ClearBridge Investments
A Legg Mason Company

4Q 2017 | Product Commentary

CLEARBRIDGE VALUE TRUST

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Portfolio Managers

Average annual total returns and fund expenses (%)

as of December 31, 2017

Class C	3-mo	1-yr	5-yr	10-yr	Since Incept. (04/16/82)	Gross	Net
Excluding sales charges	3.56	13.76	13.47	3.43	11.68	1.77	1.77
Including effects of maximum sales charges	2.61	12.81	13.47	3.43	11.68	-	-
S&P 500 Index	6.64	21.83	15.79	8.50	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 C shares have a one-year contingent deferred sales charge (CDSC) of 0.95%. 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, 2018 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

- Solid economic data, including healthy projected holiday sales, and the tax reform bill that passed in December, helped stocks climb higher.
- Yet, justifiably high expectations for future growth and returns are already largely embedded in price.
- We are still finding a few select stocks that meet our criteria of selling well below business value, and where our perception varies from that of the market.

Market overview

U.S. stocks continued their positive performance in the fourth quarter of 2017, supported by solid economic data, including healthy projected holiday sales, and, importantly, the tax reform bill that passed in December. The S&P 500 Index returned 6.64% for the quarter and ended the year up 21.83%. During the quarter the consumer discretionary, information technology (IT) and financials sectors led the market, while utilities, health care and real estate lagged. For the year, the market experienced positive returns in all but two sectors and it was led by a 38.83% gain in the IT sector. Telecommunications services and energy were the trailing sectors, declining 1.25% and 1.01%, respectively.

The most significant economic development in the quarter was the passage and signing of the tax reform bill in December. Its passage helped sustain investor optimism, which was supported as well by steady economic growth and historically low interest rates. Final third-quarter U.S. GDP growth was revised to an annualized 3.2%, largely in line with the second quarter's 3.1%. U.S. manufacturing remained strong in the quarter, with the IHS Markit U.S. Manufacturing PMI at 55.1 in December, above November's 53.9 and the highest since March 2015. Panelists in December's survey cited favorable domestic demand conditions, while business confidence rose again, reaching a two-year high. Meanwhile, consumer sentiment as reported by the University of Michigan survey remained elevated, with respondents split on the economic impact of December's tax reform bill. New-home sales rose over 17% to a seasonally adjusted 733,000 in November, the highest since July 2007, while the economy added jobs at a healthy rate.

As expected, in December the Federal Reserve raised the federal funds rate by 0.25%; equity markets reacted calmly. Core PCE, the Federal Reserve's preferred measure of inflation, rose slightly in November to 1.48% from October's 1.45%, marking three consecutive months of growth.

Crude oil prices finished the year by rising above $60 per barrel (WTI), from $51.67 at the start of the quarter, helped by cuts in non-U.S. production and concern over unrest in Iran. Both the 10-year U.S. Treasury yield and the U.S. dollar remained largely flat during the quarter, with the 10-year Treasury closing at 2.41%, and the dollar stabilizing after declining in the first three quarters of 2017.

Fund highlights

During the fourth quarter of 2017, the ClearBridge Value Trust – Class C shares generated a total return of 3.56%, excluding sales charges. In comparison, the Fund's unmanaged benchmark, the S&P 500 Index, returned 6.64% and the Lipper Multi-Cap Core Funds category average was 5.84% for the same period.

On an absolute basis, seven of the 11 sectors in which the Fund was invested in for the fourth quarter generated positive returns. The information technology (IT), financials and consumer discretionary sectors contributed the most to absolute returns, while the health care sector detracted the most.

Relative Fund underperformance was driven by stock selection effects and sector allocation. Stock selection in the health care, real estate and consumer discretionary sectors detracted the most from relative returns. Meanwhile, stock selection in the IT sector contributed to relative performance for the fourth quarter.

Synchrony Financial, Mylan, Microsoft, QUALCOMM and Alphabet were the largest contributors to performance, while the biggest detractors included Celgene, Allergan, Realogy, Alexion Pharmaceuticals and XL Group.

During the quarter we initiated positions in Universal Health and XL Group. We closed positions in Cabot Oil & Gas, CNX Resources and Biogen.

Top contributors

Synchrony Financial (SYF), in the financials sector, saw shares rise on optimism around tax reform, which would directly benefit this full taxpayer. Critically, Synchrony's credit losses have settled in a range that was expected by management, and which suggests that pretax earnings growth will also start to grow again in 2018.

Microsoft (MSFT), in the IT sector, develops software including the Windows family of products, the Microsoft Office system, the Azure cloud platform and the Bing search engine. A blowout quarter across all divisions lifted shares of the burgeoning leader in cloud services.

QUALCOMM (QCOM), in the IT sector, reported a quarterly earnings beat and raised expectations for the fourth quarter of 2017. However, the biggest driver of outperformance was the announcement by Broadcom Limited (AVGO) that it was seeking to acquire QCOM for cash and stock at a substantial premium to QCOM's share price prior to this announcement.

Top detractors

Celgene (CELG), in the health care sector, is a biotechnology company developing therapies for cancer and immune-inflammatory diseases. The stock re-rerated lower on weak sales for its Otezla treatment and a failed clinical trial of compound to treat Crohn's disease.

Allergan (AGN), in the health care sector, is a specialty pharmaceutical maker offering branded and generic drugs, including Botox, as well as over-the-counter treatments. The growing risk of competition for its franchise Botox aesthetics treatment, as well as Restasis treatment for dry eye, pressured shares. Botox competition is still several years away, and the franchise is growing. Even with the potential loss of exclusivity for Restasis, shares are trading at just over 10 times earnings, with little credit being given to its pipeline treatments for unmet needs like chronic migraines and liver disease.

XL Group (XL), a property and casualty insurer in the financials sector, was hit hard by losses from several insured catastrophic events in 2017. These events did hit XL's book value, but the aggregate losses are improving pricing, which will directly benefit XL's returns on equity in 2018. Despite this incremental improvement, XL now sells below its recently diminished book value, and at a large discount from peer insurers.

Market outlook

Market cycles, including the current one as it begins its tenth year, are very similar to endurance races. We believe the market is setting odds on three scenarios in this one, with which it is worthwhile to contrast our own subjective probabilities:

First is *Extrapolate Perfection*. This scenario is a repeat of 2017, with rising optimism and growth, but with no material increase in interest rates or inflation. The result would be a continued drop in the ERP, meaning valuation multiples would rise, greatly boosting equity returns from the likely double-digit growth in 2018 earnings. From recent investor survey data and early 2018 market action — and as exemplified by Jeremy Grantham's latest piece, "Bracing Yourself for a Possible Near-Term Melt-Up" — I would argue the market is setting odds of extrapolation at approximately 50%. This level is not surprising, as extrapolation is often the most natural human default when gauging the future, as it's the easiest for most people to imagine, especially when anchoring off recent extreme events. Our subjective odds, however, are less than 20%. The base rates of history would argue for a very low single-digit probability, and just as sprinting burns oxygen and creates lactic acid, market excesses are forming and they carry their own weight.

The second is *Run Too Hot*: The aberration in 2017, which supported perfection, was the lack of inflation and higher interest rates. Interest rates have risen from all-time lows in the summer of 2016, and it was surprising to see the nascent journey higher pause last year despite increasing growth, a continued march toward full employment, and spiking optimism. The biggest change in 2018, however, will be that the trainer of last resort, global central banks, will start draining stimulants and oxygen from the race. It is estimated that central banks will buy $3 trillion fewer bonds in 2018, and net issuance of sovereign debt will shift from negative to positive for the first time in four years. Races are won and lost on the margins, and if interest rates continue their journey higher, the character of this race will change once again. Specifically, higher interest rates would pressure stock valuation multiples through a higher discount rate, and value stocks would start to run faster relative to their growth competitors. Our subjective probability for this scenario is 50%, while we believe the markets odds are less than 30%.

And third, a *Credit Market Bonk* (when marathon runners "hit the wall"): One of the most powerful stimulants for this cycle has been the record credit flows that have roared back after the financial system froze in 2008. Despite this recovery, there have been several deflationary risk events, such as those in 2011 and early 2016, where investors got spooked of a 2008 repeat and started to head for the locker room. This would raise risk premiums across the board, including high-yield spreads. One of the biggest shifts in 2017, and a natural result of rising optimism, is that the market dramatically lowered its probability of a deflationary bust. Essentially, this was the year a deflationary scenario really came off the table, as investors finally escaped the deep-rooted pessimism of 2008. This was a necessary condition for an overheating scenario to emerge, and we think the market is now assigning a probability of less than 20% and falling. Our subjective probability is a little higher at 30%, a dominant concern being mounting distress in the traditional retail sector. There have been 50 bankruptcies in retailers during 2017, including Toys 'R' Us, and this list should grow as the Amazon disruption train keeps rolling. Like the dislocation in energy in 2016, you could reach a point where layoffs and bankruptcies mount to a degree that high yield backs up. So far, the market is sanguine on the overall risk, but it's a key risk from disruption that should be monitored.

Real risk and uncertainty are what remain after you have imagined explicit possibilities, but these scenarios are valuable in framing portfolio fitness as we begin 2018.

If the first scenario occurs, we face continued relative performance risk, as the indexes will continue to charge ahead, powered by the big tech stocks that we are now underweight. Investors should rightly ask why we wouldn't just buy some of these momentum darlings, given their incredible current fundamentals. Our challenge is that based on our bottom-up valuation work, current market prices are above business values, as the justifiably high expectations for future growth and returns are already largely embedded in price. We will not sacrifice our core valuation discipline to try and run a shorter-term momentum race; that subjects us to too much of our main concern, which is absolute risk of capital loss.

The real challenge of late-cycle investing is that risks build up in the system as expectations ultimately rise to a level that asks too much of an uncertain future. Conversely, when risk premiums are high early in the cycle, investors are getting paid handsomely to take on an uncertain future. Now investors are paying up for an optimistic future they only think they can predict. The biggest risk in the current nature of the race 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 basing his or her actions on short-term price momentum. This creates a classic duration mismatch, which will close violently when price momentum reverses. The match that could spur this reversal is an increase in interest rates, and a subsequent rise in volatility. We are not optimistic that the current crop of passive investors and quant funds have a high pain tolerance, especially as central bank stimulants are withdrawn.

Thus, at this stage in the market race we are more concerned about longer-term absolute risk from shrunken risk premiums and mounting liquidity risk than the near-term pain of relative risk from a momentum sprint. Fortunately, we are still finding a few select stocks that meet our criteria of selling well below business value, and where our perception varies from that of the market. In the current environment, these stocks tend to be ignored by the crowd, with no price momentum and lower index weights.

Top 10 equity holdings (%)	
Alphabet Inc	5.2
Synchrony Financial	4.3
Microsoft Corp	4.2
Wells Fargo & Co	3.7
Oracle Corp	3.7
Allergan PLC	3.2
Cisco Systems Inc	2.8
AutoZone Inc	2.6
Mylan NV	2.6
Kinder Morgan Inc/DE	2.6

Sector allocation (%)	
Financials	19.6
Information Technology	17.2
Consumer Discretionary	13.5
Health Care	12.9
Industrials	11.8
Energy	9.6
Utilities	4.2
Real Estate	3.8
Consumer Staples	2.9
Materials	1.7
Telecommunication Services	0.0
Cash/Other	2.8

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.

Category Average Returns' Source: Lipper Inc. **Past performance is no guarantee of future results.** Lipper returns are based on the three-month period ended December 31, 2017, and they are calculated among 811 funds in the Lipper Multi-Cap Core peer group, including reinvestment of dividends and capital gains, if any, and excluding sales charges.

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.

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.

The **Purchasing Managers Index (PMI)** measures the manufacturing and services sectors in an economy, based on survey data collected from a representative panel of manufacturing and services firms. PMI greater than 50 indicated economic expansion; below 50, contraction.

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

West Texas Intermediate (WTI), also known as Texas light sweet, is a grade of crude oil used as a benchmark in oil pricing. This grade is described as light because of its relatively low density, and sweet because of its low sulfur content. It is the underlying commodity of Chicago Mercantile Exchange's oil futures contracts.

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- A broad mix of equities, fixed income, alternatives and cash strategies invested worldwide
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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.

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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