



Emerging Markets Strategy

Key Takeaways

- ▶ Emerging market equities were impacted by energy supply shocks caused by the eruption of war in the Middle East, with the segment down slightly for the quarter after a strong start to the year.
- ▶ The Strategy slightly underperformed the benchmark as relative weakness in India and Brazil negated positive contributions in South Korea and Taiwan.
- ▶ Reaction to the conflict has been within expectations and has coincided with profit taking in several markets. We believe such short-term retrenchment can lead to a more sustainable EM return environment and opportunities for stock picking going forward.

Market and Performance Overview

Emerging markets bore the brunt of energy supply shocks caused by the U.S. and Israel's war with Iran, enduring sharp losses as military action escalated in the last month of the first quarter. The MSCI Emerging Markets Index finished the quarter down 0.2% as a 13.1% drop in March erased a strong start to the year.

Oil exporter Brazil (+19.1%) was the best-performing market for the quarter, while South Korea (+16.5%) and Taiwan (+9.1%) also outperformed, holding onto a portion of their strong technology gains. Saudi Arabia (+9.2%) delivered solid results despite being situated relatively near the conflict, driven by higher oil prices and investor confidence in the country's ability to sustain oil exports through diversified routes. India (-18.1%) suffered among the sharpest losses in EM as its dependence on foreign oil and natural gas was exposed by the latest supply shock. China (-8.9%) also underperformed due to competitive pressures among its largest e-commerce companies.

Within the benchmark MSCI Emerging Markets Index, companies in the information technology (IT, +11.3%) sector continued to lead, despite profit taking and a tempering of expectations on AI capital spending as fundamentals remained strong. Energy (+10.8%) also outperformed on the back of spiking prices for crude oil and natural gas. Materials (+1.2%) managed to top the benchmark as well but previous gains were tempered by sharp losses in March due to both higher input costs and a selloff in gold prices. The communication services (-15.3%) and consumer discretionary (-11.6%) sectors were dragged down by fears over what Chinese e-commerce companies' investments in AI and competition for market share could mean for profitability, as well as commodity-driven inflation concerns.

The ClearBridge Emerging Markets Strategy slightly underperformed its benchmark for the quarter as negative stock selection in India and Brazil offset ongoing strength in South Korea and Taiwan. From a sector standpoint, stock selection in financials, consumer discretionary and energy were the primary headwinds to relative performance, offsetting gains in IT and industrials.

At the stock level, South Korean memory producers Samsung and SK Hynix flexed their robust fundamentals with large earnings upgrades when releasing their latest financial results. However, gains were pared by quarter end on profit taking and general risk reduction due to geopolitics, especially among foreign investors. Taiwan Semiconductor was boosted by record-breaking quarterly revenue and a massive increase in planned capital expenditures to meet continued growth in AI demand.

Shares of both Delta Electronics, the Taiwan supplier of power and cooling for AI data centers, and Siewan Electric, the Chinese manufacturer of electric transmission equipment, were higher on solid demand trends in their core markets of data centers and electrical grid upgrades.

Sentiment among Indian companies took another turn lower in the quarter. On top of a rotation out of the region toward areas more indexed to AI innovation, the Iran conflict highlighted India's dependence on foreign energy to power the world's fifth-largest economy and largest population. Most impacted by this negative environment were the country's largest bank, HDFC Bank, wealth and capital markets focused Kotak Mahindra Bank as well as leading auto and industrial equipment maker Mahindra & Mahindra.

Chinese digital conglomerate Tencent was also a detractor; the company has been engaged in a public LLM subsidy battle for market share that also involves Bytedance, the leader in daily active users, and Alibaba, which boasts the largest monthly active user base. Despite this competitive threat, Tencent's core business areas, including its gaming business, continue to deliver strong growth.

Fourth-quarter results for Chinese online travel agency Trip.com showed solid demand with revenue ahead of expectations, but the stock was pressured by a guide-down on margin and regulatory scrutiny as well as inflationary pressure later in the quarter. Despite AI disruption concerns, management reiterated that agentic AI offerings are good for itinerary creation, customer service and its fragmented supply chain.

Portfolio Positioning

We added three positions during the quarter and exited another. Gold Fields is a South Africa-based gold producer that offers exposure to gold prices, helping manage the Strategy's exposure to precious metals, which has become a meaningful part of the MSCI Emerging Market Index. The stock looks attractively valued at present

based on mark-to-market profitability, which should enable very high returns on capital.

Samsung Heavy Industries is a South Korean shipbuilding and offshore engineering company. Global shipping orders are rising faster than shipping capacity. This has already created a three-year backlog for Samsung, and we are entering a period of improved pricing and rising profit margins. The purchase diversifies our Korean exposure beyond its current tech focus while maintaining exposure to sectors with improving profit characteristics.

Minth Group is a Chinese manufacturer of highly engineered auto parts and EV components. Minth's core auto business continues to grow, driven primarily by its battery housing success, which has stopped being a drag on overall margins. In addition, the tariff backdrop is less severe than some of the worst-case scenarios imagined. We also see compelling optionality in the thesis on the back of new revenue lines such as humanoid robots and liquid cooling for AI data centers.

The Strategy closed out of Shenzhen Mindray Bio-Medical Electronics, a Chinese maker of medical devices including ultrasound machines and diagnostics systems and used the sale as a source of funds for higher-conviction investments. The company appears to be heading for its third consecutive year of below-forecast earnings as demand in China has remained weak, further delaying the timing of a growth turnaround.

Outlook

Emerging market exposure to the Middle East has increased in recent years with Saudi Arabia, the United Arab Emirates, Kuwait, Qatar and Egypt all included in MSCI EM Index. Given the long-standing sanction regimes, emerging market companies have essentially zero direct exposure to Iran.

The Strategy has an underweight position with only 3.3% of the portfolio invested in Middle Eastern stocks versus the index weight of 5.7%. All our exposure is in Saudi Arabia in companies with solely domestic exposure, specifically a bank, a telecom company and a hospital operator. While the operations of these companies should be relatively insulated from the current situation, we would expect some price volatility to persist as long as the conflict remains active.

In general, we would expect to see weakness across Middle Eastern markets while this situation continues. The mitigating factor for the region is its positive sensitivity to rising oil prices. The energy sector is 3.8% of the index and we are roughly 200 basis points underweight. Given the low absolute oil exposures in the index and our even smaller active exposure, our internal portfolio risk systems estimate our portfolio demonstrates limited sensitivity to large oil price moves.

As we shared at the outset of the conflict, we expect global markets to be weak until a permanent resolution is achieved. While we don't see EM as specifically exposed, albeit with some countries such as Brazil standing to benefit from higher oil prices, major EMs in Asia are energy importers and thus more vulnerable to a supply shock than other regions. That said, the market reaction in South Korea and Taiwan has been within expectations for a geopolitical event of this magnitude and has coincided with profit taking in South Korea, as foreign investors have become more risk averse and local investors have tempered their exuberance. We believe such short-term retrenchment can lead to a more sustainable market going forward and is an opportunity for stock picking, as many individual companies continue to show resilient fundamentals.

Economies like China are more insulated from oil and natural gas shortages as its energy mix is more diversified and domestically generated, with access to locally sourced coal and oil, as well as one of the world's leading renewables infrastructures. We see a lot of progress across emerging markets overall in improving energy security, with companies like China's CATL leading the adoption of battery storage.

In the long run, recent events may even support the current positive asset allocation moves toward emerging markets we have been noting in recent quarters. The conflict underscores broader geopolitical uncertainty and questions surrounding the outlook for the U.S. dollar that have been pushing investors to diversify exposures globally. We will continue to evaluate the situation and the implications for the portfolio.

Portfolio Highlights

The ClearBridge Emerging Market Strategy underperformed its MSCI Emerging Markets benchmark in the first quarter. On an absolute basis, the Strategy produced gains across two of the nine sectors in which it was invested (out of 11 total). The positive contributors were the IT and industrials sectors while the main detractors were financials and consumer discretionary.

Relative to the benchmark, overall stock selection detracted from performance but was partially offset by positive asset allocation effects. In particular, selection in the financials, consumer discretionary, energy, materials, communication services and consumer staples sectors and an underweight to the energy sector weighed on results. On the positive side, selection in IT and industrials and an overweight to IT contributed to performance.

On a regional basis, stock selection in Brazil and India and an overweight to India hurt performance while selection in Taiwan and South Korea proved beneficial.

On an individual stock basis, the leading contributors to relative performance were Samsung Electronics, SK Hynix, Delta Electronics,

Sieyuan Electric and Taiwan Semiconductor. The primary detractors were HDFC Bank, Tencent, Mahindra & Mahindra, Trip.com and Kotak Mahindra Bank.

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