ClearBridge Investments

International Growth EAFE Strategy

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Key Takeaways

- A crisis-driven rotation out of banks and more cyclically-exposed value stocks, as well as the potential for a pause or even reversal in central bank tightening, lifted IT and similar growth companies during the quarter.
- The growth rebound, coupled with an underweight to financials and solid contributions from retail holdings, led to Strategy outperformance.
- We increased the portfolio's secular growth exposure with the addition of three new positions in the IT, consumer discretionary and communication services sectors and are constructive on our positioning should regional economies weaken.

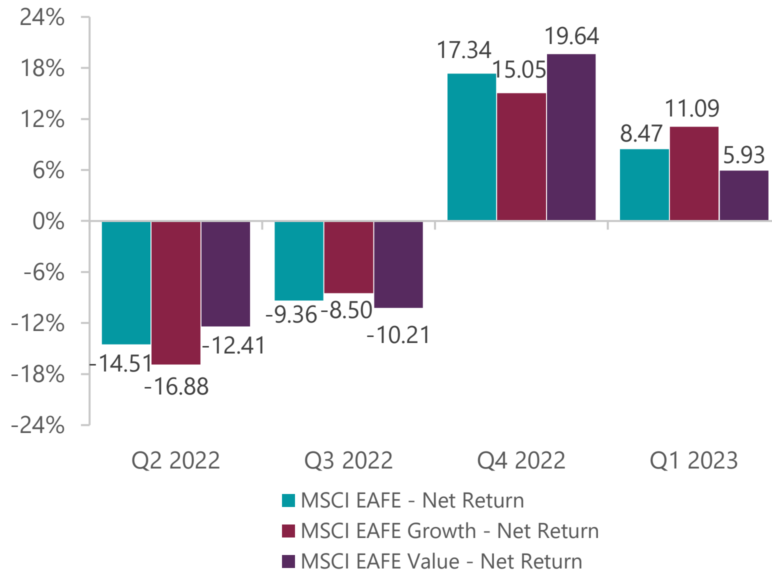
Market Overview

International equities exhibited resilience in the first quarter, looking past potential bank contagion and stubborn inflation to extend gains. The benchmark MSCI EAFE Index advanced 8.47% for the quarter while the MSCI Emerging Markets Index added 3.96%. Small caps trailed larger companies with the MSCI EAFE Small Cap Index ahead by 4.92% in the quarter.

After trailing for much of 2022, non-U.S. growth stocks earned a reprieve with the MSCI EAFE Growth Index gaining 11.09% for the quarter, outperforming the MSCI EAFE Value Index (+5.94%) by over 500 basis points. This was driven by a rotation out of banks and more cyclically-exposed value sectors such as energy, into information technology (IT) and similar growth companies deemed more insulated from potential risks to the financial system and potentially benefiting from a pause, or even reversal, in central bank tightening.

On a sector basis, the best performers in the quarter were IT (+19.56%), consumer discretionary (+17.21%), industrials (+11.72%) and communication services (+10.45%), four areas where the Strategy is well represented. Laggards included energy (+0.41%), financials (+2.72%) and health care (+5.37%). The materials (+7.59%), consumer staples (+7.58%) and utilities (+8.18%) sectors also underperformed the MSCI EAFE Index.

Exhibit 1: MSCI Growth vs. Value Performance



As of March 31, 2023. Source: FactSet.

More pronounced growth exposure enabled the ClearBridge International Growth EAFE Strategy to outperform in the quarter and pull ahead of the benchmark over the trailing 12 months. We attribute recent results to the Strategy being significantly less tilted towards financials than the index, ending the first quarter with a financials underweight of approximately 460 bps, and a bank underweight of approximately 700 bps.

The Banking Crisis

The Strategy has historically been underweight financials, and we had been in the process of reducing our exposure prior to the market dislocations caused by the closure of Silicon Valley Bank (SIVB) and Signature Bank in the U.S. and the forced sale of Credit Suisse to UBS. As we neared price targets in our European banks, French-based global bank BNP Paribas and Italian lender Intesa Sanpaolo, we began to trim positions. By the end of the quarter, we had reduced our position in BNP by over 50% and Intesa by more than 35%. The decisions were equal parts risk reduction and profit taking after the strong upward performance for each stock over the year leading up to the bank crisis.

The European banking sector trades at a P/E of just 6.1 for 2024 consensus earnings and is roughly half the multiple of the broader index. Our holdings are the respective champions of their countries and should be the recipients, rather than donors, of deposits. Regulators and central banks have a vested interest in these banks' stability and would support them with liquidity lines, if needed.

We have no exposure to Credit Suisse, whose investment bank has been in restructuring mode for years. Out of three businesses at Credit Suisse, we believe two are sound (their domestic bank and wealth management business) while the investment division has proven weak. In addition, the company's management turmoil, operational missteps and deposit outflows had been persistent headwinds for many years. The current crisis has likely just accelerated an inevitable restructuring/breakup. While we believe the forced takeover is not a perfect solution, it is the best that could be completed in a short period of time to allow the contagion risks from Credit Suisse to subside.

While we have significantly trimmed back our European bank exposure -- our only bank exposure -- we believe this market should experience less changes than the U.S. due to more stringent oversight in Europe, higher liquidity coverage ratios, substantial capital increases and uniform regulation across European banks of all sizes. While deposit costs for European banks will nevertheless increase, negatively impacting earnings over the next several quarters, we maintain that the industry is better positioned fundamentally than in the U.S.

The most significant part of our financial exposure is in stock exchanges, including London Stock Exchange Group, Deutsche Boerse and Hong Kong Exchanges & Clearing. The first two outperformed for the quarter and the group should see little impact from the SIVB closure and Credit Suisse takeover. Higher volatility, common in times of bank sector stress, is a positive for many aspects of their operations.

Beyond financials, relative performance was driven by our consumer discretionary holdings, mostly focused on the luxury market. French fashion and spirits holding company LVMH was the leading contributor for the quarter. This is a secular grower and long-time portfolio holding, with a diverse business mix that can work at different points in the cycle. The shares have been boosted by strong operating results, positive reception to its latest Dior line as well as optimism around the reopening of the Chinese luxury market. Mid-priced Spanish retailer Inditex, which operates the Zara brand and others, was also a solid contributor with good full-year numbers announced during the quarter.

Portfolio Positioning

We added a new holding in Kering which, like LVMH, is a French owner of luxury brands headlined by Gucci and Saint Laurent. To make room for Kering, we exited a position in British fashion retailer Burberry at what we viewed as a full valuation. Both of these stocks are going through turnarounds with new creative teams but Kering is priced at a meaningful discount. Within luxury, scaled players like Kering and LVMH enjoy significant advantages over smaller companies that might only have single brands – players with scale possess the best real estate, creative/merchandising/management talent and control over distribution.

Another significant addition during the quarter included secular grower SAP in the IT sector. We believe the German software maker is well-positioned as we are at the early innings of a mega enterprise resource planning (ERP) upgrade cycle to the cloud, which will last multiple years and return the company to sustainable, double-digit growth. SAP should benefit from more recurring revenues from cloud-based subscriptions as well as a broad range of solutions across the enterprise including human resources, customer relationship and spend management.

Compelling valuations and increasing optimism about China's reopening motivated the repurchase of Tencent, a Chinese Internet and social media conglomerate, whose shares had fallen sharply since we sold it in 2021. The company's earnings estimates suffered due to a weak Chinese economy shut down by COVID restrictions and many clients curtailing spending due to increased government regulation, which negatively impacted Tencent game approvals. We now believe estimates have bottomed and should start moving higher as the economy reopens, with advertising spending coming back on Tencent's social media and other media assets and corporations restarting spending on cloud services. In addition, regulators are likely to restart approval of new Tencent games within the limits on kids play time.

Outlook

As we come out of a mild winter, Europe and the United Kingdom have withstood energy shortages but continue to battle stubbornly high inflation. Yields have risen to competitive levels as the ECB and Bank of England have followed the U.S. Fed in tightening financial conditions. While we are watching inflation prints and earnings reports carefully, we continue to favor the region as it is home to many high-quality businesses that meet the characteristics we look for in secular and structural growth companies. We are also very selectively returning to emerging growth companies, repurchasing a small position in Canadian e-commerce enabler Shopify, as valuations have reset after the pandemic boom in 2020 and 2021 and growth selloff last year.

We will continue to follow our process and upgrade the portfolio The Bank of Japan has a new governor, so we will monitor his comments to determine the direction of monetary policy and whether Japan will remove its very easy stance. Sudden moves towards higher rates in Japan could impede a very slow recovery from the COVID lockdowns last year. China's recovery post their zero-COVID lockdowns has been slow. Several of President Xi's key lieutenants in China have a technology background, which offers us some optimism after the very negative attitude toward technology leaders last year. Global politics remain challenging for non-Chinese investors to re-engage as they have previously. Our positioning in China is moderate and concentrated in stocks that should advance off very low levels of last year, regardless of global politics.

The past few years have been challenging to long-term investors as style cycles have vacillated meaningfully. Both growth and international stocks were very out of favor post the Russian invasion of Ukraine in February 2022, while international value stocks reached record highs against growth stocks. Today, money supply around the world is tightening meaningfully from historically high levels, interest rates are moving up and the cost of capital is increasing. We have been watching these moves and are constructive on our current positioning. We maintain high-conviction exposures in growth companies which not only generate abundant free cash flow but who also have healthy cash balances and low debt levels. We have been trimming and selling more cyclically-oriented positions. Over the next few quarters, we will see if the impact on economies from higher rates introduced over a year ago begins to take hold. Should weakness emerge in international markets, the Strategy has a sound foundation to withstand it.

Portfolio Highlights

During the first quarter, the ClearBridge International Growth EAFE Strategy outperformed its MSCI EAFE Index benchmark. On an absolute basis, the Strategy saw gains across nine of the 10 sectors in which it was invested (out of 11 total) with the consumer discretionary and IT sectors as the leading contributors.

On a relative basis, overall sector allocation effects and stock selection contributed to performance. In particular, stock selection in the financials, health care, consumer discretionary and communication services sectors, an overweight to IT and underweights to financials and energy drove results. Conversely, stock selection in the industrials, consumer staples and IT sectors weighed on performance.

On a regional basis, stock selection in Europe Ex U.K., North America, the U.K. and Japan and an underweight to Asia Ex Japan contributed to performance while an overweight to North America and stock selection in Asia Ex Japan detracted.

On an individual stock basis, the largest contributors to absolute returns in the quarter included LVMH in the consumer discretionary sector, Novo Nordisk in the health care sector, Keyence and ASML in the IT sector and Deutsche Telekom in the communication services sector. The greatest detractors from absolute returns included positions in Recruit and Computershare in the industrials sector, AIA Group in the financials sector, Roche in the health care sector and Shiseido in the consumer staples sector.

In addition to the transactions mentioned above, we initiated a position in Safran in the industrials sector. We also closed seven positions. We sold Aflac in the financials sector to keep our financial position smaller post the market dislocation, Adidas in the consumer discretionary sector after the new CEO joined and prior to his resetting of earnings as well as Dassault Systemes and Elastic in the IT sector in favor of SAP. We exited Ashtead in the industrials sector after it reached our price target and sold Barrick Gold in the materials sector after the thesis had played out for this structural growth holding.