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Dividend Strategy

Key Takeaways

- ▶ The Strategy held up in a volatile quarter, benefiting from a sizable underweight to IT during a sharp software selloff and an overweight to energy as geopolitical tensions drove oil prices higher.
- ▶ AI has rapidly eroded traditional software moats, prompting a deliberate retreat from most software exposure and reinforcing the importance of diversification in a massively concentrated market.
- ▶ We recycled gains from defense and AI linked stocks into high-quality industrials and alternative asset managers, while sharpening energy exposure around our highest conviction names.

Market and Performance Overview

Vladimir Lenin famously said, "There are decades where nothing happens and weeks where decades happen." With two radical developments unfolding in the last three months — the war in Iran and AI's accelerating displacement of software engineers and the software industry — the first quarter was truly a quarter where it felt like decades happened. Despite the significant turmoil, the ClearBridge Dividend Strategy outperformed, remaining largely flat gross of fees while the S&P 500 Index declined 4.3%.

Tactically, we benefited from our significant underweight to information technology (IT, which declined 9.2% in the quarter) and our significant overweight to energy (which surged 38.2%). Strategically, we benefited from our commitment to broad diversification amid a market that has become massively concentrated.

Timing in markets can be a funny thing. Software developers have been using AI to accelerate coding for the last two years; yet, only in the last two months have investors realized that coders were inadvertently training their replacements. As users of Claude Code multiplied in the first quarter, the S&P 500 software sector declined 24% — a staggering amount for what appeared to be a fundamentally sound industry.

Whether AI spells the end of the software business is an open question. Some think AI will replace most applications, while others think it will threaten only marginal ones. Given the unprecedented dynamism and speed of AI, we do not pretend to have the answers. Instead, we focus our attention and investments in sectors that align more closely with our sphere of competence. We currently own just one software stock — Microsoft — and one stock — ADP — with a small, and we believe well-defended, software exposure.

Volatile times also contain a silver lining, offering us the opportunity to take advantage of dislocations to high-grade the portfolio.

Interestingly, while AI has crushed investors sentiment toward software, it has yet to shake their steadfast conviction in the hardy outlook for the semiconductor industry. The iShares Semiconductor ETF, a widely quoted proxy for the semiconductor complex, rose 9% in the first quarter. The semiconductor industry group is now the largest in the S&P 500 at 15%. Superficially, this makes sense; demand for chips is insatiable and the outlook for data center construction is beyond robust. But the value of equities derives not from their outlook over the next two to three years, but the next 10 or 20.

While AI unleashed volatility in the digital world, the war with Iran unleashed volatility in the physical world. Given our large investment in energy, the portfolio benefited from the resulting rise in oil prices. We have no idea how war will unfold. We have been pleasantly surprised by markets' resilience thus far, but we anticipate escalating negative impacts if supply disruptions persist. The U.S. is relatively insulated from impacts of the closure of the Strait of Hormuz due to its domestic energy production. Other parts of the world, however, particularly Asia, will face increasing physical shortages and significant economic contractions unless shipping resumes soon.

While we maintain a large overweight to energy, we have taken advantage of rising stock prices to exit two of our holdings, EQT and Enbridge. We have focused our energy investments in our highest-conviction ideas: Williams and ExxonMobil. EQT always represented more of a tactical investment in an improving U.S. natural gas market, rather than a long-term investment in a franchise energy company. We made substantial profits in EQT over a four-year holding period and have decided to move on.

After a long and profitable investment in Enbridge, we sold the position to concentrate our pipeline investments in Williams, which possesses a superior balance sheet and growth outlook. Further, with the U.S. pursuing confrontational trade policies toward Canada, the risks to Canadian companies dependent upon exports to the U.S. are elevated. Our investment in Williams is predicated on growing North American natural gas production and surging power demand from data centers. Rising oil prices have little direct impact on the company and its business should continue chugging along, regardless of the outcome with Iran.

ExxonMobil, however, as the largest private oil producer in the world, directly benefits from the events in the Persian Gulf. Higher oil prices will drive bumper earnings and cash flows, but that is not the only thing Exxon has going for it. Exxon's robust production growth from low-cost basins will propel volume increases and margin expansion through the end of the decade. We have modestly trimmed our position as the stock has soared, but we maintain a significant investment in the company.

Portfolio Positioning

In a choppy first quarter, we took advantage of market volatility to reduce some positions on strength and add others on weakness, upgrading our holdings and further diversifying the portfolio. We bought four “new” holdings in the quarter. Two of the four — Blackstone and Otis — we have owned before. While we sometimes sell great businesses because the valuations are extended or fundamentals deteriorate substantially, we never stop following great companies. Blackstone and Otis both sold off in the quarter, and we took advantage of those declines to welcome these old friends back into the portfolio.

Alongside our purchase of Blackstone, we significantly increased our exposure to Apollo Global Management, as concerns around private-credit markets improved risk-reward profiles for both. While losses in credit will inevitably rise from current low levels, both companies are well-positioned to navigate the cycle. Their long-duration capital enables them to weather the ups and downs, while their copious dry powder positions them to play offense. Alternative asset management remains a growth industry, and we believe we are acquiring these two best-in-class franchises at attractive prices.

As the leading elevator manufacturer, Otis is a best-in-class industrial company. While new construction activity ebbs and flows, Otis’s earnings are predominantly derived from its aftermarket repair and maintenance business, which is not economically sensitive and grows every year. While AI will disrupt many industries, well-situated industrial companies should prove resilient and accrete value over time.

Alongside Otis, we purchased shares of Honeywell during the quarter. Honeywell possesses formidable franchises in controls and aerospace. Its pending reorganization (it is splitting into three companies) should improve focus and execution while highlighting value.

We funded these purchases through monetizations of defense contractors and AI-related technology companies, both of which benefited from feverish investor enthusiasm during the period. As the geopolitical temperature has risen over the last 18 months, defense stocks have soared. Given our large holdings in defense, Dividend Strategy has benefited strongly over the last few years. At current prices, and given increasingly statist commentary from the federal government, we believe better opportunities exist elsewhere. We exited Northrop Grumman and trimmed L3Harris and RTX.

In IT, we exited Oracle and trimmed Broadcom. Our five-year investment in Oracle proved highly profitable as the company transitioned its business model from licensing to software-as-a-service (SAAS). In the last year, Oracle went all-in on building data centers for AI customers, pushing its backlog north of \$500 billion. In 2025, the stock surged as Oracle announced eye-popping AI contracts; we took advantage of that surge to begin exiting the position. More recently, investors have begun to question the return

profile of these projects, given the hundreds of billions of dollars in required capital investment and their overdependence on one, single customer: OpenAI. Aligning with OpenAI seemed like a no-brainer two years ago when it was the clear leader in AI, but with Google's Gemini and Anthropic's Claude catching up to ChatGPT, Oracle's concentrated bet on one player now seems questionable. We sold our remaining Oracle shares in the first quarter of 2026.

On the semiconductor side, we modestly reduced our position in Broadcom to fund our new investment in Taiwan Semiconductor (TSMC). While Broadcom remains well positioned, and we remain constructive on the stock, the risk-reward outlook has diminished as the shares have tripled over the last two years. Further, whereas TSMC prospers regardless of who wins the semiconductor race (TSMC manufactures chips for all the major semiconductor companies), one can conceive of scenarios where Broadcom could become less relevant in the future.

Outlook

While the U.S. is protected from the worst impacts of the energy disruption, higher prices are driving higher inflation. The longer these prices remain elevated, the more persistent and challenging the inflation and interest rate outlook will become. A slowing global economy combined with higher inflation and interest rates could present strong headwinds to markets in 2026. We continue to emphasize broad diversification and will exercise caution navigating the twin challenges of AI disruption and the war in Iran.

Our diverse portfolio emphasizes high-quality companies with low risk of disintermediation supported by strong financial characteristics and reasonable valuations. We anticipate continued dividend growth, driving increased cash returns and providing a meaningful offset to inflation. Volatile times also contain a silver lining, offering us the opportunity to take advantage of dislocations to high-grade the portfolio. We believe we are well-positioned for the current environment.

Portfolio Highlights

The ClearBridge Dividend Strategy outperformed its S&P 500 Index benchmark during the first quarter. On an absolute basis, the Strategy saw positive contributions from five of 11 sectors: the energy, materials and industrials sectors were the main contributors, while the financials and IT sectors were the main detractors.

On a relative basis, outperformance was driven primarily by stock selection in the health care and communication services sectors, overweights to energy, materials, consumer staples and real estate, and underweights to IT and consumer discretionary. Stock selection in consumer staples, energy and real estate detracted.

On an individual stock basis, the main positive contributors to relative returns were Exxon Mobil, Williams Companies, Air Products and Chemicals, Texas Instruments and an underweight to Microsoft. Apollo Global Management, Capital One, Automatic Data Processing, Unilever and not owning Chevron were the main detractors.

In addition to the transactions mentioned above, we exited AvalonBay Communities in real estate. We also received shares of Waters, a high-end lab equipment and consumables provider in the health care sector, following its spinoff from holding Becton Dickinson; we are maintaining a stub position while we evaluate the new company's dividend policy.

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