Webcast Q&A

LEGG MASON CLEARBRIDGE US AGGRESSIVE GROWTH FUND

The US stock market may be trading at an all-time high, yet certain sectors are at historically cheap levels. This Q&A is based on a webcast that took place on 14 July 2016, in which Evan Bauman discussed the Legg Mason ClearBridge US Aggressive Growth Fund and considers his highest conviction ideas for future growth potential.

KEY POINTS

- **While certain sectors of the US equity market are looking extended, the fund is trading on only 16 times earnings.**
- **Healthcare, energy, media, and storage companies in the tech space remain key areas of focus for the fund. These are areas where industry consolidation is expected to drive multiple expansion.**
- **The fund continues to avoid consumer-related sectors, as well as mega cap tech stocks and high yielding bond proxies.**
- **With US companies backed by strong balance sheets and sustained economic growth, the US equity market is expected to reach fresh highs as the year progresses.**

Q: The last update was in January. What's happened since then?

EB: In January, the market was in the midst of a sizeable sell-off, but today the US stock market, particularly large-cap stocks, is at all-time highs. The defining characteristic of 2016 is that we have had multiple corrections. The big sell-off in January was focused on commodities and cyclicals, there was further weakness in February, and then more volatility around the Brexit vote in late June. Each of these corrections has resulted in lower valuations in certain parts of the market.

Our job is to find where value resides in the marketplace. The volatility that we've seen this year has given us the opportunity to invest the fund's cash in existing long-term holdings at attractive valuation levels: having been in the mid-teens last summer, cash is less than 1% today.

However, what is striking is how negative sentiment is. It is the first time in my career that I can remember where sentiment is so unbelievably negative towards equities, despite the seven or eight-year broad bull market for US stocks. Even though the market is at all-time highs, valuations in some sectors are at historical lows. Biotech stocks, for example, have fallen to some of the cheapest levels we have ever seen. This means we have more inefficiently priced stocks in the portfolio than at any point I can remember in 20 years of managing this fund.

In part, these conditions reflect the fact that there has been a lot of money flowing into passive strategies; active management has clearly faced challenges in terms of money flows. This means there are some parts of the market that are very inexpensive and, in my view, the likelihood for consolidation in certain areas, like healthcare, media, and energy and commodity-related names, is very high.

My outlook for the broad market would be that we continue to see fresh all-time highs towards the end of this year. However, this outlook is bifurcated: while there are certain parts of the market that could potentially underperform, many areas have significant upside potential.

Q: To what extent do you focus on value, as well as growth?

EB: If you look at the 32-year history of the fund, we have always focused on growth at the right price. There is a very high tactical nature to what we do, and we will manage cash levels and try to buy when stocks get very cheap.

While performance has been poor in relative terms over the last two years, history tells us that periods of poor performance tend to be followed by very strong returns: in 1996, for example, we trailed the market by 20%, but the next five years were the strongest in the fund's history. That is why we have brought cash down because we feel many growth companies have become exceptionally cheap. However, we are not going to buy deep value or

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restructuring stories, and we don’t own financials, which are cheap stocks, but where I can't make a growth case.

With a 97% active share, there are always likely to be times when we will trail the market. In 1999, for example, we didn’t own dotcoms or telecom stocks, and we had a huge underweight to technology. As a result, we looked like a value fund because of the absence of stocks where we couldn’t justify the valuation levels. In 2000/2001, when the TMT bubble burst, we beat the market by around 60% on a relative basis and beat many of our other growth peers by even more than that. In my view, conditions are similar now.

Q: What are your strongest conviction ideas?

EB: Currently, the portfolio is probably as contrarian versus both the markets and peers as at any point that I can remember. We have a big overweight to specific well-funded energy companies with top tier assets, like Anadarko Petroleum, which is a top 10 holding in the fund. While many of these stocks have rebounded strongly from their lows, I would argue they are still very undervalued.

We also have a double-digit overweight to healthcare, including holdings in top tier biotech companies, such as Amgen, Biogen Idec and Allergan. Many of these are trading at the lowest valuation levels ever seen, due in part to fund flows out of the sector. This has driven some of these companies down to 12 and 13 times earnings, about half of where they typically trade in a normal market cycle.

In terms of underweights, we have no exposure to consumer staples or consumer cyclicals, which together is nearly a 30% underweight. However, we do hold media positions, specifically content- or programming-related assets within the US media space. The biggest holding is Comcast, which is a combination of distribution, high-speed data and content. We also own a number of pure play content related companies like Starz, which is in the process of being acquired, Discovery, AMC Networks, and a number of the Liberty Media companies.

In addition, we have a big underweight to mega-cap tech names, which I think is a crowded trade and where valuations have become relatively expensive versus many other technology companies. This underweight was probably the single biggest detractor over the last year since not only were they big winners but also big benchmark positions.

Instead we own storage companies, such as Western Digital and Seagate. Seagate is a very long-term holding, whereas Western Digital is a relatively new addition to the portfolio following their acquisition of SanDisk. Both stocks have had big moves off their lows and yet they still trade at less than 10 times earnings. Seagate also uses its free cash flow to deliver a sizeable dividend yield. That compares to some bigger companies that trade at 40, 50, 60 times earnings. Seagate surged recently as they raised guidance and I think they're going to continue to exceed consensus earnings expectations considerably into 2017. Another long-term holding is Cree, which operates in the LED lighting space. The company has just announced it is selling a non-core business for five times sales, and also pre-announced revenue results which were at the high end of expectations.

Other areas of the market where we have little, if any, exposure include financials and utilities, as well as some of the high yield sectors of the market that have been used as bond proxies.

Q: Can you elaborate on why you have built a position in Twitter?

EB: In a way, the story is similar to Facebook where we took our time and established a cost base in the high teens, believing that mobile was a great opportunity for the company on a longer-term view. With Twitter, we didn’t own the stock when it was in the 70s, the 60s, or the 50s. In fact, we only started buying in August last year when the stock was trading in the low 20s, and have added to that position in the last few months when the stock has been in the mid-teens.

Twitter has a great balance sheet and generates a good amount of cash. It is a company which trades at about a $9 billion enterprise value, compared to Facebook which is north of $300 billion. Twitter has a sizable opportunity in live video streaming and video advertising. These markets may be relatively small for them today, but through strategic partnerships with the NFL and a number of top tier media companies, Twitter’s business model could look dramatically different in 6-12 months, with significant implications for the profitability of the company. In fact, it wouldn’t surprise me if a larger media company, such as Google or a traditional media player like a Liberty or Comcast, either invests in or bids for Twitter. In my view, the valuation of the brand alone is worth multiples of what it is currently valued at in the market.

Q: Given the US stock market is trading at an all-time high, can you explain why you are so optimistic about the fund’s potential?

EB: The market may be at near all-time highs, but the fund trades at about 16 times earnings, and at a fraction of the benchmark in terms of price-to-book, price-to-sales, and price-to-cash flow. In addition, it has a dividend yield of over 1.5% since many of the companies we own are able to return cash to shareholders through dividends. That’s higher than the yield on the 10-year US Treasury bond – a pretty amazing statistic for a fund which focuses on growth.

While we are cautiously optimistic on the broad market, many of the companies in the portfolio have the potential to either be re-rated or acquired. Since the fund was launched

Webcast Q&A

back in the 1980s, we've had 82 companies acquired in the portfolio.

I think we are going to see the biggest wave of healthcare M&A over the next 12-18 months than we've ever seen. In the media space, we have continued to see consolidation, with Cablevision and DirecTV acquired, and most recently the beginning of a consolidation wave on the content side with the Starz and Lionsgate merger.

The best time to buy stocks is usually when valuations are cheap, psychology is negative, and interest rates are at low levels. This means big companies can get access to cheap money and potentially undertake sizeable M&A transactions at large premiums. We have all those three factors in place right now. It doesn't mean that there aren't economic uncertainties, but the US is very well positioned in terms of corporate balance sheets and in terms of the opportunity for sustained economic growth.

Q: Can you summarise how you feel about the portfolio?

EB: Our goal is to be the number one manager in the US. The only way you do that is to know what you own, don't worry about benchmarks, and buy companies that, ultimately, could make sense for third parties to want to own.

I think the likelihood for continued consolidation in certain areas is high. The biggest mistake right now would be selling energy or healthcare and buying the areas that everybody else owns already, which is big-cap tech and consumer-related names. There are already signs that the market is turning and I feel very positive about the fund's future upside potential.

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GLOBAL ASSET MANAGEMENT

leggmasonglobal.com

UK/Scandinavia: +44 (0) 20 7070 7444

France/Benelux: +33 15805 3347

Germany/Austria: +49 69 719143720

Italy: +39 020068 1590

Switzerland: +41 22 747 7567

Spain: +34 91702 6745