ClearBridge Investments

International Growth Strategy

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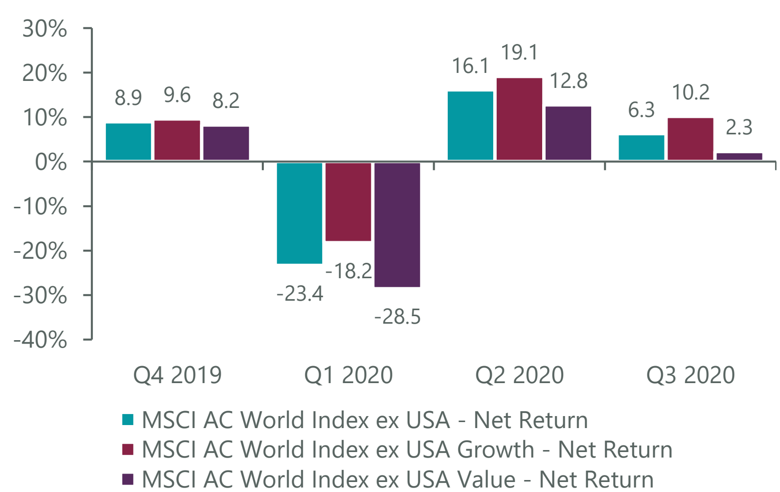
Key Takeaways

- 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.
- Our emerging markets exposure has some of the best examples of disruption occurring in these regions. We continue to reevaluate our underweight for new opportunities.
- 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: Emerging Growth Leads in Momentum Market

International 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 Ex-U.S. Index rose 6.3%, the developed market MSCI EAFE Index gained 4.8%, while the MSCI Emerging Markets Index was up 9.6%. Small caps topped larger stocks with the MSCI ACWI Ex-U.S. Small Cap adding 10.6%. International growth stocks maintained their lead over value shares with the MSCI ACWI Ex-U.S. Growth rising 10.2%, outperforming the value index by nearly 800 basis points (Exhibit 1).

Exhibit 1: MSCI Growth vs. Value Performance



Source: FactSet.

Consumer discretionary (+16.5%), information technology (IT, +13.4%) and materials (+11.1%) were the top-performing sectors while industrials (+9.9%) also outperformed the benchmark. Energy (-7.6%) and financials (-0.2%) were the worst performers, hurt by anemic global oil demand and historically low interest rates, while health care (+2.6%), communication services (+3.3%) and income-oriented consumer staples (+4.6%), real estate (+2.3) and utilities (+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. Japan also outperformed the broad international market, with the Nikkei playing catch-up to other global indexes as investors began to appreciate the level of stimulus, both fiscal and monetary, which represents a full 60% of GDP. Aggressive stimulus aimed primarily at domestic businesses was also a spark for smaller companies across the globe, many of which were at risk of failure at the onset of the pandemic. North America, and Europe Ex-U.K. slightly trailed the index while the U.K. and Asia Ex-Japan were the biggest laggards.

The International Growth Strategy outperformed the benchmark during the third quarter, as it has over the trailing one-, three- and five-year periods, despite a meaningful underweight to emerging markets. EM is the second largest exposure in the MSCI ACWI Ex-U.S., trailing only Europe Ex U.K., which reflects the steady growth of developing economies, led by China. While the portfolio's regional composition is a function of bottom-up stock selection, we have been reevaluating our EM exposure as some of the best examples of disruption are occurring in China and Brazil. In these markets we own companies like e-commerce and cloud services conglomerate Alibaba and electronic payments provider StoneCo, two of the leading contributors to performance over the last three months.

As global investors, we have observed different markets are at different stages in their adoption of innovative technologies. What matters is how that impacts growth rates, which leads us to investment opportunities. When we think about penetration of e-commerce and digitalization, Japan is relatively behind other developed companies as well as China, which is very advanced and even ahead of the U.S.

Portfolio Positioning

Latin America has made progress on the digital front, but we believe the potential there is still very much untapped with e-commerce penetration of just 4% of the population in 2019 compared to 12% in the U.S. and over 20% in China. We added to our EM exposure and this growth trend during the quarter with the purchase of e-commerce platform MercadoLibre. The company has expanded from its home market in Argentina to become a major presence in Brazil, Mexico and other countries in Latin America. Due to a combination of faster connection speeds, affordable smartphones, improved merchant participation and enhanced trust of digital transactions, MercadoLibre's Latin America end markets grew at more than twice the rate of the U.S. last year and are expected to grow rapidly in the next several years. MercadoLibre has created an ecosystem of services that will allow the company to participate strongly in that growth. Many services are complementary and will help the company to gain share by enhancing the user engagement.

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.

All manner of e-commerce and related online purchases are being streamlined through the growth of digital payment options, an evolution that has accelerated during the pandemic. We increased our participation in the payments ecosystem with the addition of French payment software provider Worldline. With its upcoming acquisition of French rival Ingenico, the company will be one of the leaders in the European payment landscape. Synergies are likely underestimated and the consolidation in Europe will continue as banks not innovative enough to compete are likely to sell their payment divisions. Worldline is one of two prime candidates to acquire these additional capabilities.

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 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 (EV). 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.

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Investing across three types of growth companies, each with distinct drivers of capital appreciation, is how we ensure diversification through varying market conditions. 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 closed a position in CNOOC, China's largest oil & gas producer, leaving negligible portfolio exposure to the fossil fuel-based energy sector. We also exited our last traditional bank holding, 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. We also closed out of Canadian cable and wireless provider Rogers Communications as the company experienced slower than expected growth due to a new strategy of shifting customers to unlimited plans which led to lower overage fee revenue. The slowdown was amplified by the pandemic, resulting in fewer net new subscribers as retail locations were shuttered.

Outlook

Our emerging growth holdings have performed well recently due to the shortage of visible growth in international markets, but it's doubtful this will go in indefinitely. 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 Airbus, Diageo and travel system provider Amadeus.

We are encouraged by the continued proactive policy response to COVID-19 in Europe and Asia. The European Green Deal is intriguing, with subsidies and other private partnerships pushing the total package to about $7 trillion. The approach to climate change is very advanced and we are very excited to invest behind it. 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.

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. Presently, the portfolio is slightly underweight China relative to our benchmark.

Portfolio Highlights

The ClearBridge International Growth Strategy outperformed the benchmark MSCI ACWI ex U.S. Index for the third quarter. The Strategy delivered gains across nine of the 10 sectors in which it was invested (out of 11 total), with the IT, industrials and consumer discretionary sectors the leading contributors.

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

On a regional basis, stock selection in EM, Japan, North America and the United Kingdom had the most positive impacts while an underweight to EM proved detrimental.

On an individual stock basis, the largest contributors to absolute returns in the quarter included Taiwan Semiconductor, Alibaba, SolarEdge Technologies, Adyen and Nintendo. The greatest detractors from absolute returns included positions in Temenos, TeamViewer, Worldline, Umicore and Shiseido.

In addition to the transactions mentioned above, we closed a position in Fanuc in the industrials sector.