

January 3, 2019

**ClearBridge Appreciation and Dividend Strategy Portfolios
Fourth Quarter Portfolio Manager Commentary**

Markets hate continued uncertainty. In our experience, financial markets can handle most events or trends when they get a good handle on the potential consequences. Major problems for markets arise when uncertain outcomes persist. We believe it is accurate to say that there are two major issues that have impacted the stock market over the past extremely volatile quarter: dispute over Federal Reserve policy and trade tensions. We believe it is also fair to say that both subjects have been accompanied by very mixed signals from Washington, leading to disarray in their wake.

It stands to reason that a favorable resolution to both issues would be greeted quite positively by markets that have taken valuations down to attractive levels.

A favorable outcome for interest rates and the Fed would be an overt recognition by the Fed Chairman and Board that further rate rises would be held in abeyance if inflation remains tame and economic indicators show deceleration or even weakness.

A positive resolution to the threat of a trade war with China would be agreements to allow more open investments and exports to China, along with more Chinese purchases of American goods. An agreement to protect intellectual property is also critical. We repeatedly have warned that tariffs create problems beyond simple cost increases. The Smoot-Hawley tariffs¹ of 1930, an ill-guided attempt to protect American companies, helped turn a recession into the Great Depression. Together with a tightening monetary policy, the economy never stood a chance. World trade shut down and credit became unavailable. Today we hear CEOs of many companies speaking about increased costs, supply uncertainties and potential threats to earnings.

The dual problems of Fed tightening and the threat of broad tariffs were enough to create havoc with stocks in the most recent quarter. Overt threats by the president on both fronts exacerbated the fears that took hold.

As the markets fell, the major underpinning of stock prices — strong earnings growth — began to be questioned. Weak energy and commodity prices could be symptomatic of spreading weakness. Home sales have softened. Too much debt in the corporate sector would be costly if the Fed continues its tightening. Tariffs add costs to businesses and consumers. Exports suffer as



countries retaliate. The Federal budget is already strained. Higher rates and decreased economic activity would add to the burden.

It is the persistent uncertainty that has damaged confidence and ultimately stock prices. The declines in the fourth quarter likely have priced in much of that uncertainty, but the markets are now in what we would call an if-then situation. If the Fed backs away from several rate hikes, if the president stops overtly criticizing it, if the trade tensions ease, then stocks should do nicely. But enough damage has been done to severely shatter confidence, which will take time and the correct decisions to restore.

We have no problem holding some cash reserves while sticking with excellent companies. Dividends helped cushion declines in 2018, and regardless of market direction, they should provide some comfort. To repeat, the outcomes do not have to be negative. Human mistakes can be averted. It is up to the Fed and the executive branch to behave responsibly. Until we get evidence of that, we will tread carefully.

We wish you a great year.

Sincerely,

A handwritten signature in black ink that reads "Hersh Cohen". The signature is fluid and cursive.

Hersh Cohen,
Portfolio Manager

A handwritten signature in black ink that reads "Diane Keady". The signature is fluid and cursive.

Diane Keady,
Portfolio Manager



¹ The Smoot-Hawley Tariff Act, also known as the United States Tariff Act of 1930, was a piece of U.S. Legislation raising import duties to protect American businesses and farmers.

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Limited investments also may be made in non-dividend-paying stocks that are not expected to pay a dividend in the near future. The manager may hold significant portions of portfolio assets in cash equivalents while waiting for buying opportunities.

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