



## International Growth ACWI ex-US Strategy



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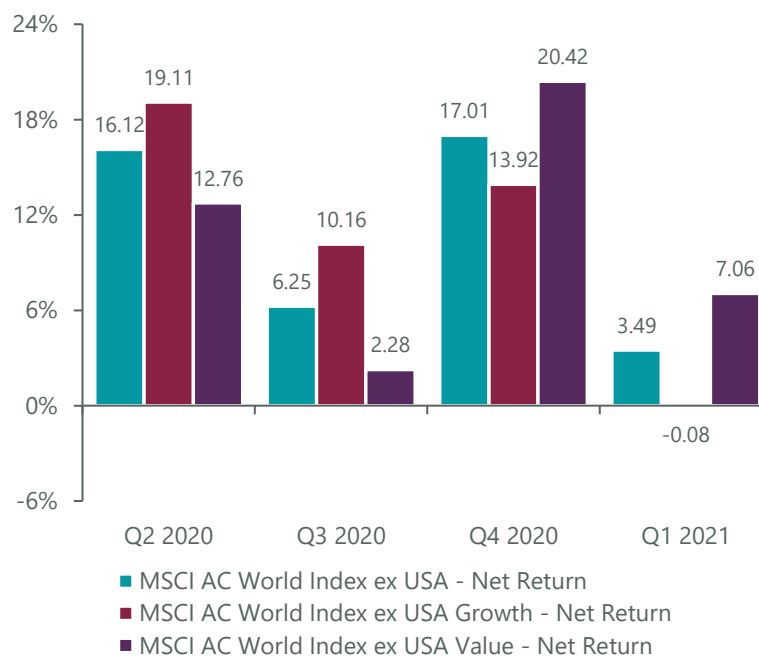
### Key Takeaways

- ▶ A rotation out of growth stocks into value on improving hopes for a global recovery and a sharp rise in bond yields weighed on the Strategy's emerging growth names, leading to underperformance.
- ▶ We reoriented the portfolio for a more cyclical market in the fourth quarter and saw good performance in these areas from structural growth companies.
- ▶ The long-term dynamics for international growth companies remain compelling due to their generally more attractive valuations, the less efficient nature of non-U.S. markets and their key role in enabling digitalization across regions and industries.

### Market Overview

International equities delivered marginal gains in a risk-on first quarter that saw a continuation of trends from late 2020 toward more cyclical and value-oriented areas of markets. While the U.S. benefited from a widespread COVID-19 vaccine rollout, other regions — primarily Continental Europe and most emerging markets — have fallen behind in vaccine distribution. This will push back an economic reopening and has weighed on stocks. The benchmark MSCI All Country World Ex-U.S. Index and the developed market MSCI EAFE Index both rose 3.5% in the first quarter while the MSCI Emerging Markets Index added 2.3%. Small caps once again outperformed larger stocks with the MSCI ACWI Ex-U.S. Small Cap Index adding 5.6%. International value stocks outperformed growth stocks significantly, with the MSCI ACWI Ex-U.S. Value rising 7.1% compared to -0.1% for the MSCI ACWI Ex-U.S. Growth (Exhibit 1).

Exhibit 1: MSCI Growth vs. Value Performance



Source: FactSet.

Aggressive U.S. stimulus policies caused the bond markets to react with a meaningful rise in 10-year Treasury yields. Global markets followed with a significant rotation into economic recovery plays. This rapid steepening of the yield curve greatly impacted growth stocks as the risk-free cost of capital increased. This was especially painful for stocks whose value is more back-end loaded, specifically the Strategy's emerging growth bucket, which did extraordinarily well last year as rates were slashed to cope with the pandemic. Beginning in the fourth quarter and continuing into the new year, we took profits in some of our biggest winners (SolarEdge Technologies, Spotify, MercadoLibre). This was not enough, however, to neutralize the sharp moves of the first quarter, causing the International Growth ACWI Ex-US Strategy to underperform the benchmark.

Growth stock performance was weak due to a combination of broad profit taking by investors and the market's optimism about a recovery from the pandemic. Areas that had been hard hit in 2020 recovered including energy (+9.6% for the quarter), financials (+8.4%), materials (+5.4%), industrials (+5.2%) and cyclicals in every area. Information technology (IT, +3.5%) finished in line with the index; however, our emerging growth names underperformed the overall group.

Many areas that moved upwards, like energy, steel and auto companies, are not areas where we see sustainable long-term growth. We reoriented the portfolio for a more cyclical market in the fourth quarter and saw good performance in these areas from

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Growth as an investment strategy is relatively new overseas and thus represents good potential for expansion.

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structural growth companies like Atlas Copco and Canadian Pacific Railway, which pared gains after announcing the acquisition of Kansas City Southern that will create the first rail operator connecting the U.S., Mexico and Canada.

We have always been clear about when we expect the Strategy to underperform. In sharp, narrow market moves, the index will always have the exact amount of whatever is moving; we may or may not. The first quarter was exactly the type of market where we would expect to face headwinds. However, the extent of that underperformance was more than we anticipated. We believe roughly 60% of the underperformance vis-à-vis our core benchmark was market related, while a few of our larger positions, including London Stock Exchange and TeamViewer, underperformed due to stock-specific news. We believe the pullback in these stocks has been overdone and they will be good future performers.

### **Portfolio Positioning**

We have observed that new additions to the portfolio often do not take off right after purchase. We make investments in companies where we believe the market hasn't properly appreciated their future long-term performance, meaning they usually take a quarter or two for our thesis to play out. Results for recently purchased stocks are in line with this trend. This quarter, we increased our cyclical exposure with companies we expect to benefit as the reopening expands across Asia, Europe and emerging markets. These include CRH, a diversified global building materials business with leading positions in aggregates, cement and concrete materials/products. The Ireland-based company is increasing its focus toward higher-margin business in developed markets and should benefit from infrastructure spending in the U.S. and Europe. We believe the market underestimates steady M&A additions to the business. Sweden's Sandvik is a global manufacturer of drills for mining and high-end machining solutions. Its mining and rock technology division is very profitable with an after-market business oriented toward mining and construction.

The job market is already coming back in the U.S. and other international markets will likely follow suit in the year ahead, providing substantial earnings growth potential for Recruit Holdings. The Japanese human resources and marketing support company owns U.S. job search platforms Indeed and Glassdoor and holds a 50% share of Japanese online advertising for small business hiring. Recruit has a unique, entrepreneurial culture and is one of the most innovative in Japan, where the use of technology is still underpenetrated and the company is well-positioned to increase share.

Compass Group is the largest global contract caterer, serving corporate dining cafeterias, sports/leisure food service and education facilities. Its business was severely impacted by the COVID-19 lockdowns, but we believe margins have troughed while customer retention rates remain high. A return to pre-pandemic levels is likely even prior to a full global recovery due to adaptations Compass made to its business model in the downturn that increased flexibility and should lead to durable cost savings.

On the consumer side, we are paying close attention to how traditional retailers are pivoting to new growth areas. We participated in the IPO of Dr. Martens, the iconic British footwear company that has restructured under new management. It's post-COVID-19 strategy includes selective store openings and a strong contribution from e-commerce. The retailer has new offerings but its key product remains the 1460 boot, which has helped it produce generous cash flow, yet we believe the market underappreciates its long-term earnings profile. We are also monitoring how those reliant on travel spending, like spirits and cosmetics companies, are adapting. Diageo, for example, is seeing travel come back quicker, especially in Asia, and is expanding into online sales.

The Strategy has purposely underweight banks versus the benchmark due to mediocre growth prospects in a low-rate environment, favoring financials exposure in areas like exchanges, insurance and digital payments. We made four financials-related purchases in the quarter, the largest in Nihon M&A, the best placed merger and acquisition intermediary in Japan for facilitating small and midsize company transactions. An aging population and increase in the average business owner's retirement age is driving the need for M&A.

While we maintain high conviction in many of the emerging and secular growth names in the portfolio, despite the short-term headwinds created by the current reflationary environment, our commitment to risk management caused us to exit a number of positions during the quarter. The extreme performance of emerging growth in 2020 meant we had gotten slightly more exposed to these companies than we felt prudent and we sold a number of strong performers. These included Tokyo Electron, a Japanese maker of semiconductor capital equipment that has more than doubled in the last year; the sale reduced our significant overweight to semiconductors. We continue to hold Taiwan Semiconductor, the world's largest foundry, as well as ASML, the leader in semi cap equipment for high-end chips. Semiconductor shortages, caused by a combination of years of capacity reductions, COVID-19 lockdowns and better than expected rebounds in industries like autos, will cause short-term

revenue pressure but are allowing companies to exert pricing power as they race to replenish depleted inventories.

## Outlook

We are not certain when a cyclical recovery will take hold in Europe, Asia and emerging markets, but equity markets are already anticipating it. While value continues to maintain an advantage over growth, interest rates drive the length of value rallies and we do not see rates going up meaningfully to maintain that momentum. The traditional value sectors of autos, banks and energy may work in the short term, but all are facing disruptive forces. Traditional banks are highly dependent on rates and are being disintermediated by fintech companies taking away their profitable businesses. We have been out of traditional fossil fuel energy for two years and, with the global climate change push, we do not see them as compatible with growth investing. Instead, we continue to add to our renewables exposure through names like EDP. And in autos, we are excited about electric vehicles but would rather own suppliers and semiconductor companies than the capital-intensive OEMs that are still juggling three engine formats.

The long-term dynamics for growth companies outside the U.S. are compelling for several reasons. Valuations are generally more attractive and investment markets are less efficient. Growth as an investment strategy is also still relatively new overseas and thus represents good potential for expansion. Finally, digitalization is continuing apace outside the U.S., with economies like Japan still early in its adoption of digital technologies. This should create a long runway for growth and steady demand for growth stocks.

## Portfolio Highlights

The ClearBridge International Growth ACWI ex-US Strategy underperformed the benchmark MSCI ACWI ex-U.S. Index for the first quarter. The Strategy sustained losses across seven of the nine sectors in which it was invested (out of 11 total), with the IT and financials sectors the primary detractors.

On a relative basis, overall stock selection detracted the most from performance. In particular, stock selection in the IT, financials and consumer discretionary sectors had the greatest negative impact on results, with weakness in software and IT services and a lack of exposure to banks contributing to the underperformance. Stock selection in communication services and industrials, as well as a lack of exposure to the energy sector, also proved detrimental. On the positive side, an overweight to industrials was the primary contributor to performance.

On a regional basis, stock selection in Europe Ex-U.K., the United Kingdom, North America and emerging markets hampered

results, while an overweight to North America and underweight to emerging markets aided performance.

On an individual stock basis, the largest contributors to absolute returns in the quarter included ASML, Taiwan Semiconductor, Atlas Copco, Tencent and Canadian Pacific Railway. The greatest detractors from absolute returns included positions in London Stock Exchange, StoneCo, Elastic, InPost and TeamViewer.

In addition to the transactions mentioned above, we initiated positions in ICON and argenx in the health care sector, InPost and Ashtead Group in the industrials sector, McDonald's Japan in the consumer discretionary sector as well as Vinci Partners, VNV Global and 3i Group in the financials sector. We also closed positions in Brambles in the industrials sector, Kao in the consumer staples sector, Hansa Biopharma, Daiichi Sankyo and Burning Rock Biotech in the health care sector as well as Constellation Software and Temenos in the IT sector.

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