ClearBridge Investments

International Growth Strategy

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Key Takeaways

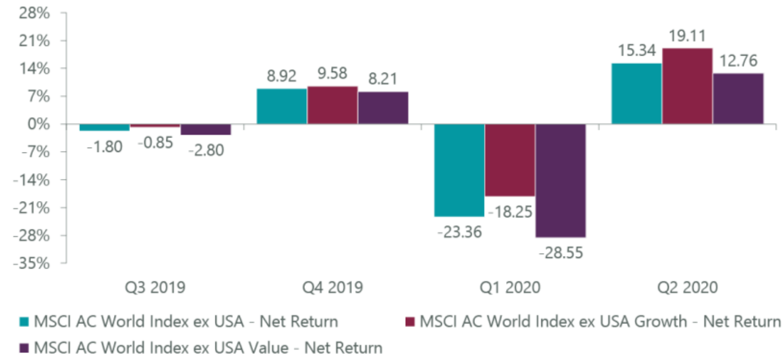
- Stay-at-home orders have altered consumer and business behaviors in ways that are accelerating secular trends where the portfolio is well-exposed through emerging growth companies.
- We actively repositioned the portfolio during the quarter, taking profits in strong performers and using the proceeds to increase exposure to technology and renewable energy.
- We expect an uneven global recovery, with technology, health care, consumer staples and communications seeing a faster rebound while economically sensitive sectors could take much longer to return to normal.

Market Overview

International equity markets rebounded strongly in the second quarter on progress in battling the global COVID-19 pandemic as well as substantial fiscal and central bank support. The benchmark MSCI All Country World Ex-U.S. Index rose 16.1%, the developed market MSCI EAFE Index gained 14.9% and the MSCI Emerging Markets Index was up 18.1%. Small caps topped larger stocks with the MSCI ACWI Ex-U.S. Small Cap up 23%. International growth stocks maintained their lead over value shares with the MSCI ACWI Ex-U.S. Growth Index rising 19.1%, outperforming the value index by 635 basis points (Exhibit 1).

On a regional basis, North America, Asia Ex-Japan and emerging markets were the best performers, Europe Ex-UK also outperformed while Japan and the United Kingdom lagged. Asia held up better than other regions due to a disciplined response to COVID-19 and an earlier economic recovery, with South Korea and China standouts. Brazil also enjoyed a strong rebound from the downturn in the first quarter, but has to deal with a rising number of COVID-19 cases.

Exhibit 1: MSCI Growth vs Value Performance



Source: FactSet.

Materials (+25.5%) and information technology (IT, +24.6%) were the top performing sectors while consumer discretionary (+19.9%), communication services (+18%), industrials (+17.5%) and health care (+16.5%) also outperformed the benchmark. Income-oriented real estate (+8.1), utilities (+11.4%) and consumer staples (+10.3%) as well as financials (+11.2) and energy (+9.9%) underperformed in a period of abundant liquidity.

The continued dominance of growth stocks may seem surprising as value tends to do best in stimulus-driven recoveries. However, the near-complete shutdown of economic activity mandated in many parts of the world to slow the spread of the pandemic makes the current global recession unique in modern history. Consumers have increased savings and trimmed spending over worries about the future. With the slower growth in global cases, particularly in Europe and Asia, activity and spending are picking up, although we are not close to a full return to past levels of activity.

Stay-at-home orders have altered consumer and business behaviors in ways that are accelerating secular growth trends where we are well exposed in the International Growth Strategy. Many parts of Europe, Japan and many emerging markets are just beginning the journey from cash to digital payments and the crisis gave payment providers an extra push. The work, shop, and live from home environment over the past two quarters led to strong uptake for e-commerce enablement platform Shopify while music streaming service Spotify and game maker Nintendo helped children and adults alike stay entertained in isolation. The crisis has accelerated these trends which normally would have taken years to achieve current penetration levels. Importantly, we feel these trends are here to stay and are unlikely to reverse meaningfully.

Portfolio Positioning

We increased our participation in online consumer spending with a new position in Just Eat Takeaway, a global leader in the fast growing and underpenetrated online food delivery market. The company has near-monopoly market positions in Germany and the Netherlands and its marketplace model generates high operating margins.

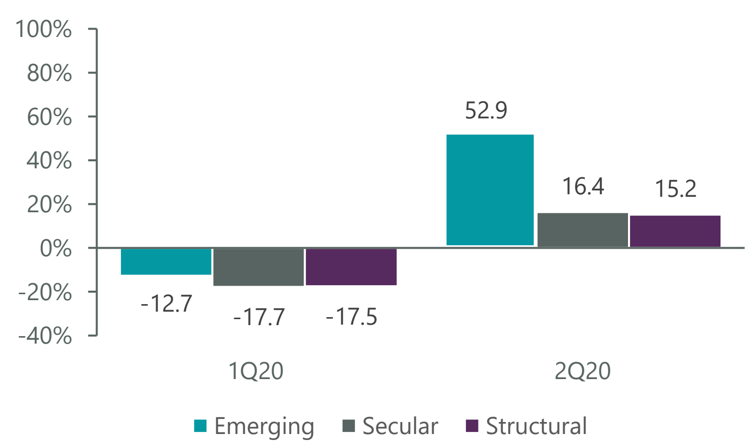
Asia was early to experience the virus outbreak and recovered early, but the region is also very disciplined when it comes to pandemics and reacted early.

Working from home accelerated trends in online collaboration with remote connectivity and video conferencing provider Teamviewer a prime beneficiary. New purchase Atlassian, an Australian maker of software to improve collaboration and productivity across different parts of an enterprise, also supports a large and expanding market for digital transformation.

Most of the aforementioned companies fall into our emerging bucket of growth stocks, enabling the portfolio to participate strongly in up markets. We balance these higher-risk names with established, fundamentally sound market leaders that make up the secular growth bucket and provide a foundation for the portfolio in periods of slower growth and higher volatility. As shown in Exhibit 2, emerging growth drove portfolio performance in the second quarter rebound while all three buckets provided downside protection compared to the benchmark during the first-quarter selloff.

Our third bucket of growth companies, structural growth, provides exposure to self-help stories where we anticipate a step change in earnings once a restructuring is complete. It also includes more cyclical companies such as Barrick Gold, a new purchase in the quarter. Barrick Gold should benefit from its reduced capital expenditure profile and expanding free cash flow at current gold prices with low levels of leverage, which will allow it to bolster dividends, share buybacks or continue acquisitions.

Exhibit 2: Consistent Performance through Diversification



Source: FactSet and ClearBridge Investments.

In addition to diversification across the spectrum of growth, we seek to differentiate the Strategy through integration of environmental, social and governance (ESG) factors into our fundamental research and stock selection approach. Our avoidance of fossil-fuel-based energy stocks has supported performance through a multiyear bear market for oil prices and, as we have shared in past commentaries, we view the adoption of electric vehicles (EVs) as a driver of future growth in transportation.

Dramatic improvements to air and water quality from reduced industrial activity during the COVID-19 lockdown highlight the importance of addressing climate change. Europe in particular has made a commitment to go green on electricity generation via renewables, EVs and energy conservation. The EU seeks to be net zero by 2050 and recent fiscal stimulus includes many green initiatives. We took advantage of market volatility in the most recent quarter to increase our exposure to renewable energy through the purchase of SolarEdge Technologies and Energias de Portugal (EDP). SolarEdge produces inverters, the electronics driving solar power systems to be more efficient and affordable. The Israeli company has a strong product pipeline for residential, commercial and utility installations and should continue to grow through further geographic expansion, market share gains and growth in average revenue per installation. EDP, a global builder and operator of electricity plants powered by renewables, could generate higher returns as it rotates assets out of more volatile electricity generation into renewables such as wind and solar farms.

Risks and Outlook

Central banks have done their part to keep global markets and financial systems functioning amid a significant drop in consumer and business activity. Balance sheets of the G3 (U.S. Federal Reserve, European Central Bank, Bank of Japan) increased over the last three by almost 50%. The response to the pandemic has been bigger than during the Global Financial Crisis, where the ECB was hesitant to act. The European Union's fiscal response has been more impactful than in the last crisis, particularly Germany's acceptance of fiscal transfers. Germany begins its 6-month rotating of the EU presidency in July and Chancellor Merkel is eager to broker a €750 billion deal. Germany wants the EU to stay together and is willing to shoulder more of the burden of proposed common bond issuance to help its weaker neighbors in southern Europe. While Germany has come around, the plan still requires the approval of the so-called Frugal Four (Netherlands, Austria, Sweden and Denmark). Such stimulus is desperately needed by countries like Italy that were already reeling before COVID-19 hit.

Japan is being equally aggressive in its policy response. During the second quarter, the government announced two stimulus plans, totaling ¥234.2 trillion ($2.2 trillion) equal to nearly 42% of GDP and over four times larger than the stimulus response during the GFC. The BOJ increased its asset purchases across corporate bonds, REITs and ETFs while maintaining negative interest rates. Despite entering a recession, Japan's unemployment rate rose just 0.1% in April to 2.6%, a sharp contrast to surges in the U.S. and elsewhere. Both workers and management have traditionally prioritized securing employment over wages, choosing furloughs over layoffs. Under Japan's furlough system, companies are legally obligated to pay workers at least 60% of their wages, which should prevent a sharp decline in consumer spending.

China was more measured in terms of stimulus compared to prior slowdowns, focused on targeted stimulus to consumers through tax breaks, lower interest rates and reserve requirement cuts. The well-orchestrated response across regions will likely shorten or limit the severity of the current global recession.

We expect an uneven recovery. The world may look very different post COVID-19, and the market assumptions of a V-shaped recovery feel a bit misplaced. Economically sensitive areas like banks and energy could take several years to return to normal. Other sectors, like health care, IT, consumer staples and communications, may see faster recoveries because they were not hit as badly or benefit from secular shifts driven by the pandemic. Our portfolio is well-positioned to participate in these trends, with some structural holdings that could outperform if the recovery is stronger than forecast.

Even as the pandemic ends, interest rates will stay low for many years. This creates a long-term earnings headwind for banks, compounded by the inroads being made by fintech disruptors. To reduce portfolio risk, we closed a position in French bank Credit Agricole in the second quarter, as it faces potentially higher loan losses and we expect to remain underweight banks until positive trends emerge. Within financials, we prefer to invest in areas with recurrent revenue streams that are not subject to the behavior of central banks, such as securities exchanges, which have multiple revenue streams including the licensing of data. Here we have exited Euronext and Hong Kong Exchanges & Clearing and consolidated our positions in Deutsche Boerse, a new buy during the quarter, and London Stock Exchange.

Containment of the virus has driven investor sentiment, with the largest drawdowns since March coming on news of spikes in virus cases. By the end of June, the number of COVID-19 infections had improved in most of the developed world while emerging economies were mixed. Asia was early to experience the virus outbreak and recovered early, but the region is also very disciplined when it comes to pandemics and mask wearing and reacted early. Latin America, particularly Brazil, has been hit very hard.

The market currently assumes that even if case numbers rise again, there will not be another global shutdown. Governments will deal with local outbreaks with immediate responses that seek to contain the virus locally. So far a second wave has been contained, yet the rise in cases in the southern and western U.S. is disturbing.

Despite a strong bounce back, international equities could have more room to run. Stocks are one of the few asset classes with capital appreciation potential as the low interest rate environment leaves fixed income challenged. Investor cash levels have been reduced, but remain elevated with plenty of dry powder still on the sidelines. Valuations of companies in developed and emerging markets continue to look compelling compared to their U.S. peers. We see M&A activity picking up as large companies with good balance sheets and access to inexpensive financing are looking for new areas of more durable growth. The virus is forcing companies to deal with outdated cost structures or underperforming businesses — we think the market is providing us with interesting new and existing areas to invest in and remain excited about the opportunities we see ahead.

Portfolio Highlights

The ClearBridge International Growth Strategy outperformed the benchmark MSCI ACWI ex U.S. Index for the second quarter. The Strategy delivered gains across the 10 sectors in which it was invested (out of 11 total), with the IT sector the leading contributor.

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

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

On an individual stock basis, the largest contributors to absolute returns in the quarter included Shopify, Spotify Technology, Adyen, StoneCo and Elastic. The greatest detractors from absolute returns included positions in Kao, Daiichi Sankyo, Barrick Gold, Atlassian and Rogers Communications.

In addition to the transactions mentioned above, we initiated positions in Daiichi Sankyo and Ansell in the health care sector and Nidec in the industrials sector. We also closed positions in ICON in the health care sector, Givaudan and SQM in the materials sector, TechnoPro and Epiroc in the industrials sector, Nitori in the consumer discretionary sector, Kerry Group in the consumer staples sector and Tencent Music in the communications services sector.