ClearBridge Investments

International Small Cap Strategy

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Key Takeaways

- Non-U.S. small cap stocks annualized an impressive rebound off the March 2020 lows, benefiting from the reopening of local economies and increasingly easier comparisons from the year-ago period.
- The Strategy had particularly strong contributions from our industrial names, many of which are benefiting from reflationary policies globally.
- After strong recent gains, many cyclical stocks are overbought and ripe for near-term consolidation. The key for us at this point of the market cycle is to be patient and avoid losing conviction during inevitable countertrend rallies in the old leadership.

Market Overview

Global stocks climbed to new highs in the first quarter of 2021, driven by the dominant themes of reopening and inflation that commenced last fall. Accordingly, value stocks outperformed growth, small caps bested large, and U.S. markets led international as America's vaccine rollouts surged ahead of most global peers. Driven by these tailwinds and positive stock selection, the ClearBridge International Small Cap Strategy significantly outperformed the benchmark MSCI EAFE Small Cap Index for the quarter and trailing 12 months.

International markets overall lagged the 6.2% rebound in the U.S., with the developed markets MSCI EAFE Index up 3.5%, the MSCI Emerging Markets Index higher by 2.3% and MSCI EAFE Small Cap Index ahead by 4.5%. The best-performing countries were Canada, Austria, Holland, Norway, Italy, Sweden, Hong Kong, Singapore, Taiwan, South Africa and the U.K. These markets tended to benefit from improving economic sentiment and rebounding global trade activity. Laggards such as Spain, Switzerland and Portugal were hurt by exposure to the still-depressed travel and tourism industries. Large cap stocks in Japan, South Korea and China also underperformed due to uncertainty surrounding technology demand, slower rollout of vaccines and deteriorating Sino-U.S. relations. The economic and currency turmoil in Turkey cast a shadow over other developing nations, with Indonesia, Malaysia, the Philippines, Brazil, Egypt and Poland posting losses for the quarter. Overall, the portfolio's

holdings in Europe and the U.K., as well as underweighting Japan, were the biggest regional contributors to returns.

> From a sector- and stock-specific perspective, we are finding a material shift in the earnings growth environment.

Small cap stocks annualized an impressive rebound off the March 2020 lows, benefiting from the reopening of local economies and increasingly easier comparisons from the year-ago period. Geographic trends generally mirrored the broader markets with the notable exception of China, where small caps strongly outperformed due to the composition being more non-tech consumer, real estate and cyclical industries. Small companies in the U.K. also posted outsized returns as the country emerged from Brexit and focused on aggressive vaccine rollouts to tackle the pandemic. Britain is now on the path to fully reopen by early summer, and we see this optimism reflected in many of our consumer and housing-related names. For example, British logistics provider Wincanton was the portfolio’s strongest contributor this quarter. Through the pandemic lockdown, Wincanton relied on its digital and general merchandise divisions to sustain the business. As the country reopens, Wincanton’s more cyclical segments such as industrial and public sector should also see sharp return in demand.

At the sector level, economically sensitive industries such as financials (+10.2%), consumer discretionary (+8.8%), materials (+6.9%) and industrials (+6.2%) led overall market performance. Our portfolio had particularly strong contributions from our industrial names, many of which are benefiting from reflationary policies globally. A good example can be seen in the shipping industry, where the global supply chain is already straining from improving demand and still-limited capacity, with shipping costs doubling over the past year. Global logistics providers are uncertain as to how much of this will become permanent and thus are reluctant to add to capacity. More recently, the surge in commodity prices has extended this capacity shortage to the dry bulk market, where spot rates have surged and fueled names such as D/S Norden and Star Bulk Carriers.

Conversely, defensive and bond-correlated sectors such as utilities (-2.3%), health care (-1.5%) and real estate (+0.1%) were the worst-performing sectors this quarter, and our portfolio benefited from being underweight these areas. Korean medical technology provider i-Sens was our biggest detractor in the quarter. i-Sens specializes in blood glucose monitoring systems, and COVID-19 not only dampened current period sales but, more importantly, delayed the clinical trials of its highly anticipated new continuous glucose monitoring (CGM) product. Despite the delays and associated costs, we remain optimistic about the company’s launch plans within the coming year and believe the stock has long-term tailwinds given the continued rise of diabetes globally.

Performance within our materials holdings also negatively impacted the portfolio's returns. Much of this relates to the correction in gold prices as interest rates have risen sharply and the overall economic picture strengthened. While we continue to believe that gold stocks represent a good inflation hedge in the long run, we also recognize that supply/demand fundamentals are much stronger in industrial commodities and we are likely to focus new positions there.

Outlook and Positioning

The events of the past year offer a vibrant view of humanity's angels and demons; our ability to be both foolish and brilliant and ever struggling with discerning the difference. Asset prices reflected this bipolarity as lockdown beneficiaries surged while the deeply depressed cyclical and financial sectors also leapt higher on reopening hopes as vaccines headed into production. Central banks embraced a new paradigm in their inflation policies and partnered with Treasury officials in monetizing fiscal stimulus that would be directly injected into the economy. Central banks have increased their balance sheet to 6x the level before the 2008 financial crisis and their speeches have taken on the mandate to create sustainable inflation and address social injustices. We are not sure if these policies are brilliant or foolish, but they clearly represent the most profound shift in the macroeconomic environment since the early 1980s when Paul Volcker famously "broke the back" of inflation.

The key lesson of history in the face of a foundational transformation is to understand what is beginning and what is ending and to prepare for a long recalibration of relative asset prices. At first, the change in leadership is viewed as impossible; it then follows the "path of most resistance," from being dismissed as temporary, irrational, fundamentally unsupported and excessive, before being fully embraced. Disciplined value managers like us tend to be pretty good at the first stages and more challenged in the latter stages of this dynamic. So, our focus over the past year has been to capture the powerful initial "unexpected" rebound in value stocks and going forward to avoid becoming pessimistic or impatient.

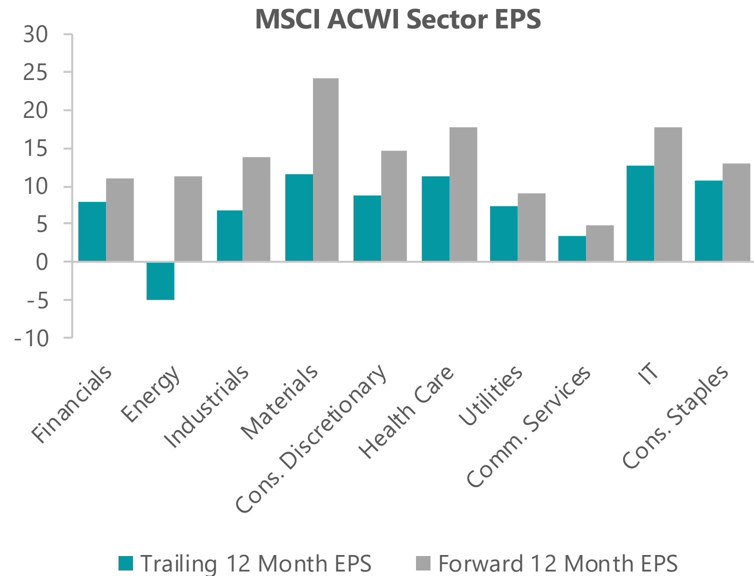
Our main belief is that we have been and will remain in a classic inflation cycle, intentionally enabled by a mix of targeted monetary and fiscal policies and necessary to support high levels of public indebtedness. Furthermore, in examining the phases of an inflationary cycle, we observe that we are likely to see several years of relative calm and prosperity before the real economy begins to suffer from the "woes of inflation." There appears to historically have always been a "goldilocks" period where growth is strong, but investors have not adjusted their inflation expectations so real and nominal interest rates remain supportive.

The IMF recently revised upward the 2021 estimate for global GDP growth to the highest level since 1976. At the same time real interest rates remain strongly negative and forward curves indicate little concern about inflation in long-term expectations. In short, we believe the Great Distortion will continue, but it has now shifted to inflating the real economy and debasing debt.

A rise in the prices of some goods is not inflationary if the prices of other goods decrease and a decline in overall demand occurs. But as we noted earlier, it is the stated goal of policy makers to not let this happen so the higher costs of energy and basic materials will be monetized. Governments are also extending unprecedented stimulus spending well beyond the depths of the pandemic lockdowns with a "build back better" mission. In the U.S., Europe, Japan, Canada and New Zealand, leaders are focused on improving social justice and addressing institutional inadequacies. While these are not necessarily bad policies, they clearly will add to nominal GDP growth and real goods inflation.

From a sector- and stock-specific perspective, we are finding a material shift in the earnings growth environment. Rather than the growth mania that has largely dominated since the 2008 financial crisis, the earnings momentum picture has now reversed, with industrial, financial, basic materials and energy companies having the best relative momentum for the first time in nearly 20 years (Exhibit 1). We find this trend is likely to last for much longer than expected when we look at the three Cs of capital, capacity and competition. Due to the long stagnation of the past decade, most value industries have been starved of capital, are adding near-record lows of capacity and have seen the level of competition decrease. As mentioned earlier, the shipping industry is a prime example of what looks like the best supply side picture in decades. Energy, metals, chemicals, cement and other basic materials producers are enjoying similar earnings and cash flow dynamics.

Exhibit 1: Cyclicals Seeing Best Earnings Growth



Data as of April 13, 2021. Source: Bloomberg.

With respect to the portfolio, we are encouraged to have fully participated in the initial rotation and strong relative performance of value stocks in the first quarter of 2021 and over the past 12 months. We believe this is just the beginning of a secular shift in market leadership and remain positioned in companies that benefit from strong operating leverage to a period of healthy nominal GDP growth. This translates to a significant overweighting in pro-cyclical sectors such as industrials, materials and energy. To illustrate, we initiated a new position in Japanese trading house Kanematsu during the quarter. Like most peers, Kanematsu had a number of end markets that were negatively impacted by the pandemic, such as mobile devices, steel, and auto/aerospace. However, the company continued to maintain a strong balance sheet and solid return on equity throughout. Offering the unique combination of a 4% dividend yield plus cyclical exposure, the shares should benefit from a return of Japanese investors to the domestic stock market as new brokerage account openings continue to surge.

From a regional perspective, Europe and the U.K. continue to be key areas of portfolio concentration as the valuations and earnings cycles remain attractive. Europe's inability to control the virus trend has been disappointing thus far but has left opportunities in laggard recovery plays related to the local economies. During the quarter, we added European hotel chain Melia Hotels as well as Spanish homebuilder Metrovacesa to the portfolio, with the thesis that Southern Europe is likely to follow the vaccination recovery path we have seen out of the U.S./U.K. Melia operates predominantly resort hotel properties in vacation hotspots throughout Southern Europe and the Americas. In

addition to topline recovery when leisure travel resumes, Melia also has significant operating leverage as an asset-heavy operator. Metrovacesa is a unique situation as a real estate developer with over 2x the land bank of peers, trading below 50% of net asset value. As housing demand in Spain recovers, this land bank provides Metrovacesa runway for significant profit and free cash flow generation, which should translate to a nearly 20% dividend yield for the next four years based on management's plans. Beyond Europe, North America and emerging markets also remain out-of-benchmark overweights, the former mostly related to our optimism toward the mining sector.

After such strong gains, many cyclical and financial stocks are somewhat overbought, and we are expecting some near-term consolidation. Any correction will be used as an opportunity to improve the fundamental quality of the portfolio. Key at this point of the market cycle is for us to be patient and avoid losing conviction during inevitable countertrend rallies in the old leadership.

In summary, the structural and generational shifts we have been discussing for some time appear to be moving from forecasts to observations. A full unwind of the mega cap growth mania is still to come but the long relative downtrends in other asset prices appear to have ended. The move in the inflation cycle from assets to real goods and the broadening out of earnings growth are key. If history is a guide, we are in the good part of the final inflation phase so the need to get defensive is premature. Some of these changes predate many investor's experience so the "path of most resistance" to recalibrating for the new environment could extend the timeframe of outperformance for long-suffering value stocks.

Portfolio Highlights

The ClearBridge International Small Cap Strategy outperformed its MSCI EAFE Small Cap Index benchmark during the first quarter. On an absolute basis, the Strategy had gains across 10 of the 11 sectors in which it was invested (out of 11 sectors total). The industrials, financials and energy sectors were the primary contributors to returns during the quarter.

On a relative basis, overall stock selection and sector allocation contributed to performance. Specifically, stock selection in the industrials and energy sectors, underweights to the real estate, information technology (IT) and health care sectors and an overweight to industrials drove returns. Conversely, stock selection in the materials and consumer discretionary sectors detracted from results.

On a regional basis, stock selection in Europe Ex-U.K. and the U.K. and an overweight to emerging markets were beneficial while stock selection in emerging markets and Asia Ex-Japan hurt performance.

On an individual stock basis, Wincanton, Cargotec, D/S Norden, Tethys Oil and Star Bulk Carriers were the leading contributors to absolute returns during the quarter. The largest detractors from absolute returns were i-Sens, NRW Holdings, Argonaut Gold, Perenti Global and Vitzrocell.

During the first quarter, in addition to the names mentioned above, we initiated positions in Marston's in the consumer discretionary sector, Optorun and u-blox in the IT sector and Krosaki Harima in the materials sector. We also closed positions in Kiwoom Securities in the financials sector, Novagold Resources in the materials sector, China Datang Renewable Power in the utilities sector, Vulcabras Azaleia in the consumer discretionary sector and Seino Holdings in the industrials sector.

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