ClearBridge Investments

Global 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

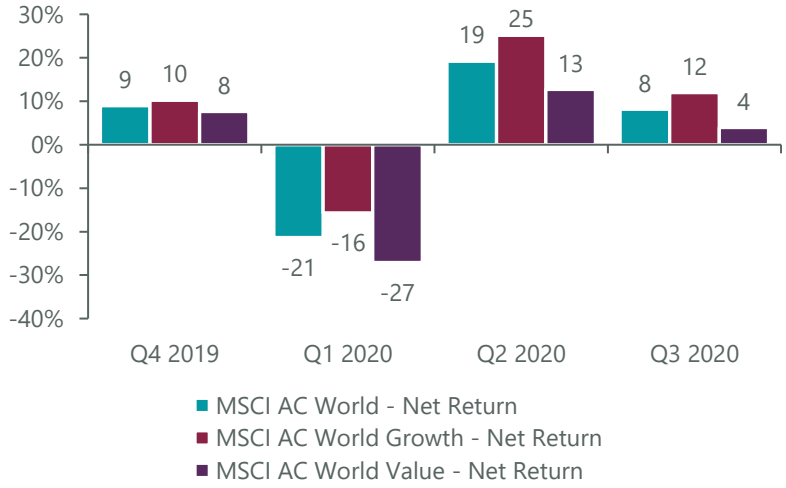
Key Takeaways

- With a nearly 60% weighting in the benchmark, U.S. stock market performance continues to dominate global returns.
- While our emerging growth stocks again led Strategy performance, we did see evidence that growth is broadening out a bit wider into structural and secular growth.
- Unpredictability of the virus and vaccine timeline, plus the likelihood of more stimulus, causes us to be patient in maintaining exposure to more economically sensitive and structural growth names.

Market Overview: Rebalancing U.S. Exposure to Support Global Growth

Global equity markets managed solid gains in the third quarter as consumers, businesses and governments continued to navigate uncertainties around the global COVID-19 pandemic and the timing of a sustained recovery. The benchmark MSCI All Country World Index rose 8.1%, paced by the strong performance of U.S. stocks. The U.S. currently represents nearly 60% of the benchmark and remains a key determinant of overall benchmark performance. The international developed market MSCI EAFE Index gained 4.8% and the MSCI Emerging Markets Index was up 9.6%. Global growth stocks maintained their lead over value shares with the MSCI ACWI Growth rising 12.0%, outperforming the value index by over 800 basis points (Exhibit 1).

Exhibit 1: MSCI Growth vs. Value Performance



Source: FactSet.

Consumer discretionary (+17.9%) was the top-performing sector while information technology (IT, +12.7%), materials (+11.7%) and industrials (+11.2%) also outperformed the benchmark. Energy (-12.8%) and financials (+1.4%) were the worst performers, hurt by anemic global oil demand and historically low interest rates, while communication services (+7.3%), health care (+4.7%), and income-oriented consumer staples (+7.2%), utilities (+4.0%) and real estate (+2.0%) also underperformed.

On a regional basis, emerging markets (EM) was the best performer, buoyed by strong domestic results in China, U.S. dollar weakness and many EM countries reporting progress in a later recovery from COVID-19 than most developed economies. North America, which consists mostly of U.S. stocks, also outperformed the broad global market as secular trends accelerated by COVID continued to reward technology and related growth names. Japan and Europe Ex-U.K. underperformed while the U.K. and Asia Ex-Japan were the biggest laggards.

The Global Growth Strategy outperformed the benchmark during the third quarter through strong stock selection, despite an underweight to emerging markets. EM is the third largest exposure in the MSCI ACWI, trailing only North America and Europe Ex U.K., which reflects the steady growth of developing economies, led by China. The portfolio's regional composition is a function of bottom-up stock selection and our valuation approach to finding sustainable and durable growth companies. The portfolio finished the quarter slightly overweight China and we see some of the best examples of technology and disruption in markets like China and Brazil today. In these markets we own companies like e-commerce and cloud services conglomerate Alibaba and electronic payments provider StoneCo, two of the portfolio's stronger contributors to performance over the last three months.

Globally we have observed markets are at different stages in their adoption of innovative technologies. What matters is how that impacts growth rates, in both duration and magnitude, and how that leads to enhanced profitability. When we think about penetration of e-commerce and digitalization of corporations and government services, Japan is relatively behind other developed companies as well as China, which is very advanced and even ahead of the U.S.

Portfolio Positioning

One area of innovation where the U.S. has a large lead is in business software delivered through the cloud. We added to our SaaS exposure in the third quarter with the purchase of Workday, a provider of software for financial, human resources and related corporate functions. Unlike many peers whose valuations have become stretched in the latest U.S. momentum run, Workday still

trades in its historical multiple range while seeing strong acceleration in its business, especially among financial customers. Remote work has opened up its core enterprise markets dramatically and Workday expects to see one of its best-selling periods in years due to the critical need for corporate software.

Online grocery delivery is another innovation in its early stages where we recently gained exposure through the purchase of Ocado Group. Grocery is the largest segment within retail yet it has the least online penetration. COVID-19 jumpstarted the shift to online grocery delivery and we believe usage will continue to rise as grocers introduce their own online offerings. Ocado is a leading pure play online grocer in the U.K. and over the last 20 years has developed an end-to-end technology that enables third-party grocers to accept online orders and automatically bag them for delivery within large fulfillment centers. Ocado licenses this technology, which includes software, robotics and proprietary algorithms, to the leading grocers across the globe, such as Kroger in the U.S., Aeon in Japan and Casino in France. We expect the company to generate high-margin licensing revenue as more grocery customers shift online using its platform.

Our EM exposure has some of the best examples of disruption occurring in these regions. We continue to reevaluate our underweight for new opportunities.

These third-quarter purchases add to our stable of emerging growth companies, stocks on the vanguard of dynamic growth trends caused by innovation or disruption that generate above-average growth rates and target large addressable markets. Emerging growers tend to thrive in periods when momentum leads like the one we have seen in the technology-led recovery from COVID-19. These companies also carry a higher level of risk compared to the more established secular and structural growth companies we also own in the portfolio and we carefully manage that risk by limiting the overall weighting of emerging growth companies.

TE Connectivity, in the secular bucket of long-term compounders generating healthy free cash flows, was another new addition during the latest quarter that increases our exposure to the growth of electric vehicles (EVs). The Swiss company makes connectors for a wide range of uses, including automobiles, data centers and medical devices. Its transportation/automotive segment revenue is outgrowing light vehicle production as electronic content per vehicle continues to grow. EVs require double the per-vehicle electronic content compared to traditional internal combustion engine vehicles.

Structural growth is our third area of focus in the portfolio. Here we seek out cyclical companies as well as those going through a restructuring or similar change that we expect will lead to a step change in returns and growth. During the quarter, we added structural names United Parcel Service (UPS) and Union Pacific (UNP) in the industrials sector. UPS has positioned itself as more valuable today, as capacity has come out of the system due to COVID-19. As a key transport provider in a surging e-commerce market, UPS is poised to gain pricing power in the next cycle, as

consumers are willing to pay for the privilege of receiving their purchases as quickly as possible. UNP suffered in the earlier stages of the pandemic and we have become positively inclined to the U.S. rails. With the industry in the process of implementing the Canadian rails playbook of precision scheduled railroading, there is the potential for significant fixed cost reductions. UNP is in the earlier stages of this implementation and has longer haul length as a Western rail provider along with a higher quality mix of end market exposure. This combination could lead to best-in-class industry margins over time.

Investing across three types of growth companies, each with distinct drivers of growth, ensures diversification through varying market conditions and not just growth environments which have been extremely favorable recently. This approach helps us control risk by providing diversified types of growth ideas while allowing us to avoid areas of the market with poor growth prospects. During the quarter we exited our last traditional bank holding in Europe, Erste Bank, increasing our underweight to the financials sector. Most banking markets in the world do not offer much growth as the low interest rate environment, which should be in place for the foreseeable future, eats into net interest income while fee income is being challenged by new entrants. The pandemic has increased the need for larger loan loss provisions and regulators are changing dividend payouts for the banking sector in Europe. Erste Bank has a good growth engine in Eastern Europe, but we believe the slow growth in Western Europe will delay a recovery in its share price. Our preference is to participate in financials through the exchanges, which have multiple revenue drivers, as well as insurance and fintech disruptors.

We sold several other positions to fund new and existing names with better growth prospects. German software maker SAP's strong recent performance led to an overweight where we decided to take profits while we also exited Canadian payments software maker Lightspeed to better manage volatility and liquidity concerns.

Outlook

Our emerging growth holdings have performed well recently due to the shortage of visible growth in global markets, If the pandemic lasts two more years, emerging growth could continue to work. Yet the unpredictability of the virus and vaccine timeline, as well as the likelihood of additional stimulus, causes us to be patient and maintain exposure to more economically sensitive and structural growth names such as French industrial manufacturer Legrand, Diageo and travel system provider Amadeus.

We are encouraged by the continued proactive policy responses to COVID-19 in Europe and Asia. The European Green Deal is becoming part of investors' awareness with subsidies and other private partnerships pushing the potential total package to $7 trillion. The approach to climate change will require immediate actions by all of us. We are pleased that governments and regulators are behind these initiatives which will have a real immediate impact. Japan is discussing another $2 billion fiscal response that will be oriented toward nearshoring production back to Japan from China and digital initiatives to modernize the economy.

Over the last six to 12 months, the U.S. market has underappreciated the zero cost of capital made possible by low interest rates, which has translated into very high price/sales multiples for growth stocks. This cannot continue indefinitely as inflation and higher bond yields will eventually remove the justification for high valuations. As interest rates and inflation normalize with better economic growth and the development of a COVID vaccine, the sector performance with the highest momentum will end, as a rotation to economically sensitive sectors will become more in favor.

The robust rebound in equities makes it easy to forget that most of the global economy remains fragile and a number of uncertainties exist beyond COVID. The controversy over Chinese video platform TikTok is the latest spark to exacerbate U.S.-China geopolitical tensions, with both sides threatening further restrictions on the operation of publicly-traded companies within their borders. We are always evaluating how such issues impact companies and the private sector and whether any government behavior interferes with profitability and shareholder returns.

Portfolio Highlights

The ClearBridge Global Growth Strategy outperformed the benchmark MSCI All Country World Index for the third quarter. The Strategy delivered gains across the 10 sectors in which it was invested (out of 11 total), with the IT and consumer discretionary sectors the leading contributors.

On a relative basis, overall stock selection and sector allocation contributed to performance. In particular, stock selection in the IT, health care and financials sectors (aided by an overweight to fintech), an underweight to financials as well as a lack of exposure to the energy sector drove relative results. Stock selection in the materials and industrials sectors were minor detractors.

On a regional basis, stock selection in North America, EM and Europe Ex U.K had the most positive impacts. while an overweight to Europe Ex U.K. detracted slightly. With the U.S. continuing to represent the majority of the benchmark, we have been trying to bring down our U.S. underweight through new ideas and adding to existing names. Much of our turnover this quarter was a result of selling to rebalance

the portfolio's U.S./non-U.S. allocation. We maintain a very robust sell discipline and when stocks reach their full intrinsic value, we will sell to find new ideas with a better risk adjusted upside.

On an individual stock basis, the largest contributors to absolute returns in the quarter included Apple, Salesforce.com, Alibaba, SolarEdge Technologies and Nvidia. The greatest detractors from absolute returns included positions in Temenos, TeamViewer, Shiseido, Spotify and Constellation Software.

In addition to the transactions mentioned above, we initiated positions in Avantor and Dex.com in the health care sector and Kao in the consumer staples sector. We also closed positions in Fanuc and Lennox International in the industrials sector, Hansa Biopharma and Novo Nordisk in the health care sector, Coca-Cola in the consumer staples sector as well as Palo Alto Networks in the IT sector.