



International Growth ADR Strategy



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Key Takeaways

- ▶ International equities continued to see less of a lift from generative AI compared to their U.S. counterparts, which created performance headwinds as well as opportunities to enhance our technology exposure.
- ▶ The Strategy lagged slightly in a challenging quarter for growth stocks but was supported by our diversified health care exposure.
- ▶ Market downdrafts often present buying opportunities where market risk perceptions differ from our own. We see banks as such an area and took advantage of price weakness to add two names, highlighting an active period of repositioning.

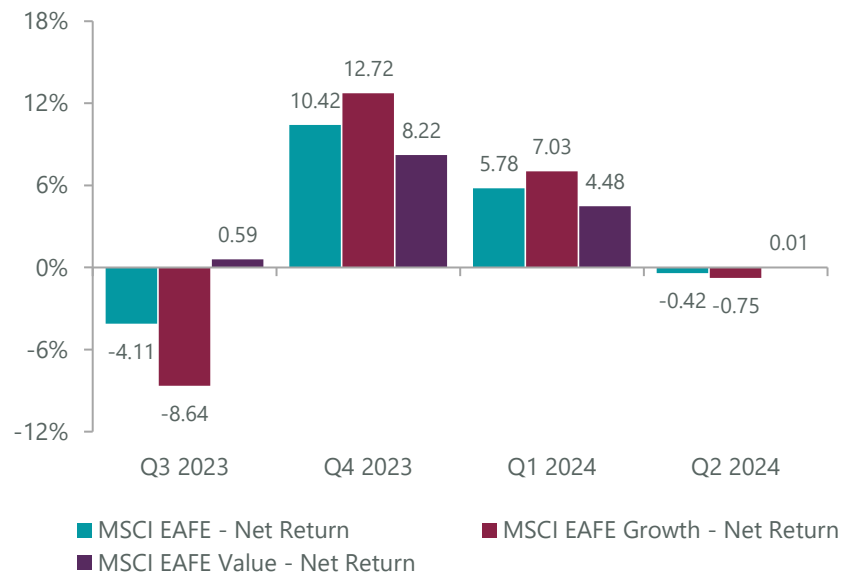
Market Overview

International equities delivered mixed results in the second quarter, supported by initial interest rate cuts in the European Union and Canada that partially offset lingering concerns about inflation and economic growth in those regions. The benchmark MSCI EAFE Index declined 0.42% and the MSCI EAFE Small Cap Index fell 1.85%, while the MSCI Emerging Markets Index added 5.00%.

From a regional standpoint, the U.K. and Asia Ex Japan delivered gains and outperformed the index, Europe Ex U.K. generally performed in line while Japan suffered significant losses for the quarter as the yen continued to fall and shorter-term investors took significant profits early in the quarter. Unexpected snap elections called in France significantly impacted that market in June, dragging down one of the more significant economies in Europe.

International growth stocks declined and trailed value stocks as bond yields rose in most regions. Most of the style divergence occurred in April following a string of hotter than expected inflation prints in the U.S., which sparked a sharp rise in yields that caused longer-duration growth assets to sell off. The MSCI EAFE Growth Index fell 0.75%, underperforming the MSCI EAFE Value Index by 76 bps. Year to date, growth maintains a 173 bps advantage over value.

Exhibit 1: MSCI Growth vs. Value Performance



As of June 30, 2024. Source: FactSet.

Amidst these growth pressures, the ClearBridge International Growth ADR Strategy slightly underperformed its benchmark for the quarter.

As has been the case for the last 18 months, international information technology (IT) stocks continued to diverge from their generative AI-driven counterparts in the U.S. This created a relative performance headwind for the Strategy as renewed strength in Taiwan Semiconductor (TSMC), the foundry of choice for chipmaker Nvidia and other AI silicon developers, was offset by weaker price performance in the quarter from semiconductor equipment maker Tokyo Electron and IT consultant Accenture. After a strong run, we had trimmed Tokyo Electron to fund the repurchase of TSMC, whose share price had lagged. We still maintain an active position in Tokyo Electron but felt that a better upside was in TSMC, where we maintain a meaningful active weight.

Accenture, in IT services, announced weaker first-quarter earnings, but then followed up later in the quarter with a better than expected order book for AI projects. The stock has been volatile during the period. Broad-based exposure to IT capex and only a small percent of revenue so far from pure AI projects has caused it to lag. However, those AI projects are ramping up fast and will become increasingly meaningful. Additionally, in order to benefit from AI, companies need to digitize their operations and move software to the cloud; all this work is good for Accenture as it advises on digitalization and cloud. We have adjusted the position size downward as earnings volatility is likely to remain elevated.

On the positive side, performance was supported by our diversified health care exposure. The primary contributors were European biopharma companies Novo Nordisk and AstraZeneca as well as medical device makers Olympus and Alcon.

In evaluating our performance, we look to both participate in as many sectors as we feel have long-term growth prospects and outperform in those sectors through our three defined growth groups — secular, structural and emerging — each of which should perform well in different market environments. The second quarter was volatile from this growth/value perspective. Significant performance in the portfolio in both the more core and growth stocks, which typically fall in our secular and emerging growth groups, contributed to better quarterly performance. From this standpoint, we are encouraged by recent portfolio moves and results and as they have stood up well against a benchmark that looks vastly different from U.S. and traditional growth indexes.

Portfolio Positioning

We have discussed the narrowness of market breadth, and international markets too have seen limited participation, making it challenging to follow our convictions on ideas and maintain broad, sector allocated portfolios. Stocks have been volatile through earnings seasons and misses have been punished brutally, even small ones.

As we have gone through the first-quarter earnings season, it has been clear that many of the previous strong areas of growth, like travel and leisure and autos, had become quite elevated, but are unlikely to continue at the same pace. Corporate spending habits seem tighter and more carefully allocated. Interest rates are still high and consumer spending more restrained — nothing alarming, but it has our attention. Automobiles, putting aside newer position Ferrari, have been showing signs of this cyclical peaking for a long time. Those stocks had done quite well until June. Those familiar with our Strategy know we are not invested in this important area of consumer discretionary, save for Ferrari, which has hurt our relative performance in consumer discretionary. This quarter we feel validated by that underweight position in the large automotive manufacturing complex.

We were quite active this quarter trimming and selling names at what we felt were at peak earnings, multiples or both. Our selling this quarter focused on reducing smaller positions impacted by higher for longer interest rates and with lower levels of market liquidity, exiting positions that reached target prices or where our confidence in a structural turnaround had eroded. As always, our portfolio moves are to improve growth, reduce portfolio level risk and increase downside protection.

Market downdrafts often present opportunities to buy companies where the market's perceptions of risk are not aligned with our own. We see banks as an area where we can take advantage of temporary price weakness due to idiosyncratic factors. We reduced our bank underweight with the additions of U.K.-based Lloyds Banking Group

and Spain's BBVA. For Lloyds, we see sizeable tailwinds in net interest income over the next few years. Lloyds hedges interest rates when extending loans to lock in a spread and stands to benefit as its loan book rolls over to higher spread loans book that reflect materially higher interest rates. While loan growth has been weak for an extended period, we expect a pickup in the second half of the year. Healthy dividend and share buyback activity should also drive total returns.

Banco Bilbao Vizcaya Argentaria (BBVA) is a very profitable bank with strong market positioning and well-developed digital capabilities in its core markets. Mexico is the bank's largest profit pool and growth contributor as an underbanked market where the company wins profitable market share. Additionally, Mexico's new government isn't expected to significantly weigh on the banking sector. We believe BBVA's intended takeover of Spanish rival Sabadell will close in the first quarter of 2025, assuming all regulatory bodies and shareholders agree. The takeover will be accretive and result in BBVA consolidating its role as a powerful player in the Spanish market. We initiated, and have increased, our position on share price weakness related to takeover uncertainty.

Swiss electrical components maker ABB, in the structural growth bucket, was the largest addition. After its recent restructuring, ABB is a more streamlined business with better cost management and a more focused market position. Revenue growth should pick up in the medium term driven by strong secular demand trends. For example, the company's low and medium voltage solutions benefit from accelerating investments in electrification. Other solutions, like motor drives, are key technologies supporting energy efficiency improvements across most industrial processes.

To make way for these new names, we exited several positions that had reached our price targets. These included Latin America e-commerce leader MercadoLibre, an emerging growth name that saw a strong price move from April lows and that has been a long-term winner for the portfolio. We took advantage to redeploy those profits into the repurchase of Singapore-based Sea Limited, a non-emerging-market idea we believe has more upside and less risk.

We exited Japan's pharmaceutical maker Daiichi Sankyo, a leader in developing antibody drug conjugates (ADC) to treat cancer. We believe ADCs are the new modality for cancer treatment and that the company's key partner for marketing these drugs, portfolio holding AstraZeneca, has been doing an exceptional job with their breast cancer drug Enhertu and will likely see similar success for lung cancer drug Dato-DXd. Future pipeline ADCs with Merck could boost the stock price further, but we feel our price objective has been achieved and the sale keeps the portfolio's health care overweight more balanced.

French contact center software maker NICE was also sold as the debate around AI's impact on its business has created exceptional price volatility. While we believe NICE will be a net winner, it will take

time for AI revenue to build, weighing on near-term stock performance. The unexpected transition of its long-time CEO added another, more significant layer of uncertainty that caused us to look elsewhere for opportunities in technology.

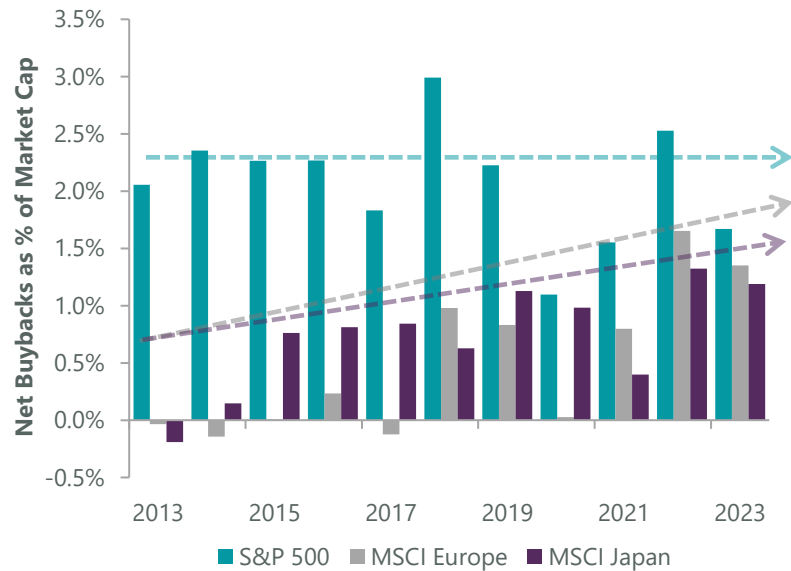
In total, the period saw us initiate seven new positions while eliminating nine others.

Outlook

The ECB took the lead in cutting rates during the quarter, which could provide temporary relief for sectors that have been pressured by higher costs of capital. While inflation remains sticky in the eurozone and further cuts could be data dependent, EU regulators set a positive tone with the move. Stabilization in the U.K. following the early July election of a centrist leader from the Labour Party could also be supportive of equities. Japanese equities took a breather in the second quarter from a currency- and reform-supported rally, but we expect actions taken by the government and exchanges to improve corporate returns and encourage greater equity ownership will continue to flow through to better earnings. Buybacks are also on the rise in Europe and Japan, which could offer a catalyst to help close the lingering performance gap between U.S. and international equities (Exhibit 2).

Chinese equities rebounded in the second quarter from an extended malaise, but we have no immediate plans to invest directly in the Chinese market beyond our existing holdings in Zai Lab and Hong Kong-based AIA Group. The Chinese economy may not get materially worse from here, nor do we feel it will get materially better until the ongoing housing problems are resolved, something that will take more time than the market believes. Certain industries are being targeted for growth at the expense of others. We have many stocks on our radar screen and most of our portfolio holdings have a portion of their business in China. The political rhetoric toward Europe, Japan and the U.S. and the companies that are key investors in that market remain unfavorable, something that in our mind is incongruous with developing a cohesive growth strategy. The U.S. political election season is also likely to highlight rhetoric unfavorable to continued investor fund movements into China.

Exhibit 2: Buybacks on the Rise



As of Dec. 31, 2023. Sources: FactSet, MSCI, S&P.

We believe recent results validate our diversified approach to growth, complementing our core holdings among secular growth companies with opportunistic ownership of structural growers and selective exposure to emerging growth names, many of which have seen their valuations become more compelling in recent quarters. While the Federal Reserve has pared back their easing efforts until gaining more confidence on the path of inflation, central bankers outside the U.S. have already begun to ease monetary conditions. We believe this transition sets up well for our portfolio of growth stocks with strong fundamentals and specific value creation strategies.

Portfolio Highlights

During the second quarter, the ClearBridge International Growth ADR Strategy underperformed its MSCI EAFE Index benchmark. On an absolute basis, the Strategy experienced gains across three of the nine sectors in which it was invested (out of 11 total), with the health care sector the primary contributor while the IT sector was the main detractor.

On a relative basis, overall sector allocation contributed to performance. In particular, an overweight to the health care sector, a lack of exposure to the real estate sector and stock selection in the consumer discretionary and health care sectors aided results. Conversely, stock selection in the IT and materials sectors and an underweight to the financials sector detracted from performance.

On a regional basis, stock selection in North America, an overweight to emerging markets and underweight to Japan supported performance while stock selection in Japan, the U.K. and Asia Ex Japan, an overweight to North America and an underweight to Asia Ex Japan proved detrimental.

On an individual stock basis, the largest contributors to absolute returns in the quarter included Novo Nordisk, AstraZeneca and Olympus in the health care sector, Taiwan Semiconductor Manufacturing in the IT sector and Atlas Copco in the industrials sector. The greatest detractors from absolute returns included positions in Tokyo Electron, NICE and Accenture in IT, LVMH in consumer discretionary and Canadian Pacific Kansas City in industrials.

In addition to the transactions mentioned above, we initiated positions Unilever in the consumer staples sector, Bureau Veritas in the industrials sector and UCB in the health care sector. Additional sales included Airbus and Computershare in industrials, Shiseido and Diageo in consumer staples, Kering in consumer discretionary and James Hardie Industries in materials.

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