

# LEGG MASON CLEARBRIDGE US EQUITY SUSTAINABILITY LEADERS FUND

## QUARTER UPDATE – Q1 2019



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### Key Takeaways

- Positive signs from U.S.-China trade negotiations and a more dovish Fed raised sentiment and pushed U.S. equities higher in the first quarter.
- We saw growth opportunity in IT and industrials and sought to unlock relative value and bolster defensive characteristics in the consumer discretionary sector.
- ClearBridge is engaging companies in the drug value chain to improve opioid distribution and develop therapeutic alternatives as well as supporting insurers as they prevent dangerous opioid cases before they begin.

### Market Overview and Outlook

Positive signs from U.S.-China trade negotiations and a more dovish stance from the Federal Reserve raised sentiment toward economic growth and pushed U.S. equities higher in the first quarter. Investors shrugged off a 35-day U.S. government shutdown and an inversion of the 3-month/10-year

yield curve, which transpired after the March FOMC meeting, to push the benchmark Russell 3000 Index up just over 14%, nearly recouping fourth-quarter losses.

The U.S. economy continued to expand at a healthy rate, albeit more slowly than the 4.2% it reached in the second quarter of 2018. U.S. GDP grew at an annualized 2.6% in the fourth quarter. The labor market showed mixed signs, adding a robust 311,000 jobs in January only to disappoint with 20,000 in February, while unemployment remained at historical lows and inflation remained benign. The Fed held rates steady in January and again in March, while lowering its forecast for future hikes due to slower expected growth. Given a pause in short-term interest rate hikes, the yield on the U.S. 10-year Treasury edged lower to finish the period at 2.41%, as some market participants interpreted the Fed's "balanced" view of the economy as a possibility of a near-term rate cut.

The risk-on quarter saw a rebound for information technology (IT) stocks, which had led indexes lower in the fourth quarter. Major contributors in the portfolio included Microsoft, whose Azure cloud platform helped drive strong quarterly results at a company that has consistently been a leader in data protection and customer privacy as well as human rights and diversity, and Apple, which has best-in-class ESG practices in areas including renewable energy use, data privacy and workplace diversity. ADP, a payroll and human resources software and services provider leveraging the cloud and delivering improving results with less environmental impact, was also a top contributor.

The pause in interest rate hikes helped real estate stocks such as portfolio holding Equinix make strong contributions as well. Equinix owns and operates data centers housing a large number of servers, storage and networking equipment and is well-

Q1 2019

**The value of investment and the income from them may go down as well as up and you may not get back the amount you originally invested. Past performance is not a reliable indicator of future results.**

positioned to participate in what we view as the early stages of a buildout in hybrid cloud services. This is notable because Equinix is mindful not only of safeguarding data, but also of ensuring it is managed efficiently and with a minimal impact on the environment. Further, as mentioned in the ClearBridge 2018 Impact Report, as part of a growing trend of increasing proxy access at U.S. companies, Equinix recently voted to amend the existing rights for shareholders, broadening shareholder inclusion in the nomination process.

Health care was the main laggard in the broad market; the portfolio's health care holdings had both positives and negatives. On the negative side, oncology, neurology and immunology therapy developer Biogen sold off after it discontinued clinical trials for its Alzheimer's treatment aducanumab. Without aducanumab, Biogen still maintains a solid base business in MS and rare diseases, and a number of development-stage assets for neurologic conditions and rare diseases and remains a leader in neurology R&D, which could lead to additional pipeline successes over time. Such characteristics could also make the company attractive to larger pharmaceutical companies in an environment where health care M&A activity has been picking up.

Health care conglomerate Danaher, meanwhile, was a significant positive contributor, as investors rewarded its acquisition of General Electric's biopharma business, its largest purchase to date. The move increases Danaher's exposure to the fast-growing biopharma industry and adds a complementary portfolio that should be immediately accretive to earnings.

Lam Research, a leading technology hardware company that makes capital equipment used in the semiconductor manufacturing process, was also a strong contributor. Lam's technologies are crucial to the miniaturization of semiconductor technology, which reduces device size and energy consumption for chips. This helps to offset the water intensity of the etch and deposition process used in creating semiconductors by Lam Research's customers in their production lines. We added to our position during the quarter as we expect Lam to see higher volumes in an industry with high barriers to entry.

In a market at the upper end of its valuation range, we sought to unlock relative value during the quarter with the initiation of a position in Home Depot, the largest home improvement retailer in the U.S. We funded the purchase with the sale of Lowe's, which had seen its relative valuation advantage close somewhat over 2018 and now faces some execution risk in its turnaround plan. We like Home Depot's relatively larger exposure to the maintenance and repair business, which gives the company defensive characteristics desirable as we enter the late stages of the economic cycle. Home Depot is a sustainability leader on multiple fronts. The company was among the first as a global buyer of sustainably sourced wood. It was early to offer floor and shelf space for energy-efficient appliances and environmentally friendly products. With the competition for skilled

talent, the company has had a commitment to diversity and inclusion and training for its associates.

## Lam's technologies are crucial to the miniaturization of semiconductor technology, which reduces device size and energy consumption for chips.

Looking ahead, we remain positive about the outlook for the U.S. equity market due to strong underlying fundamentals, though we are vigilantly watching for any increase in

market volatility. While we expect corporate earnings to remain solid as the U.S. continues to generate good economic growth, we expect the pace of growth to slow in 2019. We also continue to monitor the risks of a global trade war, which would be negative for global equity markets. The delay of the March 1 deadline for U.S. tariff increases on China and continued negotiations gives us some hope that the situation will be resolved in a reasonable time frame.

### Portfolio Highlights

The Legg Mason ClearBridge US Equity Sustainability Leaders Fund underperformed its Russell 3000 Index benchmark during the first quarter<sup>5</sup>. The primary contributors were the IT, industrials and financials sectors. The communication services, utilities and materials sectors were the main laggards.

On a relative basis, overall stock selection contributed positively to performance, while overall sector allocation detracted. Stock selection in the financials, real estate and materials sectors helped relative results. Conversely, stock selection in the communication services and IT sectors was detrimental.

On an individual stock basis, Microsoft, Danaher, Apple, ADP and Ecolab were the largest contributors to absolute performance in the quarter. The sole detractors from absolute returns were positions in Biogen and United Health.

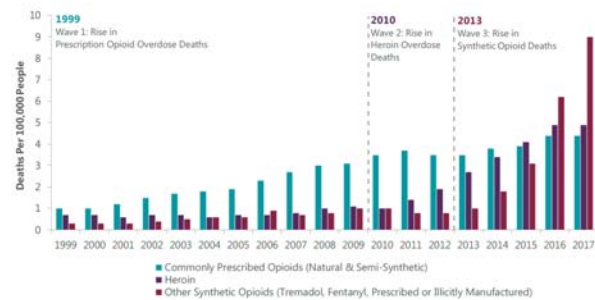
During the quarter, we established a new position in Home Depot and closed a position in Lowe's.

### ESG Highlights

Opioid abuse has become such a serious issue that it is included in the UN Sustainable Development Goal #3, Good Health & Well Being, which includes a target to strengthen the prevention and treatment of substance abuse, including narcotic drug abuse. Appropriately used, opioids are an important and effective treatment for chronic and acute pain. They carry, however, the serious risks of misuse, addiction, overdoses and death. There is no profile of a typical user or potential misuser: according to The Hartford, one in three people will be prescribed opioids in their life. Athletes and office workers, teenagers and adults, family members and neighbors — anyone could be involved or affected by opioid misuse.

Since the prescription of opioids began to increase significantly in the 1990s, the number of opioid overdose deaths has likewise risen (Exhibit 1). So has the economic burden: one study estimated the total economic burden of fatal overdoses, abuse and dependence of prescription opioids to be \$78.5 billion in 2013 alone.<sup>1</sup> The opioid epidemic causes more than 130 overdose deaths per day in the U.S.<sup>2</sup> Opioids were responsible for almost two thirds of all drug overdoses in the U.S. in 2015; roughly half of these involved prescription opioids. Yet even while prescribing rates have fallen from peaks in 2010–2012, the amount of opioids prescribed per person is still high — three times higher than in 1999.<sup>3</sup>

Exhibit 1: Rise in Opioid Overdose Deaths



As of 2017. Source: National Vital Statistics System Mortality File.

As an active investor in public equities, ClearBridge pursues a multifaceted approach to support efforts to reduce opioid addiction. ClearBridge is engaging companies in the drug value chain to better control opioid distribution and develop therapeutic alternatives to opioids. We are also supporting portfolio holdings in the insurance industry that identify those most at risk of opioid addiction and prevent dangerous cases before they begin. Helping efforts to reduce opioid addiction also aligns with our efforts to support UN Sustainable Development Goal #3, Good Health & Well Being.

### Finding Solutions Across the Drug Value Chain

Patient access to opioids and lack of education on usage risks are primary contributors to the opioid epidemic. As a shareholder of companies across the drug value chain, ClearBridge encourages and supports these companies with the ability and the responsibility to act. Our roles as an active manager include engaging with distributors on their efforts to prevent potentially irresponsible dispensation of opioid drugs and investing in pharmaceutical companies developing therapeutic solutions.

ClearBridge portfolio holdings in the distribution segment of the value chain are working to stop inappropriate diversion of prescribed opioids. The key is that they not be overprescribed, either in cases where one patient's prescription contains too much opioids at once or for too long a time, or where too many people are getting prescriptions, some unnecessarily. Distributors are making changes to how they operate to help fight the crisis. CVS Health, for example, has worked with other distributors to build a network of shared records, so one user cannot simply go to a different pharmacy to get a prescription filled. The company has also developed

programs for the safe disposal of unused opioids, preventing discarded opioids from finding a market.

In addition, we have a history of engaging health care companies on anesthesia and the adoption of non-opiate approaches to pain management. We have engaged CVS, Amerisource Bergen and UnitedHealth on how their pain clinic managers ensure appropriate opioid use.

Patients are also prescribed opioids for dental health

**Long-acting local anesthetics can work just as effectively as systemic versions and might even prevent initial opioid use.**

care; dental health care professionals write 12% of all opioid prescriptions, almost half of which are for adolescents. A recent Stanford study found that

routine painkillers prescribed to teens after wisdom teeth removal could contribute to opioid addiction in young adults.<sup>4</sup>

UnitedHealth has launched oral health programs and policies to reduce opioid access in a number of ways, such as limiting the level of the prescription through the UnitedHealth oral pharmacy policy, as well as mailing information about the risks and proper use of opioid prescriptions to patients with dependents from the ages of 16 to 22 years. In addition, UnitedHealth will track the dental professionals who are among the top 10% opioid prescribers in their network and notify them of their status. After being contacted, these professionals have reduced prescriptions by 17%. The program has been updated to flag the top 20% oral health prescribers.

While opioids are the most prevalent and cost-effective form of pain management for many use cases, we are also investing in companies developing alternative therapeutic solutions. Portfolio companies Pacira Pharmaceuticals, Alkermes and Heron Therapeutics are developing opioid substitutes which would allow use of non-systemic pain relief in surgeries – long-acting local anesthetics that work just as effectively as systemic versions might even prevent initial opioid use.

Pacira Pharmaceuticals manufactures and markets Exparel, a treatment that can serve as an alternative to alleviate post-surgical pain, a primary introduction point for opioid use. The current standard of care to manage post-surgical pain is oral or intravenous opioids and there are few alternatives that offer pain relief as effectively. Exparel is a long-acting formulation of a well-known local anesthetic injected directly into the surgical site during a procedure to block pain locally, rather than systemically. By being given Exparel during surgery, patients can either avoid the use of post-surgical opioids or significantly reduce their dose and duration of use.

We have also discussed efforts to address the opioid crisis with pharmaceutical maker Alkermes. The company sells Vivitrol, a long-acting injectable drug that reduces the effect and craving for opioids. The

drug is used as part of rehabilitation protocols, along with detoxification and therapy/counseling, and is clinically proven to decrease abuse relapse rates. Vivitrol is used instead of opioid replacement therapies like methadone. In addition to traditional drug marketing, Alkermes has engaged at all levels of government and the justice system to broaden the use of Vivitrol to combat the growing opioid addiction problem in the U.S, including in federal prisons.

Heron Therapeutics is a pharmaceutical maker with two commercial anti-nausea treatments for patients going through chemotherapy. We are excited about the prospects for a next-generation non-opioid painkiller in Heron's pipeline (HTX-011) for post-operative pain that is expected to receive FDA approval around the middle of 2019. Heron is benefiting from fast-track approval procedures that have been established by the FDA to encourage innovation and that we believe can bring non-opioid treatments to market in a timelier manner.

### Insuring a Better Approach to Use of Painkillers

As the opioid epidemic has begun to have a more and more tangible impact on employers, property & casualty insurance companies, such as ClearBridge holdings The Hartford and Travelers Insurance, have been proactively working to detect addiction and tailor rehabilitation. Due to in-house triage personnel, insurers have a unique perspective on the crisis in that they often have the first look at treatment and prescription trends that might involve opioid use. Both The Hartford and Travelers are fighting the opioid crisis by holistically working with doctors on

diagnosis and treatment for employees in filing workers' compensation claims.

Both The Hartford and Travelers are pursuing innovative programs to combat opioid addiction by using predictive analytics to identify drug-seeking behavior. The Hartford uses an analytics model that incorporates nonmedical psychosocial factors, such as subtle verbal cues, to identify claimants at higher risk of addiction. Using this model, The Hartford has seen opioid use on its claims drop by 25% from January 2015 to July 2016; the average morphine equivalent dose per claim decreased by 9% over that time frame as well.

Travelers has developed an Early Severity Predictor® to identify when an injured employee develops chronic pain, so it can work with employees and their doctors to eliminate or reduce the need for painkillers.

These programs help monitor and reduce the risks of addiction, which not only saves livelihoods and lives, but also benefits employers in terms of reduced lost work time, lost productivity and lower insurance costs. Since 2015, The Hartford has been able to help workers' compensation claimants reduce opioid use by 43%.

ClearBridge supports and encourages these practices and makes them part of our long-standing conversations with Travelers and The Hartford. Our ownership of these companies is an example of cases where smart ESG practices serve the interest of both shareholders and society.

## FUND RISKS

**Environmental, social and governance (ESG) policy:** The fund follows an ESG investment policy that may limit the number of investment opportunities available to the fund which may affect its performance compared to other funds that do not employ such investment policies.

**Geographical focus:** This fund invests primarily in the United States, which means that it is more sensitive to local economic, market, political or regulatory events in the United States, and will be more affected by these events than other funds that invest in a broader range of regions.

**Concentrated fund:** The fund invests in fewer companies than other funds which invest in shares usually do. This means that the fund does not spread its risk as widely as other funds and will therefore be affected more if an individual company has significant losses.

**Fund operations:** The fund is subject to the risk of loss resulting from inadequate or failed internal processes, people or systems or those of third parties such as those responsible for the custody of its assets.

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## IMPORTANT INFORMATION

All data ClearBridge Investments as at 31 March 2019 unless otherwise stated.

<sup>1</sup> Florence CS, Zhou C, Luo F, Xu L. The economic burden of prescription opioid overdose, abuse, and dependence in the United States, 2013. *Med Care* 2016; 54:901–6

<sup>2</sup> Wide-ranging online data for epidemiologic research (WONDER). Atlanta, GA: CDC, National Center for Health Statistics; 2017. Available at <http://wonder.cdc.gov>.

<sup>3</sup> Centers for Disease Control and Prevention. Vital Signs: Changes in Opioid Prescribing in the United States, 2006–2015. *MMWR* 2017; 66(26):697–704.

<sup>4</sup> <https://med.stanford.edu/news/all-news/2018/12/opioid-prescriptions-from-dentists-linked-to-youth-addiction-risk.html>

<sup>5</sup> Performance is calculated on a NAV to NAV basis, with gross income reinvested and after deduction of annual fund expenses. Past performance is not a reliable indicator of future results.

From 25 March 2019, the pricing of securities held in Legg Mason Global Funds Plc[\*] ("LMGF") and Legg Mason Qualified Investor Funds (II) Plc (collectively the "Funds"), will use the mean (or mid) value of the bid and ask prices, to calculate the Funds' Net Asset Values ("NAV"). The Funds previously used a bid price methodology for fixed income securities, and last traded price for equity securities.

[\*]The NAV pricing methodology of the LMGF Legg Mason Western Asset US Government Liquidity Fund is unchanged."

Unless otherwise noted the "\$" (dollar sign) represents U.S. Dollars.

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