ClearBridge Investments

International Growth ADR Strategy

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Key Takeaways

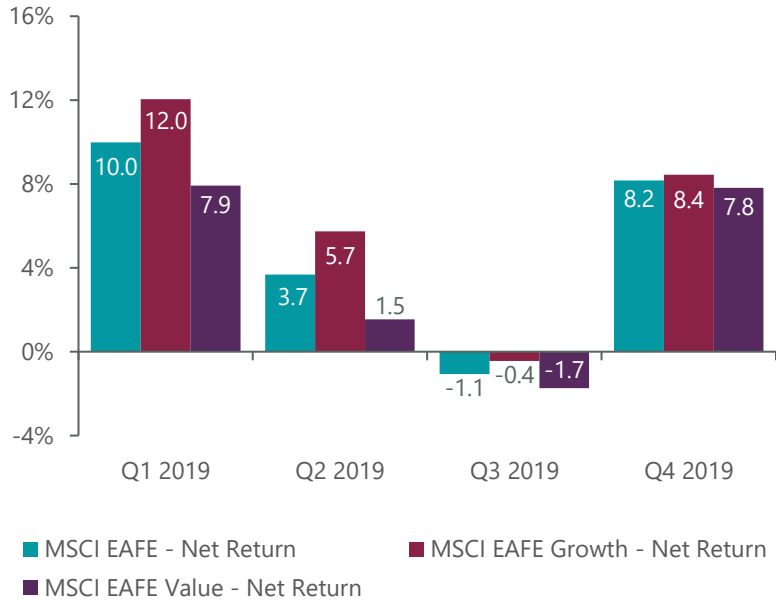
- A scaling back of economic and geopolitical uncertainty combined with easing global monetary policy sparked an international equity rally to close the year.
- The portfolio delivered strong relative and absolute performance for the quarter and the year, supported by contributions from a diversified group of growth companies.
- Attractive valuations as well as positive technical and currency trends should enable the long-running bull market for non-U.S. growth stocks to continue.

Market Overview

The mood turned positive in international markets in the fourth quarter as several actions removed a measure of uncertainty that plagued investor sentiment for most of 2019. Non-U.S. equities delivered strong results, with the benchmark MSCI EAFE Index delivering a gain of 8.17%, the MSCI EAFE Small Cap Index advancing 11.52% and the MSCI Emerging Market Index rising 11.84%. International growth stocks maintained an advantage over their value counterparts with the MSCI EAFE Growth Index up 8.45% for the quarter compared to a gain of 7.82% for the MSCI EAFE Value Index (Exhibit 1). Growth topped value by 1,181 basis points for 2019.

The fourth-quarter rally was driven by the beneficial impact of rate cuts by the U.S. Federal Reserve, optimism on a conclusion to phase one of a U.S.-China trade deal, signs of global growth stabilization and an apparent resolution in the United Kingdom as the Conservative Party won a majority in the latest election, marking the beginning of the end of Brexit uncertainty.

Exhibit 1: MSCI Growth vs Value Performance



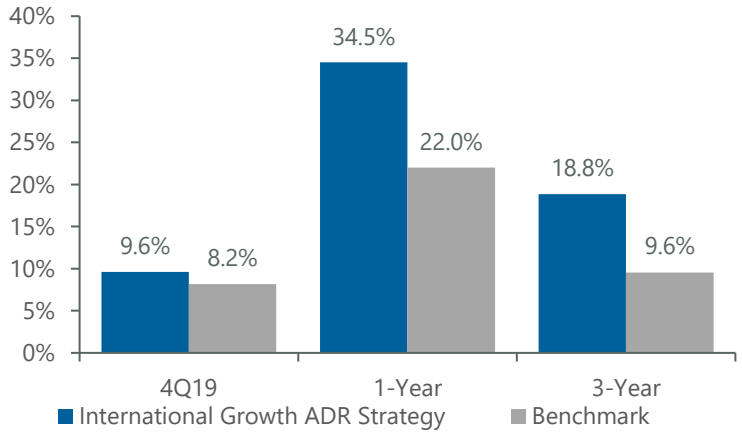
Data as of Dec. 31, 2019. Source: MSCI.

On a regional basis, the UK (+11.1%) delivered the best returns among developed markets, Europe Ex-UK (+8.2%) performed in line with the benchmark while Japan (+7.6%) and Asia Ex Japan (+5.6%) lagged. Notable outperformers on a country level included China (+31.1%, reflecting the performance of Alibaba in the benchmark), Ireland (+13.8%) and Germany (+9.9%). Emerging markets (+18.2%) delivered the best regional performance but represents a minimal weighting in the benchmark.

On a sector basis, information technology, materials, industrials, consumer discretionary and financials outperformed, reflecting a bid to cyclical stocks from a better global economic outlook as well as a preference for companies with the most visible growth prospects. Health care also outperformed for the second straight quarter as abating headwinds related to an overhaul of the U.S. health care system supported better overall sentiment for the sector. Yield-oriented consumer staples as well as energy and communication services lagged in a strong up market.

Amidst this backdrop, the Strategy outperformed both the benchmark and the MSCI EAFE Growth Index for the fourth quarter, completing a strong year of absolute and relative performance (Exhibit 2). Our valuation approach to growth applied across a broad spectrum of growth companies with strict attention to risk management enabled us to weather general market weakness in the third quarter and still participate in more momentum-oriented periods, including the fourth quarter.

Exhibit 2: Recent Performance vs. Benchmark



Data as of Dec. 31, 2019. Source: FactSet.

Chinese e-commerce and payments conglomerate Alibaba rallied late in the year with the apparent thawing of trade tensions between the U.S. and China. Alibaba is a direct play on the Chinese consumer, which is where we see the best near- to medium-term growth trends in the world's second-largest economy. Alibaba falls in our emerging growth bucket of companies with disruptive business models and above-average growth profiles that can also carry a higher degree of risk. Music streaming service Spotify and DIY e-commerce tools provider Shopify were also leading contributors among our emerging growth holdings.

Secular growth companies make up the bulk of the portfolio. These are long-term compounders with established business models, leading market positions and strong balance sheets to weather difficult conditions. German enterprise software developer SAP and French luxury goods maker LVMH drove performance in the secular bucket. Swiss pharmaceutical makers Roche, which we added to during the year, and Novartis, a new purchase in 2019, were also strong secular growth contributors as the drug development thesis begins to play out.

For portfolio balance and to ensure we are not overlooking non-traditional growth opportunities, we also target stocks that we consider structural growth stories. These are companies that are either in a cyclical industry that is coming out of a trough period or are involved in a restructuring or similar change that should lead to a step change in earnings. Here we are seeing good results out of Taiwan Semiconductor.

Portfolio Positioning

We added to our bank exposure in the fourth quarter with the purchase of French financial services firm Credit Agricole. France has among the best loan growth in Europe and Credit Agricole is a good self-help story in this market. It has been divesting non-core divisions to reinvest in its higher-yielding existing core businesses.

A valuation approach to growth enabled us to weather market weakness and participate in more momentum-oriented periods.

The company is seeing improvement in its investment bank and holds a stake in the solidly growing asset manager Amundi.

To make room in the portfolio for companies with better top-line growth stories, we sold out of three positions during the quarter. We exited Anheuser-Busch InBev due to disappointing recent results. We had held the stock based on the view debt paydown would accelerate following the IPO of Budweiser Asia Pacific, growth rates would pick up in Asian markets and the company had a low bar to top expectations in its larger markets in the U.S. and Latin America. But weak results in Asia and other key markets exposed increased competitive intensity in the global beer industry and called into question our growth forecasts.

We also closed out of Canadian oil sands producer Suncor Energy, eliminating the portfolio's energy exposure. We are negative on the relative long-term growth prospects of the fossil fuel energy industry due to abundant supply as well as a weak global demand growth outlook. Supply is addressed by new discoveries while demand is under pressure from regulation and new, more renewable technologies.

Outlook

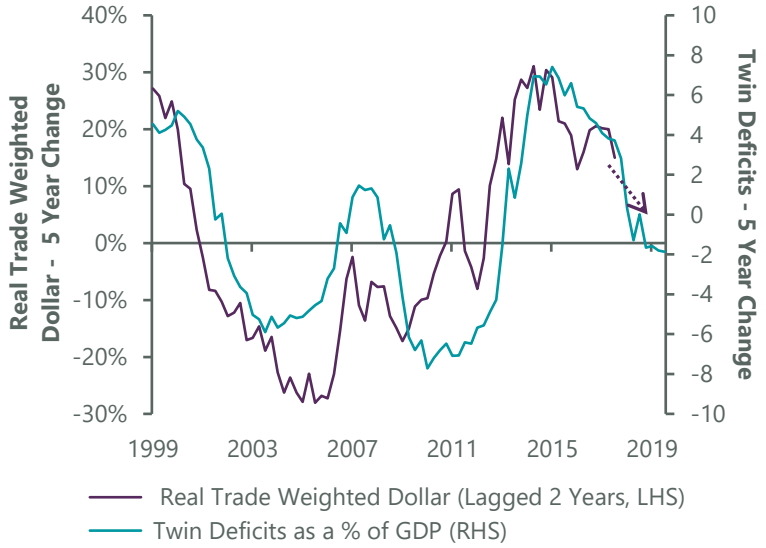
We see reasons for optimism in 2020 that are underpinned by policy moves. The European Central Bank has resumed a measured program of quantitative easing and the U.S. Federal Reserve has lowered interest rates. China and Japan continue to stand ready to provide liquidity to their economies should there be signs of economic weakness. In past cycles, increasing money supply has supported stock values after a several month lag, with the manufacturing sector picking up soon after. International manufacturing PMIs seem to have stabilized with China's PMI showing improvement. Given the likelihood of a short-term truce in the U.S.-China trade war, which would be supportive for international developed and emerging markets, we are setting the stage for a broad-based recovery by the second half of 2020.

International equity valuations remain attractive, particularly in the United Kingdom and Europe compared with U.S. equities. European stocks are at 50-year lows versus the U.S., which has represented a good entry point the last two times performance dispersions became this extreme. Near-term risks in Italy are contained for now with a new moderate government in place. Fiscal stimulus is being discussed within the EU, which would be a clear positive, while the Brexit saga appears near an end.

Investors remain underinvested in the international equity asset class. While cash allocations have come down from the third quarter, they remain high with plenty of dry powder to put to work. Low expectations and a slow churn higher in the market have left investors on the sidelines. In addition, currency could

finally be a tailwind for international returns as yield differentials narrow and the U.S. twin deficits climb (Exhibit 3).

Exhibit 3: Currency Headwinds Could Dissipate



Data as of Sept. 30, 2019, most recent available as of Dec. 31, 2019.
Source: BEA, Federal Reserve, FactSet.

We are aware that the bull market is in late stages, but with central bank stimulus and very low interest rates, the markets can continue to perform. Often the last one-to-two years before a recession are strong performance periods. The risks for 2020 are more geopolitical or tied to the potential for central bank policy errors. The latest Middle East developments involving the U.S. and Iran will likely have no major impact in the short term, but could create trouble for the world economy if oil prices spike and sustain levels which impede global growth. In this ever-changing environment, international growth stocks have held up well and our team remains focused on our valuation approach to growth. With this market backdrop, we believe that growth as a category continues to outperform other areas as investors seek growth that is not predominantly economically driven.

Portfolio Highlights

The ClearBridge International Growth ADR Strategy outperformed the benchmark MSCI EAFE Index for the fourth 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 IT, consumer discretionary, health care and financials sectors.

On a relative basis, overall stock selection and sector allocation both contributed to performance. In particular, stock selection in the consumer discretionary, financials, communication services and IT sectors as well as an overweight to IT drove relative results.

Conversely, stock selection in the consumer staples and industrials sectors and an overweight to consumer staples detracted from relative performance. Japan, a market that had been very strong through the first nine months of the year, weakened during the fourth quarter, underperforming the market overall. In areas such as industrials and consumer staples some of our Japanese stocks lagged.

On a regional basis, stock selection in Europe Ex UK and an overweight to emerging markets had positive impacts. The UK had a strong finish in the quarter versus other markets; primarily due to the resolution after three-plus years of worst-case Brexit fears not materializing.

Our emerging markets exposure allows us to find strong growth opportunities that provide higher and more sustainable growth ideas than ones we can find in developed markets, particularly Japan. Our positions here are largely oriented to growth in Asia and China, two areas which performed strongly for the quarter.

On an individual stock basis, the largest contributors to absolute returns in the quarter included Alibaba Group, ICON, SAP, ASML Holdings and LVMH. The greatest detractors from absolute returns included positions in Shiseido, Anheuser-Busch InBev, Temenos, Fanuc and SQM.

In addition to the transactions mentioned above, we initiated positions in Adyen and Hexagon in the IT sector and closed a position in Check Point Software Technologies in the IT sector.