FRANKLIN TEMPLETON | ClearBridge

Emerging Markets Strategy

Market Overview

Emerging markets were caught up in a rotation out of AI-related stocks in July as investors began to question the payoff from historical levels of capital spending on model development. The MSCI Emerging Markets Index declined 3.1% for the month, as negative AI sentiment caused the unwinding of leveraged bets in South Korea, leading the market to fall 17.1%, while AI-heavy Taiwan was down 5.4%. Meanwhile, China was up 9.0% as its domestic AI models saw greater uptake globally, Brazil rose 6.4% on energy strength and a reallocation of investor flows, and India (+1.7%) showed resilience due to its lack of AI exposure and domestic refining capacity that has helped to offset oil price volatility.

From a sector standpoint, index performance reversed from the leadership seen for most of the year. Consumer discretionary (+14.4%) was the best performer in a strong relief rally led by key names in China and India. Energy (+8.5%) and financials (+5.7%) also outperformed. Meanwhile, the AI-indexed information technology (IT) sector tumbled 12.7% and industrials was down 7.5%.

The level of volatility in South Korea during the month has never been seen before in our tenure managing EM equities. The sharp price swings, however, were driven by degrossing out of highly leveraged ETFs rather than a weakening in fundamentals. Such vehicles are still new in a South Korean market that has been encouraging greater retail participation and became overheated before regulators tightened some investment requirements.

Performance Overview

The ClearBridge Emerging Markets Strategy underperformed its benchmark in July, hurt by weakness in IT and industrials across South Korea and Taiwan that offset strength in India.

South Korea's Shinhan Financial benefited from the rotation away from AI stocks as well as good quarterly results that included the announcement of a new share buyback program. Shinhan is participating well in the country's Value Up program by increasing shareholder returns through dividends and buybacks.

In China, China Merchants Bank was a primary recipient of general optimism in the banking sector optimism. Tencent rebounded on the launch of an updated large language model that has been well received and a signal that the digital conglomerate is catching up with peers on the AI front.

> While EM markets have been volatile recently, we don't see any meaningful changes in the fundamental outlooks of our portfolio companies.

In India, jewelry and broadline retailer Titan delivered strong financial results and announced a new five-year plan to double its revenues. We believe the fundamental jewelry story is playing out as Titan continues to take share in a fragmented market.

South Korea memory leader SK Hynix ended a wild month of trading down 29%, primarily due to being a large holding in leveraged ETFs that unwound. Fundamentally, the company issued a very strong outlook and continued to sign long-term agreements (LTAs) with customers but was hurt by a slight quarterly revenue miss due to delays in shipments of next-generation memory products.

Samsung was impacted by the same technical headwinds as SK Hynix but it too highlighted a positive outlook for memory with 60% to 70% of its business now in LTAs. The company's backlog is expected to increase into 2027 as demand remains strong, while on the foundry side, Samsung is ramping up to full utilization.

HD Hyundai Electric was caught up in the AI selloff as a key supplier of transformers to support the power grid for data centers. Longer term, power grids in many countries need upgrading, which caused the company to revise its order guidance upward.

TSMC delivered great quarterly results and raised full-year guidance but was another victim of the sharp rotation out of AI amid concerns over the sustainability of AI capex. Also in Taiwan, Delta Electronics was lower as quarterly results came in below estimates due to slightly higher component costs and product delays. However, the company expects trends to improve handily in the second half.

Portfolio Positioning

The Strategy initiated positions in China's Zhongji Innolight and NAURA Technology Group.

Innolight is a key supplier of optical modules to AI data centers globally, including large U.S. hyperscalers. We believe the company is well-placed to benefit from increasing optical content as well as overall growth in AI data centers. Innolight is a large-scale module assembler, sourcing components from suppliers globally, but is also developing its own intellectual property which gives us more confidence in the long-term growth outlook for the company. While the company's share price has performed well recently, we still think Innolight's long-term potential is underestimated and that both high earnings compounding and valuation re-rating are possible from here.

Semiconductor capital equipment maker NAURA Technology has historically been a challenger to global large wafer fabrication equipment companies but has now established itself as lead domestic supplier for certain equipment. The company will likely continue to benefit from a separation of U.S./EU and Chinese supply chains for semiconductors. While it is in a cyclical industry, we believe the structural drivers (improved foundry utilization, higher semiconductor pricing and China localization) mean NAURA is capable of high compounding of earnings with potential for further upside.

Outlook

We manage a low turnover portfolio and typically will not react to daily or weekly gyrations in the markets or specific holdings. Instead, such short-term, flow-driven markets prompt us to ramp up due diligence on our companies to ensure we are still confident with the fundamentals. While EM markets have been volatile recently, we don't see any meaningful changes in the revenue and profit outlooks for the businesses we own and maintain conviction in our current portfolio construction.

While performance in EM has been relatively concentrated in recent months, we continue to see long-term positive drivers for the portfolio from several areas, in particular: China, India and IT. In China, we see a stabilization in macro conditions combined with market valuations that are still relatively cheap on a global basis. In India, where the market has underperformed EM recently, we see long-term opportunities in high-quality, domestic-focused companies that the market has overlooked.

Even with the July selloff, technology has been the key driver of EM year to date. This strength has been earnings-driven, which has kept valuations in check, with SK Hynix and Samsung Electronics trading at multiples well below emerging markets overall. We remain positive on the outlook for the IT hardware sector as we continue to see a supportive combination of growing global demand and constrained supply. The latest indications are for the supply-demand situation to tighten further heading into 2027, which should be a fundamental support to our AI-related IT and industrial holdings.

Portfolio Highlights

The ClearBridge Emerging Markets Strategy underperformed its MSCI Emerging Markets Index benchmark in July. On an absolute basis, the Strategy delivered positive contributions across six of the nine sectors in which it was invested (out of 11 sectors total). The primary contributor to performance was the consumer discretionary sector while the IT sector was the main detractor.

Relative to the benchmark, overall sector allocation and stock selection detracted from performance. In particular, stock selection in the IT and industrials sectors and an IT overweight weighed on results. Conversely, stock selection in the consumer discretionary sector contributed to performance.

On an individual stock basis, the primary relative detractors were SK Hynix, Samsung Electronics, Taiwan Semiconductor, Delta Electronics and SK Square. The largest relative contributors included Shinhan Financial, China Merchants Bank, Tencent and not holding Samsung Electro-Mechanics and Yageo Corp.

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