Key takeaways

- The market rose 14% and recovered most of the declines suffered in the fourth quarter of 2018.
- Lower interest rates boosted markets worldwide as weaker economic indicators drove the Fed to give more accommodative guidance.
- While no company is fully insulated from the economic cycle, we actively emphasize companies with less cyclical and more predictability.

Market overview and outlook

The first quarter of 2019 was terrific for the stock market and Dividend Strategy. The market rose 14% and recovered most of the declines suffered in the fourth quarter of 2018. Equities were not the only asset class that bounced in the first quarter — indeed, the risk-on trade suffused markets around the world. Global equity markets rose, oil prices increased over 30%, and the high-yield sector (also known as “junk bonds”) enjoyed one of its best first quarters in decades.

The driver of this asset reflation was not an improvement in economic fundamentals. Headline economic indicators continued to slow both in the U.S. and abroad. Furthermore, many of the policy-related storms that we have been tracking continue to loom just off shore: trade wars, Brexit, geopolitical turmoil, increased political polarization, to name a few.

The U.S. economy grew at an annualized rate of 2.6% in the fourth quarter: still positive, but lower than earlier in the year. U.S. manufacturing activity, as measured by the PMI, fell in March to the lowest level in nearly two years. Inflation
continued to decline, as did housing starts. Internationally, central banks grew more dovish, with the European Central Bank lowering its inflation projection and growth forecast and China weighing more aggressive stimulus measures to stem weakness.

Ironically, it was precisely the deterioration in economic fundamentals and the persistence of policy concerns that forced the Fed to drop its plan to increase interest rates, thereby catalyzing markets’ recoveries. Just three months ago the Fed anticipated two rate hikes in 2019, whereas now it forecasts none.

The bond market reacted sharply to the Fed’s pivot. The 10-year Treasury yield fell to 2.4% from a recent high of 3.2% just five months earlier. As the threat of rising rates receded, equity markets rallied briskly. Longer-term interest rates declined below short-term rates, resulting in an inverted yield curve. The yield curve is normally upward-sloping, which means that as the term of a loan increases the interest rate goes up. Intuitively this makes sense. All else being equal, lenders should charge more for lending money over longer periods. With an inverted yield curve, however, the opposite is true.

In previous market cycles the presence of an inverted yield curve for an extended period has frequently presaged a recession. The past is often predictive of future events, but of course it is not always so. Will the first quarter’s inverted yield curve prove to be a temporary anomaly? Does the inverted yield curve mean a recession is around the corner? Or, is it continued spillover from the unprecedented monetary policy of the last decade?

The answers to these questions will drive a significant portion of investment returns across asset classes over the next 12–24 months. Yet, as bottom-up investors, we do not spend an inordinate amount of time dwelling on these questions. Instead, we work to construct a diversified portfolio of idiosyncratic investment ideas. We focus on great companies in growing markets with the following: strong balance sheets, dominant market positions, recurring/predictable revenues, pricing power, high returns on invested capital, significant free cash flow, great management teams, and (finally) the ability to compound earnings and dividends at healthy levels over the long term. While no company is fully insulated from the economic cycle, we actively emphasize companies with less cyclicity and more predictability. This should make our portfolio more defensive if volatility returns.

While the inverted yield curve has dominated discussion of late, we have spent as much time considering the longer-term implications of the Fed’s about-face. Ten years past the Great Financial Crisis, interest rates remain radically below their pre-crisis levels and growth remains structurally slower. We hold out hope that growth ultimately returns to higher levels — which would permit the Fed to safely raise rates to more normal levels — but we underwrite investments to the status quo to provide an appropriate margin of safety.

The last six months have been a roller coaster. The market cratered in the fourth quarter, and it soared in the first quarter. As we survey the current state of the markets and the world, we take comfort in the fundamental building blocks of our portfolio: a current dividend yield above Treasury bonds, expected dividend growth in the high single digits and dividend support providing ballast for turbulent seas.

**Fund highlights**

For the quarter ended March 31, 2019, the ClearBridge Dividend Strategy Fund — Class A shares had a cumulative return of 13.18%, excluding the effects of sales charges. In comparison, the Fund’s unmanaged benchmark, the S&P 500 Index, returned 13.65%.

On an absolute basis, the Fund had gains across the 11 sectors in which it was invested for the quarter. The main contributors to Fund performance were the information technology (IT), energy and financials sectors. The health care and real estate sectors, meanwhile, were the laggards.

On a relative basis, stock selection added to performance for the quarter, but it was offset by sector allocation. In particular, an underweight to IT and an overweight to financials weighed on relative results, as did the Fund’s cash position. An underweight to the health care sector, meanwhile, was additive. Stock selection in the communication services and consumer discretionary sectors detracted from relative returns, while stock selection in the energy, utilities and materials sectors contributed positively.

On an individual stock basis, the largest contributors were Williams Companies, Microsoft, American Tower, Blackstone and Mastercard. Positions in Berkshire Hathaway, Pfizer and Coca-Cola were the sole detractors from absolute returns in the quarter.

During the quarter, we established positions in United Technologies, in the industrials sector, and closed positions in Brookfield Renewable Partners, in the utilities sector, Healthcare Trust of America, in the real estate sector, and PepsiCo, in the consumer staples sector.
Top contributors
The leading individual contributors to Fund performance for the quarter included:

Mastercard (MA), in the IT sector, provides transaction processing and other payment-related products and services in the U.S. and internationally. Mastercard continued its strong performance in the quarter, exceeding earnings expectations and providing positive forward guidance. The payments company is steadily increasing volume and making headway in digital payments.

Microsoft (MSFT), in the IT sector, is one of the largest software companies in the world. Shares rose as tech stocks bounced back and also on continued strong execution and continued success of Office 365 and the Azure cloud services platform.

Blackstone Group (BX), in the financials sector, is a leading private equity and alternative asset manager. Shares rose, as the company continues to grow assets under management, reportedly closing in on $20 billion of commitments in the first phase of capital raising for its latest buyout fund.

Bottom contributors
In terms of individual stocks, the leading detractors to Fund performance for the quarter included:

Coca-Cola (KO), in the consumer staples sector, is a beverage company engaged in the manufacture, marketing, and sale of nonalcoholic beverages worldwide. Shares were slightly down, as the beverage giant lowered sales growth projections.

Pfizer (PFE), in the health care sector, is a global biopharmaceutical company. Pfizer finished an excellent year with a modest earnings beat, although investors scrutinized the implications of future patent expirations. The stock also edged down along with the pharmaceutical stocks as the group came under pressure from the government’s push for greater drug price transparency.

Berkshire Hathaway (BRK), in the financials sector, is a large insurance/reinsurance company and the owner of the Burlington Northern Railway and diversified manufacturing and services companies. Shares fell early in the quarter in sympathy with Apple (Berkshire Hathaway is a large owner) but recovered to finish only slightly in the red.
### Top 10 equity holdings (%)

<table>
<thead>
<tr>
<th>Company</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Microsoft Corp</td>
<td>3.8</td>
</tr>
<tr>
<td>Home Depot Inc/The</td>
<td>2.7</td>
</tr>
<tr>
<td>Merck &amp; Co Inc</td>
<td>2.6</td>
</tr>
<tr>
<td>American Tower Corp</td>
<td>2.5</td>
</tr>
<tr>
<td>Blackstone Group LP/The</td>
<td>2.4</td>
</tr>
<tr>
<td>Comcast Corp</td>
<td>2.4</td>
</tr>
<tr>
<td>Apple Inc</td>
<td>2.4</td>
</tr>
<tr>
<td>Johnson &amp; Johnson</td>
<td>2.2</td>
</tr>
<tr>
<td>Williams Cos Inc/The</td>
<td>2.1</td>
</tr>
<tr>
<td>JPMorgan Chase &amp; Co</td>
<td>2.0</td>
</tr>
</tbody>
</table>

### Sector allocation (%)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financials</td>
<td>18.4</td>
</tr>
<tr>
<td>Information Technology</td>
<td>12.7</td>
</tr>
<tr>
<td>Consumer Staples</td>
<td>11.6</td>
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<tr>
<td>Industrials</td>
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<tr>
<td>Materials</td>
<td>8.9</td>
</tr>
<tr>
<td>Health Care</td>
<td>8.2</td>
</tr>
<tr>
<td>Communication Services</td>
<td>8.0</td>
</tr>
<tr>
<td>Energy</td>
<td>7.4</td>
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<tr>
<td>Consumer Discretionary</td>
<td>5.6</td>
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<tr>
<td>Utilities</td>
<td>4.0</td>
</tr>
<tr>
<td>Real Estate</td>
<td>2.5</td>
</tr>
<tr>
<td>Cash/Other</td>
<td>1.5</td>
</tr>
</tbody>
</table>

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.

- **Brexit** is an abbreviation of “British exit,” which refers to the June 23, 2016 referendum by British voters to exit the European Union.
- 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** was the recessionary period between December 2007 and June 2009 caused primarily by the U.S. housing market bubble collapsing.
- **Junk bonds** are bonds that carry a higher risk of default than most bonds issued by corporations and governments.

The **Institute for Supply Management’s composite PMI Index** (formerly the National Association of Purchasing Managers Index) is based on a survey of purchasing executives who buy the raw materials for manufacturing at more than 350 companies. The **S&P 500 Index** is an unmanaged index of common stock performance.
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- A diverse family of specialized investment managers, each with its own independent approach to research and analysis
- Over a century of experience in identifying opportunities and delivering astute investment solutions to clients

What should I know before investing?

Equity securities are subject to price fluctuation and possible loss of principal. Real estate investment trusts (REITs) are closely linked to the performance of the real estate markets. REITs are subject to illiquidity, credit and interest rate risks, and risks associated with small- and mid-cap investments. 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. Short selling is a speculative strategy. 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. Derivatives, such as options and futures, can be illiquid, may disproportionally increase losses, and have a potentially large impact on Fund performance. Dividends may fluctuate and a company may reduce or eliminate its dividend at any time. Fixed income securities involve interest rate, credit, inflation and reinvestment risks; and possible loss of principal. As interest rates rise, the value of fixed income securities falls.

Any information, statement or opinion set forth herein is general in nature, is not directed to or based on the financial situation or needs of any particular investor, and does not constitute, and should not be construed as, investment advice, a forecast of future events, a guarantee of future results, or a recommendation with respect to any particular security or investment strategy or type of retirement account. Investors seeking financial advice regarding the appropriateness of investing in any securities or investment strategies should consult their financial professional.

Portfolio holdings and sector allocations may not be representative of the portfolio manager’s current or future investment and are subject to change at any time.

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