ClearBridge Investments

International Growth Strategy

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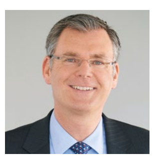

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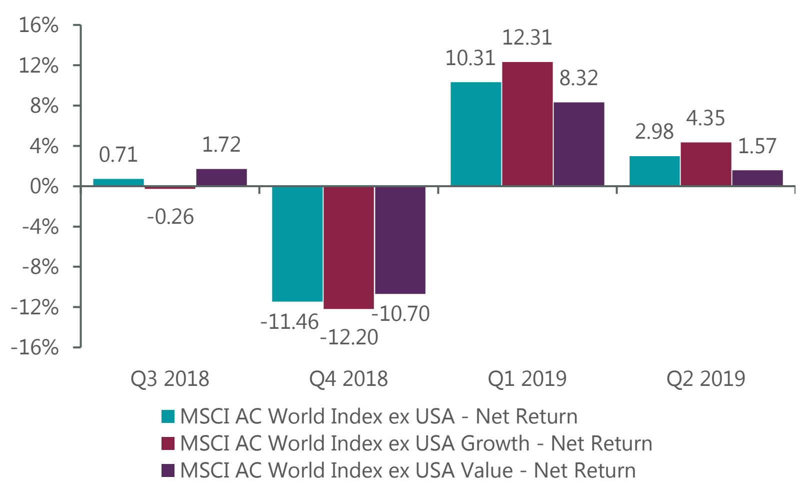
Key Takeaways

- More accommodative central banks and signs of progress in the U.S.-China trade dispute supported a continued rebound of international growth stocks.
- We believe our portfolio companies and the equity markets we target can manage around the myriad geopolitical and global growth risks in the current environment.
- We added to our allocation in secular growth companies while trimming exposure to companies in the emerging and structural growth buckets.

Market Overview

International equities managed gains through an eventful second quarter where trade and central bank policy took center stage. The benchmark MSCI All Country World Ex-U.S. Index advanced 2.98%, the MSCI All Country World Ex-U.S. Small Cap Index added 1.39% while the MSCI Emerging Market Index edged 0.61% higher. International growth stocks outperformed their value counterparts with the MSCI ACWI Ex-U.S. Growth Index up 4.35% for the quarter compared to a gain of 1.57% for the MSCI ACWI Ex-U.S. Value Index (Exhibit 1).

Exhibit 1: MSCI Growth vs Value Performance



Source: FactSet.

The ongoing trade dispute between the U.S. and China waxed and waned during the quarter - as it has for most of President Trump's tenure - causing volatility to spike and then settle. A breakdown in trade talks in May led the U.S. to raise tariffs from 10% to 25% on $200 billion worth of goods, causing investors to flee risk assets. At the same time, the Trump administration also stepped up actions against Huawei, banning the Chinese telecom giant from doing business in the U.S. and effectively barring U.S. suppliers from selling to the company. In late June, however, Trump backtracked on the Huawei ban and delayed implementation of the latest round of tariffs following a meeting with his Chinese counterpart, Xi Jinping, at the G-20 summit.

As long-term investors, we never orient stock selection or portfolio construction around politics. Global trade tensions, as well as political flareups in local markets like Italy and other countries questioning their participation in the European Union, can spark extreme pessimism and sour investment sentiment. Perhaps the biggest impact from the ongoing trade dispute, as well as geopolitics in general, is on business confidence, which delays long-term capital spending plans. We are seeing it in the manufacturing indices, where almost all major international economies are below 50, indicating a shrinking of manufacturing activity. We acknowledge and closely monitor the near-term impacts of these uncertainties - Brexit being another current example - but longer term, we believe the companies we own and the equity markets that we target manage around these risks. We will be listening closely to what companies are seeing and noting in their outlooks as second-quarter earnings reports come in.

Our optimism is supported by central banks that have become more accommodative in the last several months. The U.S. Federal Reserve communicated the potential for an interest rate cut in the near-term should economic data weaken while ECB President Draghi continued to delay the wind down of its current quantitative easing measures. Should the Fed begin to aggressively cut rates, we could see a strengthening euro. It’s worth noting that the solid performance of the portfolio year-to-date has come with virtually no contribution from currency. China also remains aggressive in using stimulus measures to offset the headwinds to growth caused by trade and tariff actions. But this time the Chinese government is seeking to help the consumer, the state-owned companies and the private companies via tax cuts and lending facilities. Monetary conditions have improved over the course of the last few months, but we expect further stimulus.

Meanwhile, valuations continue to look attractive across regions. European earnings remain nowhere near peak, creating the potential for multiple expansion. We also remain positive on the strength of the consumer, which is being supported by low unemployment and rising wages, especially in Asian markets where cosmetics, luxury goods and athletic apparel companies are seeing healthy demand. We recently attended a conference of global consumer staples companies where the tone was considerably more positive than the prior year. Companies pointed to relatively resilient demand, easing commodity prices and pricing power, particularly on the premium end. They also stressed the importance of renewed innovation, new products and re-engaging with customers to drive revenue growth.

Portfolio Positioning

Considering the strength of the markets and higher international equity valuations, we continued to trim and sell positions that have reached our intrinsic value targets and look for new ideas. This is where our proprietary model is so useful in pointing to overlooked ideas where conditions are improving and steering us away from troublesome areas. The model also helps provide a clearer view of the overall portfolio, enabling us to make strategic shifts when necessary, across the spectrum of growth.

During the second quarter, we added to our allocations in secular growth companies, those with established market positions and more predictable earnings. This included the purchase of Interxion, a Dutch-based data center operator for hyperscale cloud providers. Cloud adoption is growing faster in Europe than the U.S. because companies there are further behind. Interxion has seen good growth and occupies a unique position in serving European enterprise customers. We also added a position in Nexon, a Japan-based video gaming company that generates most of its business from one dominant game franchise in South Korea. Market worries that the game will lose its popularity and the delay of a bidding process for control of the company has weighed on the stock, creating an attractive entry point into what we believe will remain a solid gaming business.

Meanwhile, we reduced exposure to the riskier emerging growth allocation which has performed very strongly on the back of continued rate reductions, extending valuations even further. This included completion of our sale of Chinese Internet conglomerate Baidu, trims of several other positions as well as the initiation of a new position in Canadian digital payment provider Lightspeed. The company offers a cloud-based payment solution for restaurants and brick and mortar retailers that still rely primarily on legacy, on-premise infrastructure and recently rolled out a new payment product which could help increase its share of existing customers' business. Lightspeed is a leader in what we view as a very large addressable market of small and mid-size merchants.

We also trimmed our weighting in structural growth companies - businesses that are in cyclical industries or are going through a restructuring that should result in a step up in profitability. In addition to the sale of Swiss building materials company Sika, which had hit its price target, we trimmed our stake in Canadian Pacific Railway and added a new position in Brambles, an

Australian-based global leader in providing pallets for freight transport. Brambles is restructuring its business around higher margin products and is led by a management team with a good track record in such projects.

Outlook

The drawdown in the fourth quarter of 2018 had made us more positive on international equities at the beginning of the year, however we are now becoming more cautious with Manufacturing PMI indicators around the world taking a notable leg down. The upcoming earnings season could lead to increased volatility, especially for companies that disappoint or issue weak guidance, but we believe the global economy will continue to expand, although likely at a lower rate than previously thought. This environment should be supportive of growth stocks.

Increasing cash flow and lower debt levels should offer portfolio companies greater flexibility should markets become turbulent.

While the macro cannot be ignored, we would like to re-emphasize that while aware of our macro surroundings, we do not position the portfolio for macro performance but rather through stock selection as the dominant contributor to portfolio performance. We continue to seek out quality growers with good and increasing cash flow generation, which should help shield us from potential volatility. Cash flow is an underappreciated but very powerful weapon, particularly in downturns, as it allows management to buy back shares, pay dividends and have the opportunity to undertake M&A at lower valuations. Our portfolio as whole maintains half of the debt levels on company balance sheets compared to the benchmark, which should offer greater flexibility should markets become turbulent.

Portfolio Highlights

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

On a relative basis, overall stock selection was the primary contributor to performance. In particular, stock selection in the IT, consumer staples, financials and industrials sectors drove relative results. Conversely, stock selection in the energy and materials sector detracted from relative performance.

On a regional basis, stock selection in Europe Ex UK, Japan and the United Kingdom had positive impacts, offsetting weakness in emerging markets.

On an individual stock basis, the largest contributors to absolute returns in the quarter included SAP, Nintendo, Temenos, Shopify and Nestle. The greatest detractors from absolute returns included positions in StoneCo, Umicore, SQM, Tencent Music and Alibaba.

During the quarter, in addition to the names mentioned above we closed a position in Aumann in the industrials sector.