International Growth EAFE Strategy

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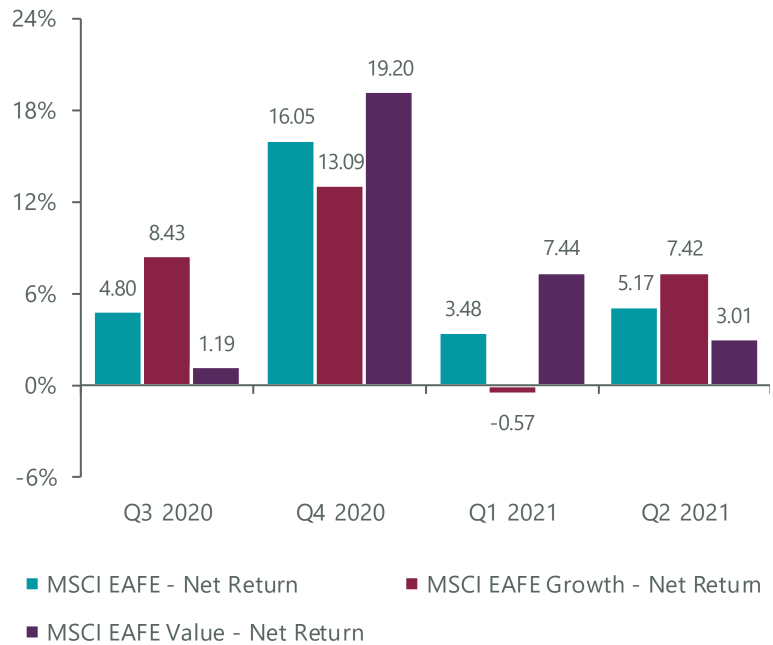
Key Takeaways

- Recent Strategy outperformance has been broad-based, led by more defensive, secular growth companies, with structural and emerging growth holdings also contributing.
- Banks and energy are two areas we have mostly avoided, but our valuation approach to growth helped identify two European banks and a global oil services provider in the quarter whose risk/reward were too attractive to overlook.
- International equity markets have seen rotating leadership due to various factors such as the likelihood of interest rate increases and differing monetary policies, moves creating short-term headwinds that should ultimately lead to attractive long-term performance for non-U.S. growth stocks.

Market Overview

Rotation among international equities continued in the second quarter, with growth stocks regaining momentum as bond yields stabilized, commodity prices corrected and investors took some profits in previously strong-performing cyclical and low-quality shares. The benchmark MSCI EAFE Index rose 5.2% in the second quarter while the MSCI Emerging Markets Index added 5.1%. Small caps in developed markets underperformed larger stocks with the MSCI EAFE Small Cap Index adding 4.3%. International growth stocks outperformed value stocks, with the MSCI EAFE Growth Index rising 7.4% compared to 3.0% for the MSCI EAFE Value Index (Exhibit 1). Value, however, remains ahead of growth year-to-date and over the trailing 12 months, boosted by record-setting fiscal and monetary stimulus packages and their impact on the global economy.

Exhibit 1: MSCI Growth vs. Value Performance



Source: FactSet.

Equities have endured quite a roller-coaster ride over the last 18 months. As pandemic lockdowns were put in place, outperformance was driven by defensive and compounding growth companies, while cyclicals and value stocks collapsed. At the bottom of the recession, amid high earnings uncertainty, growth stocks took over, especially what we would consider emerging growth and work-from-home beneficiaries. And finally, as positive news on COVID-19 vaccines emerged and a recovery began, leadership switched forcefully into value and cyclicals. On balance, this is not an unusual sequence of events during a recession, but the magnitude of these moves was both unusual and compressed. Thus, we need to look at this entire cycle to understand where we are today.

The ClearBridge International Growth EAFE Strategy had a very strong 2020, outperforming the benchmark despite these changing regimes, even keeping pace amid the first leg of the value rotation in the fourth quarter. The first quarter of 2021, however, was the most challenging part of this cycle from a performance standpoint. Bonds sold off, the yield curve steepened and long-duration assets suffered. In the meantime, low-quality value stocks such as deep cyclicals in the steel, mining and banking industries kept rallying while many of the high-quality stocks we favor were essentially flat. What we did not own led to underperformance for the quarter. This was not a surprise as such narrow value markets are exactly the type of environment where we would expect to struggle in the short term.

> A newer driver of global equity prices is record investor demand.

By the second quarter, bond yields stabilized and market performance clearly broadened, with quality and growth participating along with value. In this broader market, Strategy performance improved and enabled us to top the benchmark. We are encouraged that recent outperformance has been broad-based, with more defensive, secular growth companies leading, while structural and emerging growth holdings have also contributed.

The latest rotation was reflected in sector leadership flipping from the previous quarter, with growth and defensive areas such as health care (+9.3%), consumer staples (+8.4%) and information technology (IT, +8.2%) outperforming while cyclicals in the energy (+2.9%), financials (+3.2%) and industrials (+3.7%) sectors lagged. This dichotomy was most telling in Europe where top first-quarter performers like auto parts and travel & leisure gave way to retail, health care and food & beverage companies over the last three months.

Within the portfolio, secular growers Nestle, L'Oreal and Diageo were among the top contributors for the quarter. The latter two consumer companies, as well as luxury retailer LVMH, were lifted by strong retail spending in China, a market further along in its return to normalcy than most Western economies and one that has recovered without the same level of stimulus as the U.S., Europe and Japan.

Several of our emerging growth holdings also rebounded strongly after a sharp first-quarter selloff. These included Canadian e-commerce enablement platform Shopify, which continues to thrive from a secular shift to online purchases; Australian collaboration software maker Atlassian; and Elastic, a Dutch developer of software for searching and analyzing data. Each of these stocks, as well as several of our other emerging growth holdings like electronic payment providers Adyen and StoneCo, are key players in the secular trend of digital transformation occurring at varying levels of speed and success across global markets.

Portfolio Positioning

The outstanding performance of our emerging growth bucket in 2020 caused valuations to rise to uncomfortable levels, spurring us to take some profits and begin to reposition into more attractively priced structural and secular names. We are invigorated by the results from many of these new additions to the portfolio, which are benefiting from an improving business cycle as well as company-specific moves. Professional services firms Thomson Reuters and Teleperformance, as well as commercial aircraft maker Airbus, were solid performers. We also saw strong results from Givaudan, a Swiss maker of fragrances and food products. While our more manufacturing-oriented holdings like Atlas Copco and Sandvik lagged, we believe we are still early in the economic cycle for these types of businesses.

Banks and energy are two areas we have mostly avoided over the last several years but our valuation approach to growth helped us identify several companies in the second quarter whose risk/reward were too attractive to overlook. In banking, we initiated a position in BNP Paribas, the largest lender in Europe. We expect another earnings beat from the bank in the second quarter, mainly due to lower cost and provisioning levels. BNP is well-capitalized and could resume dividend payments in the fourth quarter. The likely granting of permission by the ECB for banks to reduce their capital should lead to further rerating of BNP and the entire sector. Intesa Sanpaolo, Italy's largest bank by assets, was another addition in the quarter and should benefit from a recovery in Southern Europe. Intesa and BNP should be boosted when EU fiscal spending plans are implemented and loan growth begins to accelerate. Both have strong enough fundamentals to withstand a likely push out of future interest rate increases.

Our sustainability orientation has led us to favor renewable energy providers such as EDP and SolarEdge over traditional fossil fuel energy companies. Renewables stocks moved up very strongly over the last several quarters on optimism about huge green stimulus plans in Europe and the U.S. so we took profits and sold Vestas and SolarEdge Technologies as valuations became demanding.

We returned to the energy sector with the purchase of services and equipment provider Schlumberger at what we view as a trough in capital spending among oil and gas exploration and production companies. As a technology leader, Schlumberger should generate strong free cash flow over the next few years as the industry recovers, using its excess cash to gain market share from smaller players and to expand into new areas of growth. Through its scale, presence, partnerships and technology, Schlumberger is targeting expansion into new large addressable markets such as carbon capture, hydrogen, geothermal and lithium extraction.

We have also been active in managing our growth exposure in the IT and Internet sectors. This has included selling music streaming service Spotify out of the emerging growth bucket and adding a new position in secular grower Samsung Electronics. Samsung's DRAM and NAND businesses are global market share leaders with the industry's most favorable cost structure. Margins and returns in the memory industry have structurally improved post-industry consolidation and the recent cyclical weakness has provided us a good entry point. Additionally, the South Korean company's smartphone business, the largest in the world, should benefit from market share gains and a strong 5G upgrade cycle.

The other major area of focus is understanding recent developments in China. We are closely monitoring the government's aggressive regulatory stance toward large technology companies, which pressured the recent IPO of rideshare company Didi and has weighed on portfolio holdings Tencent and Ping An Insurance, which we had trimmed earlier in the year. The Chinese recovery from COVID-19 has occurred with much lower levels of state support than in the West. So far, we have not seen negative impacts on Chinese consumer spending as retailers continue to use Tencent and Alibaba's e-commerce platforms. Zai Lab, the portfolio's other Chinese holding, was up significantly in the second quarter as it continues to find new best-in-class molecules for its growing portfolio of products for unmet medical needs in high demand and a key focus of the government in the world's second-largest economy.

Outlook

We believe the prospects for non-U.S. stocks are attractive with several major additional uplifts to come from further fiscal stimulus in the form of an EU Recovery Fund (that represents 2.7% of eurozone GDP) and additional stimulus from Japan that should help offset the risk of new COVID-19 variants impacting the pace of economic reopening. The market has been rotating due to various factors such as how investors feel about the likelihood of interest rate moves and monetary policy. Manufacturing readings in Europe have been very strong and spending is about to ramp up, yet the region continues to struggle with supply shortages and high raw materials prices. These headwinds will influence results in the short-term but should be beneficial to the Strategy's structural growth and some secular growth holdings over time.

Another driver of global equity prices is record investor demand. Nearly $1.2 trillion flowed into global equities in the first half of 2021, about 1.5x cumulative flows into the asset class over the last 20 years, according to Bank of America Global Research. Global debt allocations, meanwhile, are at their lowest levels in 20 years. This is on top of the historic levels of liquidity being injected into the global financial system by central banks and governments. We continue to believe much of these inflows will find their way into international growth stocks and have positioned the Strategy to optimize our participation in as many attractive opportunities across the growth buckets and sectors as possible.

Portfolio Highlights

During the second quarter, the ClearBridge International Growth EAFE Strategy outperformed its MSCI EAFE Index benchmark. The Strategy delivered gains across nine of the 10 sectors in which it was invested (out of 11 total), with the IT, consumer staples, consumer discretionary and health care sectors the primary contributors.

On a relative basis, overall stock selection and sector allocation contributed to performance. In particular, stock selection in the consumer staples, consumer discretionary, health care and materials sectors and an overweight to the IT sector had the greatest impacts on results. Conversely, stock selection in the IT sector was a marginal headwind to results.

On a regional basis, stock selection in North America, an overweight to emerging markets and an underweight to Japan aided results, while stock selection in emerging markets and an overweight to North America hurt performance.

On an individual stock basis, the largest contributors to absolute returns in the quarter included Nestle, Elastic, L'Oreal, Adidas and LVMH. The greatest detractors from absolute returns included positions in Ping An Insurance, TeamViewer, SolarEdge Technologies, BNP Paribas and MonotaRO.

In addition to the transactions mentioned above, we closed positions in Legrand in the industrials sector, Morphosys, Hansa Biopharma and Burning Rock Biotech in the health care sector and Victoria in the consumer discretionary sector.

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