ClearBridge Investments

International Growth ACWI ex-US 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

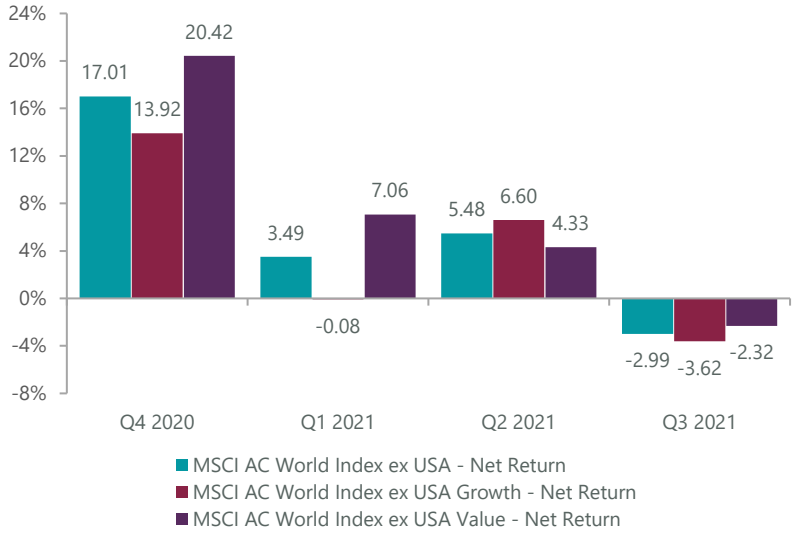
Key Takeaways

- The comeback for growth stocks over the last two quarters has been erratic, with volatility in yields and recovering economic activity providing a bid to more cyclical sectors like energy and financials. Emerging growth stocks remain the most vulnerable to yield spikes.
- The Strategy was held back by weakness among our emerging markets holdings. While we have sharply reduced our China exposure due to continued government interference and regulatory concerns, we continue to view markets like Brazil as a compelling source of innovation and growth.
- While recent performance has been disappointing, we are encouraged that the Strategy has held serve in Europe, our largest region of investment, and is seeing improving results in Asia Ex Japan.

Market Overview

International equities were mostly lower in the third quarter, pressured by inflation concerns, a backup in yields, continued regulatory actions in China as well as lingering effects and renewed shutdowns from outbreaks of the COVID-19 Delta variant. The benchmark MSCI All Country World Ex-U.S. Index fell 2.99% in the quarter while the MSCI Emerging Markets Index plunged 8.09%. Small caps in international markets held up better than larger stocks with the MSCI ACWI Ex-U.S. Small Cap Index advancing 0.09%. International value stocks held up better than growth stocks, with the MSCI ACWI Ex-U.S. Growth Index down 3.62% compared to a loss of 2.32% for the MSCI ACWI Ex-U.S. Value Index (Exhibit 1). Value also maintains a sizable advantage over growth year-to-date and over the trailing 12 months as record amounts of liquidity, aimed at stimulating a global recovery, continued to boost cyclical and low-quality areas of the market.

Exhibit 1: MSCI Growth vs Value Performance



Source: FactSet.

The comeback for growth stocks over the last two quarters has been erratic, with volatility in yields, recovering economic activity and demand for commodities causing investors to maintain some cyclical exposure. Sector performance for the third quarter illustrated this market diversity with energy (+6.70%) the best-performing sector in the benchmark while financials (+1.06%), industrials (+0.44%), information technology (IT, -0.95%), health care (-1.92%) and utilities (-1.92%) also outperformed. Meanwhile, the retail-oriented consumer discretionary (-11.48%) and communication services (-9.97%) sectors as well as materials (-5.54%) lagged due to supply chain and inflationary concerns.

The ClearBridge International Growth ACWI Ex-US Strategy trailed the benchmark during the third quarter, due to weakness among our emerging markets holdings as well as structural underweights to the cyclical energy and financials sectors We have mostly avoided owning traditional energy companies and instead focused on the renewables space. Within financials, we favor exposure to payment providers and exchanges as we do not see meaningful long-term growth drivers among traditional banks.

We are more constructive on emerging markets, which we see as a key area for innovations such as financial payments and e-commerce, which remain at very low penetration levels in both absolute and relative terms. However, we also recognize the higher levels of risk inherent in these markets as well, as new government policies have the potential to impact our investment thesis for specific countries, industries or companies. Such a situation is currently playing out in China.

Beijing's crackdown on several large tech companies and Chinese firms raising foreign capital has elevated our concerns about the country's pivot toward increased regulation and reduced overseas

China is fast becoming a market where we no longer have confidence in how capital will be allocated for shareholders.

reliance. Privately held companies are Beijing's main target and China is fast becoming a market where we no longer have confidence in how capital will be allocated for shareholders. Most global investors feel the same way as earnings and multiples for these stocks have derated. Political risk in the country has ramped up significantly, causing the cost of capital to rise commensurately. We have said we would move aside when the government starts reallocating capital, and we did so in the third quarter with the sale of our largest Chinese position, in Internet conglomerate Tencent, as well as national insurer Ping An Insurance.

Biotechnology company Zai Lab is now our only holding in China. The government wants to grow the domestic health care space as part of its social mission, so although Zai is not a big position, we still believe it is a growth story with immense optionality. The stock was hurt in the quarter by negative sentiment spreading into more areas of the Chinese market. China remains a significant demand source for large global companies and we continue to maintain exposure to its consumer spending through holdings Shiseido, L'Oreal, LVMH and Burberry.

Brazil is another emerging markets focus for the Strategy and here we were hurt by payments company StoneCo. The stock sold off primarily due to surprise write-downs in its lending business, which began in the first quarter and continued into the second and have weighed on earnings. Lending is a relatively new business for StoneCo but was expected to be a substantial growth driver. Non-performing loans increased in the first quarter largely at merchants heavily impacted by COVID-19 lockdowns. Technical issues have caused delays in the government's launch of a nationwide receivable marketplace, compounding the negative impacts on new business profitability. Stone, in turn, has halted lending until that marketplace opens. We believe the worst of the write-downs are behind us and core company fundamentals remain solid.

Despite the near-term weakness in StoneCo, we remain bullish on the fintech space as the preferred way to participate in the financial sector over traditional banks. This worked against us in a rising-rate period that supported the share prices of most banks and insurance companies. Our fintech holdings, which also include Dutch merchant payments provider Adyen and French travel- and leisure-focused payment platform Worldline, fall into the emerging growth bucket of companies with disruptive business models, higher growth rates and large potential market opportunities. We continue to see great promise in these companies as more consumers and companies across the globe embrace digitalization.

The other major headwind to relative performance in the quarter was Canadian Pacific Railway. The stock has been a strong

performer for the Strategy but negative sentiment around its bidding war for U.S. rail operator Kansas City Southern has weighed on the stock since late May. As a result, the cyclical uptick we expected from the company has been masked by the takeover. Indeed, we have been frustrated by the muted performance among Canadian Pacific and other recently added positions in our structural bucket of growth companies with more cyclical business models or that are undergoing a restructuring that should lead to a step change improvement in earnings. As more regions reopen from COVID-19 and spending rebounds, we expect better performance from our structural names, including Airbus and hospitality and food service provider Compass.

Portfolio Positioning

In addition to our exits from China, we closed out of two other positions in Asia. We sold Japan's Nintendo following a weaker than expected start to its fiscal year. We have owned Nintendo for several years, but growth rates have come down recently as the company enters the latter innings of the Nintendo Switch console cycle. The slowdown has been compounded by tough year-over-year comps against the very successful software title launch of Animal Crossings in 2020. We also believe supply chain chip constraints create some risk that the company will not be able to deliver on its fiscal year Switch unit estimates, which would weigh on profits and the earnings multiple for the stock. We closed a smaller position in Japan's Nihon M&A to fund ideas elsewhere in the portfolio, including additions to Japanese global staffing conglomerate Recruit Holdings.

In the IT sector, we added to our exposure during the quarter with the purchase of NICE, an Israeli-based enterprise software company and leader in the cloud-based contact center as a service market. NICE is a very profitable, reasonably priced stock with underappreciated cloud assets. Its omnichannel customer contact center software is considered best-in-class and we expect sustained high growth rates in this business as customer service contact centers are still in the early innings of cloud migrations. Cloud adoption has increased in priority for enterprises post COVID-19, given the need for better customer engagement across phone, text, social media and websites.

Also in IT, we took advantage of depressed earnings and a trough in the global capex cycle to repurchase a position in Keyence, a best-in-class Japanese provider of sensors for industrial applications. Keyence achieves both rapid growth and high operating margins (50%) by way of a unique business model and culture. Keyence's vision sensor solutions enjoy strong pricing power within its core machine vision business, which enables computers to see and collect information and benefits from a rapidly evolving industry at the acceleration stage of the S-curve.

As a leader in the space, Keyence should grow above the industry rate while generating very high returns on capital due to its asset-light business model and international expansion plans, in our view.

Outlook

While this quarter's performance has been disappointing, we are encouraged that the Strategy has held serve in Europe, our largest region of investment, and is seeing improving results in Asia Ex Japan. Like China, Japan is a country in flux; Japanese markets experienced heightened volatility in the third quarter due to a change in prime minister and mixed reactions to the Tokyo Olympics. Value stocks remain very much a focus of market attention, with the best performance in areas such as energy and financials, segments we are notably underweight.

International markets are facing many of the same uncertainties as the U.S. with inflation flaring in Europe and the U.K. while these regions struggle with labor shortages as populations slowly return to work. The employment situation is especially acute in the U.K. where Brexit is limiting the ability of employers to import as much labor as they did before the country split with the European Union. Commodity and price inflation are also working its way through global supply chains, increasing the importance of pricing power among our portfolio companies. We are confident in what we own, with companies like food delivery firm Just Eat Takeaway paying its drivers well and providing health care benefits.

As we enter earnings season, meeting forecasts will be made tougher by supply chain issues from shipping to manufacturing and production. Despite this backdrop, we are in a market of high expectations where investors continue to punish companies that do not beat their numbers. We expect to see balanced performance from the portfolio during earnings season supported by companies that are coming out of COVID-19, like medical device maker Alcon, contract research organization ICON, Compass Group, Amadeus and others.

Portfolio Highlights

During the third quarter, the ClearBridge International Growth ACWI Ex-US Strategy underperformed its MSCI ACWI Ex-U.S. Index benchmark. The Strategy delivered gains across two of the 10 sectors in which it was invested (out of 11 total), with the health care sector the primary contributor, while the consumer discretionary, IT communication services and consumer staples sectors were the largest detractors.

On a relative basis, overall sector allocation contributed to performance but was offset by negative stock selection effects. In

particular, stock selection in the financials, IT and energy sectors as well as underweights to energy and financials weighed the most on results. On the positive side, stock selection in the consumer discretionary sector and overweights to the IT and industrials sectors contributed to performance.

On a regional basis, stock selection in emerging markets hurt performance while stock selection in Asia Ex Japan and an underweight to emerging markets aided performance.

On an individual stock basis, the largest contributors to absolute returns in the quarter included Atlassian, Recruit Holdings, Icon, Hoya and Alcon. The greatest detractors from absolute returns included positions in StoneCo, Zai Lab, Tencent, Samsung and Canadian Pacific Railway.

In addition to the transactions mentioned above, we initiated a position in Naver in the communication services sector and closed positions in TeamViewer in the IT sector, Dr. Martens in the consumer discretionary sector and Vinci Partners in the financials sector.

Past performance is no guarantee of future results. Copyright © 2021 ClearBridge Investments.
All opinions and data included in this commentary are as of the publication date and are subject to change. The opinions and views expressed herein are of the portfolio management team named above and may differ from other managers, or the firm as a whole, and are not intended to be a forecast of future events, a guarantee of future results or investment advice. This information should not be used as the sole basis to make any investment decision. The statistics have been obtained from sources believed to be reliable, but the accuracy and completeness of this information cannot be guaranteed.

Performance source: Internal. Benchmark source: Morgan Stanley Capital International. Neither ClearBridge Investments, LLC nor its information providers are responsible for any damages or losses arising from any use of this information. Performance is preliminary and subject to change. Neither MSCI nor any other party involved in or related to compiling, computing or creating the MSCI data makes any express or implied warranties or representations with respect to such data (or the results to be obtained by the use thereof), and all such parties hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability or fitness for a particular purpose with respect to any of such data. Without limiting any of the foregoing, in no event shall MSCI, any of its affiliates or any third party involved in or related to compiling, computing or creating the data have any liability for any direct, indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages. No further distribution or dissemination of the MSCI data is permitted without MSCI's express written consent. Further distribution is prohibited.