ClearBridge Investments

International Value Strategy

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"If history repeats itself, and the unexpected always happens, how incapable must Man be of learning from experience."

- George Bernard Shaw

Key Takeaways

- Economic policies geared to social enfranchisement, digital modernization and climate change will clearly add to nominal GDP growth and real goods inflation.
- Industrial, financial, basic materials and energy companies now have the best relative earnings momentum for the first time in nearly 20 years. We find this trend is likely to last for much longer than expected due to constraints on capital, capacity and competition.
- We believe the recent outperformance of international value stocks is just the beginning of a secular shift in market leadership and the Strategy remains positioned in companies that benefit from strong operating leverage to a period of healthy global growth.

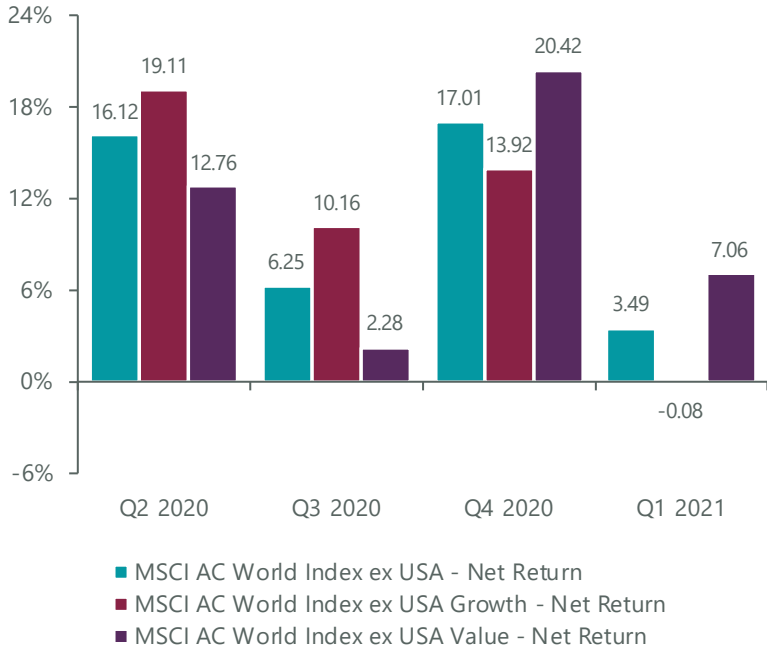
Market Overview

What a difference a year makes. At the end of March 2020 global markets had experienced a sharp drop with long-suffering assets such as value and non-U.S. stocks, commodities and energy reaching generational relative lows. Uncertainty and fear surrounding the pandemic had shuttered much of the world's economy and investors worried that central banks had little scope to help with rates already at zero. Effective treatments for COVID-19 were expected to be years away and mitigation efforts were dependent upon a high degree of social cohesion that appeared lacking in the Western world. Then, about nine months later, Sandra Lindsay, a critical care nurse in the U.S. became the first person vaccinated upon formal regulatory approval of a novel vaccine based upon a genetic technique that was essentially discarded. A rebound carried the MSCI All Country World Ex-U.S. Index to a 49.4% gain over the 12-month period ended in the first quarter.

On display was a vibrant view of humanity's angels and demons; our ability to be both foolish and brilliant and ever struggling with discerning the difference. Asset prices reflected this bipolarity as lockdown beneficiaries surged initially while the deeply depressed

cyclical and financial sectors also leapt higher on reopening hopes as vaccines headed into production. These behaviors were reflected in the swift switch in global equity leadership from growth to value (Exhibit 1) with the MSCI All Country World Ex-U.S. Value Index gaining 7.1% in the first quarter, outperforming its growth counterpart by over 700 basis points. Central banks embraced a new paradigm in their inflation policies and partnered with Treasury officials in monetizing fiscal stimulus that would be directly injected into the economy. Central banks have increased their balance sheet to 6x the level before the 2008 financial crisis and their speeches have taken on the mandate to create a sustainable inflation and address social injustices. We are not sure if these policies are brilliant or foolish, but they clearly represent the most profound shift in the macroeconomic environment since the early 1980s when Paul Volcker famously "broke the back" of inflation.

Exhibit 1: MSCI Growth vs. Value Performance



Source: FactSet.

The "untouchables" of energy and financial stocks led for the first quarter, gaining 9.6% and 8.4%, respectively. Materials (+5.4%) and industrials (+5.2%) also outperformed as cyclicals rallied on reopening and stimulus hopes. Communication services companies (+4.9%) posted solid gains as telecom, media and advertising firms rose on expectation of vaccinated consumers returning to work, shopping and travel. Defensive sectors including utilities (-1.3%), staples (-2.4%) and health care (-3.8%) posted losses for the quarter. Consumer discretionary shares (+2.1%) were mixed as lockdown-boosted firms experienced a correction while reopening beneficiaries rose. The information technology sector (IT, +3.5%)

was similar in that hardware stocks like semiconductor companies were strong while cloud and software providers tended to underperform. Real estate share performance (+3.5%) continued to diverge, with housing-related companies rising and commercial property owners weak.

Momentum becoming cheaper and less crowded is supportive of value stocks but is being misread as a positive sign it's safe to return to growth stocks.

International markets overall lagged the rebound in the U.S., primarily due to relative weakness in Japan (+1.6%) and emerging markets (+2.3%). The best-performing countries were Canada, Austria, Holland, Norway, Italy, Sweden, Hong Kong, Singapore, Taiwan, South Africa and the U.K. These markets tended to benefit from improving economic sentiment and rebounding global trade activity. Laggards such as Spain, Switzerland and Portugal were hurt by exposure to the still-depressed travel and tourism industries. Japan, South Korea and China also underperformed due to uncertainty surrounding technology demand, slower rollout of vaccines and deteriorating Sino-U.S. relations. The economic and currency turmoil in Turkey cast a shadow over other developing nations, with Indonesia, Malaysia, the Philippines, Brazil, Egypt and Poland posting losses for the quarter.

Deep value factors dominated for the quarter led by price/book, price/sales and price/cash flow metrics. Measures of fundamental momentum, such as estimate revisions and forward earnings growth, also outperformed. Price momentum underperformed but correlations and characteristics of the factor are changing rapidly as value stocks become an increasing portion of the best performing cohort. This shift in momentum becoming cheaper and less crowded is therefore supportive of value stocks but is being misread as a positive sign that it is safe to return to growth stocks. Quality tended to underperform while high-beta and volatility/risk metrics rallied strongly. Smaller companies outperformed overall but this was mostly due to exceptional gains in the U.S.

Global Stimulus Salutary to Value Industries

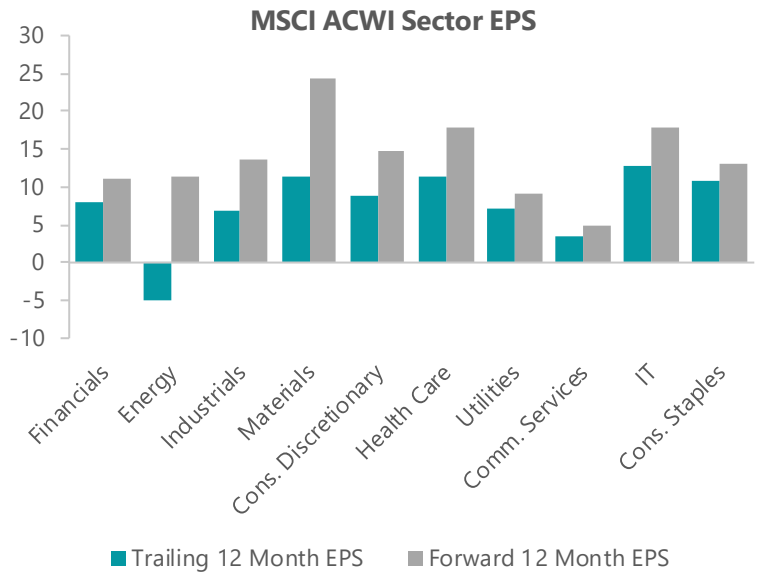
The key lesson of history in the face of a foundational transformation is to understand what is beginning and what is ending and prepare for a long recalibration of relative asset prices. At first, the change in leadership is viewed as impossible; it then follows the "path of most resistance," from being dismissed as temporary, irrational, fundamentally unsupported and excessive, before being fully embraced. Disciplined value managers like us tend to be pretty good at the first stages and more challenged in the latter stages of this dynamic. So, our focus over the past year has been to capture the powerful initial rebound in value stocks and going forward to avoid becoming pessimistic or impatient. Understanding the broad top-down framework is important while most of our work is on identifying the specific fundamental beneficiaries of the shifting economic environment.

A rise in the prices of some goods is not inflationary if the prices of other goods decrease and a decline in overall demand occurs. It is the stated goal of policy makers to not let this happen so the higher costs of energy and basic materials will be monetized. Governments are also extending unprecedented stimulus spending well beyond the depths of the pandemic lockdowns with a "build back better" mission. From the U.S. and Europe to Japan, Canada and New Zealand, leaders are focused on improving social justice and addressing institutional inadequacies including women's rights, homelessness, public health, income inequality, educational access and spending on innovation and modernization of digital infrastructure. Our point is not that these are necessarily bad policies but that they clearly will add to nominal GDP growth and real goods inflation.

At least for the next year or two this stimulus is hopefully in concert with a post-pandemic return to normal. Consumer behavior should begin to boost travel, physical retail, apparel, restaurant, gym and beverage spending. The global supply chain is already straining from improving demand and still limited capacity with shipping costs doubling over the past year. Global logistics providers, uncertain as to how much of the recent rise in rates will become permanent, are reluctant to add to capacity. Portfolio holding Inditex, one of the largest apparel retailers in the world, with leading positions in Europe and the U.S. with its Zara brand, should be a beneficiary of this pent-up demand. The pandemic caused a drop in financial performance, but the company has historically been among the most profitable apparel sellers in the sector. Exposure to Spain and Southern Europe positions the company well for a rebound in travel and tourism. Inditex has a localized and diversified supply chain, which will help the brand gain market share in the currently inventory constrained world.

From a sector and stock perspective, we are finding a material shift in the earnings growth environment. During the asset price phase of the current inflation cycle, the real economy stagnated with little overall earnings growth since 2013 in the U.S. and back to the 2008 global financial crisis in Europe and Japan. This had the effect of making profit growth rarer and expanded the premium for "growth" stocks as earnings struggled for most "value" sectors. Over the past two quarters this has reversed as industrial, financial, basic materials and energy companies now have the best relative earnings momentum for the first time in nearly 20 years (Exhibits 2 and 3).

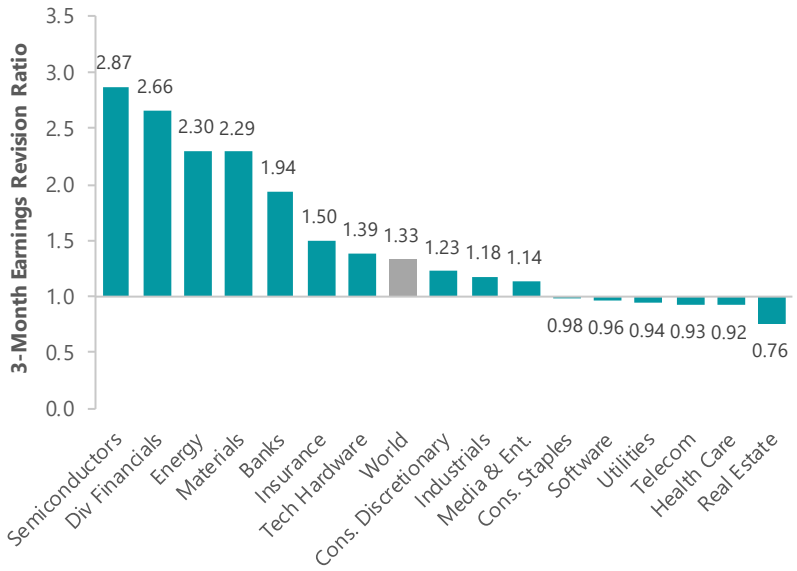
Exhibit 2: Cyclicals Seeing Best Earnings Growth



Data as of April 13, 2021. Source: Bloomberg.

To see why this trend is likely to last for much longer than expected, consider the three Cs of capital, capacity and competition. Due to the long stagnation of the past decade, most value industries have been starved of capital, are adding near-record lows of capacity and have seen the level of competition decrease. The shipping industry is not adding much net new tonnage yet the top five companies have doubled their market share over the past 10 years. Until recently, many of them were focused on paying down debt and selling ships to buy shares back. The global leader, portfolio holding A.P. Moller-Maersk, has cut capital spending from a peak of $10 billion to about $1.3 billion with free cash flow at a record high and up over 7x since 2015. Energy, metals, chemicals, cement and other basic materials producers are enjoying similar earnings and cash flow dynamics.

Exhibit 3: Value Industries Also Delivering Highest Earnings Revisions



Revisions of stocks in the MSCI All Country World Index. Source: BofA Global Quantitative Strategy, MSCI, IBES.

Portfolio Positioning

Our focus since the start of 2020 has been to capture the important initial rotation into value stocks. Encouragingly, we fully participated in the strong relative performance of value stocks in the first quarter of 2021 and over the past 12 months. We believe this is just the beginning of a secular shift in market leadership and remain positioned in companies that benefit from strong operating leverage to a period of healthy nominal GDP growth. Our holdings are directly correlated with interest rates and are supported by a steeper yield curve. We are overweight the industrials, basic materials, consumer discretionary, financials and energy sectors, in that order. A good example is new addition Marubeni, a leading Japanese trading company 5% owned by Warren Buffett. The company is steadily improving profitability and governance with the return on equity rising to 15% over the next year. Earnings are rising strongly due to leading positions in copper and iron ore as well as improved agricultural product demand. Marubeni is also a beneficiary of post-pandemic reopening with a strong aircraft leasing business, apparel manufacturing, retailing and shipping subsidiaries.

The Strategy is less exposed to defensive and bond-related industries such as consumer staples, health care, utilities and real estate. The U.K. and Europe continue to be our key regional portfolio concentrations as the valuation and earnings cycles in both remain attractive. Japan is becoming relatively more interesting as a laggard reopening and commercialization

beneficiary and we expect to gradually increase our exposure. We continue to be underweight emerging markets as policy support, valuation and earnings momentum is still more favorable in developed Western economies.

After such strong gains, many cyclical and financial stocks are overbought, and we are expecting some near-term consolidation. Any correction will be used as an opportunity to improve the fundamental quality of the portfolio. According to quantitative research by Bank of America Merrill Lynch, investors remain crowded in mega cap tech and have yet to move significantly to financials and cyclical sectors. The key at this point of the market cycle is for us to be patient and avoid losing conviction during inevitable countertrend rallies in the old leadership. The shifts driving the portfolio are broader and likely more durable than simple style-based metrics imply. We expect the growth and momentum characteristics of the portfolio to steadily improve as traditional value sectors benefit from the profound shift in policies and secular economic dynamics. This represents a return to normal for our investment process, which targets a combination of attractive factors within a value discipline.

Risks to Our Outlook

By June, at least 60% of the U.S. population will have some form of immunity and at this level, places like Israel have seen a rapid decline in serious disease, hospitalizations and deaths. But given the impact of new variants, being "almost vaccinated" is not a license to reduce mitigation practices and new waves of infections are evident here in Michigan as well as in India, Brazil, the Philippines and parts of Europe. This could delay travel and consumer activity in the important summer season and push back economic recovery into the second half of the year in affected regions.

We expect central banks to limit the rise in long-term interest rates but if the bond vigilantes return this could increase the cost of fiscal stimulus and threaten the global recovery. The inflation term premium at 60 basis points is well below the long-term average of over 200 basis points, so the risk is a too-rapid reversion to the mean. As a warning sign, U.S. Treasurys recorded the worst quarterly selloff since 1980 in the March interim.

There were three meaningful financial collapses in the quarter related to the danger of combining crowded and expensive trades at momentum extremes with excessive leverage. This may indicate broader systemic risks behind the extrapolative fantasy stock mania. If so, the shift in earnings leadership we outlined might be more dramatic than expected.

The U.S. rivalry with China could become more acrimonious and threaten the global supply of semiconductors out of Taiwan. China could begin to cut off access to its domestic consumer market

while subsidizing the development of local brands, hurting large multinational companies with a significant investment in China.

Portfolio Highlights

The ClearBridge International Value Strategy outperformed its MSCI All Country World Ex-U.S. Index benchmark during the first quarter. On an absolute basis, the Strategy had gains across nine of the 10 sectors in which it was invested (out of 11 sectors total). The consumer discretionary, financials and industrials 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 and industrials sectors were the primary drivers of results. Stock selection in the financials, materials, consumer staples and IT sectors and underweights to the consumer staples and health care sectors also aided performance. An underweight to the communication services sector detracted from results.

On a regional basis, stock selection in Europe Ex-U.K., the U.K. and Japan were beneficial.

On an individual stock basis, Volkswagen, Glencore, Barclays, CNH Industrial and BNP Paribas were the greatest contributors to absolute returns during the quarter. The largest detractors were Greatview Aseptic Packaging, Fresenius Medical Care, Novagold Resources, Roche and Newcrest Mining.

During the quarter, we initiated positions in Airbus in the industrials sector, Daito Trust in the real estate sector as well as Marston's and Melia Hotels International in the consumer discretionary sector. We also closed positions in Novagold Resources and Akzo Nobel in the materials sector, Jardine Strategic Holdings in the industrials sector and Far East Horizon in the financials sector.