2Q 2018 | Product Commentary

CLEARBRIDGE VALUE TRUST

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Portfolio Managers

Average annual total returns and fund expenses (%)

as of June 30, 2018

Class A	3-mo	1-yr	5-yr	10-yr	Since Incept. (02/02/09)	Gross	Net
Excluding sales charges	1.69	5.66	10.74	N/A	14.44	1.05	1.05
Including effects of maximum sales charges	-4.15	-0.42	9.43	N/A	13.72	-	-
S&P 500 Index	3.43	14.37	13.42	N/A	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. If sales charges were included, performance shown would be lower. 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 and/or reimbursed in various periods. Returns for less than one year are cumulative. Performance for other share classes will vary. 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.

Net expenses are the Fund's total annual operating expenses for the share classes indicated and would reflect contractual fee waivers and/or reimbursements, where these reductions reduce the Fund's gross expenses. These arrangements cannot be terminated prior to December 31, 2019 without the Board's consent. 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.

S&P 500 Index is a market capitalization-weighted index of 500 widely held common stocks. Investors cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges.

Key takeaways

- The stock market overcame trade frictions to rise during the second quarter of 2018.
- Energy was the best-performing sector in the second quarter, and it is a large active bet for us.
- As more benign policy realities give way to decent fundamentals at a massive discount, we think the opportunity in drug stocks will be realized.

Market overview

The stock market overcame trade frictions to rise 3.4% during the second quarter of 2018, as measured by the S&P 500 Index. Small-cap companies, with a large base of U.S. sales, performed even better. Trade represents about 15% of the U.S. economy, but for other countries it is far more important. As such, emerging markets had one of the worst quarters in several years, while Europe declined as well. Expectations of superior U.S. growth resulted in 5% appreciation of the U.S. dollar relative to the euro. Oil prices rose to a five-year high, owing to a multitude of factors, including strong demand, threats of U.S. sanctions against buyers of Iranian oil, outages in Venezuela and Libya, and transportation constraints in the Permian Basin.

Despite sustained healthy U.S. economic performance, including a modest acceleration in inflation, concerns that trade would reduce U.S. growth held back increases in U.S. Treasury yields (up in the second quarter to 2.86% from 2.74%). We continue to monitor the shape of the yield curve, given the historical relationship between curve inversion and economic recession. The spread between 10-year and 2-year

Treasury paper narrowed from 47 basis points (bps) to 33 bps during the quarter. While a flatter yield curve continues to bear watching, we note that stock market returns have historically been good in periods approaching and somewhat after inversion.

Energy was — by far — the best-performing sector in the second quarter. Technology and consumer discretionary stocks, driven by strong earnings, also generated healthy returns. Trade concerns and the previously mentioned impact on Treasury yields resulted in considerable performance lags among financial, industrial and consumer staples stocks. Utility and real estate stocks — which had lagged earlier in 2018 and all of 2017 as interest rates rose — outperformed.

One of our biggest active bets is in U.S. drug stocks: this defensive group has fallen on hard times despite very strong fundamentals for select stocks. Investors may not be taking policy risk from a trade war seriously, but they have fully embraced drug pricing risk. The prevailing narrative is that drug stocks are not investable because drug pricing is at risk of collapsing. This narrative has unfortunately been supported by bad behavior from fallen market drug-stock darlings like Valeant, which absolutely abused pricing power. President Trump has also promised imminent drug price declines, spreading the idea with his tweets.

But we see drug spending becoming less, not more, of an issue. Net pricing for branded prescription drugs has risen only 2.4%, 3.2% and 1.9% in the past three years, despite the list price increases of 7% to 12% that power the headlines. This limited net pricing has actually kept drug spending as a percentage of U.S. GDP stable since 2010.

Despite the reality of stable drug pricing, the drug price narrative has led to a massive de-rating of drug stocks. Currently depressed valuation levels have been rivaled only by Hillarycare and Obamacare fears, which generated equally powerful drug pricing risk narratives. However, from such valuation levels the drug stocks always delivered strong forward returns. We think this will be the case once again, as reducing drug pricing is a very challenging policy goal to actually implement. The complexity and difficulty are evident in the lack of actionable ideas in the recently announced Trump drug pricing proposals. As more benign policy realities give way to decent fundamentals at a massive discount, we think the opportunity in drug stocks will be realized.

Energy is another large active bet for us. Just as the BRIC narrative of peak supply led to very poor management behavior in the form of excessive capital investment and ultimately excess supply, the peak demand narrative is leading to great capital allocation behavior. For the first time in our multidecade investment experience, energy management teams are focused on returns and generating free cash flow. This discipline is powered by long-term fears of peak oil demand, which is gating long-term capital investment that will ultimately limit supply. Peak demand is very likely a long-term reality, as is peak supply for that matter, but current investment discipline will likely undersupply the market in the coming years. The upside risk from an energy cycle is not reflected in many of the stocks, as investors focus on the trauma of the 2015 oil price collapse, anchored along with the management teams on the peak demand narrative. As capital intensity falls, risks tend to fall in unison and stocks tend to enjoy higher valuation multiples.

Fund highlights

During the second quarter of 2018, the ClearBridge Value Trust – Class A shares generated a total return of 1.69%, excluding sales charges. In comparison, the Fund's unmanaged benchmark, the S&P 500 Index, returned 3.43%.

On an absolute basis, five of the 11 sectors in which the Fund was invested in for the quarter generated positive returns. The energy, information technology (IT) and utilities sectors contributed the most to absolute returns, while the industrials and health care sectors detracted the most.

Relative Fund underperformance was driven by stock selection effects and sector allocation effects. Stock selection in the health care, IT and real estate sectors detracted the most from relative returns. An overweight to the financials sector also dampened relative returns. Meanwhile, stock selection in the energy, utilities and financials sectors contributed to relative performance for the quarter, as did an overweight to the energy sector.

Devon Energy, Kinder Morgan, Alphabet, Microsoft and AES were the largest contributors to performance, while the biggest detractors included Realogy, Mylan, Brighthouse Financial, Adient and Celgene.

During the quarter we initiated positions in Merck, Owens Corning and KION. We closed positions in Stericycle, O'Reilly Automotive, Signet Jewelers and CBS.

Top contributors

Devon Energy (DVN), in the energy sector, has positioned itself with high-quality shale assets in the STACK and Permian Basin. Devon has coupled this focus on leading shale assets with a major upgrade in capital allocation. It will divest $5 billion in noncore assets in 2018, which will allow it to reduce debt and buy back approximately 20% of shares outstanding over the next 15 months. Despite these major internal improvements, the stock price is still not fully reflecting the recent rebound in oil prices and the free cash flow that should be generated at these price levels.

Alphabet (GOOG), in the IT sector, has been a laggard in the FAANG group because investors have been frustrated by the company's lack of cost discipline. Its recent performance has started to improve. One driver of the improvement is Softbank's investment in General Motors' autonomous driving unit. The price Softbank paid to GM provided a valuation benchmark to Google's world-leading self-driving business and prompted the market to recognize the hidden value in some of the early-stage investments Google has been making, at least partially.

AES (AES), in the utilities sector, is starting to enjoy the full benefits from its pivot to faster-growing renewable energy projects, while also paying down debt and reducing costs. The result is a major reduction in AES's risk profile, which will culminate in investment-grade metrics by next year. At the same time, the earnings and cash flow growth has been steadily improving, which is fully supporting its 4% dividend yield. These fundamental improvements, along with the major risk reduction, should continue to close the gap between price and a higher and growing business value.

Top detractors

Realogy (RLGY), in the real estate sector, has underperformed on a confluence of events, although we still view shares as substantially undervalued. Continued pressure on agent commission costs as peers have become more aggressive on recruitment has pressured margins of late. Additionally, drags on existing home transactions from modestly higher interest rates and the recent change in the tax code that has lowered the incentive to own homes have led to concerns about go-forward revenues. We believe that the existing home market remains cyclically depressed, and that even as inventory levels remain low, higher prices will provide an offset for Realogy's brokerage operations while ultimately spurring more selling activity as homeowners look to monetize. Furthermore, materially improved agent recruitment and increased market share suggest the worst is past from a commission cost perspective, yet shares currently embed a sharp and permanent decline in the profitability of the enterprise that we believe is quite unlikely.

Mylan (MYL), in the health care sector, took a hit after the company announced a delay in the Food and Drug Administration (FDA) approval of a key pipeline drug, generic Advair. The delay also poses some risk that management needs to lower its 2018 earnings guidance. We think generic Advair approval is not an if but a when problem. We still like the stock at 7x this year earnings, which more than discounts some near-term earnings risk. Mylan's strong biosimilar pipeline has started to enter the market, and its long-term growth outlook is bright.

Celgene (CELG), in the health care sector, is a biotechnology company developing therapies for cancer and immune inflammatory diseases. Negative reaction to two acquisitions announced by the company and an unfavorable ruling from the FDA on its treatment for relapsing multiple sclerosis weighed on shares.

Outlook

We continue to believe the biggest risk in the current market is rising liquidity risk: asset prices require more growth and long-term cash flow to justify rising prices, extending their duration, while the marginal buyer is increasingly acting on short-term price momentum. This creates a classic duration mismatch, which should close violently when price momentum reverses. The match that could ignite this reversal is an increase in interest rates, and a subsequent rise in volatility. Some of these concerns have begun to play out in 2018. Our focus on names with attractive prospects for long-term value has led us to a portfolio differentiated from market-capitalization-weighted indexes like its benchmark. We believe that following a disciplined valuation process allows us to potentially exploit a behavioral advantage, by thinking mathematically and probabilistically rather than emotionally, even in periods of rapid market gains, and especially during periods of market volatility.

Top 10 equity holdings (%)	
Alphabet Inc	5.7
Microsoft Corp	4.4
Allergan PLC	4.1
Oracle Corp	3.7
Wells Fargo & Co	3.5
Kinder Morgan Inc/DE	3.4
Alexion Pharmaceuticals Inc	3.3
American International Group Inc	2.8
Synchrony Financial	2.8
Exelon Corp	2.7

Sector allocation (%)	
Information Technology	19.4
Financials	18.4
Health Care	16.6
Industrials	11.8
Energy	11.4
Consumer Discretionary	7.8
Utilities	4.8
Real Estate	3.7
Consumer Staples	2.9
Materials	2.1
Telecommunication Services	0.0
Cash/Other	1.2

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.

A **basis point (bp, or bps)** is equal to 1/100th of 1%, or 0.01%.

BRIC is an acronym for the combined economies of Brazil, Russia, India and China.

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

Duration is an estimated measure of the price sensitivity of a bond to a change in interest rates.

FAANG is an acronym for the five most popular and best performing tech stocks in the market, namely Facebook, Apple, Amazon, Netflix, and Alphabet's Google.

Food and Drug Administration (FDA) is a government agency established in 1906 with the passage of the Federal Food and Drugs Act.

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

Gross domestic product (GDP) is an economic statistic that measures the market value of all final goods and services produced within a country in a given period of time.

Liquidity risk is concerned with an investor having to sell a bond below its indicated value, the indication having come from a recent transaction.

Obamacare is a federal statute signed into law in March 2010 as a part of the health care reform agenda of the Obama administration. **Hillarycare** is a term used by some to refer to Hillary Clinton's role as chair of the Task Force on National Health Care Reform, which developed the Health Security Act of 1993.

S&P 500 Index is an unmanaged index of common stock performance.

U.S. Treasuries 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. Treasuries when the securities are held to maturity.

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. 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. Because this Fund expects to hold a concentrated portfolio of securities, and invests in certain regions or industries, it has increased vulnerability to market volatility.

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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.

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.

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