ClearBridge Investments

Market Commentary

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"Nothing any good isn't hard." ***– F. Scott Fitzgerald***

Memories of painful experiences are often a critical and adaptive part of living, in that painful memories can keep you out of harm's way by minimizing repeat mistakes. The challenge, however, is that memories are highly subjective, and with the passage of time you often forget how intense something felt at the time.

In the realm of physical pain, my biggest outlet for stress is training and competing in triathlons with my wife and several colleagues from ClearBridge. They are all better than me, which is painful enough, but I often don't have enough time to fully prepare for the longer events. This inevitably leads me to swear off competing again, until I ultimately find myself standing in a cold body of water at the beginning of another grueling physical experience. In all seriousness, I love competing, and the rewards of doing so from a health and emotional perspective far outweigh short bouts of physical pain that are soon enough forgotten.

Besides math and time, you also need a strong constitution to turn myopic loss aversion into long-term opportunity.

On the other hand, the pain that investors frequently encounter as they navigate the vagaries and complexity of financial markets is a different beast altogether. In fact, as the great behavioral psychologists Daniel Kahneman and Amos Tversky detailed with the concept of myopic loss aversion: investors feel the pain of losses at roughly twice the magnitude of comparable gains. To make matters worse, investors typically check their performance and evaluate their portfolios frequently, almost guaranteeing a steady stream of short-term emotional pain.

Unfortunately, the potential for short-term pain was extremely high during the recently concluded third quarter. The S&P 500 Index was down over 6%, which was the worst return since the third quarter of 2011. In many ways the key behavioral challenge, and ironically the opportunity, of this entire market cycle is that it started with the acute pain of the Great Financial Crisis (GFC). During the GFC, many stocks dropped to levels that rightly reflected the existential risks of another great depression, as investors grappled with frozen credit markets and a debt-driven deflationary spiral. These extreme initial conditions have been followed by smaller but nonetheless painful deflationary storms: the first Greek exit risk (2010), the loss of the U.S.'s AAA credit rating (2011), Eurozone breakup risk (2012) and last year's Ebola scare. During this quarter's deflationary storm, market fears centered on risks of an Emerging Market (EM) crisis, driven primarily by slowing growth in China. To be sure, these are all real risks: deflation and debt is a particularly toxic brew for risk assets, and the probability of an EM-driven credit event has clearly risen.

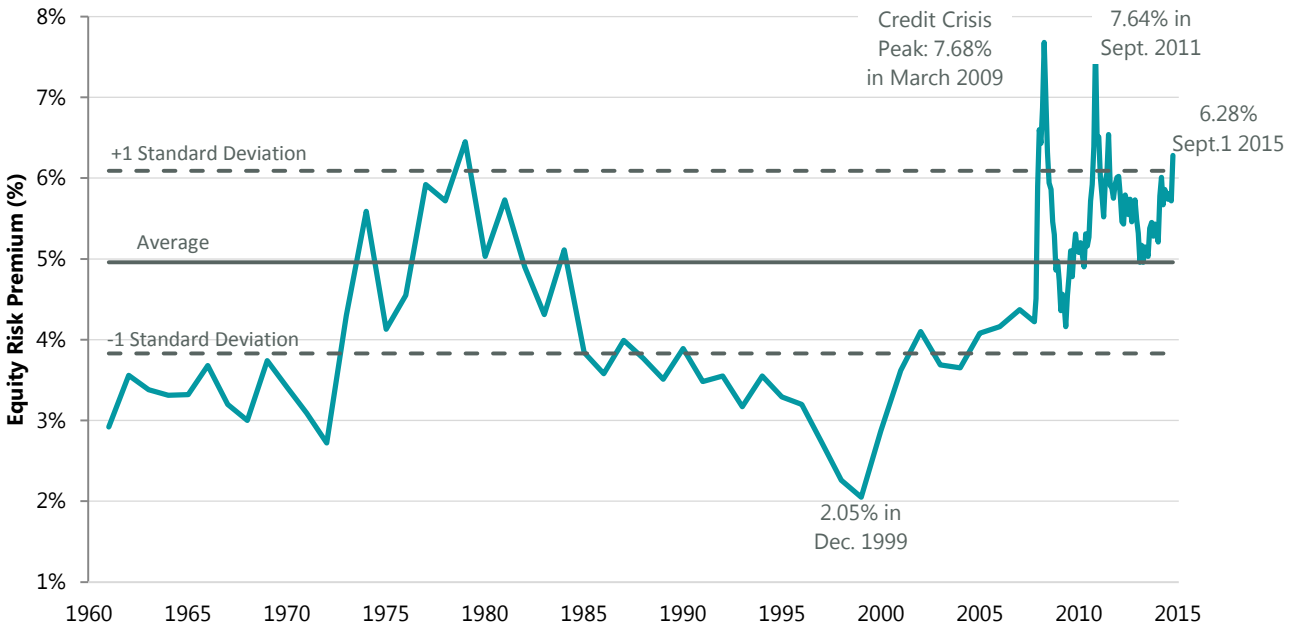
What these recurring storms highlight is that hits to investor confidence from the GFC and subsequent storms have resulted in a razor-thin level of commitment to equities, and declines in stocks are viewed through the lens of risk and pain and certainly not opportunity. Furthermore, the price volatility associated with myopic loss aversion is exacerbated by the evolving structure of markets. This evolution has further shifted the ownership level and decision making from individual securities and their specific fundamental and valuation characteristics, to classes and sectors of assets that are characterized by the correlation and volatility of their returns. This is most succinctly captured by the notion of equities as clusters of "risk assets," which can only be safely owned during "risk-on" markets. Price is paramount and deterministic, valuation and increasingly fundamentals are secondary at best!

At this point, you may be asking where is the opportunity amid these recurring waves of deflationary pain and compression of individual stocks into risk-driven clumps. As valuation-driven managers, we gauge opportunity at both the broad market and individual stock level by assessing the underlying value proposition, and specifically the potential for exploitable price-to-value gaps.

Starting at the broad equity market level, we try to measure opportunity by constantly monitoring the Equity Risk Premium (ERP), which is the expected excess return from equities over the risk-free-rate (typically the yield on the 10-year Treasury note). To be clear, whether you try to measure the ERP using historic excess returns or by calculating potential forward excess returns, ERP is never a perfect measure of reality. However, measures of ERP that are made consistently through time do generate valuable relative comparisons that can help to robustly answer a key question: what level of investor sentiment is reflected in equities at a given time?

In Exhibit 1, we show ERP as calculated by Professor Aswath Damodaran, a valuation expert and finance professor at NYU. What the exhibit shows is a love affair with equities that occurred during the great bull market of the 1990s, and subsequent equity bubble, which ended very badly during the GFC. Since peaking at 7.68% during the crisis, each deflationary storm has caused spikes in the ERP to levels that are historically elevated. Essentially, investor confidence in stocks has remained at persistently low levels relative to history, with investors demanding elevated risk premium to take on the potential pain of stocks. From our perspective as long-term valuation managers, this persistent investor skepticism towards equities has been a major tailwind for this market cycle. Yes, it may just suggest good relative returns for equities versus potentially over-valued bonds, but it also suggests that the classic investor arc from fear to greed that characterizes every risk cycle should be elongated.

Exhibit 1: Equity Risk Premium – U.S. (Jan. 1960 – Aug. 2015)



Source: Aswath Damodoran (http://pages.stern.nyu.edu/~adamodar/), ClearBridge Investments.
Equity Risk Premium: Excess return above the risk-free rate that compensates investors for taking on the relatively higher risk of investing in equities. Data calculates implied equity risk premium by using free cash flow to equity (FCFE) for the S&P 500 Index. Treasury rate used is the constant-maturity U.S. 10 year bond including coupon and price appreciation.

At the individual stock layer, the marginal shift in market structure to frame stocks as correlated clusters is resulting in periods of indiscriminate selling of individual stocks. Frankly, it is much easier to sell a single exchange-traded fund (ETF) to reduce "risk" exposure, than hitting the sell button several times after weighing the merits of each security. As these shifts in asset allocation preferences roll through, the shifting tide of sentiment results in increased stock-level volatility. The volatility is exacerbated by liquidity differences in the underlying securities, which can cause sizeable dislocations between price and underlying value. If you can do valuation math, it can really pay to discriminate!

Besides some basic valuation math, however, you also need time. Post the GFC, and certainly during all these risk-off storms, pair-wise stock correlations have spiked. This simply means that individual stock price action gets even less differentiated during fear-driven sell-offs, as the glue hardens stocks into buckets of gross risk. As a result, correlation spikes can make stock picking a fool's errand in the short to intermediate term. However, differences in fundamentals and valuation at the security level do matter tremendously over time as panic recedes and stocks inevitably unstick. This is the essence of time arbitrage for long-term investors that pick stocks.

Finally, besides math and time, you also need a strong constitution to turn myopic loss aversion into long-term opportunity. Even though every market cycle is different, and market structures are always evolving, our glacially-evolving brains struggle to adapt to these rapid changes. In particular, our brains frame the world through stories, and especially causal narratives. In markets, people typically form these narratives through price action, and when stocks are going down most investors cannot rest until they form a satisfying story of what is wrong. The challenge this presents is that economies and markets are so complex and dynamic, that our simple stories are typically extremely poor models of the underlying reality. Regardless, when stocks we own are getting blasted by macro-driven selling that begets more selling, the immediate behavioral reaction is "Houston, we have a problem!" This is when many investors hit the eject button. Often there is a real problem to justify the selling but many times the problem is either fleeting or is fully reflected in the price and then some, which creates an opportunity. The key to successful investing is trying to determine the difference in a disciplined manner, as you seek informed conviction while not crossing the thin line to stubbornness.

Our investment process tackles the challenges and opportunities of indiscriminate selling by pricing risk at the security level, while dealing with the inherent uncertainty of complex markets through portfolio construction:

- To price risk we value securities under various future scenarios that run from dismal to great, and assign probabilities to these scenarios to calculate an expected value. Our biggest concern with a given security is that we are not well-calibrated, and misprice the risk-and-reward proposition with a realized price that falls outside our range of values. This simply means that we missed something and we didn't really get paid for the risk we were taking. Unfortunately, calibration errors occur occasionally but they are also usually manageable.
- The goal of portfolio construction is to own a portfolio of mispriced securities that do not correlate, typically because their inherent fundamental drivers and factor exposures vary widely. Our biggest concern with portfolio construction is that we end up making a correlated mistake, as a future outcome impairs business value across several of our holdings and results in a permanent capital loss. It is more difficult to recover from this risk. This is why we work as a team that constantly challenges each member, assesses our valuation work, and updates and evaluates data on portfolio construction. Basically, we have to survive the big risk events, while generating attractive long-term returns as price and value converge in the underlying portfolio holdings.

Even with a core focus of getting paid for the risks we take, and constantly trying to optimize our portfolio construction, as concentrated managers we are subject to periods of underperformance. These challenging episodes typically coincide with the deflationary storms that precipitate risk-off selling. The majority of performance headwinds in this cycle resulted from our valuation discipline favoring the much more attractive price-to-value gaps in cyclical industries: financials, enterprise technology, merchant power, and selectively in the currently much-hated materials and energy space. Besides getting amply paid for this cyclical risk in a world scared by deflation and anemic global growth, we also balance our portfolio construction with mispriced health care and consumer names that have done well in this deflationary environment. Finally, we are focused on balance sheet strength and cash flow generation across the portfolio, with a key goal of avoiding solvency or liquidity issues should an emerging markets credit event surface in the next few quarters.

So far this year, our performance challenges have mostly come from four stocks: Keurig Green Mountain Coffee (GMCR), CONSOL Energy (CNX), Yahoo! (YHOO) and Calpine (CPN). We will make brief comments on each

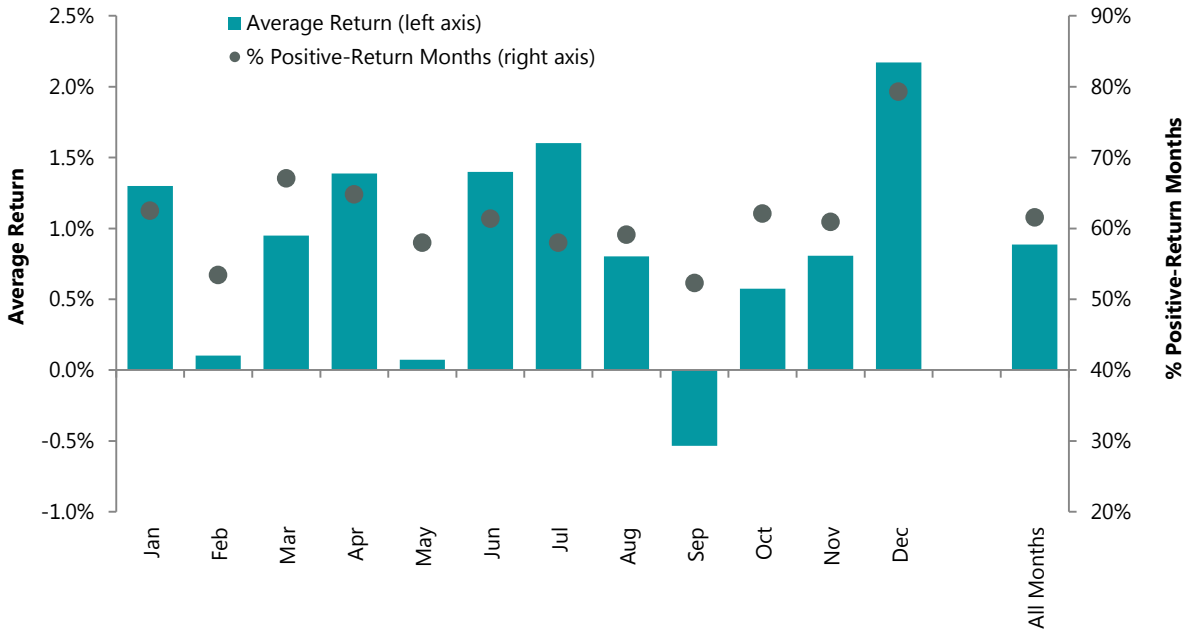
of these stocks, lessons learned, and where we stand on each. A critical observation in support of portfolio construction and eluding correlated bets is that these four stocks all have unique challenges, and don't reflect any common underlying issue.

- GMCR dominates the single-serve coffee market, and is in the process of launching a single-serve cold beverage machine, the KOLD system. GMCR is a good business with returns on invested capital (ROIC) in the low- to mid-teens, and positive free-cash-flow that has resulted in a net cash balance sheet. When we originally purchased GMCR we believed we were paying very little for the KOLD product cycle, and we liked the quality and portfolio diversification benefits of a consumer staple name with growth potential. Unfortunately, GMCR's legacy hot business faced tremendous challenges over the past year on disappointing brewer sales and pricing pressure on the single-serve pods. This has resulted in a major decline in earnings and cash flow estimates. The main issue with GMCR is that when we bought it, the stock was "crowded" with investors expecting double-digit growth. When the stock went "ex-growth," the major miss in expectations caused a flood of selling that exaggerated the down move in the stock. Subsequently, we have adjusted our process to screen all holdings and prospective names for crowding, which is a risk factor that is not captured by standard volatility measures like beta. GMCR is now at the bottom of our valuation range, and KOLD is now essentially a free option. However, if GMCR cannot stabilize its core hot fundamentals, the stock could be a value trap, and we are assessing this risk and sizing the position accordingly.
- CNX is a low-cost coal producer in the Northern Appalachian Basin, and a low-cost natural gas producer in the prolific Marcellus and Utica gas fields. CNX's management had the tremendous foresight to realize that coal's long-term prospects were challenged and diversified into natural gas roughly five years ago. CNX was uniquely positioned as its coal assets were low-cost enough to generate free cash flow, which CNX reinvested in natural gas. CNX also entered into joint ventures with larger partners to reduce the gas development costs, and has continued to sell down its ample holdings of non-core assets. Critically, CNX also recently placed 20% of its coal assets in a separately traded MLP, which will allow them to completely separate the coal and natural gas businesses with time. We originally invested in CNX because we liked the quality and diversity of its assets, and were able to get the gas assets relatively cheap due to the coal overhang. What we didn't anticipate was the severity of the current depression in coal, which served to increase the sensitivity of CNX's stock to changes in natural gas prices. The result was a wider-than-anticipated valuation range, a stock-level calibration issue we try to avoid. The key for CNX going forward is that they will survive the depression in coal as they continue to prove out their gas assets, and we continue to think the long-term fair value for CNX's assets is much higher. However, we have purposely let our position in CNX get much smaller in the portfolio, and at roughly 1% it represents our only natural gas and coal exposure at this point.
- YHOO is a classic sum-of-the-parts valuation opportunity, which is a value strategy that typically works when the parts are actually getting separated or monetized. This has been the case with YHOO, which is spinning off its 15% ownership in Alibaba (BABA), and will be left with a 35% ownership in Yahoo! Japan, the legacy U.S. Yahoo business and over $4 billion in cash. Our valuation math on YHOO has been fine, but the stock sold off as BABA has been hit on China concerns and questions surrounding the company's ability to spin out BABA tax-free. As a result, we are at the lower end of our valuation range for YHOO, but we still think most scenarios will lead to a higher price over the next several quarters as tax issues and BABA challenges are already fully reflected in the price.
- CPN is a non-regulated power producer with primarily gas-fired power generation assets in the Mid Atlantic, Texas and California power markets. CPN enjoys very low-cost generation assets that actually benefit from low gas prices, as it makes their gas-fired fleet more competitive and drives utilization. The result is massive free-cash-flow generation, which management has been using to buy back stock well below our assessment of business value, thus materially improving our intrinsic business value per share. CPN and the entire non-regulated power sector have been hit extremely hard by the severe correction in energy-related stocks, despite the continued strong fundamentals. We think this guilt by association is misplaced, and have made CPN our largest active bet. What could turn CPN into a mistake? If there is a material breakthrough in energy storage capacity, this would allow solar and wind power to gain a material advantage over traditional carbon-fired power sources. We think this risk is remote at this point, and CPN would be one of the last businesses to feel its full effects, but we will carefully watch this risk and adjust our probabilities accordingly.

Beyond these recent performance detractors, we don't think the dynamics of this market cycle have changed. Even with the rising risks of an emerging market credit event, the odds of a near-term U.S. recession still look low to us at less than 20% over the next 12 months. The banking system is in great shape, the critical housing cycle remains slow and steady, lower commodity prices are a massive wealth transfer to U.S. consumers, and the job market is still improving. We also expect companies to remain the steady bid for U.S. stocks as buyback activity remains robust, coupled and greatly boosted by historically-elevated deal activity. Most important, with the recent elevation in the Equity Risk Premium and the indiscriminate selling, the portfolio's valuation upside is back to 2012 levels. Finally, as Exhibit 2 below shows, on average September has historically been the one negative month for equity returns. Just as I have been conditioned for the physical pain of triathlon season from late spring to early fall, investors have been conditioned to dread September. This has historically been a bad time to panic given the typical returns seen in the fourth quarter.

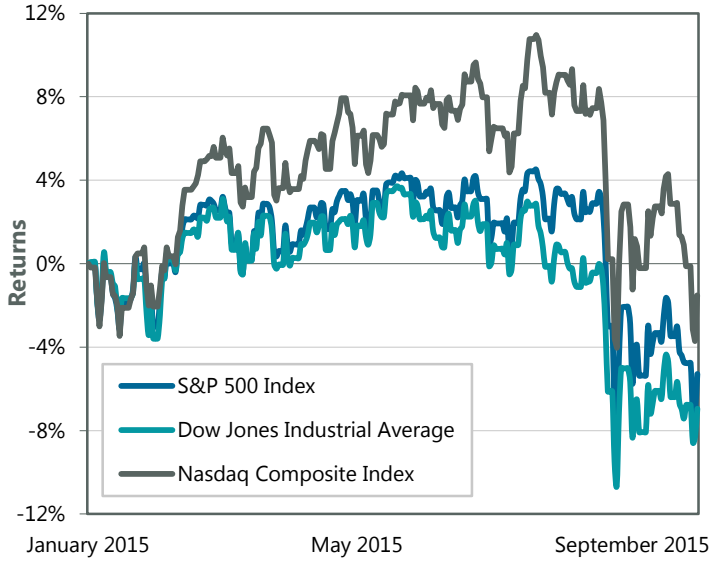
In closing, a deep-seated human desire is to avoid all pain, but pain is an integral part of life and investing. In many ways, we get into real trouble when we try to avoid it. The real goal is to constantly learn from adversity and find ways to turn challenges into long-term opportunity.

Exhibit 2: S&P 500 Index Average Returns by Month (From Jan. 1928 – Sept. 2015)



Source: Bloomberg Finance, L.P., ClearBridge Analysis.

Year To Date



Broad U.S. Market Indices

Index Name	September	QTD	YTD
S&P 500 Index	-2.5%	-6.4%	-5.3%
Dow Industrials	-1.4%	-7.0%	-7.0%
Nasdaq Composite Index	-3.2%	-7.1%	-1.5%
S&P 100 Index	-2.2%	-6.1%	-5.0%
Russell 1000 Index	-2.7%	-6.8%	-5.2%
S&P Mid-Cap 400 Index	-3.2%	-8.5%	-4.7%
Russell 2000 Index	-4.9%	-11.9%	-7.7%
Russell 1000 Growth Index	-2.5%	-5.3%	-1.5%
Russell 1000 Value Index	-3.0%	-8.4%	-9.0%

S&P 500 Sector Indices

Index Name	September	QTD	YTD
S&P 500 Consumer Discretionary	-0.6%	-2.6%	4.1%
S&P 500 Consumer Staples	0.5%	-0.2%	-1.0%
S&P 500 Energy	-6.7%	-17.4%	-21.3%
S&P 500 Financials	-3.0%	-6.7%	-7.1%
S&P 500 Health Care	-5.7%	-10.7%	-2.1%
S&P 500 Industrials	-1.8%	-6.9%	-9.8%
S&P 500 Information Technology	-1.0%	-3.7%	-3.0%
S&P 500 Materials	-7.4%	-16.9%	-16.5%
S&P 500 Telecomm Services	-3.6%	-6.8%	-3.9%
S&P 500 Utilities	2.9%	5.4%	-5.9%

Broad Foreign Market Indices (USD)

Index Name	September	QTD	YTD
FTSE 100 Index (UK)	-4.5%	-9.6%	-7.4%
DAX Index (Germany)	-6.0%	-11.5%	-9.4%
CAC 40 Index (France)	-4.3%	-6.6%	-1.0%
MICEX Index (Russia)	-6.5%	-13.8%	4.0%
NIKKEI 225 (Japan)	-6.2%	-11.8%	0.9%
Hang Seng Index (Hong Kong)	-3.2%	-19.8%	-8.8%
Kospi Index (South Korea)	0.8%	-10.8%	-5.1%
Shanghai SE Composite (China)	-4.3%	-29.7%	-6.4%
BSE Sensex 30 Index (India)	0.9%	-8.2%	-7.1%
Brazil Bovespa Index	-11.3%	-33.3%	-39.7%

Source: Bloomberg (through Sept. 30, 2015).
Past performance is no guarantee of future results.
All returns are in U.S. dollars.

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