ClearBridge Investments

International Growth Strategy

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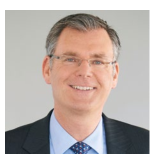

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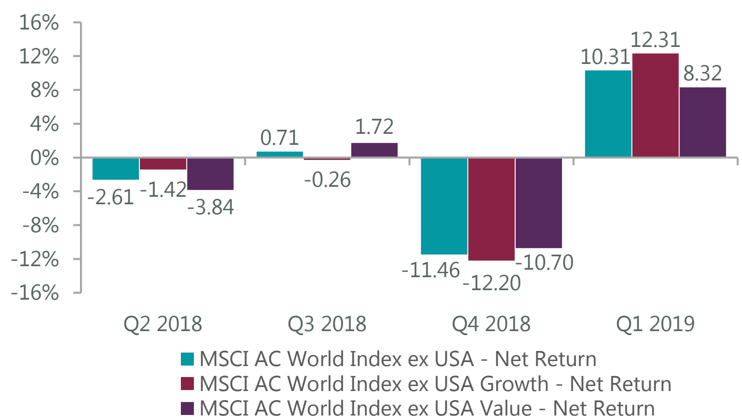
Key Takeaways

- Stimulative economic policies and a bounce back of growth stocks from oversold positions drove strong performance for the market and the portfolio.
- We took advantage of performance gains to take profits and reposition the portfolio across the three types of growth companies we target.
- We believe the resolution of geopolitical issues and continued strength on the consumer side will support international growth stocks going forward.

Market Overview

International equites staged a broad-based rally in the first quarter, rebounding from fourth-quarter lows on the likelihood of continued accommodation in Europe and China. The benchmark MSCI All Country World Ex-U.S. Index advanced 10.31%, the MSCI All Country World Ex-U.S. Small Cap Index added 10.36% while the MSCI Emerging Market Index gained 9.93%. International growth stocks outperformed their value counterparts with the MSCI ACWI Ex-U.S. Growth Index up 12.31% for the quarter compared to a gain of 8.32% for the MSCI ACWI Ex-U.S. Value Index (Exhibit 1).

Exhibit 1: MSCI Growth vs Value Performance



Source: FactSet.

International markets rose in the face of stubbornly weak economic data, particularly on the manufacturing side, and ongoing geopolitical headwinds. Manufacturing activity in both

Europe and China has been contracting, with the ongoing trade disputes between the U.S. and China contributing to this malaise, impacting the outlook for global growth. Rising input costs on both the commodity front – Brent crude oil was up 24% in the quarter and copper 15% – and wages, have been hurting margins and raised concerns over continued negative earnings impacts.

Offsetting industrial weakness, services PMI is decidedly more positive with good job and wage growth in most regions. This has been positive for consumer spending, which, when combined with aggressive stimulus measures, have kept the non-manufacturing sectors of the markets in good shape. China has shifted from deleveraging to accommodative policies aimed at stimulating growth and consumption (rather than just increasing lending) and to protect against the negative effects of tariffs. Personal and VAT tax cuts, increases in lending facilities and other actions by China are sizable, representing 2.8% of GDP, and are focused on the consumer, state-owned enterprises and private companies.

The Chinese consumer has been particularly strong, both domestically and through tourism spending in places like Japan. Evidence of that strength has shown up in the performance of Alibaba, the Chinese e-commerce and media conglomerate that was the portfolio's best performer during the first quarter. Japanese cosmetics maker Shiseido has benefited from the return of tourism spending after fears of decline with the new Chinese e-commerce law in January, as has luxury goods group LVMH. The consumer portions of the portfolio were some of the best performers to start the year, with the companies we own meaningfully outperforming similar stocks in the benchmark.

Moving west, stocks in Europe and the UK represent more than half of the portfolio's exposure and managed to hold up against a political backdrop that remains very much unsettled. As of this writing, the Brexit situation remains unresolved although we are optimistic about a neutral to positive outcome. A solution will likely be reached in April and we think a hard Brexit, the UK leaving the Common Union with trade governed by WTO rules, is unlikely. The UK currently has three options: accept Prime Minister Theresa May's Brexit proposal, hold a second national referendum on Brexit – basically a re-vote by a British population with a much better understanding of what leaving the EU entails than three years ago – or revoke Article 50 altogether and remain in the EU as if nothing ever happened. The portfolio has limited exposure to domestic UK businesses and we are optimistic that this will not remain a distraction much longer.

There is a strong chance a resolution will be reached before the broad elections for European Parliament on April 23. We expect these elections to result in the status quo as the populist factions on the left and the right will have trouble forming coalitions. Stability in the EU Parliament should mean less risk for European equities while a Brexit resolution would also be a positive for the market. Moving past these events, the biggest long-term risk for Europe is Italy. The fourth largest economy in Europe is the only one that has made no labor or pension reforms, which makes it less competitive and gives Italy few options should it experience a recession. Our exposure to Italy is also limited.

While the ECB has not made drastic moves like the Chinese government, its decision during the first quarter to keep interest rates lower for longer has sparked a rally in growth stocks. In a moderating economy like we are seeing across most of our target markets, growth investors can benefit from rising revenue and earnings and a lower cost of capital. Lower rates are also positive for M&A activity.

We see several catalysts that could jumpstart depressed EU earnings over the course of 2019.

Portfolio Positioning

International growth stocks enjoyed some of their strongest gains in several years in the first quarter and consistent with our valuation and risk-focused approach, we took some profits. In the health care sector, we closed a position in Mettler-Toledo as the U.S.-based supplier of precision instruments, solutions and services to the laboratory, industrial and food retailing industries hit our target price, as well as Hoya Corp. a Japanese manufacturer of contact lenses and optical products for medical and industrial applications. We also closed out of Aflac, a major provider of life and health insurance in Japan, as it hit our price target and finished selling out of Vale, a Brazilian mining company and the world's largest producer of iron ore as we saw more upside in other areas.

The proceeds of these sales were directed into several new names across our emerging, secular and structural growth buckets. This diversified approach allows us to access growth in all its forms while helping to control risk. In the emerging growth bucket of higher risk companies with above-average top line growth, we tapped into an attractive IPO market with the purchase of Tencent Music (TME). TME is the leader in Chinese online music with 800 million monthly average users, eight times the nearest competitor. We expect the company to sustain strong top line growth for years to come as its investment in exclusive content drives the paying user ratio above current 4% levels.

The purchase of Novartis, a Swiss-based global pharmaceutical firm, adds to our group of secular growers that typically offer ballast to the portfolio with limited volatility and good downside protection. Following the spinout of its eyecare business Alcon, we believe Novartis will be a cleaner story with potential upside to many of its pharmaceutical franchises. A new CEO is transitioning the company away from a conglomerate structure to focus on prescription medicines, increasing the pace of innovation and redeploying capital toward higher science advanced technology platforms.

We also established a new position in Taiwan Semiconductor (TSM), a name we have owned in the past. TSM is a classic structural growth company, where its future growth path should be much different than the recent past, in this case due to what we see as a cyclical upswing in the semiconductor cycle. The stock is back to trading at trough multiples relative to the S&P 500 Index and we think we are past the cyclical weakness in smartphones and cryptocurrency as well as inventory restocking, and that new product cycles around data centers and 5G should re-accelerate growth. Additionally, TSM has seen a structural shift and is now leading in technological execution, allowing it better pricing; and potentially many more clients. The purchase of Spin Master, a Canadian toy maker and entertainment company, is another structural play that has a very interesting pipeline of new products. The Toys R Us bankruptcy caused the toy market, especially in the U.S., to become highly promotional, providing a one-time opportunity to get into a well-positioned company.

Outlook

While the U.S. is beginning to feel the effects of slowing earnings growth, EU earnings remain depressed and well off their past peak. We see several catalysts that could jumpstart earnings over the course of 2019. We have seen currency headwinds rolling through many of the European companies, which has depressed attractive constant currency growth. We believe the FX effects should start to roll off in the second quarter and by the second half of the year, this should improve investor sentiment around European equities. We have also been seeing higher producer prices which should lead to pricing power taking hold across industries. This in turn should lead to revenue and operating results as price increases go through. And finally, the EU is more exposed to emerging markets than the U.S. and as emerging markets demand becomes less depressed, that should flow through to earnings.

With respect to China, we see recent consumer strength continuing. A resolution in trade negotiations would also help improve sentiment and provide companies all over the world a more predictable playbook from which to manage their businesses. We also expect China’s efforts to expand the money supply begin to take effect later in the year, which should provide support to the struggling manufacturing side of their economy.

Portfolio Highlights

The ClearBridge International Growth Strategy outperformed the benchmark MSCI All Country World Ex-U.S. Index for the first quarter. The Strategy delivered gains across the nine sectors in which it was invested (out of 11 total), with the primary contributors coming from the financials, IT and consumer discretionary sectors.

On a relative basis, overall stock selection and sector allocation contributed to performance. In particular, stock selection in the financials, consumer discretionary, consumer staples, IT and industrials sectors and an overweight to IT drove relative results. Conversely, stock selection in the materials sector detracted from relative performance.

On a regional basis, stock selection in Europe Ex UK, emerging markets, Japan, Asia Ex Japan and the United Kingdom as well as an overweight to North America had positive impacts.

On an individual stock basis, the largest contributors to absolute returns in the quarter included Alibaba, Nestle, Shopify, London Stock Exchange and TechnoPro Holdings. The greatest detractors from absolute returns included positions in Hansa Biopharma, Spin Master, Hoya Corp., Amdocs and MonotaRO.

During the quarter, in addition to the names mentioned above we added a new position in Elixinol Global in the consumer staples sector. The Strategy also closed several positions, including Keyence in the IT sector.