International Growth Strategy

Key Takeaways

- The swing from growth to value stocks we witnessed late last year shifted back to growth in the first quarter.
- European equities performed well during the quarter, as we may be seeing a decline in political risk on the Continent.
- While the global economy may appear sensitive to potential shocks, we remain focused on longer term opportunities, and are therefore positive on international equities.

Market Overview and Outlook

Diminishing expectations among investors that the Trump administration will be able to enact its pro-growth policies in the United States seem to have stopped the steep rise of the U.S. dollar (USD) versus most foreign currencies. And we began to see inflows into international equities, as the dollar slid and MSCI EAFE Index outperformed the S&P 500 by nearly 120 basis points during the first quarter. Rifts in the Republican Party revealed by the failure of Congress to pass a health care replacement bill could make other complex proposals, such as tax reform and infrastructure spending, more difficult and time consuming. Tempered prospects for such policies stalled the post-election reflation trade and drove the value of the dollar down. This development, combined with improving economic conditions in Europe and other overseas markets, helped boost international equities in both developed and emerging markets. Furthermore, as Exhibit 1 shows, the swing from growth to value stocks we witnessed in the fourth quarter of last year shifted back to growth, with the MSCI EAFE Growth Index returning 8.52% in the first quarter compared to a 6.05% gain for the MSCI EAFE Value Index. This is a theme we continue to monitor with interest. The core MSCI EAFE Index returned 7.25%, while the MSCI Emerging Markets Index gained 11.45%.

European equities performed particularly well during the quarter. Concern about the potential of anti-EU candidates winning elections had been holding markets back and keeping valuations relatively low. But with a positive result for EU solidarity in the Dutch election, we may be beginning to see a decline in political risk on the Continent. Of course, the upcoming French election will be an important milestone to understand which direction the EU will go. It is looking increasingly probable the centrist reform candidate Emmanuel Macron will defeat anti-immigration National Front candidate Marine Le Pen in the most likely run-off scenario come May 7. In this event, the markets are likely to breathe a sigh of relief. But the more important analysis will be to understand how his specific proposals to reduce payroll taxes, reform France’s pension systems, and invest more in workers and education would seek to boost productivity and growth, and ultimately how they might affect stocks.
Regardless, we believe that political risks will fail to dampen what is already becoming clear – Europe is on the right path for a broad recovery. Most economic indicators are pointing in the right direction, and the European Commission is forecasting growth for every EU economy in 2017 and 2018 for the first time since 2008. Combined with broader global economic growth, it’s likely that European companies will see faster earnings growth over the remainder of 2017 and 2018 – a positive development for investors in European equities.

A major beneficiary of the decline in the USD were emerging market (EM) stocks, which rebounded nicely from a fourth quarter decline. EM equities in the countries which saw their currencies perform the best versus the dollar also tended to outperform during the first quarter. For example, three top performing equity markets (using the MSCI indices) with stronger currencies during the quarter – Mexico, Korea and Taiwan – returned more than the S&P 500 in both local currency and dollar terms.

China, where a sizeable portion of our EM holdings are based, remains of major importance to the global economy given its size and connection to the rest of the world. The country’s high public and private debt levels remain a long-term issue for the government to tackle, but there has been less focus on this issue in recent months, as the government stimulus program contributed to economic recovery and stabilizing of commodity prices from last year’s trough. By definition, the two largest economies matter, and the U.S.-China relationship will continue to be of particular significance to global markets. The Trump administration’s stances on China and international trade have raised questions about the relationship in the near term. But we do not foresee a broadly hostile trade policy. Regardless, we remain constructive on China’s long-term potential, particularly as the country’s growing consumer class necessitates development of new products and services.

Periods like now – when policy risks and valuations appear relatively high, coupled with highly disruptive technologies – is when active management in the international growth space can be beneficial. Our investment process is built around identifying high-quality growth stocks underappreciated by the market, and we expect our performance to be the outcome of bottom-up stock selection, rather than macro variables. We believe opportunities continue to present themselves across our defined growth segments: emerging, secular and structural.

The emerging growth segment is generally our smallest allocation and valuations for international emerging growth companies are relatively high. However, this category features what we believe to be long-term winners in new industries, such as electric and autonomous vehicles. We have been analyzing for some time the adoption of these new technologies, as this shift could have significant implications for many industries and companies in the future. And we have been participating in this far-reaching transformation of the auto industry through our investment in Mobileye, which develops software for self-driving cars. Mobileye
announced this quarter that Intel, the chipmaker, had agreed to acquire the company for upwards of $15 billion, helping to drive the strategy’s performance in the first quarter and validating our belief in the importance of autonomous vehicles to a wide range of associated industries for the future.

During the quarter, we added a new position in our emerging segment, French biotech company Advanced Accelerator Applications (AAAP), which is an underappreciated and underfollowed business with a novel radiopharmaceutical product that treats neuroendocrine tumors. AAAP’s drug has completed a Phase III trial and could reach market by late 2017. We systematically evaluate the market for what we believe are undervalued opportunities in growth companies, in this case a company with innovative approaches to treatment (such as molecular nuclear medicine) and with clear potential benefits for patients. These types of emerging growth companies should yield long-term results regardless of short-term swings in the markets.

In our secular growth segment, new portfolio addition Broadcom is illustrative of the traits we look for: established, superior business models; underappreciated growth prospects; margin expansion; and long-term compounding of capital returns. Broadcom reported an earnings beat in the first quarter and raised its guidance on product momentum in both its wireless and wired business segments. The semiconductor industry has remained strong due to industry consolidation and expectations for new applications like artificial intelligence, but we also believe Broadcom to be a truly durable player in the field with expectations of better-than-industry-average organic growth for the foreseeable future.

Finally, in our structural growth segment, we have added selectively to European financials after many years of depressed earnings stemming from interest rate declines and regulatory demands. This led to numerous high-quality European financials trading at weakened valuations; but our view is that with faster economic growth and an uptick in the yield curve, solid step-ups in earnings are possible for some European banks through loan growth and rising interest rates. Intesa Sanpaolo and UniCredit, two Italian banks we added positions in during the first quarter, fit our criteria. They have been undervalued and underappreciated, and should be poised to benefit from improving economic growth in Italy and in the broader eurozone. Furthermore, Intesa has a solid balance sheet and a viable growth strategy laid out by a competent management team. UniCredit, meanwhile, has largely solved its balance sheet issues and recruited a new outsider CEO to implement reforms and deliver stronger earnings growth.

While the global economy may appear sensitive to political risks and other potential shocks, we remain focused on longer term opportunities, and are therefore positive on international equities. Europe genuinely appears to be turning a corner for the better, and stocks should broadly benefit from an environment in which election risks ease and economic growth ticks up. Asian economies remain dynamic, with opportunities across our three growth segments. Ultimately, we continue to identify high-quality growth stocks trading at discounts to intrinsic value – the kinds of international equities that have the potential to offer superior long-term returns for investors seeking international exposure.

**Portfolio Highlights**

The ClearBridge International Growth Strategy had a positive absolute return for the first quarter and outperformed the benchmark MSCI All Country World Ex-U.S. Index. The main contributors to performance were the information technology (IT), industrials, financials and consumer staples sectors. The sole detractor was the energy sector.

On a relative basis, the Strategy outperformed its benchmark driven by positive sector allocation and stock selection effects. Stock selection in the IT sector contributed the most to relative performance for the quarter. In addition, an underweight to the energy sector, which underperformed the broader index, and an overweight to the IT sector, which outperformed, helped relative returns. Meanwhile, stock selection in the consumer discretionary sector detracted somewhat from relative performance.

On a regional basis, stock selection effects across Europe ex UK, emerging markets and the United Kingdom, contributed the most to relative returns for the quarter. Stock selection in Asia ex Japan and North America detracted from relative performance.

On an individual stock basis, the largest contributors to absolute returns in the first quarter included Mobileye, Vale, Alibaba Group, Check Point Software and SAP. The greatest detractors from absolute returns included positions in Pandora, Orocobre, Lululemon, Suncor Energy and Schlumberger.

During the quarter, we added several new positions, including Adient in the consumer discretionary sector; Advanced Accelerator Applications in the health...
care sector; BHP Billiton in the materials sector; Broadcom in the IT sector; Credit Suisse, Intesa Sanpaolo, Standard Chartered and UniCredit in the financials sector; and Direct Energie in the utilities sector. Meanwhile, we exited our positions in Ambev and Fomento Economico Mexicano in the consumer staples sector; Stabilus and Wolseley in the industrials sector; NXP Semiconductors in the IT sector; Essilor International in the health care sector; ANTA Sports Products in the consumer discretionary sector; and UBS and ORIX in the financials sector.