ClearBridge Investments

International Value Strategy

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"The future is already here – it's just not evenly distributed."
-William Gibson

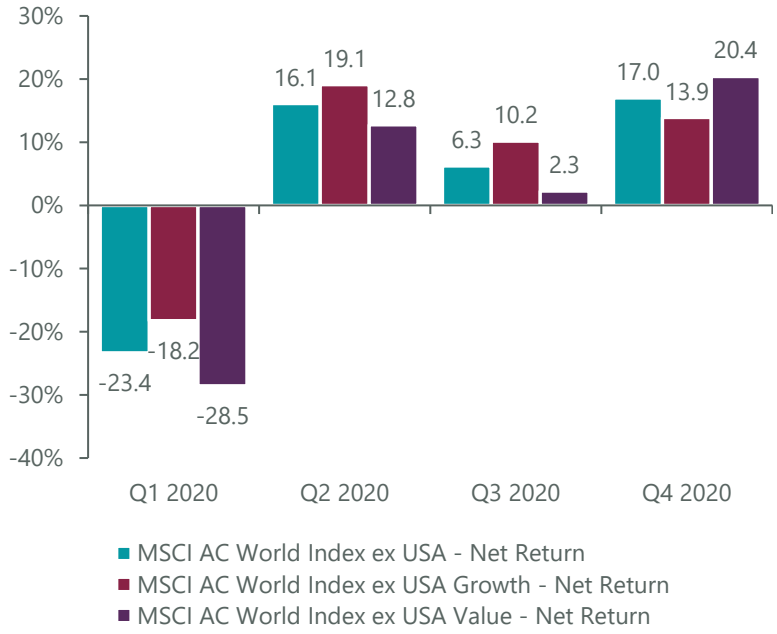
Key Takeaways

- Many assets that fell to generational lows earlier in the year, such as cyclicals, banks, smaller companies, commodities, emerging markets and traditional energy shares, led a fourth-quarter rebound.
- A global shift to reflationary economic policies, combined with a more capital-intensive wave of technological development, could lead to the strongest growth in 20 years, supporting cyclical and value stocks.
- The portfolio is most exposed to the cyclical materials, industrials, energy, financials and consumer discretionary sectors with a bias toward Europe and the U.K.

Market Overview

Global markets rebounded strongly in the final quarter of 2020 as positive news on vaccine development offset a rise in COVID-19 cases and the reintroduction of restrictions in the U.S., Japan, Hong Kong, Europe and the U.K. Companies poised to benefit from a normalization of economic activity that were hit hardest earlier in the year led the rally with the benchmark MSCI All Country World Ex-U.S. Index rising 17%, the developed market MSCI EAFE Index gaining 16.1% and the MSCI Emerging Markets Index advancing 19.7%. In a reversal of the first three quarters of 2020, value benchmarks meaningfully outperformed comparable growth cohorts, with the MSCI ACWI Ex-U.S. Value rising 20.4% compared to 13.9% for the MSCI ACWI Ex-U.S. Growth (Exhibit 1).

Exhibit 1: MSCI Growth vs. Value Performance



Source: FactSet.

On a sector level, optimism about an economic recovery lifted cyclical shares, with the financials (+24.7%) and energy (+22.5%) sectors among the top-performing sectors in the quarter, joining information technology (IT, +24.7%) where semiconductor makers responded to optimism toward consumer spending. Materials (+20.0%) also outperformed the benchmark as excitement about a broadening global recovery led these underperformers for the first three quarters of 2020 much higher. Defensive sectors like health care (+6.2%) and consumer staples (+8.5%) lagged, as did those negatively correlated with interest rates, including real estate (+12.6%).

On a regional basis, emerging markets companies in the benchmark delivered the best gains (+20.2%) due to support from a falling U.S. dollar, rising commodity prices and hopes for economic recovery. Overall, international shares broadly outperformed the U.S., with Japan, Europe and the U.K. all rising 15% to 16%.

The global economy and financial markets experienced sharply divergent behavior. While unemployment soared and small businesses collapsed as the pandemic shut down about a third of activity, the owners of capital in the largest companies saw their wealth rise by $1.8 trillion to a new record. Abundant and cheap liquidity led to a classic mania in industries that proved to be lockdown beneficiaries and powered a record rebound in share prices.

Reflationary Policies to Spark Above-Trend Growth

While the combination of a pandemic and speculative asset price bubble creates a challenging investment environment, it can also act as a catalyst for change. Historically, the most difficult and uncertain times have often fueled important inventions, discoveries and human progress. We believe such conditions have now begun to unfold. Since the stock market depths of late March, many assets that fell to generational lows have led the rebound such as cyclicals, banks, smaller companies, commodities, emerging markets and traditional energy shares. This encompasses a substantial cohort of value stocks, which have also rebounded from the largest relative drawdown in 20 years as compared to growth shares. Still, for the full year, value stocks lagged as the "disruptor" mania continued. The performance of the ClearBridge International Value Strategy mirrored this pattern with a large drawdown in the first quarter reversed by strong gains from the March lows.

We believe the change in asset price behavior is likely to continue and represents just the beginning of a profound and secular shift as we have in place the most reflationary policies in modern history. Mainstream thinking of policymakers moving toward a central role for fiscal stimulus in addressing growth, fairness and efficiency represents the most important shift since Monetarism took hold in the 1950s. A new paradigm built upon a "modern" version of Keynesianism is simply that at low rates, monetary policy is less effective and fiscal policy is less expensive. The key measure of success is not the level of asset or consumer prices, but employment and labor conditions. "Trickle up" economics promises to be the prevailing policy for the next decade or more.

Consequently, central bankers have pledged to allow price rises to "overshoot" their 2% targets to address longer-term inequalities and imbalances. As inflation accelerates, monetary officials additionally face the conundrum of needing to keep rates from rising too sharply by increasing their monetization of longer-maturity government debt. This will lead to monetary policy remaining expansionary for longer into an economic recovery than at any time in the past 20 years. A weakening U.S. currency both reflects these policies and adds to inflationary pressures as commodity prices rise.

The coming Keynesian period of fiscal stimulus, combined with a more capital-intensive wave of technological development, could lead to much stronger growth than we have experienced over the past two decades. Led by decarbonization, transportation electrification and renewable energy, the world is entering a period of mass application and diffusion of transformative technologies. A move to the broader application of artificial intelligence, 5G wireless connectivity and the Internet of Things will reinvigorate a broad range of industries and should raise overall productivity.

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Niche products such as electric vehicles (EV) are entering the commercialization phase as hundreds of new models from dozens of companies come to market. Given that the skills and capabilities required to commercialize a product are profoundly different than in the early adoption stage, a broader group of companies will experience dynamic growth and new leaders are likely to emerge. Already, portfolio holding Volkswagen has jumped to the top in market share in Europe as demand surges for EVs. Portfolio holding BMW is also introducing several new models and poised to take a slice of global EV sales. Finally, it would be unwise to ignore Japanese firms that have proven to be masters of commercialization, with Toyota promising to get more aggressive in the battery-powered vehicle space. The Chinese EV landscape is also becoming rapidly more dynamic and competitive with fresh investor capital funding several local brands.

Cyclically dependent and financial shares are well-positioned to experience stronger than expected growth as the global economy recovers from the pandemic downturn and benefits from these secular trends. Researchers at Merrill Lynch note that, for the first time in a decade, earnings revisions and expected growth are now best in cyclical and traditional value sectors such as banking, mining, industrials, energy and autos. It increasingly appears that the best way to find growth is to buy value.

Portfolio Positioning

We see compelling evidence of a secular shift to reflation and stronger growth that is already driving a change in relative asset prices. Consequently, the portfolio is most exposed to cyclically related sectors such as materials, industrials, energy, financials and consumer discretionary. New addition Jardine Strategic Holdings is a good example. Based in Singapore, Jardine is one of the leading industrial and consumer product conglomerates in Asia. It owns several key brands and assets including Mandarin Oriental Hotels, Hong Kong Land and Dairy Farm International along with exposure to auto sales, palm oil production, consumer packaging, and financial services. These companies are poised to benefit from the short-term post pandemic recovery and longer-term growth in the Asian middle class.

We have a lower weighting in defensive and bond-correlated industries such as staples, health care, real estate, utilities and telecommunications providers. Technology stock valuations range from pricing in a boom to a bubble, leaving the portfolio less than benchmark exposed.

From a broader perspective we have built up significant holdings in companies that benefit from the mass adoption and commercialization phase of digitalization. This includes shipping, metals, cement, construction, industrial, auto related and consumer firms such as mining company Glencore, which is levered to demand growth from vehicle electrification and storage of renewable energy. Glencore is one of the largest and lowest cost producers of copper where prices are rising strongly as spending on the transformation of our energy infrastructure grows. Welcoming a new CEO this year, the board has already committed to the most aggressive reduction in emissions in the industry of 40% by 2035 and net zero in 2050. This should lead to an ESG re-rating for the company and improved investor demand for the stock.

Financial and energy shares represent our deepest value and most contrarian investments. While profitability at banking and financial intermediaries is likely to be somewhat constrained by structurally lower interest rates, the yield curve has still steepened over the past year. Any further rise in rates would add materially to the sector's profits. Banks also entered the pandemic downturn with three times the capital and limited bad debt exposure relative to the 2009 crisis. This leaves the companies well-positioned for strong loan growth, industry consolidation and eventually returning cash to shareholders.

The energy sector faces more structural challenges given vehicle electrification and renewable power growth. But what is less widely appreciated is this outlook has led to a decline in capital spending with the effect of depletion likely to offset the impact of energy transition for the next several years. Even in 2025, about 90% of new vehicles will be powered by fossil fuels. Finally, the near-term economic recovery and longer-term rise in global growth will still increase oil and gas demand even if overall intensity relative to GDP is declining. For example, oil demand in China hit a new high last year despite the pandemic downturn with similar new highs in consumption expected this year in many emerging markets (EM). These conditions will allow well-positioned energy producers to generate significant free cash flows and pay attractive dividends.

Europe and the U.K. continue to offer strong value and cyclical recovery potential and are home to many of the critical enablers of the broader technological transformation. These regions also have meaningful exposure to EM economies which somewhat offsets our lower direct EM weighting. Many companies in Japan also overlap with our European and British stocks but with less compelling fundamentals. As a result, we are less than benchmark weighted. Our exposure to Asia is similarly constrained by the bottom-up preference for European and U.K. industrials and materials shares.

Outlook

Risks to our outlook include disappointing developments related to the pace of vaccinations. The initial rollout has encountered what appears to be normal glitches but barriers to providing the final "jab" could delay mass inoculation. Also, the markets remain in the capitulation phase of a historic mania, the end of which could cause a general outflow from global stocks. Finally, there is a chance that bond investors react strongly to a combination of massive supply and the new reflationary policy regime. Cheap money is at the foundation of many inflated asset valuations and a sharp rise in rates would have broad and negative implications for financial markets and economic growth.

The global pandemic and the final stages of a historic speculative bubble represent the catalysts for a profound shift in the prevailing investment environment. As both the virus and mania fade into history we are optimistic about the signs that policy, cyclical and secular conditions are aligning to create a stronger, more sustainable and inclusive global economy. The commercialization and mass application of new technologies promises to provide benefits to a broad range of citizens, companies and nations. Value stocks around the world are well-positioned for further gains as the overlooked architects and enablers of this coming transformation.

Portfolio Highlights

The ClearBridge International Value Strategy outperformed its MSCI All Country World Ex-U.S. Index benchmark during the fourth quarter. On an absolute basis, the Strategy had gains across eight of the nine sectors in which it was invested (out of 11 sectors total). The financials, industrials and consumer discretionary sectors were the primary contributors to returns during the quarter while the health care sector was a detractor.

On a relative basis, overall stock selection and sector allocation contributed to performance. Specifically, stock selection in the consumer discretionary, financials and industrials sectors and underweights to the consumer staples and health care sectors had the most significant positive impacts on returns. Conversely, stock selection in the health care and energy sectors and an underweight to the IT sector detracted from results.

On a regional basis, stock selection in Europe Ex-U.K. and the U.K. were beneficial while stock selection in Asia Ex-Japan and North America and an underweight to EM hurt performance.

On an individual stock basis, Glencore, Barclays, BNP Paribas, Capri Holdings and A.P. Moller-Maersk were the greatest contributors to absolute returns during the quarter. The largest detractors from absolute returns were Bayer, Novagold Resources, Newcrest Mining, Sanofi and CNOOC.

During the quarter, we initiated positions in Banco Bilbao Vizcaya Argentaria in the financials sector and Royal Dutch Shell in the energy sector. We also closed positions in Bayer in the health care sector, UniCredit and Banco Santander in the financials sector, Atos in the IT sector, Baidu in the communication services sector, CNOOC in the energy sector and Capri Holdings in the consumer discretionary sector.