ClearBridge Investments

International Value Strategy

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"We can be blind to the obvious, and we are also blind to our blindness."

-Daniel Kahneman

Key Takeaways

- We believe investors focused on current data points are missing or misreading a number of key trends and developments supportive of value stocks, such as monetary and fiscal policy shifts and the capacity for significant interest rate increases.
- The most robust value cycles occur when the value factor aligns with the strongest absolute and relative earnings growth. This has been a key driver of the rebound in value shares since the lows of last March.
- The correction in reflation beneficiaries provided the opportunity to add to high-conviction holdings and retain our pro-cyclical stance with overweights to industrials, materials, energy and financials.

Investors Seeing the Forest for the Trees

In the famous "Invisible Gorilla" experiment, Daniel Simons and Christopher Chabris had people focus on a task: counting the number of passes in a basketball game, while a person in a gorilla costume walked across the court pounding their chest. The test subjects were so consumed by the counting exercise that when asked, only half of them noticed the gorilla. About 50 years earlier, demographic experts were predicting little growth in the U.S. population from 1948 to the year 2000. Despite the evidence that was probably crawling under their feet, they did not see the entire baby boom and missed over 120 million Americans. Resonating for us from these examples is how critical it is to focus less upon what is drawing our attention and more on what is obvious that we might be missing. This includes noticing both details (the gorilla) and the big picture (the baby boom) that are obscured by distractions or our own historical biases.

During the second quarter, investors were focused on the "great inflation debate," counting COVID-19 cases and variants and "peak" recovery evidence along with an abundance of other distracting absurdities. We believe this is leading to missing or misreading a number of key trends and developments.

U.S. market leadership appears likely to finally give up ground to the global laggards as economic growth becomes broader.

From a broad, macro standpoint the landscape is profoundly changing. What is popularly known as "the Fed put" has shifted from protecting and inflating the value of financial assets to directly stimulating the real economy. Central banks are committed to increasing real goods prices and wages, and generating strong nominal GDP growth. This is aligned with massive fiscal stimulus that aims to boost activity as a means of reducing inequality and addressing urgent environmental needs. Given these policies and the requirement to debase away a large public debt burden, the current debate about whether inflation is transient or sustained is moot. Any sign that inflation or growth is faltering will be met with aggressive easing. In short, the new Fed put means markets are more likely to experience overheating worries than growth scares.

In contrast, current bond rates indicate monetary and fiscal policies will fail with the global economy, returning to stagnation and well below-trend growth. After the sharpest 12-month rise in history, from 0.51% in March of 2020 to 1.75% a year later, yields on the 10-year U.S. Treasury have fallen back under 1.3%. Sluggish loan growth and low monetary velocity are cited as signs that inflation and the recovery are faltering, which is also confirmed by a flattening yield curve. But this conclusion ignores significant differences compared to the 2009 global financial crisis (GFC) experience. During the GFC recession, non-financial company deposits fell by $255 billion. In the COVID downturn, firms' deposit balances rose by over $1 trillion. Europe embarked on a program of reducing leverage in the banking system and fiscal austerity after the GFC bust but is now rapidly increasing fiscal stimulus. China's expansionary policies between 2009 and 2011 aided global growth but also encouraged a massive supply response from the energy, industrial and basic material producers. Now, commodity companies are limiting capital spending and capacity expansion in favor of improving cash returns to shareholders.

Spending and Growth Could Neutralize Rising Rates

Another idea obscured by the investor focus on durability of current price gains is that interest rates could rise significantly without an increase in inflation. Real interest rates are back to the lowest levels since the 1970s at around negative 2%. The longer-term average is roughly positive 2%. Therefore, if nominal economic growth remains healthy due to abundant global liquidity, the tendency will be for real rates to normalize and the yield curve to steepen even if inflation remains well contained. Additionally, interest rates could rise even in the face of moderating growth in the money supply if velocity begins to improve. As the global economy more fully reopens over the next year, fiscal spending begins, record low inventories are rebuilt,

capital spending improves, and consumers utilize some of their record savings it would not be surprising to see money multiply.

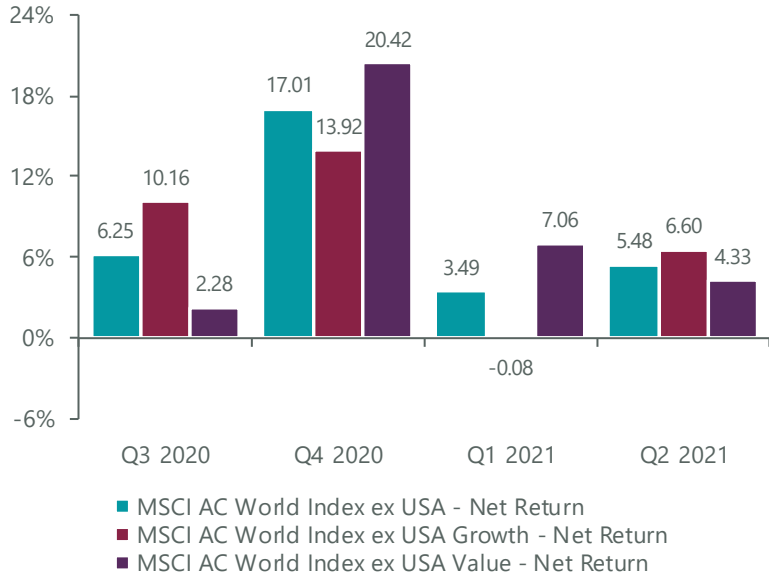
In addition to significant domestic spending, the nations of the West have announced a program of "orange barrel diplomacy" to rival China's Belt and Road initiative. Called 'Build Back Better World', this European-led grant and loan facility is designed to help developing nations with crucial infrastructure that improves growth and environmental sustainability. This will serve to increase demand for basic materials such as cement, copper, aluminum and steel. Industrial, engineering, shipping and construction firms should also benefit from the largest infrastructure investment boom since the post WWII reconstruction period.

Market Overview

We consider these to be distractions amidst a healthy rise in international equity prices. The benchmark MSCI ACWI Ex-U.S. Index rose 5.5% in the second quarter, with the developed market MSCI EAFE Index up 5.2% and the MSCI Emerging Markets Index ahead by 5.1%. European equities (+7.9%) outperformed, with solid returns in Denmark, Finland, Austria, France and Switzerland. Concerns about the spread of new variants and associated lockdowns caused a correction in more cyclically dependent countries in June. As a result, Germany, Italy, Spain, Norway and Portugal underperformed for the full quarter. An increase in COVID cases in previously spared Asian countries contributed to poor overall performance in the region, with Japan (-0.3%) and Asia Ex-Japan (+4.42) underperforming the benchmark. Markets in China (+2.3%) and Hong Kong also performed poorly as investors worried about policy tightening and a regulatory crackdown on leading technology firms. In emerging markets, strong gains in Latin America and Europe were offset by weakness in Asia.

From a sector standpoint, the bond market rally favored a blend of defensive and growth-oriented industries. Technology hardware and software stocks rebounded strongly. Health care and media companies also outperformed. Energy was the lone cyclical sector with better than index returns as oil prices continued to rebound on supply tightness. Peak growth and policy tightening concerns also rose, leading to underperformance of the industrials and financials sectors.

Exhibit 1: MSCI Growth vs. Value Performance



Source: FactSet.

Price and earnings momentum factors delivered the best performance for the quarter. Quality and low volatility also did quite well. Traditional value metrics such as price/book and price/earnings lagged by as much as 600 basis points depending on benchmark and region, with the MSCI ACWI Ex-U.S. Value Index trailing its growth equivalent by 230 bps (Exhibit 1). Smaller company shares tended to underperform. Emerging markets experienced an unusual contrast with this environment with both value and small capitalization factors leading.

Earnings Growth Still Favors Value Stocks

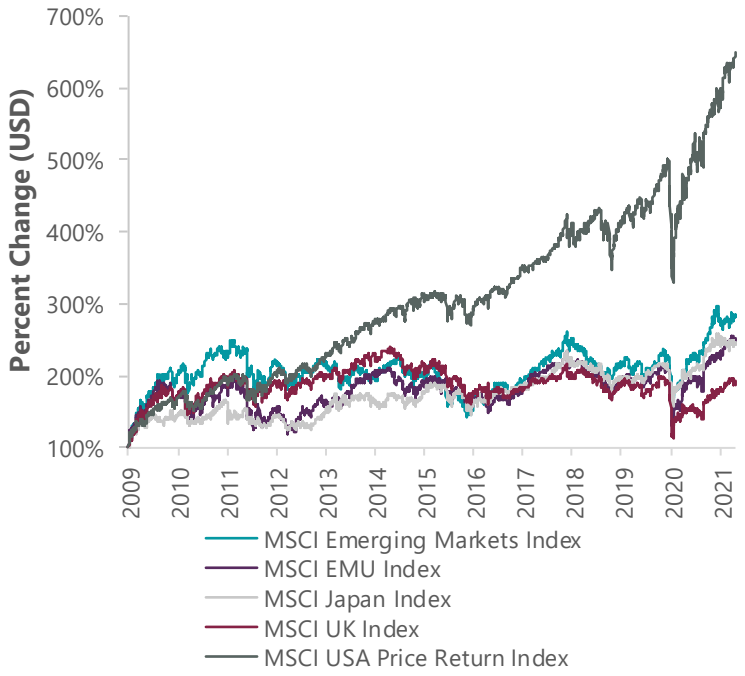
Valuation is an important consideration when making an investment as it takes into account the difficulty of forecasting the future and also determines the level of participation in a business's economics. Ideally, the benefit of a low valuation is that long-term growth potential is heavily discounted, allowing for significant exposure to revenues, earnings and free cash flows for every dollar of investment. However, this can remain unrewarded unless the company can grow these fundamental metrics more quickly or for longer than expected. Consequently, the most robust value cycles occur when this factor aligns with the strongest absolute and relative earnings growth. This has been a key driver of the rebound in value shares since the lows of March 2020.

Based upon relative earnings, profit growth, forecast revisions, earnings surprise and marginal returns on capital, the most undervalued sectors such as financials, materials, energy and industrials have been registering the strongest gains. We believe

the durability of these trends remain underappreciated by the market given the continued low relative valuations and generally pessimistic long-term growth estimates. For example, shipping companies began the year with analysts forecasting profits to fall by 50% to 80% over the next two years. As new capacity additions are at record low levels while demand recovers, daily rates are remaining elevated, allowing the companies to lock in attractive earnings and free cash flows. This has led to a near doubling of expected profits for this year and next with potential for the cycle to extend well into 2023, propelling portfolio holding Maersk to strong gains that made it the leading contributor in the quarter. In contrast, sectors where trillions in capital have been flowing and growth expectations are exponential have been experiencing little improvement in forward estimates as competition and comparisons become more challenging.

As the U.S. market rises to new highs it is hard to ignore the boom in profitless company IPOs, record blank check company offerings SPACS, unprecedented retail participation and extremes in investor positive sentiment and flows into equity funds. At the same time, the laggard regions of Europe, Asia and emerging markets are making structural changes to bolster growth, profitability and competitiveness. Clearly parts of the market are close enough to increase the odds of some meaningful and sustained correction in the relative performance and valuations versus non-U.S. equities. Indeed, the performance differential between domestic and international equities has rarely been wider (Exhibit 2).

Exhibit 2: U.S.-International Performance Variance Grows



Data as of June 30, 2021. Source: FactSet.

Portfolio Positioning

We continue to believe that the generational shift in the investment landscape from the March 2020 lows has yet to be fully reflected in relative valuations and performance. As a result, the correction in reflation beneficiaries in June provided us the opportunity to add to high-conviction holdings and upgrade the valuation, quality and potential growth of the overall portfolio. We retain our pro-cyclical stance with greater than benchmark exposure to industrials, materials, energy and financials.

During the quarter we took gains in select industrials, including Japanese heavy machinery manufacturer Komatsu, that had appreciated nearer to our target prices. We also added to both energy and consumer discretionary shares including a new position in Inpex, a leading Japanese oil and gas producer. Inpex is a deeply undervalued beneficiary of rising oil prices and the energy transition, priced at 7x earnings, half of book value and paying a 4% dividend. The company is also exposed to the structurally strong demand for "green" bridge fuels such as liquefied natural gas (LNG), hydrogen, clean ammonia, carbon neutral natural gas and carbon capture technologies. The company's free cash flow is powerful, and between now and 2025 is expected to equal the entire market value of the firm. Fears surrounding the Delta variant allowed us to add to Marston's, a well-positioned reopening beneficiary in the pub industry, as well as Melia Hotels. Among more defensive industries we see little value and growth potential outside of health care, where the downturn in activity related to the pandemic appears to be moderating.

Technology stocks generally remain expensive with extremely high earnings expectations, but we initiated a position in German enterprise software maker SAP. After years of underperformance and stagnating earnings, new management has fully embraced transitioning to the cloud and targeted a tripling of related revenues by 2025. Shifting clients to cloud-based services will eventually increase both growth and profitability, and deliver strong free cash flows. Such a strategy transformed the valuation of Microsoft, and we see it as a significant opportunity as this is not priced into the current valuation of SAP.

From a geographic standpoint, we have made few changes and still see the best combination of value and earnings growth in Europe and the U.K. Our screening process has begun to identify a greater number of undervalued companies in Asia and emerging markets, so we expect to increase our weightings in these countries at some point over the coming quarters. Overall, the powerful trends we have discussed in previous notes surrounding the commercialization and mass application of new technologies, infrastructure spending, decarbonization and wage gains helping consumers remain important drivers to our portfolio.

Investors have yet to recalibrate asset allocation around the new central bank policies and support for fiscal objectives. The old Fed put has shifted to a new global mandate to move inflation to the next stage and into the real economy. Companies are already benefiting from this transition as firms with operating leverage tied to the real economy are posting the best performance and earnings growth. This still is viewed like the Invisible Gorilla with most investors only seeing the opportunity to return to stagnation era winners. The U.S. market leadership appears likely to finally give up some ground to the global laggards as economic growth becomes broader and more inclusive.

Portfolio Highlights

The ClearBridge International Value Strategy underperformed its MSCI All Country World Ex-U.S. Index benchmark during the second quarter. On an absolute basis, the Strategy had gains across six of the 10 sectors in which it was invested (out of 11 sectors total). The industrials and materials sectors were the primary contributors to returns during the quarter while the information technology (IT) sector was the main detractor.

On a relative basis, overall stock selection and sector allocation detracted from performance. Specifically, stock selection in consumer discretionary, IT and energy and an underweight to the health care sector hurt results. On the positive side, stock selection in the industrials sector and an underweight to the communication services sector aided performance.

On a regional basis, stock selection in Europe Ex-U.K. and the U.K. were detrimental while an overweight to Europe Ex-U.K. and an underweight to Japan contributed to performance.

On an individual stock basis, A.P. Moller-Maersk, BBVA, Glencore, Richemont and Korea Investment Holdings were the leading contributors to absolute returns during the quarter. The largest detractors were Volkswagen, Komatsu, Barclays, Galaxy Entertainment, and Standard Chartered.

During the quarter, in addition to the transactions mentioned above, we initiated a position in GEA Group in the industrials sector. We also closed a position in Sony in the consumer discretionary sector.