of high-quality companies with strong balance sheets at attractive valuations remains the best way to generate attractive long-term returns. Unfortunately, this does not mean we can do so every quarter. The rapid succession of macro factors over the last two years has resulted in a severe disconnect between market performance and company fundamentals, with hyperbolic swings in market sentiment helping performance one moment and hurting it the next. Despite these challenges, we remain confident in our approach and our portfolio.

Portfolio Highlights

The ClearBridge Mid Cap Strategy underperformed its Russell Midcap Index during the third quarter. On an absolute basis, the Strategy had losses across 10 of the 11 sectors in which it was invested during the quarter. The leading detractors were the health care, financials and consumer discretionary sectors, while the industrials sector was the sole positive contributor.

On a relative basis, overall stock selection detracted from performance, but was partially offset by a positive contribution from sector allocation. Specifically, stock selection in the health care, financials, materials and consumer discretionary sectors weighed on relative returns. Conversely, stock selection in the industrials and IT sectors and an underweight allocation to the real estate sector contributed to returns.

On an individual stock basis, the biggest contributors to absolute returns in the quarter were WillScot Mobile Mini, Regal Rexnord ([RRX](#)), Workiva ([WK](#)), ON Semiconductor and Aspen Technology. The largest detractors from absolute returns were Syneos Health, Avantor ([AVTR](#)), NCR ([NCR](#)), Catalent and Coty ([COTY](#)).

In addition to the transactions listed above, we also exited positions in Momentive Global ([MNTV](#)) in the IT sector and Molina Healthcare ([MOH](#)) in the healthcare sector.

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