ClearBridge Investments

International Growth EAFE Strategy

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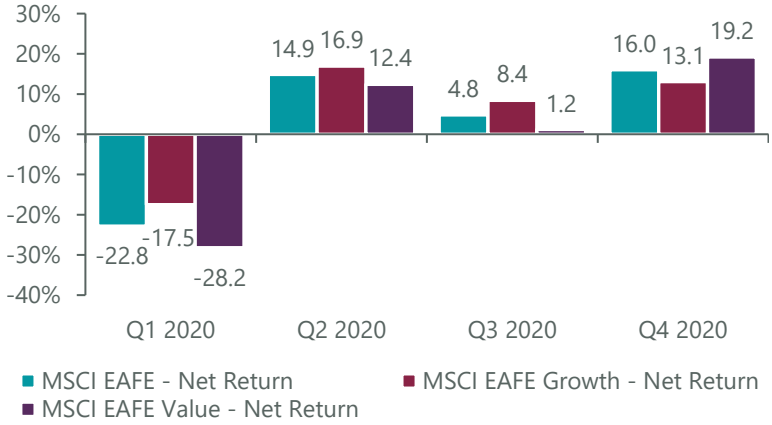
Key Takeaways

- Optimism over a return to normal economic activity globally sparked a rotation into value stocks. These trades typically last one to two quarters and we believe it will take an unlikely rise in inflation to sustain the current value run.
- Given the strong performance of growth stocks through the year, we took the opportunity to trim and sell more fully priced ideas and increase exposure to a recovering global economy.
- 2020 was a year of monumental progress in renewable energy and the adoption of electrified transport, highlighting the importance of ESG analysis in guiding our portfolio construction and risk management process.

Market Overview

Significant progress in the development of COVID-19 vaccines, resolution of the U.S. presidential election and continued Federal Reserve policy accommodation along with potential further fiscal support lifted international equity markets to strong gains to close a tumultuous 2020. The benchmark MSCI EAFE Index gained 16.1%, while the MSCI Emerging Markets Index was up 19.7%. Small caps outperformed larger stocks with the MSCI EAFE Small Cap Index adding 17.3%. After a long streak of growth style dominance, international value stocks and sectors outperformed growth stocks and the benchmark in the fourth quarter, with the MSCI EAFE Value Index rising 19.2% compared to 13.1% for the MSCI EAFE Growth Index (Exhibit 1).

Exhibit 1: MSCI Growth vs. Value Performance



Source: FactSet.

Optimism about an economic recovery lifted cyclical shares, with the energy (+31.2%), financials (+25.4%), consumer discretionary (+22.4%) and materials (+20.1%) sectors outperforming in the quarter. These parts of the market were boosted as manufacturing in some parts of the global economy, notably Asia, returned to pre-COVID-19 levels. Information technology (IT, +16.9%) and communication services (+16.4%) also outperformed the benchmark but ceded their extended leadership positions. Defensive sectors like health care (+4%), and consumer staples (+6.9%) lagged in the rotation into more economically sensitive areas.

These rotation trades normally last from two to five months, so we are likely at least halfway through the current value run. We have been examining what it would take to see an extended rotation into value and it's closely tied to inflation. Higher inflation would lead to a rise in long-term interest rates, but we have yet to see any upswing in prices or market rates.

On a regional basis, Asia Ex-Japan, led by mining and cyclicals in Australia, was the best performer. China, surprisingly, was a laggard in EM but strong performance from semiconductors and cyclicals oriented toward improving global trade helped Taiwan and South Korea. EM, which have a minimal weighting in the benchmark but is well represented in the ClearBridge International Growth EAFE Strategy, were helped by continuing U.S. dollar weakness and strong rebounds in key emerging currencies that had been fairly volatile and weak throughout the first three quarters of 2020. Europe Ex-U.K. and the U.K. shrugged off virus surges, a fresh set of COVID-19 restrictions and more Brexit drama to perform roughly in line with the benchmark, with performance led by the year's underperformers in financials, mining and travel-related services. North America, which also has a negligible representation in the MSCI EAFE Index, was lifted by cyclical exposure in Canada, while Japan performed roughly in line with international developed markets.

The U.K. became the first country to roll out an approved COVID-19 vaccine in early December and markets have quickly discounted a brighter future. Assuming successful vaccine distribution, we believe the global economy should recover in the back half of 2021 and into 2022. However, early indications of successful rollouts are few at the time of this writing. International markets, especially those in service-oriented regions like Southern Europe that rely on personal contact to do business, should benefit more than the U.S. in a recovery as they have greater exposure to cyclical industries.

International stocks were also lifted by a relief rally when it became clear Joe Biden will be the next U.S. president. The leadership change should improve relations between the U.S. and the rest of the world. Biden is seen as more consistent and

rational with his international policies negotiated diplomatically rather than by presidential decree. His first task will be repairing relationships with U.S. allies, Europe and Japan in particular, which should help trade with both regions. It will be very important to watch diplomatic agendas and the U.S. stance toward China. The Chinese are pragmatic in their policymaking and very interested in de-escalating the situation with the U.S. While they want to become independent from the West and de-escalation would buy them time to further these efforts, their stance on human rights, minority persecution and their moves in Hong Kong will mean that this administration may not necessarily perform a complete about-face in policy from the Trump administration.

In an extraordinary move during the quarter, the Chinese government forced the cancellation of the planned $30 billion Ant Group initial public offering that would have valued the company at $300 billion as Beijing began reining in e-commerce and fintech companies Alibaba and its subsidiary Ant. Alibaba, which owns a third of Ant, saw its shares rise strongly ahead of Ant's planned November IPO. Alibaba shares dropped after Chinese regulators canceled the offering then fell again in late December when the government announced an antitrust probe into the company. We have been trimming Alibaba shares steadily through the year but decided that government intervention across its business had the potential to disrupt growth rates and profitability at least in the near term. We decided to close the position as we continue to evaluate Chinese government intervention and regulatory changes toward the company and others. Currently, we continue to hold Chinese Internet conglomerate Tencent and insurer Ping An and are monitoring developments to ensure these companies' ability to generate revenue and earnings growth are not impaired by government interference.

Climate Focus Supports Renewable Energy

The pandemic has caused many of us to reflect on the current state of affairs and reminded us of the fragility of our personal welfare, economic systems and how impending climate change may further change our world. At the corporate level, climate issues are becoming central to investment conversations, as are societal issues, such as gender and race, and governance issues. 2020 was a monumental year for progress in renewable energy and the adoption of electrified transport. It will be remembered as the year the world started to reverse centuries of damage with the European Union announcing the Green Deal and leaders committing to cutting greenhouse gas (GHG) emissions to zero by 2050 and setting an ambitious short-term goal to cut GHG 55% by 2030. It is the centerpiece of the European Union recovery plan.

Non-U.S. equity valuations remain compelling, even after the bounce we've seen over the last three quarters.

Beyond trade, a Biden White House should also lead to greater U.S. support for global green initiatives. Several other large economies, including China, also came out with net-zero pledges. Many countries have adopted regulation to promote electric vehicles (EVs) and set end dates for the sale of gasoline-powered vehicles. California Governor Gavin Newsom issued an executive order banning the sale of new gas-powered vehicles after 2035, making California the first U.S. state to join the U.K., France, Canada and several other nations in putting an end date to sales of internal combustion engine cars.

We believe the unfolding energy transition will continue to accelerate. Companies exposed to the supply chains of solar technologies, wind power, the electric powertrain as well as batteries are well-positioned to benefit from increased demand as deflationary tailwinds, incentives and widespread public support drive the global adoption of these technologies. The Strategy continues to be well-exposed to these positive long-term trends through several holdings such as EDP, SolarEdge and Nidec. The need for more power sources to support greater electrification of transportation, as well as falling costs for batteries and wind technology, also caused us to re-establish a position in Danish wind turbine producer Vestas Wind Systems during the fourth quarter.

Our integration of ESG as a part of our analytical work and investment process at the front end has enabled us to identify ideas to both invest in and, importantly, avoid. ESG as an investment focus is accelerating and remains the top recipient of active investment flows globally. We are well-placed to succeed in this environment and believe that our use of ESG as a tool will progress to a place where ClearBridge's focus has long been established regardless of whether the portfolio is specifically oriented exclusively toward ESG or is more broad-based. PricewaterhouseCoopers believes ESG and sustainable investment will shift fund flows from 15% today to nearly 60% of European fund assets by 2025. Over two thirds of European institutional investors will no longer purchase funds without ESG and sustainability within their mandate. This will have broad implications for companies, in Europe and elsewhere, that are top performers in ESG and sustainability, as well as implications for those who do not take sustainability seriously.

Portfolio Positioning

Given the strong performance of growth stocks throughout the second and third quarters, we took the opportunity to trim and sell ideas that we felt were fully priced and increase exposure to a recovering global economy. This involved increasing our structural growth allocations, including repurchasing two previously held names: Swedish industrial manufacturer Atlas Copco and Canadian Pacific Railway. Atlas Copco has refocused

its business away from mining over the last several years. Capital spending in many of its end markets are at depressed levels and should benefit from a post-COVID-19 recovery, while its low capital intensity and strong free cash flow generation can be redeployed into accretive acquisitions. Canadian Pacific has led the U.S. rails in implementing Precision Scheduled Railroading, driving down operating ratios and increasing margins. While some of its end markets have been weak in the past year with nearly no top-line growth, improved economic recovery in those areas, acquisitions and some new contracts could help volumes recover and operating ratios improve to the mid-low 50s by 2023, helping drive profitability to new highs.

In addition, we established new positions in Alcon, a Swiss maker of medical devices for eye care, and Cellnex, a Spanish operator of cell phone towers. Alcon has major positive product cycles in both of its core businesses — cataract surgery and contact lenses — that will accelerate revenue and earnings. It also has a significant opportunity to expand margins by investing in new manufacturing and leveraging its commercial investment. As the largest independent tower company in Europe, Cellnex is poised to capture a large portion of tower sales likely to result from divestment by telecom companies. This should significantly increase Cellnex's asset base, bolstering a defensive business model with high recurring revenue and predictable cash flows from long-term contracts.

We added more cyclicality to the portfolio by increasing our exposure to industrials while continuing to underweight traditional financials such as banks. Those funds have instead been redeployed into the fintech area, which we consider financials but which the market classifies as IT.

Outlook

Since the lows of the first quarter, technology and related communications and Internet stocks have done well, as have the Asian countries that implemented the earliest lockdowns and are further along in their recovery. We are well-exposed in the portfolio to the secular growth trends of cloud computing, artificial intelligence, renewables and electric vehicles. Europe, Japan and most emerging markets have not rebounded as vigorously and are more cyclical in nature; this is where we see the most attractive opportunities in the near term.

Non-U.S. equities should also benefit as the high levels of cash still sitting on the sideline are put to work. Asia and Japan have seen inflows already, but Europe and the rest of emerging markets have not. Valuations remain compelling, even after the bounce we've seen over the last three quarters. Central banks learned their lessons from the financial crisis and will keep interest rates low and monetary policy accommodative. This is all positive

for equity markets and even Japan, which has been out of favor for decades, is undergoing secular changes under a new prime minister, including a drive for greater digitalization.

One thing we have all learned from recent events: predicting human behavior, economic performance and having a strong top-down view around which to orient portfolios does not work. Our focus on understanding companies and their near-term and long-term growth potential, adjusting and re-adjusting our view of growth as it develops and evaluating new growth areas is where we will put our efforts.

Our proprietary model helps identify, from the thousands of companies out in the marketplace, interesting ideas with good growth and attractive valuations. From there we have to dig in and do the fundamental work of validating growth characteristics, valuations, cash flows and, of course, ESG characteristics. 2020 was a humbling year with many gains and great personal losses and sacrifices. We hope that 2021 will not deliver so much of the negatives of last year and we will remain vigilant and focused on delivering returns in line with our multidimensional growth approach and valuation discipline.

Portfolio Highlights

The ClearBridge International Growth EAFE Strategy underperformed the benchmark MSCI EAFE Index for the fourth quarter. The Strategy delivered gains across the nine sectors in which it was invested (out of 11 total), with the IT sector the primary contributor.

On a relative basis, overall sector allocation detracted from performance but was partially offset by positive stock selection. In particular, an underweight to the financials sector, a lack of exposure to the energy sector and stock selection in the consumer discretionary, financials, materials and communication services sectors hurt results. On the positive side, stock selection in the IT sector was the primary contributor to performance while selection in the health care, consumer staples, utilities and industrials sectors and an underweight to health care also helped.

On a regional basis, stock selection in North America, Europe Ex-U.K. and the U.K. and an overweight to EM hampered results, while stock selection in EM and Japan proved beneficial.

On an individual stock basis, the largest contributors to absolute returns in the quarter included StoneCo, Tokyo Electron, Taiwan Semiconductor, ASML and Nidec. The greatest detractors from absolute returns included positions in SAP, Alibaba, MorphoSys, Ocado Group and Givaudan.

In addition to the transactions mentioned above, we established positions in TE Connectivity in the IT sector, MercadoLibre in the consumer discretionary sector and Burning Rock Biotech in the health care sector and closed positions in TechnoPro Holdings in the industrials sector as well as SAP and Lightspeed POS in the IT sector.