ClearBridge Investments

International Growth Strategy

Elisa Mazen,
Managing Director,
Head of Global Growth,
Portfolio Manager

Thor Olsson,
Director,
Portfolio Manager

Michael Testorf, CFA,
Managing Director,
Portfolio Manager

Pawel Wroblewski, CFA,
Director,
Portfolio Manager

Key Takeaways

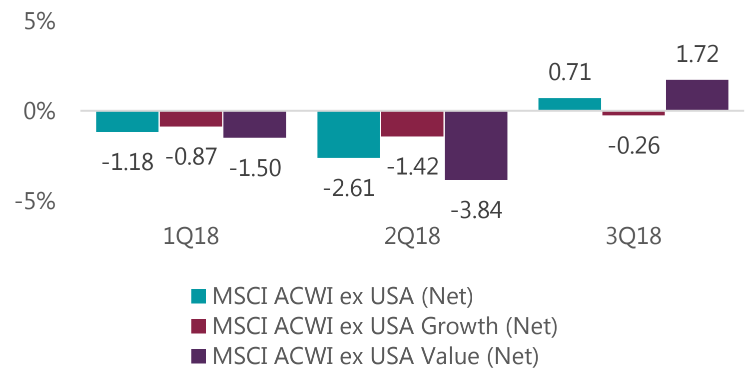
- Negative sentiment related to trade risks and currency headwinds kept international equity returns in check.
- Solid performance of secular growth stocks, especially in Europe, highlight the positive economic backdrop in developed markets.
- Being disciplined in managing risk and opportunistic in identifying new growth ideas guided our portfolio changes during the quarter.

Market Overview and Outlook

Worsening sentiment from the escalation of trade tensions and unfavorable currency trends restrained performance in international markets during the third quarter. The benchmark MSCI All Country World Ex-U.S. Index gained 0.71%, snapping two quarters of losses, while the MSCI All Country World Ex-U.S. Small Cap Index fell 1.42% and the MSCI Emerging Market Index declined 1.09%. Developed market growth stocks trailed their value counterparts with the MSCI ACWI Ex-U.S. Growth Index up 0.71% for the quarter compared to a gain of 1.72% for the MSCI ACWI Ex-U.S. Value Index (Exhibit 1), which was led by the performance of energy.

A follow-on effect of negative sentiment has been investor outflows from international funds, particularly in emerging markets, which have pressured equity and fixed income returns. Year-long weakness in Chinese stocks worsened during the quarter with a selloff in large cap technology shares causing the MSCI China Index to fall 7.51%. We believe both headwinds are transitory and that select companies in China and other emerging markets remain good ways to participate in secular growth trends. We are monitoring hot spots in emerging markets that contributed to the volatility in the asset class. We believe once key elections in Brazil are decided, trade discussions are resolved and U.S. midterm elections are over, emerging markets can find footing.

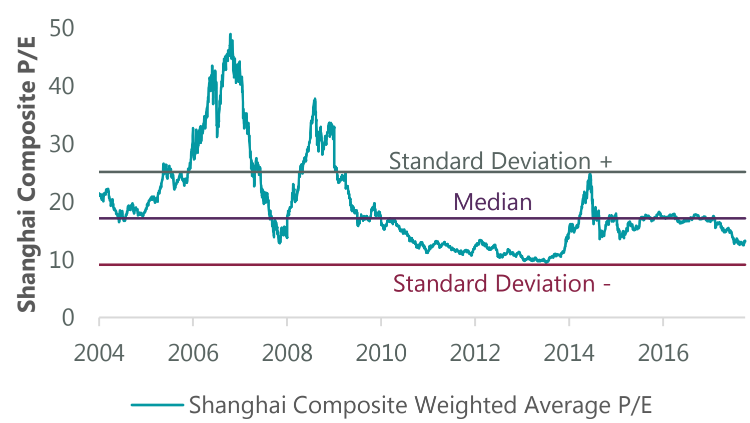
Exhibit 1: MSCI Growth vs Value Performance



Source: FactSet.

We are optimistic about China. The Strategy owns Chinese tech companies Alibaba, Tencent and Baidu, which have been hurt recently by a combination of profit taking, the potential for greater regulation as well as increased capital spending to support future growth. Chinese officials are cognizant of the importance of their expanding consumer class and are proactively taking steps to support consumer spending and ward off the negative impacts of tariffs. As we shared in a recent blog, China is once again taking steps to stimulate its economy by increasing the money supply, encouraging bank lending and easing the value of its currency. Importantly, this is happening in the context of attractive valuations for the market (Exhibit 2).

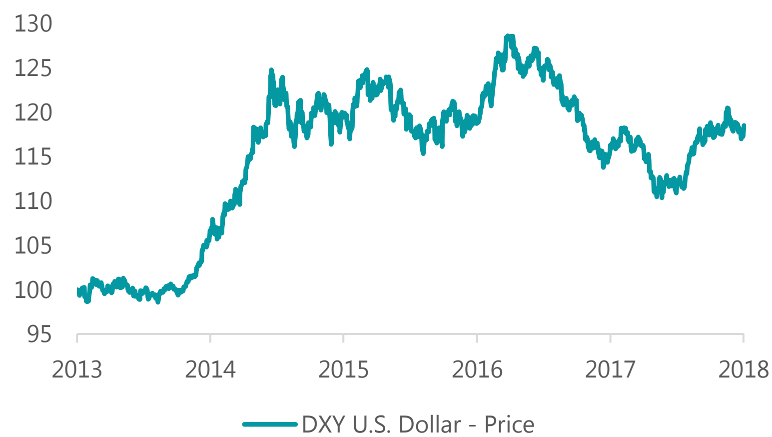
Exhibit 2: Chinese Equity Valuations at Multi-Year Lows



As of Sept. 30, 2018. Source: Bloomberg.

Ongoing strength of the U.S. dollar (USD) versus the yuan as well as other emerging and developed market currencies (Exhibit 3) again masked fundamentally sound performance in many regions. The growing risk of inflation, starting in the U.S., could further strengthen the USD should the U.S. Federal Reserve step up its rate tightening program. Many international companies and governments have substantial USD-denominated debt and such a rate move would lead to higher funding costs. On the other hand, a weakening USD would provide a catalyst for international markets. This could happen as the ECB slowly moves from quantitative easing into more of a tightening regime.

Exhibit 3: U.S. Dollar Has Been Strengthening



As of Sept. 30, 2018. Source: FactSet.

In Europe, the euro has suffered from the unsettled state of politics and fiscal policy in Italy while the UK's unsuccessful Brexit negotiations with the European Union (EU) has hurt British shares. The populist majority in Italy's coalition government has called for a budget that will result in higher than expected deficits and could cause conflict with the more fiscally conservative EU. We were disappointed with the latest moves by the new ruling coalition, which delay much needed economic reforms. Italy is the only major EU market to not enact reform measures, whereas its neighbors in Portugal, Ireland, Finland and the Baltics are seeing improving economic results following fiscal restructuring.

These geopolitical issues, however, should be overcome by positive developments on both the consumer and corporate fronts. Wages continue to rise in the eurozone, employment is trending toward post-financial crisis highs and consumer confidence is at record levels. Meanwhile, industrial activity remains healthy, capital investment is improving and corporate balance sheets remain strong.

Europe was our best-performing region during the third quarter, lifted by several companies in our secular growth bucket, one of three categories of growth companies that we target in the Strategy. Irish contract research organization ICON, Spanish travel technology provider Amadeus and German software maker SAP are the types of steady compounders of earnings and cash flows that we consider secular growth companies and that constitute the majority of the portfolio.

> Geopolitical issues in Europe should be overcome by positive developments on both the consumer and corporate fronts.

Many of the same macro dynamics are in place in Japan, one of the better-performing markets in the third quarter with a gain of 3.68%. Japanese equities like medical and IT equipment manufacturer HOYA are also benefiting from ongoing governance reforms aimed at prioritizing profitability and enhancing shareholder returns.

We round out the portfolio with emerging growth companies that possess above-average growth rates and target large addressable markets but also carry higher degrees of risk. These risks may result from companies being earlier in their business development or choosing to reinvest all available cash to grow, which can negatively impact earnings. We added to the emerging growth bucket in the third quarter with the purchases of Shopify and Keywords Studios.

Shopify, in the IT sector, is a Canadian e-commerce software provider that enables small businesses to establish an online store and manage all aspects of the sales, marketing and fulfillment process. Its comprehensive offering supports a positive customer experience and increases the likelihood of repeat purchases. Keywords Studios is an Irish provider of technical services to video game developers. Video games continue to be one of the fastest growing segments of consumer spending, with the requirements for realistic graphics and interactive experiences driving the need for advanced post-production services.

Zai Lab, another recent addition, provides exposure to the burgeoning biotechnology market in China, which is severely underserved due to lack of access to innovative treatments. Zai Lab licenses the Chinese rights to drugs being developed by smaller U.S. biopharmaceutical firms. Many of its products, geared to the cancer, infectious and auto-immune diseases markets, are already approved in the West or have successfully completed high-quality clinical trials.

Valuation guides our portfolio construction decisions as we seek to avoid paying up for growth and to be disciplined in selling positions that reach our price targets. Italian bank Intesa Sanpaolo is a good example. We closed the position in the second quarter after the bank performed well ahead of the current Italian political turmoil. Shares of Intesa declined nearly 30% through the summer, impacted by negative sentiment rather than fundamental weakness, providing an attractive point to buy back the stock in September. We were also active in managing position sizes of stocks that have performed well this year, trimming financial software maker Temenos last quarter and reducing our position in chipmaker ASML this quarter on concerns about how the semiconductor cycle would impact valuations.

Portfolio Highlights

The ClearBridge International Growth Strategy underperformed the benchmark MSCI All Country World Ex-U.S. Index for the third quarter. The main contributor to performance was the health care sector. The primary detractors were the consumer staples and consumer discretionary sectors.

On a relative basis, overall stock selection detracted from performance. In particular, stock selection in the consumer staples, consumer discretionary and communication services sectors and an overweight to consumer discretionary hurt relative results. (Communications services is a renamed telecommunication services sector that now includes select names from the consumer discretionary and IT sectors.) Stock selection in the health care and energy sectors were the primary contributors to relative performance.

On a regional basis, stock selection in Japan, the United Kingdom and emerging markets weighed on results, while stock selection in Europe Ex UK and North America had positive impacts.

On an individual stock basis, the largest contributors to absolute returns in the third quarter included ICON, Canadian Pacific Railway, Amadeus IT Group, Petrobras and SAP. The greatest detractors from absolute returns included positions in Coca-Cola Japan, Tencent, TravelSky Technology, Rentokil and HDFC Bank.

During the quarter, in addition to the names mentioned above, we added new positions in Hansa Medical and Novo Nordisk in the health care sector. The Strategy also closed several positions, including Venator Materials and Greatview Aseptic Packaging in the materials sector, China Pacific Insurance in the financials sector and Shimano in the consumer discretionary sector.