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
Managing Director,
Portfolio Manager

Key Takeaways

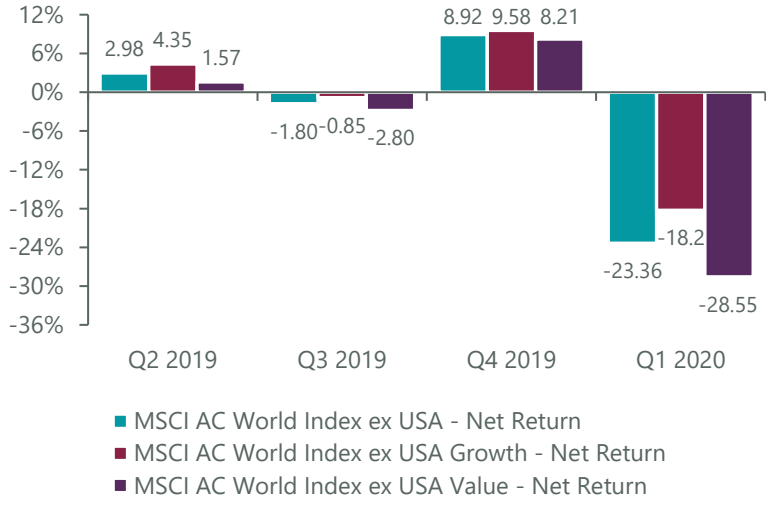
- During this period of elevated market volatility, the Strategy's quality orientation toward companies with strong balance sheets and sustainable cash flows has allowed us to gain ground against the benchmark.
- We have taken advantage of attractive valuations to add positions in financial companies that should be beneficiaries of heightened volatility and technology stocks supporting the shift to remote work environments.
- We believe our focus on valuing companies on long-term cash flows, where one year does not determine the intrinsic value, will pay off.

Market Overview

A coronavirus outbreak centered in China rapidly expanded into a global pandemic in the first quarter, sending global equities into a bear market and grounding economies across the world to a near halt. International equities were not spared in the selloff with the benchmark MSCI ACWI Ex U.S. Index plunging 23.4%, and the MSCI Emerging Market Index falling 23.6%. Large cap and growth stocks held up better than smaller and more value-oriented shares with the MSCI ACWI Ex U.S. Small Cap Index declining 28.9% while the MSCI ACWI Ex-U.S. Growth Index was down 18.3% for the quarter, compared to a loss of 28.6% for the ACWI Ex-U.S. Value Index (Exhibit 1).

On a regional basis, Japan (-16.8%) held up the best, followed by Europe Ex UK (-23.4%) and emerging markets (-23.9%) while Asia Ex Japan (-26.2%), the UK (-27.5%) and North America (-27.6%) were the worst performers.

Exhibit 1: MSCI Growth vs Value Performance



Data as of March 31, 2020. Source: MSCI.

On a sector basis, health care (-9.2%), communication services (-14.1%) and consumer staples (-14.7%) offered the most resilience while information technology (IT, -17.5%) also outperformed. Energy (-38.5%) and financials (-31.0%), meanwhile, suffered the deepest losses.

Given very sizeable and relatively expeditious reactions around the world for stimulus both monetary and fiscal, markets recovered from extraordinarily high fear levels in mid-March to end with losses less severe than those of the Global Financial Crisis (GFC) in 2008. At quarter end, the Chinese economy was showing initial signs of life but regions in Europe continued to be among the hardest hit by the virus known as COVID-19. Italy has seen the worst humanitarian toll, with an early outbreak outside Milan leading to a shutdown of the region that soon spread to the entire country. Spain has also suffered a high death rate despite aggressively implementing a lockdown of economic activity.

Stimulus spending varied but for many countries was above amounts seen back in 2008, particularly in Europe and the UK (Exhibit 2). Unlike during the GFC, where the EU was slow to react with aggressive action, European policy makers have quickly thrown a lot at this crisis and in a coordinated manner to prevent stress in credit markets and to underpin confidence for both consumers and workers. It is unlikely that this will be all they do as it remains to be seen how large the crisis will be in Europe and how long it will last. Having learned hard lessons from the GFC, they will do whatever it takes to prevent this health crisis from becoming a liquidity crisis.

Exhibit 2: Key Fiscal Stimulus Announcements

Country	Global Fiscal Stimulus Announced, % of GDG		
	Fiscal Stimulus, % 2019 GDP	Weight in Global GDP (%)	Contribution to Global Fiscal Stimulus, % GDP
U.S.	9.3	24.8	2.3
China	1.4	16.3	0.2
Japan	18.4	6.0	1.1
Germany	18.9	4.5	0.8
UK	4.0	3.2	0.1
France	1.9	3.1	0.1
Italy	1.4	2.3	0.0
Canada	3.6	2.0	0.1
Korea	2.6	1.9	0.1
Spain	1.4	1.6	0.0
Australia	0.8	1.6	0.0
Total		**67.3%**	**4.8%**

Data as of March 27, 2020. Source: J.P. Morgan Global Strategy Group.

A new €750 billion European Pandemic Emergency Purchase Program eases rules around quantity of government debt the European Central Bank can buy while the new EU budget will provide up to €8 billion in financing to incentivize banks to provide liquidity to small and mid cap companies. The policy response measures are meaningful and aimed at ameliorating the impact of mandatory lockdowns by targeting three areas: 1) preserving employment and a significant amount of current wages as businesses shut down; 2) easing cash shortages in the corporate sector, especially among small and medium-size businesses; and 3) facilitating credit flows from banks to companies. The total fiscal response so far is 2.6% of EU GDP and 3.2% of UK GDP, well above the cumulative 2.3% of GDP spent during the GFC. We expect they will do more on the fiscal side as countries like Germany have no debt, giving them plenty of room for deficit spending.

Japan, where the outbreak has been limited compared to other Asian countries, has been undertaking aggressive stimulus plans for years to achieve its 2% inflation target. In response to the economic disruption from COVID-19, the Abe administration and Bank of Japan (BOJ) have chosen to maintain some accommodative policies, while escalating others and enacting new targeted

We have generally avoided credit distressed companies, which has been critical as mandatory shutdowns leave many companies with few options to stay afloat.

supportive measures. The BOJ has chosen not to reduce its already negative interest rates further in order to avoid the adverse impact on the banking sector and mitigate the impact of a strengthening yen on the economy. It has chosen to step up its asset purchase plan, doubling its ETF purchase rate to ¥12 trillion, which represents stimulus of approximately 2.3% of GDP. To support small and medium-size businesses, the BOJ has introduced special funding consisting of 0% loans up to the value of corporate debt pledged as collateral for up to a year. Fiscal measures include ¥48.6 billion to directly prevent the spread of the virus as well as support the medical system and greater testing.

During this period of elevated market volatility, the quality orientation of the Strategy toward companies with strong balance sheets and sustainable cash flows has allowed us to gain ground against the benchmark. As growth managers, we believe having an approach to buying different growth types (secular, structural and emerging) while also sizing those stocks and groups for their riskiness allows us to perform in a variety of market environments, including this one. While we understand these are unprecedented times, the focus on quality characteristics should allow the Strategy to hold up in current market conditions while also performing in an up market once we pass through this period.

Portfolio Positioning

Our initial portfolio actions following the virus outbreak were oriented toward demand in China. Having had a front row seat to the events in Asia in early January, we were concerned early on about the spread of the virus. Health care systems in Asia, especially China, are still developing and the concerns we had about how this would play out turned into a worst-case scenario in terms of spread and impact. With a population that was far more mobile in terms of both domestic and international travel than during the SARS epidemic, the outbreak, we realized, had the potential to be large. We also wondered what would happen if the virus spread to the U.S. and other developed and densely populated markets. With that in mind, there were areas where we felt stocks had been relatively fully priced and markets were still being far too complacent on developments in China. We trimmed names oriented toward travel retail and the Chinese consumer, including Alibaba, LVMH and Burberry.

Risk management is core to our approach to managing the portfolio and we are constantly reassessing the credit and economic environment and analyzing whether something has changed in our theses for owning companies in the current crisis. We have been speaking with all of our companies frequently, trying to understand impacts to earnings and valuations, as well as re-evaluating ideas on our watch list of companies for potential entry points. We are positioned to take advantage of new ideas

that we have evaluated as well as names we feel are sufficiently stress tested and at bear assumption levels. We will buy them when we, as a team, believe the risk is fully discounted. We are maintaining somewhat higher cash balances while we await more actions from central banks and politicians to stabilize credit markets to prevent more serious systemic shocks.

We took advantage of a discount valuation to initiate a position in emerging growth company Elastic, a Dutch search and data analysis platform. The platform enables companies such as existing clients Uber and Instakart to better access and leverage data. Moreover, its technology is used by enterprises in many different markets, including observability, application performance management, enterprise search, site search, log management and security. The company is in the early stages of penetrating these markets, which we estimate to total $45 billion or more. Also within the emerging growth bucket, we added to a position in Teamviewer, a German cloud-based connectivity and video communication platform used initially by small businesses and now enterprises to connect for meetings and remotely access desktops, servers and devices. Teamviewer's key product strengths are cloud-based, easy to install, intuitive and adaptable. Management has expanded the use cases to include desktop sharing, video conferencing, and remote control of IoT devices, applications in high demand as remote work has increased due to virus-induced lockdowns around the world.

We have generally avoided credit distressed companies and this has been even more critical as mandatory shutdowns of economic activity leave many companies with few options other than tapping financing to stay afloat. Our financials holdings illustrate our quality orientation. We continue to maintain a meaningful underweight position in banks broadly. Additionally, our holdings in Asian insurance (AIA, Ping An) and capital markets (London Stock Exchange) have been key drivers of relative performance compared to the benchmark. We have eliminated our premium valuation bank positions, HDFC Bank and KBC Group, whose premium is predicated on continued earnings growth. The current market implies the potential for material earnings declines. We know that multiple de-ratings are often more painful than earnings cuts. In their place, we have taken advantage of attractive valuations to add positions in security exchanges Euronext and Hong Kong Exchanges & Clearing, which should be beneficiaries of heightened volatility. The CBOE Volatility Index (VIX) has averaged about 15 over the last 10 years but soared over 80 in March, creating a lot of flow for the exchanges, which will lead to good first-quarter results for their equity and commodity derivatives as settlement businesses. Hong Kong Exchanges offers trade links with mainland China, while Euronext is a collection of local European stock exchanges focused on cash and derivatives trading.

We have also been underweight areas of international equities that are capital intensive and currently being critically impaired, such as energy and materials and to a lesser extent, industrials. Our lack of exposure to industrial base metals and petrochemicals has helped significantly as we head into an environment where demand is likely to fall considerably.

Outlook

We believe that a recession is very much in the cards, but something far worse has been averted at the price of extreme monetary and fiscal expansion. The same cannot be said for earnings. As we enter the second quarter, dividends at nearly all European banks and many companies are being suspended, as they need to marshal their cash resources to endure for an indeterminable period. Cash raises of equity and bond issuance for solid credits are beginning. Share buybacks that were being undertaken are similarly suspended. Rents are not being paid to landlords, credit to consumers and small businesses is getting three-month extensions and much more. We will likely have an earnings period like none we have experienced before, with uncertainty around the end of the virus and the consumer demand shock for a period of time (Exhibit 3). We know developed markets are very consumer reliant, with approximately 70% of U.S. and 60%–65% of European GDP dependent on consumption. There will be very little in terms of near-term earnings; rather, the question is how deep will be the declines? If losses happen, for how long and do companies have the wherewithal to make it through to the other side of the health crisis and hopeful rebound in consumer spending? 2020 is likely to be a write-off for corporate earnings, and this is already reflected in some areas of the market, but we think we are still at a fairly early stage in the market's earnings reset.

Exhibit 3: Earnings Poised to Plummet Across the Globe

	2020e EPS		
	Current	**Jan. '20**	**% Change**
MSCI World	32.7	33.6	-2.8
S&P 500	165.4	174.3	-5.1
Stoxx 600	25.5	27.7	-8.0
Euro Stoxx	25.4	27.4	-7.1
FTSE 100	533.5	574.9	-7.2
Topix*	119.7	122.8	-2.5
EM	78.8	86.8	-9.3%

Data as of March 27, 2020. Source: IBES, * for year ending March 2021.

Our focus on valuing companies on long-term cash flows, where one year does not determine the intrinsic value, will pay off. Focusing simply on earnings misses the point. We are conferring with our companies to ensure their cash resources/debt lines will see them through. Our focus on quality businesses, including balance sheet strength, demonstrates why this matters, now more than any of the years post the GFC. The cut in dividend payments and buybacks means growth is now on more equal footing to other parts of the market, potentially making growth an even moreattractive segment. And there will be companies that can prosper as a result of this pandemic and the changes in consumer behavior that result.

Thank you for entrusting your investments with us. We are working together but remotely and remain in very close contact with team members thanks to technologies that make our conversations and communications seamless. We are working around the clock to ensure that the portfolio will weather the uncertainty over the coronavirus and its potential impact on earnings and market downside, and also to position the portfolio to come out of this shock in a way that rewards you for that patience.

Portfolio Highlights

The ClearBridge International Growth Strategy outperformed the benchmark MSCI ACWI ex U.S. Index for the first quarter. The Strategy registered losses across the nine sectors in which it was invested (out of 11 total), with the communication services sector holding up the best while the IT and financials sectors suffered the widest losses.

On a relative basis, overall stock selection and sector allocation contributed to performance. In particular, stock selection in the financials, communication services, materials, industrials and health care sectors, an overweight to IT as well as underweights to financials and energy drove relative results. Conversely, a lack of exposure to the utilities sector was the primary detractor.

On a regional basis, stock selection in Europe Ex UK and emerging markets had the most positive impacts.

On an individual stock basis, the largest contributors to absolute returns in the quarter included Teamviewer, Zai Lab, Nexon, Tencent Holdings and Nintendo. The greatest detractors from absolute returns included positions in StoneCo, HDFC Bank, Airbus, CNOOC and Burberry Group.

In addition to the transactions mentioned above, we initiated positions in Tokyo Electron in the IT sector, Kerry Group in the consumer staples sector and MorphoSys in the health care sector. We also closed positions in Hexagon in the IT sector, Investor AB in the financials sector, Nexon in the communication services sector, Victoria, Spin Master and McDonald's Japan in the consumer discretionary sector as well as Ambev in the consumer staples sector.