2Q 2019 | Product Commentary

CLEARBRIDGE ALL CAP VALUE FUND

Albert Grosman and Sam Peters, CFA
Portfolio Managers

Average annual total returns and fund expenses (%)

as of June 30, 2019

Class A	3-mo	1-yr	5-yr	10-yr	Since Incept. (11/12/81)	Expenses Gross	Expenses Net
Excluding sales charges	1.93	1.01	5.71	10.68	9.83	1.19	1.19
Including effects of maximum sales charges	-3.95	-4.81	4.47	10.03	9.65	1.19	1.19
Russell 3000 Value Index	3.68	7.34	7.31	13.14	N/A	-	-

Performance shown represents past performance and is no guarantee of future results. *Current performance may be higher or lower than the performance shown. Investment return and principal value will fluctuate, so shares, when redeemed, may be worth more or less than the original cost. Class A shares have a maximum front-end sales charge of 5.75%.Total returns assume the reinvestment of all distributions at net asset value and the deduction of all Fund expenses. Total return figures are based on the NAV per share applied to shareholder subscriptions and redemptions, which may differ from the NAV per share disclosed in Fund shareholder reports. Performance would have been lower if fees had not been waived in various periods. Returns for less than one year are cumulative. For the most recent month-end information, please visit www.leggmason.com*

Gross expenses are the Fund's total annual operating expenses for the share class(es) shown. Because the Fund does not currently have fee waivers or reimbursements, gross and net expense ratios are identical. Please see the prospectus for more details on fees, expenses and expense limitation arrangements, if any. In periods of market volatility, assets may decline significantly, causing total annual Fund operating expenses to become higher than the numbers shown in the table above.

The **Russell 3000 Value Index** measures the performance of the broad value segment of the U.S. equity universe. It includes those Russell 3000 companies with lower price-to-book ratios and lower forecasted growth values. Investors cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges.

Key takeaways

- Having global bond and equity markets in total disagreement is not unique to the second quarter, but the magnitude of cross-market dissonance has been increasing.
- There are several scenarios where the pricing embedded in both bond and equity markets could prove to be spectacularly wrong.
- With no evidence of inflation and some mounting signs of a global slowdown, we have worked hard to diversify the cyclical exposure in the portfolio so it can be much less dependent on macro forecasts and more robust to a broad range of potential outcomes.

Market overview

One of the biggest paradoxes in financial markets is that investors are forced to accept irreducible uncertainty about the future, and yet we collectively cling to forecasts in a desperate attempt to reduce the irreducible. Basically, when it comes to the future, no one knows, but everyone wants to know. Dealing with this paradox leads most people down a path of either stubborn denial of uncertainty, or grudging acceptance. Investors should choose the acceptance route. Our expectations-driven investment process helps turn the uncertainty of the future into an advantage. To illustrate, this letter will walk through a few steps, starting with a macro forecasting exercise and then drilling into portfolio construction and some individual stock examples.

Evaluating forecasts is always challenging, even in hindsight, as most forecasters are skilled in the art of using vague

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probabilistic terms that makes the forecast “appear” correct across a broad range of outcomes. However, let’s pretend there was a perfect second-quarter forecast that got all the Trump tweets right, knew the trade war was going to intensify, knew that global growth was going to slow, and knew that fears of a recession were going to increase to such a degree that Fed easing was back on the table. If you had this perfect forecast, there would still be the challenge of predicting market outcomes, and how easy would that be?

There would certainly be some forecasting logic to support the second quarter’s global plunge in interest rates, but maybe not to the degree that has priced a new record $13 trillion in bonds at negative yields. Combine that global abundance of bonds that guarantee a long-term loss with the continued inversion of the U.S. Treasury yield curve, and the world’s sovereign debt markets have priced in a very high probability of recession. How does that extreme embedded expectation reconcile itself with U.S. equity indexes at record highs, and very benign credit spreads? Even with global central banks’ artificially low rates acting as liquidity-driven rocket fuel for almost all asset prices, we struggle to see how even the world’s greatest forecast could cut through the noise and fit a macro and market forecast into a cohesive package.

Having global bond and equity markets in total disagreement is not unique to the second quarter, but the magnitude of cross-market dissonance has been increasing. Why? We suspect it’s a powerful feedback loop between capital flows and price momentum. During the second quarter, capital flows to bonds versus equities reached record levels. This added a tremendous amount of fuel to bond markets already supported by the major central banks, especially with resurrected hopes that the U.S. Federal Reserve is getting back in the easing game. The capital flows that did target equities were guided by the deep feedback channels that have come to favor what has worked over this market cycle, specifically U.S. tech stocks. As a result, tech ended up as the best-performing sector year to date, but it wasn’t due to fundamentals. According to Bernstein research, the 12-month outlook for revenue and earnings growth is worse for tech than the overall U.S. market. Despite these fundamental headwinds, tech valuation multiples have expanded over 40% so far in 2019, versus a still-healthy 20% multiple expansion for the overall market, with the tech sector now trading at a 15-year high versus the broader market.

This divorce from underlying fundamental reality is why feedback loops ultimately lead to excess and then dramatic reversals. The current challenge for investors, however, is the massive divergence in what feedback has priced into these two major asset classes. Bonds are increasingly priced for a recession and little else; a recession would ultimately crush tech stocks, which remain cyclical despite current narratives focused on cycle-escaping secular growth. There are also scenarios where the pricing embedded in both markets could prove to be spectacularly wrong.

The Value of Diversifying Cyclical Exposure

A core goal of our investment process is to invert the forecasting challenge and build diverse portfolios that are not reliant on a narrow or extreme set of scenarios. In some ways achieving greater diversification than the indexes has never been easier, given the shift away from active management. With so much capital concentrated in the major U.S. equity indexes, passive exposure has become increasingly less diversifying. More and more people are skewed to U.S. assets, and particularly U.S. tech. If anything, this feedback process is accelerating, but it is also dependent on extrapolation and is increasingly vulnerable to change.

The gift for active managers, if you make what has been a difficult choice to diverge from the index, is that there are myriad ways to create much more diverse portfolios vis-à-vis the index. Greater diversity makes a portfolio much less dependent on macro forecasts and more robust to a broad range of potential outcomes. We think we have achieved this diversification goal, and it has been achieved without sacrificing a valuation or fundamental advantage versus the index. As we highlighted in last quarter’s update, we continue to enjoy a portfolio with better earnings estimate revisions than the broader market. This has also translated into a higher starting cash dividend yield than the market, with better growth prospects. What’s the catch?

Well, one of the great divergences in the market is the now-extreme valuation difference between growth and value stocks at a broad level. Expensive stocks are getting more expensive and cheap stocks are getting cheaper, and in a classic sign of feedback the divergence is accelerating. As this process has continued, many value stocks are already reflecting a recession. As a result, the market is paying us a nice premium to take on the macro risk from cyclical stocks in the form of attractive free cash flow yields, good existing returns, clean balance sheets, and capital returns through buybacks and dividends that are well above the market.

Portfolio positioning

One of the best ways to capture this value premium is in the financials sector, which remains our biggest overweight. Investors remain wary of financials, given their near-death

experience during the Great Financial Crisis (GFC), but regulated U.S. financials stocks have gone from too little capital during the GFC to excess capital. This excess capital is being paid out through dividends and buybacks that are generating at or above a 10% total yield for many of our holdings. This yield is in the top decile of the broader U.S. equity market and is a massive compounding advantage in a world with over $13 trillion in negative yielding debt. In many ways, the regulatory response of the GFC has paid big benefits for financials shareholders, and regulatory risk has moved on to the much-beloved tech sector.

An added benefit of financials is that the stocks embed a free option on what we think would be the biggest surprise for markets: a policy mistake that leads to higher sovereign interest rates. Financials stocks would be one of the few and the biggest beneficiaries of a shift in the macro environment to higher rates. To be clear, this would be the ultimate surprise, as there is no evidence of risks being built into so-called risk-free sovereign yields and no sign of inflation inflecting higher; and interest rates have just gone the other way in a dramatic fashion. However, we think policy risk that could drive such a change is rising dramatically. We have an executive branch that is trying to politicize the Fed, coupled with an increased belief that debt can be monetized to support fiscal expansion. If anything, the longer inflation stays dormant and term premiums built into interest rates remain negative, the more policy will shift away from the initial conditions that give us the policy flexibility we enjoy today: the extreme political independence of the Volcker Fed.

Risks that can be conceptualized but not observed in any data are always the greatest risks for investors. The current observed data support a healthy fear of deflation, and that risk is accordingly dearly priced in almost all assets. On the other side, what we consider the tail risk of higher rates is all theory and in no current data, but we are rapidly establishing new ground on the policy front. The risks of the unobserved, however, are what market turning points are made of. At turning points markets have proven to be non-ergodic, which is a fancy way of saying that observed past probabilities no longer apply to future outcomes. One of the great historical examples was that a root cause of the GFC was that housing prices had never declined in aggregate, until they did. The result was a record amount of capital destruction on, ironically, AAA-rated assets. As market cycles age, the assets that are most cherished are often the most dangerous, even when they are considered the safest assets. With indexes losing diversification and “safe” bond yields once again approaching record-low levels, we think policy risk could prove to be this cycle’s non-ergodic match.

However, with no evidence of inflation and some mounting signs of a global slowdown, we have worked hard to diversify the cyclical exposure in the portfolio. The most direct way we have done this is with a large position in global staples stock Unilever, which has rallied very directly with the move in defensive stocks. Besides Unilever, given the great demand, especially during the second quarter, our challenge has been to buy individual defensive stocks without paying a steep defense valuation premium. We want insurance on the cheap. These opportunities have typically come by buying sustainably high dividend yields in out-of-favor sectors, such as what we did with Kinder Morgan and Suncor, in energy. We also will buy a stable defensive business after an unsustainable dividend has been cut to a sustainable level. Buying after a cut has often led to good outperformance, as the market seems to initially underappreciate the improved footing as a company addresses its issues and the long-term prospects for a return to dividend growth. Finally, there are also times when companies in traditional defensive areas, like utilities and staples, fall below business value and we can buy quality when no one wants it. This contrarian approach to defense has worked well for us and has accomplished our goal of diversifying the cyclical value exposure.

One area of defense that has been very mixed for us, but which may be starting to see better days, is drug stocks. As several large biotech and pharmaceutical stocks declined over the last few years, we built out a large portfolio of positions trading well below our assessment of business value. This worked relatively well in the case of Johnson & Johnson and Merck. Unfortunately, in our other drug holdings the valuation multiples declined to a much deeper level than we expected, which has made these stocks anything but defensive. The root cause of the valuation compression has been fears about the underlying business models as drug price inflation has slowed, and there are lingering concerns of a regulatory backlash. Unlike the rest of health care, we think these regulatory and pricing risks are now fully reflected in our holdings, and the stock prices are now embedding long-term value destruction from research and development (R&D). Historically, buying R&D when it is heavily discounted by the market has been a good long-term strategy, and it was a major factor in the announced strategic acquisition of our holding in Allergan late in the second quarter. Even at a substantial deal premium, Allergan is still trading well below market valuation multiples and our assessment of long-term value. Thus, we think this

will prove to be a good deal, as the acquirer, Abbvie, is getting a diversifying cash flow stream at a discount and R&D optionality for free. Most importantly, combined with other recent strategic acquisitions, such as Bristol Myers' acquisition of Celgene, these deals should help stabilize sector valuations. Allowing some of the defensive characteristics of these stocks to come through for the portfolio.

During the quarter we established two new positions, one in utilities and one in technology.

- On the utilities side, we invested in the independent power producer Vistra Energy. Although not a traditional regulated utility by any stretch, Vistra does have a balanced business model that is split between a very stable retail business and a power generation business. This balance will allow Vistra to generate a very high free cash flow stream, which will be used to pay down debt to targeted levels by the end of 2020. At the same time, Vistra management will grow its over 2% cash dividend at a high rate, while also buying back stock below our assessment of business value. We believe, however, that the greatest potential mispricing for the stock is the tightening power market in Vistra's core Texas power market. This tightening is being driven by continued coal-fired power plant retirements that are not being fully offset despite investment in alternative power and natural fired plants. This should put upward pressure on long-term power prices, which would allow Vistra to grow long-term cash flow above embedded expectations.
- Within technology, we added Qualcomm after its surprise legal settlement with Apple. After every major event, we always ask ourselves if the resulting move in the stock was appropriate, an overreaction or an underreaction. In the case of Qualcomm's surprise settlement with Apple, expectations math suggested it was an underreaction despite the big upward move in the stock. The key driver will be the greatly enhanced earnings and cash flow generation once the 5G cycle kicks in fully over the next few years. We estimate that Qualcomm's base earnings power in 2021 will be at least $6, and this should ramp along with the 5G cycle. Against this earnings potential, Qualcomm was still valued well below the market's valuation multiple and other 5G peers, despite its dominant position. With continued legal risk, however, we do expect Qualcomm stock to continue to experience major volatility, and we will build out the position as opportunities arise.

One of the first things investors learn about is the virtue of the only free lunch in finance: diversification. As market feedback loops drive the indexes toward concentrated extremes, the opportunity and obligation of active managers is to keep diversification on the menu. Diversification will always be critical, as investors can never escape the paradox of uncertainty, and portfolios must maintain a robustness to surprise. Our investment process embraces the reality of irreducible uncertainty, as our long-time goal is to build diverse portfolios with embedded expectations well below what history has delivered and a wide range of potential futures.

Fund highlights

During the second quarter of 2019, the ClearBridge All Cap Value Fund – Class A shares generated a total return of 1.93%, excluding sales charges. In comparison, the Fund's unmanaged benchmark, the Russell 3000 Value Index, returned 3.68%.

On an absolute basis, the Fund had gains in five of the 11 sectors in which it was invested during the quarter. The primary contributors to the Fund's performance were the financials and industrials sectors. The energy, utilities and health care sectors were the main laggards.

In relative terms, the Fund underperformed its benchmark primarily due to stock selection decisions during the quarter. Stock selection in the health care, utilities and communication services sectors detracted the most from relative returns during the period. Conversely, stock selection in the financials sector proved beneficial.

On an individual stock basis, the greatest contributors to absolute returns during the quarter were positions in American International Group, Citigroup, KeyCorp, Synchrony Financial and Unilever. Mylan, Encana, Foot Locker, Halliburton and Realogy were the largest detractors from absolute performance.

During the quarter we initiated positions in Qualcomm in the IT sector and Vistra Energy in the utilities sector. We also received shares of Dow and Corteva in the materials sector following their spin-off from holding DuPont de Nemours. We closed positions in Biogen in the health care sector and Realogy in the real estate sector.

Top contributors

The top contributors to Fund performance for the quarter included:

American International Group (AIG), in the financial services sector, is a large, diversified insurance company. Shares were up after the company reported meaningful progress on initiatives designed to generate consistent underwriting profits for its P&C operations. As underwriting changes continue to filter through the P&L over the coming quarters, margin improvement should be sustainable.

Citigroup (C), in the financials sector, is one of the largest U.S. money center banks; **KeyCorp (KEY),** also in the financials sector, is a regional bank. Financials moved in sync with the broad market in the second quarter, showing strength on first-quarter results, weakness on yield concerns, then a rebound in June as optimism on U.S.-China trade tensions raised expectation for increased business activity and a more accommodative Fed offered potential support to the economy. The Fed's annual stress tests of large banks (DFAST) confirmed that banks can weather very challenging economic and market conditions, and CCAR showed that almost every large bank had sufficient capital to increase the amount of capital that will be returned to shareholders over the next year via dividends and share buybacks.

Bottom contributors

Mylan (MYL), in the health care sector, sold off after reporting a revenue miss in Europe, although overall earnings were ahead of consensus, and again after lawsuits were filed alleging generic drug makers of conspiring to raise medicine prices. The top-line miss was mainly due to currency, and operating income was in line. With further new product launches ($1.1B in total in 2019), we found the severe stock price drop inconsistent with the fundamental trajectory, especially given the improving U.S. generic market condition. We have reason to believe first-quarter headwinds were due to one-off issues in Europe and cash flow should recover starting in the second quarter. Meanwhile, the first settlement reached between the government and generic company Heritage Pharmaceuticals, of $7.1M, regarding price fixing suggests MYL's legal liability should be manageable.

EnCana (ECA), in the energy sector, produces and distributes natural gas throughout North America. Encana delivered its sixth consecutive earnings beat, driven by increased production volumes and higher oil price realizations. At the same time, income fell year over year (due to lower natural gas sales price), quarterly revenue decreased 6% year over year, and sentiment in the energy sector remained extremely challenged, driving down the stock.

Halliburton (HAL), in the energy sector, is one of the largest providers of products and services to customers in the energy industry related to the exploration, development and production of oil and natural gas. The company generates strong cash flow, which it has used to invest in its business and to reward investors through an increasing dividend and share repurchases. More recently, Halliburton has been pressured by shortened cycles in North American oil field services and more intense and frequent supply/demand imbalances.

Market outlook

Global bond and equity markets are in total disagreement: the world's sovereign debt markets have priced in a very high probability of recession, while U.S. equity indexes are at record highs. The current challenge for investors is the massive divergence in what feedback has priced into these two major asset classes. In equities, tech ended up as the best-performing sector in the first half of 2019, but it wasn't due to fundamentals. According to Bernstein research, the 12-month outlook for revenue and earnings growth is worse for tech than the overall U.S. market. This divorce from underlying fundamental reality is why feedback loops ultimately lead to excess and then dramatic reversals.

Given the difficulty of forecasting macroeconomic and market developments, a core goal of our investment process is to invert the forecasting challenge and build diverse portfolios that are not reliant on a narrow or extreme set of scenarios. Greater diversity makes a portfolio much less forecast dependent and more robust to a broad range of potential outcomes. We think we have achieved this diversification goal, and it has been achieved without sacrificing a valuation or fundamental advantage versus the index.

Top 10 equity holdings (%)	
Wells Fargo & Co	4.1
Johnson & Johnson	4.1
Oracle Corp	3.9
Merck & Co Inc	3.8
Synchrony Financial	3.7
Citigroup Inc	3.5
Verizon Communications Inc	3.4
Exelon Corp	2.8
Kinder Morgan Inc/DE	2.7
Unilever PLC	2.7

Sector allocation (%)	
Financials	28.7
Health Care	13.3
Industrials	9.2
Energy	9.1
Information Technology	8.8
Consumer Discretionary	7.0
Consumer Staples	5.8
Utilities	5.2
Real Estate	4.3
Communication Services	4.3
Materials	2.1
Cash/Other	2.0

Percentages are based on total portfolio as of quarter end and are subject to change at any time. For informational purposes only and not to be considered a recommendation to purchase or sell any security.

Definitions and additional terms:

Please note that an investor cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges.

Buyback is the repurchase of outstanding shares (repurchase) by a company in order to reduce the number of shares on the market.

Comprehensive Capital Analysis and Review (CCAR) is a regulatory framework introduced by the Federal Reserve in order to assess large banks and financial institutions.

Dodd-Frank Act Stress Tests (DFAST) is a bank stress test.

The **Federal Reserve Board ("Fed")** is responsible for the formulation of policies designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

Free cash flow (FCF) is a measure of financial performance calculated as operating cash flow minus capital expenditures.

The **Great Financial Crisis (GFC)** was the recessionary period between December 2007 and June 2009 caused primarily by the U.S. housing market bubble collapsing.

Russell 3000 Value Index measures the performance of the broad value segment of the U.S. equity universe. It includes those Russell 3000 companies with lower price-to-book ratios and lower forecasted growth values.

Sovereign bond yield is the interest rate paid on a government (sovereign) bond.

U.S. Treasurys are direct debt obligations issued by the U.S. government and backed by its "full faith and credit." The U.S. government guarantees the principal and interest payments on U.S. Treasurys when the securities are held to maturity.

Paul Volcker is an American economist and a former Chairman of the Federal Reserve.

The **yield curve** shows the relationship between yields and maturity dates for a similar class of bonds.

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What should I know before investing?

Equity securities are subject to price fluctuation and possible loss of principal. International investments are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging markets. Small- and mid-cap stocks involve greater risks and volatility than large-cap stocks. Short selling is a speculative strategy. Unlike the possible loss on a security that is purchased, there is no limit on the amount of loss on an appreciating security that is sold short. Income and dividends are not guaranteed, and a company may reduce or eliminate its dividend at any time. The manager's investment style may become out of favor and/or the manager's selection process may prove incorrect, which may have a negative impact on the Fund's performance.

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