ClearBridge Investments

International Growth ADR Strategy

Elisa Mazen
Managing Director,
Head of Global Growth,
Portfolio Manager

Thor Olsson
Director,
Portfolio Manager

Michael Testorf CFA
Managing Director,
Portfolio Manager

Pawel Wroblewski CFA
Managing Director,
Portfolio Manager

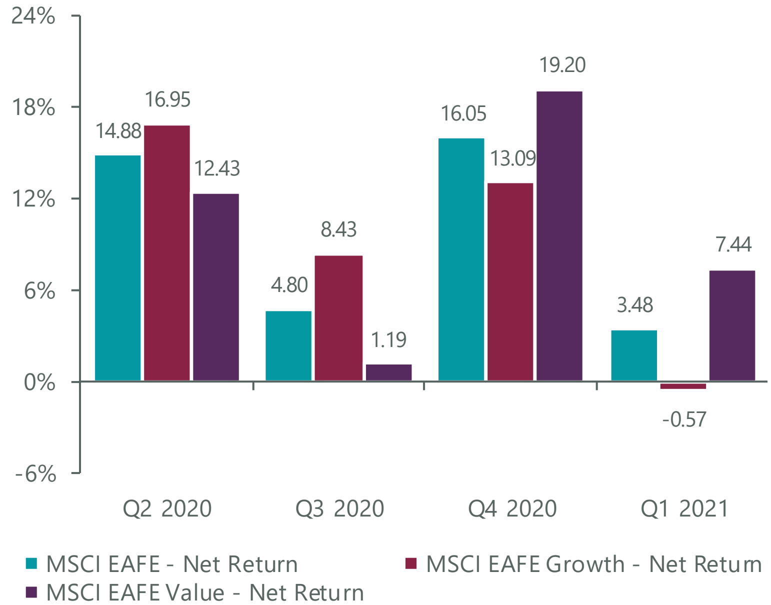
Key Takeaways

- A rotation out of growth stocks into value on improving hopes for a global recovery and a sharp rise in bond yields weighed on the Strategy's emerging growth names, leading to underperformance.
- We reoriented the portfolio for a more cyclical market in the fourth quarter and saw good performance in these areas from structural growth companies.
- The long-term dynamics for international growth companies remain compelling due to their generally more attractive valuations, the less efficient nature of non-U.S. markets and their key role in enabling digitalization across regions and industries.

Market Overview

International equities delivered marginal gains in a risk-on first quarter that saw a continuation of trends from late 2020 toward more cyclical and value-oriented areas of markets. While the U.S. benefited from a widespread COVID-19 vaccine rollout, other regions — primarily Continental Europe and most emerging markets — have fallen behind in vaccine distribution. This will push back an economic reopening and has weighed on stocks. The benchmark MSCI EAFE Index rose 3.5% in the first quarter while the MSCI Emerging Markets Index added 2.3%. Small caps once again outperformed larger stocks with the MSCI EAFE Small Cap Index adding 4.5%. International value stocks outperformed growth stocks significantly, with the MSCI EAFE Value Index rising 7.4% compared to -0.6% for the MSCI EAFE Growth Index (Exhibit 1).

Exhibit 1: MSCI Growth vs. Value Performance



Source: FactSet.

Aggressive U.S. stimulus policies caused the bond markets to react with a meaningful rise in 10-year Treasury yields. Global markets followed with a significant rotation into economic recovery plays. This rapid steepening of the yield curve greatly impacted growth stocks as the risk-free cost of capital increased. This was especially painful for stocks whose value is more back-end loaded, specifically the Strategy's emerging growth bucket, which did extraordinarily well last year as rates were slashed to cope with the pandemic. Beginning in the fourth quarter and continuing into the new year, we took profits in some of our biggest winners (SolarEdge Technologies, Shopify, Spotify). This was not enough, however, to neutralize the sharp moves of the first quarter, causing the International Growth ADR Strategy to underperform the benchmark.

Growth stock performance was weak due to a combination of broad profit taking by investors and the market's optimism about a recovery from the pandemic. Areas that had been hard hit in 2020 recovered including energy (+10.6% for the quarter), financials (+9.7%), industrials (+5.4%), materials (+5.2%), and cyclicals in every area. Information technology (IT, +2.4%) underperformed and our emerging growth names underperformed the overall sector.

Many areas that moved upwards, like energy, steel and auto companies, are not areas where we see sustainable long-term growth. We reoriented the portfolio for a more cyclical market in the fourth quarter and saw good performance in these areas from structural growth companies like Atlas Copco and Canadian Pacific Railway, which we repurchased during the quarter. Canadian Pacific pared gains after announcing the acquisition of

Kansas City Southern that will create the first rail operator connecting the U.S., Mexico and Canada.

We have always been clear about when we expect the Strategy to underperform. In sharp, narrow market moves, the index will always have the exact amount of whatever is moving; we may or may not. The first quarter was exactly the type of market where we would expect to face headwinds. However, the extent of that underperformance was more than we anticipated. We believe roughly 60% of the underperformance vis-à-vis our core benchmark was market related, while a few of our larger positions, including London Stock Exchange and TeamViewer, underperformed due to stock-specific news. We believe the pullback in these stocks has been overdone and they will be good future performers.

Digitalization is continuing apace outside the U.S., which should create a steady demand for growth stocks.

Portfolio Positioning

We have observed that new additions to the portfolio often do not take off right after purchase. We make investments in companies where we believe the market hasn't properly appreciated their future long-term performance, meaning they usually take a quarter or two for our thesis to play out. Results for recently purchased stocks are in line with this trend. This quarter, we increased our cyclical exposure with companies we expect to benefit as the reopening expands across Asia, Europe and emerging markets. These include CRH, a diversified global building materials business with leading positions in aggregates, cement and concrete materials/products. The Ireland-based company is increasing its focus toward higher-margin business in developed markets and should benefit from infrastructure spending in the U.S. and Europe. We believe the market underestimates steady M&A additions to the business.

Compass Group is the largest global contract caterer, serving corporate dining cafeterias, sports/leisure food service and education facilities. Its business was severely impacted by the COVID-19 lockdowns, but we believe margins have troughed while customer retention rates remain high. A return to pre-pandemic levels is likely even prior to a full global recovery due to adaptations Compass made to its business model in the downturn that increased flexibility and should lead to durable cost savings.

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. The Strategy has purposely underweight banks versus the benchmark due to mediocre growth prospects in a low-rate environment, favoring financials exposure in areas like exchanges, insurance and digital payments. We sold out of Erste Bank, our last traditional bank holding, during the quarter. The pandemic has increased the need for larger loan loss provisions and regulators are changing dividend payouts for the banking sector in Europe. Erste 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.

While we maintain high conviction in many of the emerging and secular growth names in the portfolio, despite the short-term headwinds created by the current reflationary environment, our commitment to risk management caused us to exit several positions during the quarter. We sold our stake in Swiss pharmaceutical maker Novartis in favor of adding to Alcon, a Swiss maker of medical devices for eye care.

Among materials names in our structural bucket, we sold SQM as the stock hit our price target. Lithium prices remain at levels well below previous highs and while we expect they may reach higher levels in the future; high pricing likely encourages additional supply onto the market. We redeployed these funds into other names in materials, primarily CRH. Umicore was also sold on stronger performance, driven by precious metals that boosted the results of its recycling division as well as continued growth in the electric vehicle market.

The extremely strong performance of emerging growth companies in 2020 meant our weight in this area had gotten ahead of where we were comfortable and we trimmed a number of names, including Adyen and Shopify.

Outlook

We are not certain when a cyclical recovery will take hold in Europe, Asia and emerging markets, but equity markets are already anticipating it. While value continues to maintain an advantage over growth, interest rates drive the length of value rallies and we do not see rates going up meaningfully to maintain that momentum. The traditional value sectors of autos, banks and energy may work in the short term, but all are facing disruptive forces. Traditional banks are highly dependent on rates and are being disintermediated by fintech companies taking away their profitable businesses. We have been out of traditional fossil fuel energy for two years and, with the global climate change push, we do not see them as compatible with growth investing. Instead, we continue to add to our renewables exposure through names like EDP. And in autos, we are excited about electric vehicles but would rather own suppliers and semiconductor companies than the capital-intensive OEMs that are still juggling three engine formats.

The long-term dynamics for growth companies outside the U.S. are compelling for several reasons. Valuations are generally more attractive and investment markets are less efficient. Growth as an investment strategy is also still relatively new overseas and thus represents good potential for expansion. Finally, digitalization is continuing apace outside the U.S., with economies like Japan still early in its adoption of digital technologies. This should create a long runway for growth and steady demand for growth stocks.

Portfolio Highlights

The ClearBridge International Growth ADR Strategy underperformed the benchmark MSCI EAFE Index for the first quarter. The Strategy sustained losses across seven of the nine sectors in which it was invested (out of 11 total), with the IT and financials sectors the primary detractors.

On a relative basis, overall stock selection detracted the most from performance. In particular, stock selection in the financials, IT, consumer discretionary and communication sectors had the greatest negative impact on results, with weakness in software and IT services and a lack of exposure to banks contributing to the underperformance. An overweight to IT and a lack of exposure to the energy sector also proved detrimental. On the positive side, stock selection in the materials sector and an underweight to health care were the primary contributors to performance.

On a regional basis, stock selection in Europe Ex-U.K., North America and the United Kingdom and an overweight to emerging markets hurt results, while stock selection in emerging markets and an overweight to North America aided performance.

On an individual stock basis, the largest contributors to absolute returns in the quarter included ASML, Tokyo Electron, Taiwan Semiconductor, Atlas Copco, and Umicore. Semiconductor shortages, caused by a combination of years of capacity reductions, COVID-19 lockdowns and better than expected rebounds in industries like autos, will cause short-term revenue pressure but are allowing companies to exert pricing power as they race to replenish depleted inventories. Taiwan Semiconductor, the world's largest foundry, as well as semiconductor capital equipment makers ASML, the leader in semi cap equipment for high-end chips, and Tokyo Electron, are thriving in this constrained environment. The greatest detractors from absolute returns included positions in London Stock Exchange, StoneCo, TeamViewer, Elastic and Nintendo.

In addition to the transactions mentioned above, we sold Kao in the consumer staples sector.