ClearBridge Investments

Sustainability Leaders Strategy

Derek Deutsch, CFA
Managing Director,
Portfolio Manager

Mary Jane McQuillen
Managing Director,
Head of ESG Investment,
Portfolio Manager

Key Takeaways

- Our differentiated positions in the health care sector made strong contributions as the market began to reward the heavily discounted sector.
- ClearBridge has been holding interactive ESG engagements with Amazon, a new position and a significant impact opportunity, since 2019.
- ClearBridge holdings are proactively developing forward-thinking solutions that foster stronger hiring and retention cultures, helping to ensure the businesses remain competitive for years to come.

Market Overview and Outlook

Continued economic recovery supported by a 95% reduction in U.S. COVID-19 cases combined with moderating concerns of sustainably higher inflation helped U.S. equities make strong advances in the second quarter. The benchmark Russell 3000 Index rose 8.24%.

Energy stocks continued to lead the market (+12.55%) amid strong economic growth and recovering energy demand, while real estate, an inflationary hedge, was also strong (+11.69%) as was the information technology (IT) and communication services sectors (+11.37% and +11.09%, respectively). Utilities and consumer staples trailed, as a pro-growth environment outweighed any relative benefit these yield-oriented sectors would normally experience with Treasurys declining, while at the same time the market priced in some near-term rolling off of the Fed’s asset purchases. Inflation concerns remained front and center for investors but were less acute as manufacturing PMI growth steadied and some commodity prices moderated, weighing on the industrials and materials sectors.

The Strategy’s core positions in Microsoft and Apple led individual contributors, as these high-quality companies continue to execute phenomenally, firing on all cylinders.

Our differentiated positions in the health care sector also made strong contributions as the market began to reward the heavily discounted sector. Danaher, for example, is seeing customer activity approach pre-pandemic levels and is executing well. In addition to improving health through its life sciences (research tools for biopharmaceutical, food and beverage, medical, aerospace and microelectronics industries) and diagnostics (tools for use in labs and critical care settings) businesses, Danaher offers environmental and applied solutions that keep global food and water supplies safe.

CVS Health saw strength in its pharmacy benefits manager business as well as its managed care business, Aetna, helping to confirm our positive view of CVS's repositioning of its business model from a dispensary model to a service model. With CVS store-based health care services offering patients better convenience, encouraging better health care compliance and ultimately lower costs, we believe the company is at the forefront of a changing mindset in the health care services sector.

> CVS is reinforcing our positive view of its repositioning from a dispensary model to a service model.

Two additional names in the health care sector in the quarter, partially funded with a sale, made strong contributions and helped push our relative exposure to the sector from underweight to overweight. We added Thermo Fisher Scientific to increase our exposure to health care tools, which has been an attractive and core segment within health care. Thermo Fisher's instruments are used to monitor and protect air, water, and food quality, and the company has strong long-term fundamentals, a top-tier management team and a diversified business.

We also added Progyny, a leading provider of fertility benefit management services to self-insured employers. This is an increasingly important, albeit relatively underpenetrated benefit for employers, particularly those seeking to improve access and support diversity, inclusion and equity initiatives.

Progyny realizes substantially better outcomes for patients (higher pregnancy rates, lower miscarriage rates and lower twins rates), which leads to significant cost savings for payers along with the obvious better outcomes for patients and families. Progyny's mission is to improve the employee experience around fertility issues in order to aid clients in employee recruitment and retention. The company offers a rare win-win-win for employers, employees and health systems, with clear savings and quality improvements. With the company still relatively underpenetrated in its total addressable market and with logical adjacencies (labs/diagnostics, return-to-work support) and demographic tailwinds (families getting started later leads to higher infertility risk), Progyny should sustain its elevated top-line growth profile.

The Strategy also benefited from strong showings from financials holdings such as recent addition Morgan Stanley, a leading bank holding company offering a variety of financial services worldwide, and one of the largest broker-dealers, investment banks and wealth managers in the U.S. Morgan Stanley has been a leader in helping direct capital to address global sustainability challenges. Its sustainability efforts include capital markets actions such as issuing green bonds and it was early in its support for sustainability in investing and its concern for the environment. Morgan Stanley reported a great quarter with record revenues and strength across the businesses as it works to integrate and find synergies with recent acquisition E*TRADE. Following stress tests for banks, Morgan Stanley increased its dividend and share repurchase plan more than expected.

Commodity price increases have led to margin pressure across industries, and in some cases have altered our thesis for holding a company. This was the case this quarter with top detractor Array Technologies, an equipment manufacturer that makes trackers and associated software for ground-mounted solar projects, which we sold and may revisit again in the future. Margins also came under pressure for pasture-raised eggs company Vital Farms, due to an increase in commodity prices that it was unable to pass through to end customers. This aspect of the business model is being re-evaluated by management; we saw better opportunities elsewhere and sold our position.

We also sold medical device and laboratory supplier Becton Dickinson to fund the new position in Thermo Fisher, which we viewed as having superior fundamentals and risk/reward characteristics.

The Strategy's goal of generating strong risk-adjusted performance while investing in companies that can make a positive impact on society and the environment is often supported by holdings that are companies with significant customer bases, making our engagements with them effective platforms for driving change. This is the case with new holding Amazon.com, the leading retail e-commerce site and provider of web hosting and related cloud services that continues to benefit from the migration of commerce from offline to online. We initiated a position in Amazon based on its strength in several areas, including retail, its Amazon Web Services cloud business and advertising; from a valuation perspective, Amazon has become more attractive as profitability has improved and the stock has gone sideways in an up market.

ClearBridge has been holding interactive engagements with Amazon on several ESG issues for several years, including labor and environmental issues, and we have seen improvements over that time. From a sustainability perspective, Amazon has made meaningful ESG commitments and improved labor practices and it faces fewer regulatory issues than many large tech peers. Labor management remains a key focal point and the company has made increased commitments to its labor force, including in December 2018, when Amazon increased its minimum wage standard to $15 an hour in the U.S., well above the federal minimum wage standard. Amazon is also taking steps toward environmental sustainability that would put it ahead of peers if goals are achieved. In June 2019, Amazon set new targets to be carbon neutral by 2040 and to use 100% renewable energy by 2030.

Amazon has a long track record of innovation that benefits consumers and third-party sellers and has raised the bar multiple times on delivery and selection within its e-commerce business. In 2018, 58% of Amazon's gross merchandise value (GMV) was generated by third-party sellers on the Amazon platform.

Given the colossal size of Amazon's operations — it has over one million employees and ships nearly three billion packages each year — we see Amazon as a significant impact opportunity through continuous improvements in its operations, such as its net-zero carbon by 2040 goal.

We remain constructive on the U.S. economy as well as global economic recovery, even as we are monitoring vaccination efforts and the threat of COVID-19 variants. Inflation and cost pressures should prove to be either transitory or manageable overall by the high-quality companies we focus on, or both. Despite a pause in momentum for tech-heavy solar energy companies as rates rose earlier this year, these stocks have seen robust growth overall and we see both cost and policy drivers acting as long-term tailwinds. Despite fuller valuations in the market as a whole, we are still finding opportunities where value is not being recognized and where companies with strong sustainability profiles are poised to lead.

Portfolio Highlights

The ClearBridge Sustainability Leaders Strategy underperformed its Russell 3000 Index benchmark during the second quarter. On an absolute basis, the Strategy had gains in eight of 10 sectors in which it was invested (out of 11 sectors total). The main contributors were the IT, health care and financials sectors. The utilities, materials and consumer staples sectors were the main laggards.

On a relative basis, overall stock selection and sector allocation detracted from performance. Stock selection in the IT, communication services, materials and consumer discretionary sectors detracted the most, while stock selection in the health care sector contributed positively.

On an individual stock basis, Microsoft, Apple, Danaher, Morgan Stanley and BlackRock were the largest contributors to absolute performance in the quarter. The main detractors from absolute returns were positions in Array Technologies, Brookfield Renewable Partners LP, Marriott International, Regal Beloit and Hain Celestial.

ESG Highlights: Cultivating Human Capital for Long-Term Success

Cost pressures in a reopening U.S. economy are coming from a variety of sources: shutdown-related supply shortages, a Suez Canal blockage rippling across global shipping, a semiconductor plant fire in Japan, and, not least, a tight labor market as demand for goods and services outpaces labor supply.

Managing human capital — a mixture of employee skills, wellness, productivity and innovative ability — through a pandemic and recovery is requiring approaches focused on the long-term success of both employees and the bottom line. Among these, wage inflation is conducive to reducing economic inequality in many industries.

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As the pandemic wanes and the labor market tightens, ClearBridge holdings in essential retail, rideshare and logistics businesses are balancing labor and shareholder interests by proactively developing forward-thinking solutions that foster stronger hiring and retention cultures, helping to ensure the businesses remain competitive for years to come.

Essential Retailers Prioritize Retention

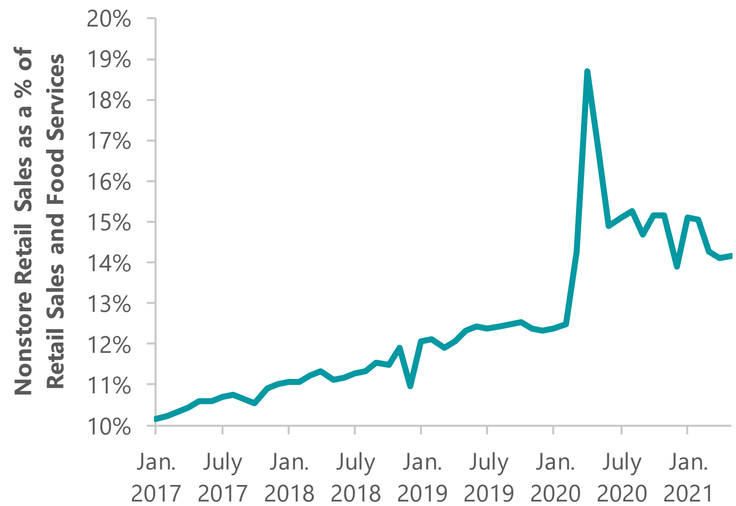
The pandemic has created challenges for businesses large and small; one major challenge for large essential retailers such as ClearBridge holdings Home Depot, Walmart and Costco has been ensuring adequate staffing to meet demand under trying conditions. All three instituted enhanced pay practices during the pandemic, with raises, unplanned bonuses and other benefits helping compensate employees for their efforts in a difficult environment. Over the course of the pandemic, for example, Home Depot has invested $2 billion in expanded benefits for employees. These have included extra weeks of paid time off that employees could use either as vacation time or supplementary pay, paid time off for employees contracting COVID-19 or requiring to be quarantined, and relaxed time off policies.

While some of the compensation measures are temporary, some have transitioned into permanent wage hikes. At Home Depot, expanded benefits include $1 billion a year in permanent raises for hourly workers. In September 2020 Walmart raised wages for 165,000 employees, including a number of entry positions to $15 an hour. It followed this in February with a raise for 425,000 workers that moved its average pay above $15 an hour. In February 2021 Costco, which we have long acknowledged as a leader in workplace practices, raised its starting wage to $16 an hour; its average wage at the time was $24 an hour.

The expanded benefits have meant a hit to margins for these companies, even while the essential services nature of their businesses has meant large influxes in sales that could offset these outlays, but we view the moves as forward-thinking human capital management.

There is a strategic benefit in raising wages and benefits to keep these businesses competitive. For one, being earlier rather than later in enhancing employee compensation also sends a strong positive message to workers that builds good will and trust. Proactively supporting employees through enhanced compensation measures also better positions these companies amid a scramble for talented workers in a new e-commerce-driven retail paradigm the pandemic has helped cement (Exhibit 1).

Exhibit 1: A New Plateau of E-commerce



As of May 31, 2021. Source: Census Bureau.

One benefit of proactively raising worker compensation as these companies compete in a growing e-commerce paradigm is better employee retention, a key competitive advantage as higher retention saves costly onboarding and training efforts and keeps institutional knowledge strong. In terms of ensuring access to sufficient labor, Home Depot shared with ClearBridge that there has been no reduction in the number of applications for temporary workers it has been receiving, an indication its human capital policies are ensuring it is still able to attract talent even amid higher competition.

The pandemic has accelerated the move to e-commerce and put forces into play that should result in higher wages both for workers in large retail supporting e-commerce and adjacent industries such as restaurants. Anecdotally, we have seen some spillover effects from wage increases from large essential retail employers (Walmart employs 1.5 million; Home Depot 500,000; Costco 273,000) in that industries competing for this labor pool, such as restaurants, are now seeing worker scarcity as candidates prefer higher-paying distribution center jobs or jobs at grocery stores that are steadier and not reliant on tips.

There is some confirmation of this in the latest job data, which show average hourly wages for retail workers rose 8.6% in June from February 2020, while restaurant and hospitality workers' wages rose 7.9%, both above the overall wage growth of 6.6%.

The average hourly wage in the hospitality sector was $18.23 an hour in June, and $21.92 in the retail sector.

While there are prices for the expanded compensation in terms of adjacent businesses, there is also potentially a modest downside for customers in the form of broader inflation as businesses pass on the expenses through price increases, ultimately weakening purchasing power for those enjoying higher wages. This does not seem to be the case at present, however. Companies may also be reducing sale promotions as a way to mitigate labor cost increases. At the same time, many companies will try to offset higher labor costs with technological innovation that will seek to boost efficiencies over the long term.

Culture Shift Coincides with Transport Boom

The recent acceleration of e-commerce has also meant workers are benefiting from upward wage pressure in freight and transportation. Wage inflation, however, is not enough for employee retention. United Parcel Service (UPS) is going a step further by shaping culture, and it is paying off.

Under the new CEO, Carol Tomé, UPS has increased its focus on ESG to retain and attract the next generation of workers. The goal is to move from being a “trusted but stodgy” shipper to a modern innovative company through greater attention to sustainability as well as diversity and inclusion. Seeking to be a “people-led” company, UPS has been tracking the employee experience in order to understand and improve employee engagement. UPS measures its employee experience by asking how likely employees are to recommend others work there. That metric stood at 51% globally at the end of 2019 but has improved by six percentage points under Tomé’s leadership as UPS drives diversity and inclusion efforts across the company, including investing in training, modernizing appearance standards, and adding a Chief Diversity, Equity, and Inclusion Officer on the executive leadership team. Ultimately, UPS hopes to get this “likely to recommend” metric up to 80%.

UPS is also driving environmental goals through its recent pledge to be carbon neutral in all of its operations by 2050. This aligns with the company’s mission to attract next-generation talent. The carbon neutral pledge includes goals of 25% renewable electricity for facilities and 40% alternative fuel for ground vehicles by 2025; 50% reduction in CO2 per package delivered for its global small package operations; and powering 100% of its facilities with renewable electricity and running its air fleet with 30% sustainable aviation fuel by 2035.

Tomé’s “people-led” approach builds on a long history of engaged workers at UPS; its employees and retirees own Class A stock, which entitles them to 10 votes per share versus Class B (public stock) at one vote per share, giving employees and retirees disproportionate say in voting matters.

Rideshare Moving Ahead of Peers on Labor

The pandemic has also brought attention to the question of gig worker employment status for companies, including ClearBridge holdings Uber and Lyft. In the U.K., Uber proactively classified its drivers as "workers" ahead of final rulings from the British court system. The worker status in the U.K. is a designation between self-employed and employed status that entitles drivers to minimum wage, holiday pay and in some cases a pension.

ClearBridge has engaged with Uber on labor issues since its IPO, and we have given feedback over that time to the CEO, CFO, Chief Legal Officer and Investor Relations on labor relations as well as strategy and communications. Uber's agreement on this designation is ahead of other competitors in the market and the legal mandate represents a step forward in the company's thinking about labor. The agreement represents a short-term hit to earnings, yet in some ways it places Uber ahead of the market in its ability to balance labor and shareholder interests. Workers benefit from improved conditions, with new contributions amounting to roughly 3% of a driver's earnings, while Uber establishes more certainty on costs and visibility into its regulatory environment and operation conditions in the future.

Continuing to Engage on Important Social Issues

Human capital management is a frequent topic of engagement for ClearBridge with our portfolio companies as it touches on a number of related important social issues in our ESG framework, such as employee health and safety, recruitment and retention, health care affordability and access, union relations, and diversity and inclusion. Our belief is that strong human capital management practices, while they may entail costs that affect the bottom line, are ultimately a competitive advantage, especially when labor is in short supply. In the long run, having the right workforce in place also drives the top line.