ClearBridge Investments
A Legg Mason Company

1Q 2018 | Product Commentary

CLEARBRIDGE INTERNATIONAL VALUE FUND

Paul D. Ehrlichman, Sean M. Bogda, CFA, Safa R. Muhtaseb, CFA, and Grace Su
Portfolio Managers

Average annual total returns and fund expenses (%)

as of March 31, 2018

Class A	3-mo	1-yr	5-yr	10-yr	Since Incept. (02/18/86)	Gross	Net
Excluding sales charges	-1.78	12.26	5.72	3.04	5.81	1.42	1.25
Including effects of maximum sales charges	-7.42	5.80	4.47	2.43	5.61	-	-
MSCI AC World Ex US Index	-1.18	16.53	5.89	2.70	N/A	-	-

Performance shown represents past performance and is no guarantee of future results. *Current performance may be higher or lower than the performance shown. Investment return and principal value will fluctuate, so shares, when redeemed, may be worth more or less than the original cost. Class A shares have a maximum front-end sales charge of 5.75%. Total returns assume the reinvestment of all distributions at net asset value and the deduction of all Fund expenses. Total return figures are based on the NAV per share applied to shareholder subscriptions and redemptions, which may differ from the NAV per share disclosed in Fund shareholder reports. Performance would have been lower if fees had not been waived in various periods. Returns for less than one year are cumulative. For the most recent month-end information, please visit www.leggmason.com.*

Gross expenses are the Fund's total annual operating expenses for the share class(es) shown.

Net expenses are the Fund's total annual operating expenses for the share classes indicated and would reflect contractual fee waivers and/or reimbursements, where these reductions reduce the Fund's gross expenses, which cannot be terminated prior to December 31, 2019 without Board consent. In periods of market volatility, assets may decline significantly, causing total annual Fund operating expenses to become higher than the numbers shown in the table above.

The **MSCI All-Country World Ex-US Index** (MSCI ACWI Ex US Index) is a market capitalization-weighted index designed to measure the equity market performance of developed and emerging markets. Investors cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges.

Key takeaways

- Profound shifts are driving the current turmoil in global markets, as artificially depressed interest rates that inflated asset prices and deflated volatility are normalizing.
- Evidence of inflation continues to build, with the outperformance of a range of assets from Brazilian equities to Australian small-caps, and from commodities to emerging markets.
- The portfolio is targeting undervalued companies in Japan, Asia and emerging markets that provide a combination of strong earnings growth, rising dividends, expanding free cash flows and healthy balance sheets.

Market overview

Until the last days of January, the global markets had been in "autonomous mode," rising uninterruptedly without a need to grab the steering wheel or worry about any curves in the road. Then, the low-volatility, risk parity, machine-based algorithmic momentum models that have dominated fund flows ran into a few potholes. In February, bond yields began to rise as the continued healthy economic expansion and the coming fiscal stimulus from U.S. tax cuts met a world of central bankers contemplating an exit from quantitative easing. Clearly, interest rates did not reflect an environment of sustained growth and reflation and bond prices fell. As rates rose, stock strategies sold everything but large-cap technology shares and drove the global markets lower. While the FAANGs remained relatively strong, the low volatility and bond correlation foundation of the most rewarded and crowded trades began to crack. When confronted with rising volatility and bonds that suddenly fell along with stocks, the algorithms began to reverse their recent ETF purchases and in early March the declines resumed.

By the end of the first quarter, as the headlines filled with worries about a potential trade war, the sell-off broadened and even the unstoppable FAANGs joined the correction. Investors feared that the economy was either too strong and likely to trigger a bear market in bonds or that a new bout of protectionism and political instability would kill off the nascent global expansion. International stocks joined in the selling, falling 1.2% on average, based on the MSCI All Country-ex U.S. World Index. Developed international markets lagged, with the MSCI EAFE Index declining 1.5%, hurt by underperformance in Europe, while emerging markets (EM) managed gains, with the MSCI Emerging Markets Index advancing 1.4%.

We don't attribute last quarter's market correction to the "shocking" realization that Facebook is not focused on our well-being or that President Trump prefers the stick to a carrot in trade negotiations. Nor do we find the moderation in global economic momentum evident in the first quarter particularly troublesome at this point. Moving beyond the headlines reveals profound shifts that are driving the current turmoil in global markets. Artificially depressed interest rates stemming from the unprecedented central bank buying of bonds both inflated asset prices and deflated volatility. The exit from this period of extraordinary monetary accommodation, what we call The Great Distortion, is under way just as the demand for private and government borrowing is materially tightening global liquidity. As these distortions are removed, fundamental economic dynamics are normalizing with respect to volatility and interest rates.

We believe that the Great Reversion has begun but that it remains largely hidden in a noise-filled investment environment with investors anchored to past trends. The reflationary evidence continues to build, with the outperformance of a range of assets that benefit from rising prices including Brazilian stocks, Australian small-cap firms, the GSCI commodity index, EM and oil prices. Gold prices have also broken out of a long-term relative downtrend as compared with both bonds and stocks. Economic activity did lose some momentum in the first quarter, after posting solid growth in 2017. The Citigroup Economic Surprise Index showed worse-than-expected results in Europe, Japan and the U.K., offset by gains in China, Asia, EM and the U.S. While these trends led to increased concerns about the potential for a global downturn, a peak in such short-term indicators is consistent with a move from the recovery to expansion phase. Historically, the pace of economic gains tops out three or more years before the advent of a meaningful drop in activity.

As a value manager, it is both a source of frustration and an incredible opportunity that stock prices are largely disconnected from fundamental factors such as free cash flows, debt coverage ratios, dividends and valuations. We acknowledge the pitfalls of buying optically cheap stocks on peak profits that are poised to fall. But the number of high-quality companies with substantial room for earnings recovery, delivering strong growth, rising dividends and improving free cash flows and near decade record relative valuation lows, is extraordinary. The contrast with the darlings of the Internet of Everything bubble is also striking. For example, Amazon has a market value of about $700 billion, while the other 32 retailers in the S&P 500 are worth just $1.4 trillion. The situation is similar in China, where the "old economy" stocks have about three times the free cash flow of the social media and e-commerce firms and are expected to deliver nearly the same earnings growth for less than 10 times earnings.

Timing of a sustained move from distortion to reversion and the reconnection of asset prices to fundamentals is difficult to predict but also unnecessary for a true long-term investor. The shift will only become obvious well after a period of strong gains and the current uncertainty surrounding value stocks fades into a clearly compelling narrative.

One catalyst that could create near-term opportunities is the pressured trade situation. Being contrarian investors, when stock prices fall due to a specific concern, we work to find a silver lining. Looking beyond the obvious harm of a trade war, the impact of President Trump's confrontational approach may be to broaden and further liberalize global trade. Firstly, as with the metals tariffs, the president quickly shifts from stick to carrot and begins a negotiation process that delays and dilutes the negative impact. Secondly, in reaction to a more antagonistic U.S., other nations are incentivized to strike trade deals with each other, to increase their bargaining power.

Outlook and positioning

Based on the behavior of value-based metrics, investors continue to ignore fundamentals, just as we believe they are going to begin to matter once again. Specifically, shares in Japan, Asia and EM provide a combination of undervaluation, strong earnings growth, high and rising dividends, expanding free cash flows and healthy balance sheets. As a result, we will continue to move the portfolio exposure from West to East. In Europe, our focus is increasingly upon beneficiaries of improving domestic demand, while we reduce overall exposure to the global exporters. The poor relative performance of U.K. stocks due to Brexit-related concerns has increased the number of ideas in that market, and we may raise our weighting, especially in small- and mid-cap companies.

Our sector allocation remains tilted toward firms that will benefit from the global economic recovery, with an overweighting in industrials and materials. While our holdings of oil and gas stocks is likely to rise, we are shifting a portion of our cyclical exposure to the consumer discretionary sector as wage growth and job markets improve around the world. We believe health care stocks have finally begun to discount much of the downward pressure on drug prices, and we have increased their weighting in the portfolio. Financial shares remain the largest sector commitment, as they represent both powerful optionality as the yield curve normalizes and exposure to improving business activity. Unattractive valuations, high embedded growth expectations and potentially peaking profits keep us at less than market weight in technology. The more defensive sectors, such as telecoms, utilities and consumer staples, have become more interesting after lagging for several years, but we still lack the fundamental conviction to meaningfully add to these industries.

Markets during the first quarter reminded us that the transition from distortion to reversion will be met with resistance, disbelief, confusion and fear. The nature of the current "re-norming," which simultaneously raises the cost of capital and pressures inflated asset prices, challenges the very foundation on which many egos and empires have been built. While a further correction and increased volatility are likely, our disciplined process continues to highlight the significant opportunity in preparing for the coming shift in the global economic and investment landscape.

Fund highlights

For the quarter ended March 31, 2018, the ClearBridge International Value Fund — Class A shares had a cumulative return of -1.78%, excluding the effects of sales charges. In comparison, the Fund's unmanaged benchmark, the MSCI All Country World Ex-US Index, returned -1.18%, while the Lipper International Multi-Cap Value Funds category average returned -1.30% for the same period.

On an absolute basis, the Fund had gains in four of the 10 sectors in which it was invested. The primary contributor to performance was the consumer discretionary sector, while the primary detractors were the industrials, information technology (IT) and materials sectors.

In relative terms, stock selection detracted from performance. Stock selection in the industrials, IT, health care and consumer staples sectors detracted the most from relative returns during the period. Conversely, strong stock selection in the financials and consumer discretionary sectors aided relative performance during the period.

On a regional basis, stock selection in Europe Ex-UK, the United Kingdom and Japan were the primary detractors from relative performance. Meanwhile, an underweight to North America had a positive impact.

On an individual stock basis, positions in Duratex, Prada, Far East Horizon, China Construction Bank and UniCredit were the greatest contributors to absolute returns during the quarter. Renewi, WPP, Hengan International Group, AXA and ThyssenKrupp were the largest detractors from absolute performance.

In the first quarter, we initiated new positions in Bangkok Bank, in the financials sector, ProSiebenSat.1 Media, in the consumer discretionary sector, and Cathay Pacific Airways, in the industrials sector. We also closed positions in Grupo LALA SAB and Marine Harvest, in the consumer staples sector, Itau Unibanco, in the financials sector, Leopalace21, in the real estate sector, Samsung, in the IT sector, and Tarkett, in the industrials sector.

Top 10 equity holdings (%)	
Banco Santander SA	2.5
Honda Motor Co Ltd	2.3
China Construction Bank Corp	2.2
BNP Paribas SA	2.1
Hitachi Ltd	2.0
Novartis AG	2.0
Rio Tinto Ltd	2.0
BP PLC	2.0
UBS Group AG	1.8
thyssenkrupp AG	1.7

Sector allocation (%)	
Financials	26.6
Materials	15.2
Consumer Discretionary	13.9
Industrials	12.7
Health Care	7.3
Information Technology	6.9
Energy	5.9
Consumer Staples	3.1
Telecommunication Services	1.5
Real Estate	1.0
Utilities	0.0
Cash/Other	5.9

Percentages are based on total portfolio as of quarter end and are subject to change at any time. For informational purposes only and not to be considered a recommendation to purchase or sell any security.

Definitions and additional terms:

Please note that an investor cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges.

Category average returns' Source: Lipper Inc. **Past performance is no guarantee of future results.** Lipper returns are based on the three-month period ended March 31, 2018, and they are calculated among 157 funds in the Lipper International Multi-Cap Value peer group, including reinvestment of dividends and capital gains, if any, and excluding sales charges.

Brexit is an abbreviation for "British exit," which refers to the U.K.'s decision in a June 23, 2016 referendum to leave the European Union (EU).

The **Citigroup Economic Surprise Indices** are objective and quantitative measures of economic news defined as weighted historical standard deviations of data surprises (actual releases versus Bloomberg survey median). A positive reading of the Economic Surprise Index suggests that economic releases have on balance been beating consensus.

FAANG is an acronym for the five most popular and best-performing tech stocks in the market, namely Facebook, Apple, Amazon, Netflix and Alphabet's Google.

Free cash flow (FCF) is measure of financial performance calculated as operating cash flow minus capital expenditures.

The **Goldman Sachs Commodity Index (GSCI)** is a composite index of commodity sector returns which represents a broadly diversified, unleveraged, long-only position in commodity futures.

MSCI All-Country World Index ex-US (MSCI ACWI ex-US) is a market capitalization-weighted index designed to measure the equity market performance of developed and emerging markets.

MSCI EAFE Index is a free float-adjusted market-capitalization index designed to measure developed market equity performance, excluding the U.S. and Canada. The MSCI EAFE Index consists of the following 21 developed market country indexes: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

Quantitative easing (QE) refers to a monetary policy implemented by the Federal Reserve in which it increases the excess reserves of the banking system (supply of money) through the direct purchase of U.S. Treasury securities.

The **yield curve** shows the relationship between yields and maturity dates for a similar class of bonds.

LEGG MASON
GLOBAL ASSET MANAGEMENT

- Brandywine Global
- Clarion Partners
- **ClearBridge Investments**
- EnTrustPermal
- Martin Currie
- QS Investors
- RARE Infrastructure
- Royce & Associates
- Western Asset

leggmasonfunds.com

1-800-822-5544

Youtube.com/leggmason

linkedin.com/company/legg-mason

@leggmason

Legg Mason is a leading global investment company committed to helping clients reach their financial goals through long-term, actively managed investment strategies.

- A broad mix of equities, fixed income, alternatives and cash strategies invested worldwide
- A diverse family of specialized investment managers, each with its own independent approach to research and analysis
- Over a century of experience in identifying opportunities and delivering astute investment solutions to clients

What should I know before investing?

Equity securities are subject to price fluctuation and possible loss of principal. Small- and mid-cap stocks involve greater risks and volatility than large-cap stocks. International investments are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging markets. To the extent the Fund invests in fixed income, these securities are subject to various risks, including but not limited to credit, inflation, income, prepayment and interest rates risks. As interest rates rise, the value of fixed income securities falls. Active management does not ensure gains or protect against market declines.