ClearBridge Investments

Small Cap Value Strategy

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Key Takeaways

- It was the fifth consecutive quarter of gains for small cap value stocks, which have more than doubled in value since March 2020 and are up roughly 32% since the end of 2019.
- Our Strategy performed in line with its benchmark, helped by strong performance among consumer discretionary stocks.
- While speculative mania risks permanent loss of capital, we continue to find companies we believe will hold their value and provide investment dollars over the coming years.

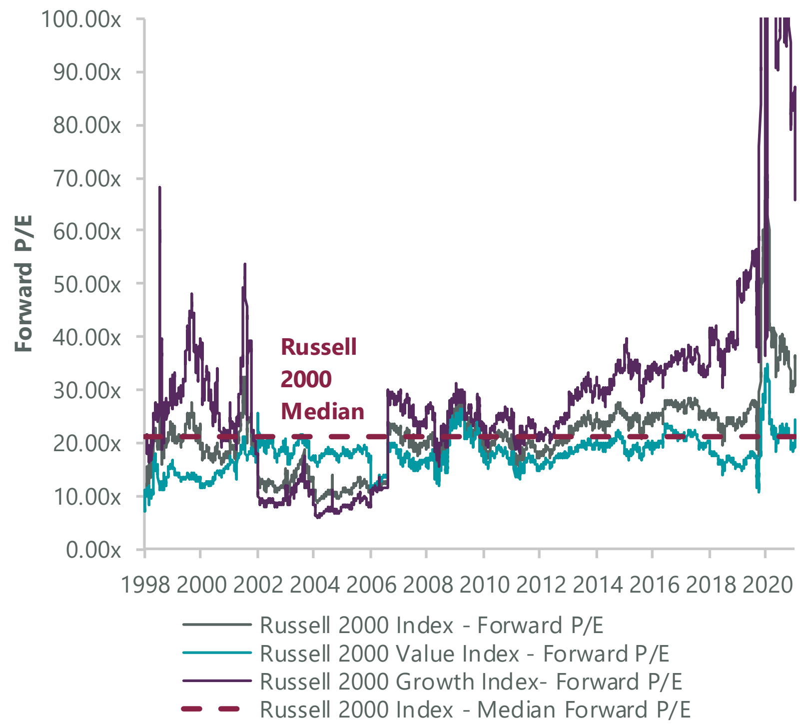
Market Overview and Outlook

The ClearBridge Small Cap Value Strategy delivered strong returns in the second quarter, performing in line with the benchmark Russell 2000 Value Index, which rose 4.6%. Communication services was the leading sector in the benchmark in the quarter, driven almost solely by the ludicrous 450% rise in AMC Entertainment, followed by energy and real estate. It was the fifth consecutive quarter of gains for the Russell 2000 Value Index, which has more than doubled since March 2020 and is up roughly 32% since the end of 2019, prior to the COVID-19 selloff. The Russell 1000 Index performed even better, despite the pandemic.

Our Strategy outperformed with strong results from consumer discretionary stocks like Everi Holdings and Vista Outdoor. Everi Holdings is a provider of casino games, cash access and customer relationship technologies to the gaming industry that outperformed as gaming activity and growth in placement of new games generated strong financial results. Vista Outdoor, a manufacturer of a wide range of products serving the outdoor sports and recreation markets, also performed well in the period on continued demand and growing margins. Gray Television, a television station owner/operator in the communication services sector, was also strong.

The index's ~32% increase since 2019 came not just despite the pandemic, but also despite the market's roaring performance leading up to 2020. We noted at the time that growth stocks had driven a 12% compounded annual growth rate in the Russell 2000 since 2011, putting the Russell 2000 Growth Index near its highest forward P/E multiple since the dot-com bubble, while the Russell 2000 Value Index was near its 20-year average. Well, not surprisingly, it's higher now. The Russell 2000 is over 36x forward earnings, while the value index is over 24x and growth more than 65x. All of those multiples top those achieved at the height of the dot-com boom.

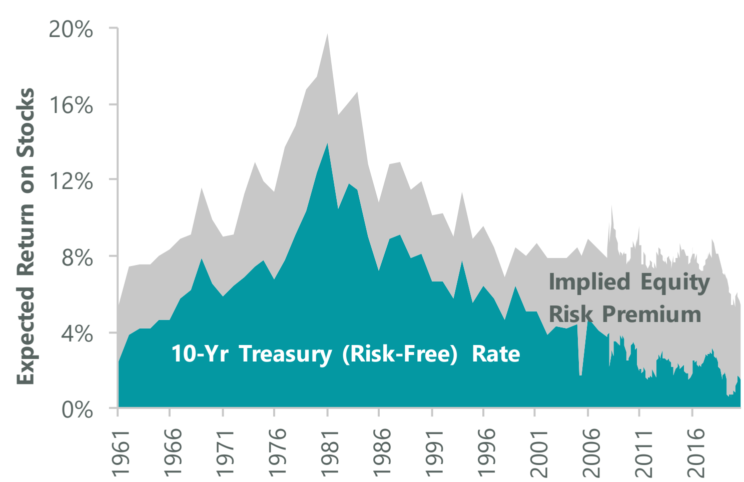
Exhibit 1: Historically High Multiples



Source: S&P, ClearBridge Investments.

What's more remarkable about now relative to 2000 is that the federal-funds rate is near zero and 10-year Treasury notes yield only about 1.3%. Not only is the equity risk premium low; so is the risk-free rate, meaning that the cost of equity is the lowest it's been since the 1960s.

Exhibit 2: Equity Risk Premium



Source: Aswath Damodaran, Bloomberg.

> Coming out of the dot-com bubble, unexciting value stocks did much better than hyper-growth Internet stocks.

Given the extremely low cost of equity and debt capital, it's not surprising that speculating has replaced investing for many people. A true investment vehicle produces income — a bond coupon or a stock dividend or buyback — that justifies the opportunity cost of employing capital and provides a basis for valuing the investment. Speculative instruments don't generate any return on investment per se, except by selling them to someone else at a higher price. Jewelry, baseball cards, art and currency are all examples of speculative instruments. They may have emotional value or be worth more or less than in the past, but their economic value depends solely on what other people will give you in return for them. Putting real money into something speculative, like bitcoin, means missing out on the cash flow available from a stock or bond. But when the expected return on those investments is low, the opportunity cost is minimal. So sure, why not throw some dollars at dogecoin, or non-fungible tokens (NFTs), or even some long-shot stock like AMC or GameStop, on the off chance that the mania continues, and one can make a quick buck?

Here's why one shouldn't participate in these schemes: permanent loss of capital. Yes, if some software company is trading at 30x sales with no profits in sight, maybe it will go to 40 times or 50 times, or perhaps it will grow and become profitable enough to create further long-term value. But if the future resembles every other speculative mania in the past, it's likely to be much lower eventually and never fully recover. There are many people who would say that it's different this time, that stocks are at a permanently high plateau, that cryptocurrencies will replace fiat money, that their particular NFT is the next Mona Lisa, and they may be right. But if they're wrong, much of the capital put in those vehicles will be permanently destroyed. It's not just about low opportunity costs, but permanent capital destruction.

Another pitfall in this undisciplined market are the sharks looking to profit off it. MKM Partners reports that more than 350 special purpose acquisition companies (SPACs) launched in the first half of 2021, raising $110 billion, following the $84 billion SPACs raised in 2020. These are "blank-check" vehicles that hold investor money until they find a company to buy, generating no return in the meantime and returning the money in two years if they can't find a deal. SPACs are not created equal — some sponsors are more credible than others — but the amount of money going to this speculative channel, prior to finding a company to buy (whose price is unknown), is noteworthy. Many other companies are going public much earlier in their lifecycles than they have in the past because the window for capital is wide open. Some are helping themselves to a bunch of free or low-cost equity, like AMC and Plug Power, who used irrational share appreciation to lard the balance sheet with cash. Finally, companies are handing out ever more generous gifts, like equity grants and loan forgiveness, to insiders, while investors show they don't care by overlooking these grants as "non-cash" or "non-recurring."

Fortunately, there are still good investments out there. Although their number is shrinking, some stocks are priced attractively now, with asset values or recurring cash flows that limit their downsides. Coming out of the dot-com bubble, unexciting value stocks did much better than hyper-growth Internet stocks. Many stocks with high near-term cash flow potential are being ignored in this market because they're not flashy and don't seem to have multi-bagger potential. But what they will do is hold their value and provide investment dollars over the coming years that hopefully can be put to work in a better risk-return environment.

We continue to find companies we believe fit this description at reasonable prices, such as Constellium, a new position in the second quarter. Constellium is an aluminum processor with a history of excess returns on capital above cost that has lagged during a major capacity increase to serve the auto industry, which should see strong demand given aluminum's favorable environmental characteristics relative to steel.

Right now, it feels like we all should be looking for the next AMC or GameStop or bitcoin. It's hard to ignore their gaudy returns. As Benjamin Graham said, "The intelligent investor is likely to need considerable will power to keep from following the crowd." But history has repeatedly shown that, at times like these, what investors need most of all is patience, discipline and capital preservation, in order to have dry powder for the next attractive investment cycle.

Portfolio Highlights

The ClearBridge Small Cap Value Strategy modestly outperformed the Russell 2000 Value Index, the Strategy's benchmark, during the second quarter.

On an absolute basis, the Strategy had gains in eight of 11 sectors in which it was invested for the quarter. The primary contributors to the Strategy's performance were the consumer discretionary, information technology (IT), materials and energy sectors. The consumer staples, industrials and utilities sectors detracted.

On a relative basis, the Strategy outperformed its benchmark due to sector allocation effects, partially offset by stock selection effects. Stock selection in the communication services, energy, industrials, consumer staples and real estate sectors detracted the most. Conversely, stock selection in the consumer discretionary, IT, financials and materials sectors proved beneficial.

On an individual stock basis, Everi Holdings, Vista Outdoor, Gray Television, CommVault Systems and Textainer were the largest contributors to absolute performance. The primary detractors were Amarin, SkyWest, TriState Capital, TreeHouse Foods and Wabash National.

Besides names discussed above, during the quarter we initiated positions in BancorpSouth Bank and Unum in the financials sector, Custom Truck One Source in the industrials sector and Ashford Hospitality Trust in the real estate sector. We closed positions in MP Materials and Cabot in the materials sector and First Financial Bancorp in the financials sector.