ClearBridge Investments

International Growth Strategy

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Key Takeaways

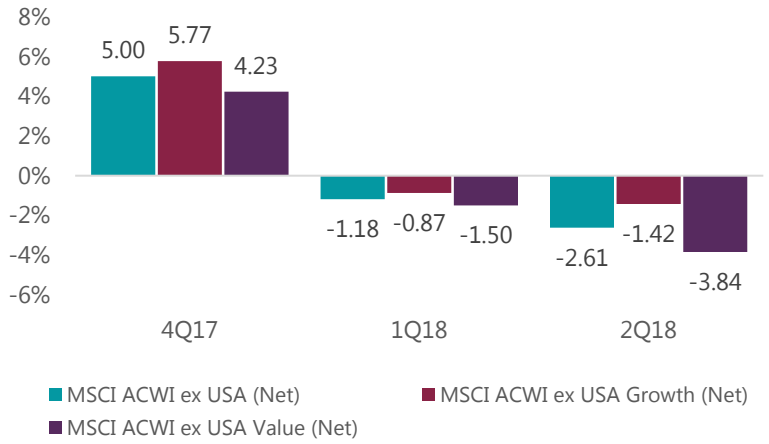
- Simmering trade tensions, populist election results and investor pessimism overshadowed encouraging economic and earnings trends.
- Strength in information technology and solid stock selection across industries drove portfolio outperformance.
- We were active in repositioning the portfolio across the three types of growth companies we target: structural, secular and emerging.

Market Overview and Outlook

Trade risks, geopolitical uncertainty and poor investor sentiment drove international markets to a second straight quarter of losses in the April to June period. The benchmark MSCI All Country World Ex-U.S. Index declined by 2.61%, the MSCI All Country World Ex-U.S. Small Cap Index fell 2.44%, while the MSCI Emerging Market Index dropped by 7.96%. Developed market growth stocks held up better than their value counterparts with the MSCI ACWI Ex-U.S. Growth Index down 1.42% for the quarter compared to a loss of 3.84% for the MSCI ACWI Ex-U.S. Value Index. Currencies were an important determinant of non-dollar returns with all G-10 currencies weaker versus the U.S. dollar (USD), while emerging markets suffered the most from a stronger USD.

The Strategy produced a positive absolute return for the second quarter as our price discipline enabled us to avoid some of the headwinds impacting international equities, specifically the political uncertainty emanating from Italy and perceptions of weakening economies in the eurozone and China. Taking a differentiated approach when sourcing growth ideas for the portfolio leads us to companies well-positioned to control their own fate. This focus also helps lessen some of the negative impacts of market and economic forces.

Exhibit 1: MSCI Growth vs Value Performance



Source: FactSet.

The escalation of trade tensions primarily, but not solely, between the U.S. and China is the biggest worry among investors right now. The outcome of what we view as aggressive trade negotiations by the U.S. is hard to predict and could have ripple effects into other regions like Europe. The German economy is highly dependent on trade, particularly areas like autos, and demand would be negatively impacted by the inflationary impact of tariffs. Inflation could also become an issue in the U.S. and create a sales headwind for products targeted by tariffs. The Trump administration's trade policies appear related to U.S. midterm elections and we are hopeful that trade becomes less of a focus once midterms are complete.

Global politics seems to be rising in importance in investor's calculus and we are monitoring those moves closely. The failure of Italy to form a coalition government in May reintroduced populist risks to the viability of the eurozone and caused a sharp selloff in the banking sector. We are also following election outcomes in Mexico and Brazil as they will largely determine economic policies in those emerging markets. However, once elections take place, we find that investor expectations shift and adjust to the new regimes and move on to other concerns. Within Europe, continued easy money and favorable global economic growth has helped.

Rising perceptions of risk have caused the USD to appreciate against the euro and other currencies. This is beneficial for European exporters but presents problems for commodity-dependent emerging markets, which finance their debt in USD. Those with higher levels of USD-denominated debt have been particularly hard hit. Reflective of these concerns, the most volatile segments of international markets in the second quarter were industrials and other economically sensitive sectors.

As growth investors we want to maintain significant exposure to the economic transformation underway in China.

The portfolio is fairly well protected against this volatility as we are underweight cyclicals, including financials. We reduced our European financials exposure during the quarter by closing a position in Italian lender Intesa SanPaolo, which enjoyed a solid run ahead of the recent political turmoil. Intesa falls into our structural growth bucket of companies going through short-term issues that we believe are fixable, in this case the bank had shored up its balance sheet and was benefiting from rising interest rates.

We are more constructive on industrials and took advantage of attractive entry points recently to add two new positions in Japan. TechnoPro Holdings, a provider of engineering talent, falls into our bucket of secular growers with leadership positions and the ability to compound earnings and cash flows over time. After years of outsourcing, Japanese industrial companies in need of engineering talent but unable to find it themselves are turning to TechnoPro, which hires, trains and places seasoned engineers across multiple disciplines. The company enjoys pricing power due to these talent shortages and is growing its business through enhanced recruiting of engineers out of university and acquiring more expertise, such as in construction engineering, through M&A.

We also added MonotaRo, an online distributor of machine tools, engine parts and related industrial goods that falls into our emerging growth bucket of companies whose above-average growth rates or entry into new markets are just becoming recognized. MonotaRo is the primary overseas business of U.S. industrial distributor Grainger. The company is a leader in online industrial procurement that is in its infancy in Japan and brings efficiency to a highly fragmented market. It is also adept at developing new verticals and could expand beyond Japan to other Asian markets such as Indonesia.

The somber mood over non-U.S. economic fundamentals is not properly discounting the meaningful improvement we expect to see in the eurozone and other regions. Capital spending in the eurozone is at 20-year lows and poised to recover while cash levels are strong. Earnings per share in the region, meanwhile, sit 20% below peak, leaving room for growth and multiple expansion. EU monetary policy also remains highly accommodative compared to the tightening regime occurring in the U.S., making capital available for large projects like the construction boom we are seeing around Paris. Construction spending is also picking up in Spain while eurozone PMIs are expected to inflect higher after five straight monthly declines to start the year. Improving residential and commercial development should benefit companies like secular grower Legrand, a French manufacturer of low-voltage electrical devices supporting the movement toward electronic connectivity that we recently added to the portfolio.

The other region with growth questions is China. It's worth noting that China has been orchestrating an economic slowdown to correct imbalances in housing, financing and industrial expansion. Chinese leadership is pursuing a more sustainable long-term growth trajectory for its economy by focusing on high-tech fields where they have really been disadvantaged, like pharmaceuticals, semiconductors and aerospace. The Chinese companies that we own are central in these efforts to modernize the economy through innovation. Alibaba is investing to streamline and modernize national distribution and infrastructure. We have trimmed back our Alibaba position after a strong run and deployed the proceeds into another Chinese company, Baidu, that manages big data needed to support mapping software and autonomous cars. Another holding, gaming leader Tencent, is diversifying into payment systems. Chinese growth may be technically slowing, but we see it as evolving. As growth investors we want to maintain significant exposure to this transformation.

Areas that have struggled recently, such as consumer staples, are also poised for a turnaround. Global consumer packaged goods companies have been hurt by challenges in shifting to new sales channels. We are focusing on consumer areas more immune to these challenges like cosmetics, where companies expect to see better sales out of Europe as well as continued strength in Asia. In addition, the rebound in the cyclical energy sector supports our optimistic view of global growth. Some of the strongest upward earnings revisions are occurring in energy. A focus on growth companies causes us to avoid the integrated oil majors in favor of exploration & production companies like Canada's Suncor Energy, Brazil's Petrobras and China's CNOOC, a new position.
The team is positive on a lot of factors we think will be supportive of international equities going forward. But we are also cognizant of the passive momentum trade that has been lifting many of the technology companies in the portfolio and have been lowering our tech exposure to manage risk. We will always have a significant weighting in technology, but our valuation discipline keeps us from chasing stocks past our price targets.

Portfolio Highlights

The ClearBridge International Growth Strategy had a positive absolute return for the second quarter and outperformed the benchmark MSCI All Country World Ex-U.S. Index. The main contributors to performance were the health care and consumer staples sectors. The primary detractor was the financials sector.

On a relative basis, overall stock selection and sector allocation contributed to performance. In particular, stock selection in the information technology (IT), consumer staples, financials, health care, consumer discretionary, industrials and utilities drove

relative results. Stock selection in energy and an underweight to the sector were the primary detractors from results.

On a regional basis, stock selection in Europe Ex UK, Japan, the United Kingdom and emerging markets contributed the most to relative returns for the quarter.

On an individual stock basis, the largest contributors to absolute returns in the second quarter included Shiseido, Rentokil, Direct Energie, Suncor Energy and Temenos. The greatest detractors from absolute returns included positions in Ambev, Fanuc Corp., Erste Group Bank, Petrobras and Cielo.

During the quarter, in addition to the names mentioned above, we added new positions in Teleperformance in the industrials sector, AIA Group in the financials sector, Mettler-Toledo in the health care sector, Sika in the materials sector and Victoria in the consumer discretionary sector. The Strategy also closed several positions, including Munters Group, Nidec Corp. and Localiza Rent a Car in the industrials sector, Cielo in the IT sector and Direct Energie in the utilities sector.