ClearBridge Investments

International Growth EAFE Strategy

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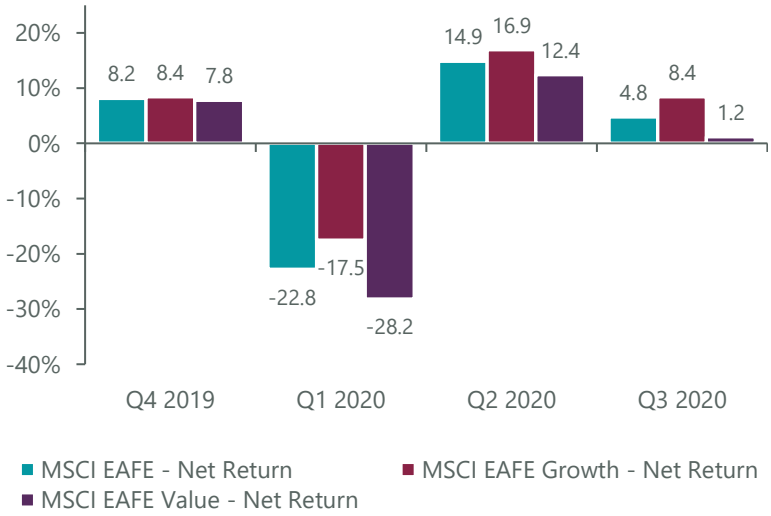
Key Takeaways

- While our emerging growth stocks again led 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 the region 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: Capturing Secular Trends at Different Stages

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 EAFE Index gained 4.8%, while the MSCI Emerging Markets Index was up 9.6%. Small caps topped larger stocks with the MSCI EAFE Small Cap Index adding 10.3%. International growth stocks maintained their lead over value shares with the MSCI EAFE Growth Index rising 8.4%, outperforming the value index by over 700 basis points (Exhibit 1).

Exhibit 1: MSCI Growth vs. Value Performance



Source: FactSet.

Materials (+10.8), industrials (+10.3%), consumer discretionary (+9.7%) and information technology (IT, +8.1%) were the top-performing sectors in the benchmark. Energy (-13.4%) and financials (-1.3%) were the worst performers, hurt by anemic global oil demand and historically low interest rates, while health care (+2.9%), communication services (+4.0%) and income-oriented real estate (+2.9) and utilities (+3.0%) 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. Europe Ex-U.K. slightly outperformed the index while the U.K., Asia Ex-Japan and North America lagged.

The International Growth EAFE Strategy outperformed the benchmark during the third quarter, as it has over the trailing one- and three-year periods, boosted by an overweight to emerging markets. EM's solid performance 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

Online grocery delivery is an 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 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.

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. The portfolio has no exposure to the energy sector and a significant 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. While we maintain a limited exposure to banks, our preference is to participate in financials through the exchanges, which have multiple revenue drivers, as well as insurance and fintech disruptors.

We sold a position in Canadian cable and wireless provider Rogers Communications to fund new and existing names with better growth prospects. Rogers has 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 on 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

During the third quarter, the ClearBridge International Growth EAFE Strategy outperformed its MSCI EAFE Index benchmark. On an absolute basis, the Strategy delivered gains across the nine sectors in which it was invested (out of 11 total), with the IT and industrials sectors the leading contributors.

On a relative basis, overall stock selection and sector allocation contributed to performance. In particular, stock selection in the IT, industrials, consumer discretionary, financials,

communication services and health care sectors, an overweight to IT, and an underweight to the financials sectors drove relative results. Conversely, stock selection in the consumer staples sector was a detractor.

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

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