# International Growth • International Equity Strategies

International Growth invests primarily in large cap, growth-oriented companies in both developed and emerging markets. The strategy's management team employs both top-down and bottom-up fundamental analysis to identify attractive countries and economic sectors as well as high-quality companies worthy of a long-term investment allocation. The portfolio's primary objective is long-term capital appreciation. The maximum direct exposure to emerging markets is 25% of the portfolio's total value.

## Mid-Year Market Update

As we begin the second half of 2021, we would like to take the opportunity to provide a mid-year update on where the international equity markets stand. Despite the ongoing COVID-19 pandemic, intensifying geopolitical tensions, rising valuations, and other uncertainties, the performance of non-U.S. stocks has been very strong during the past six months. In fact, performance for the asset class has been robust for the past year, with the MSCI World ex-U.S. Index generating a return of 34.2% for the year ended June 30, 2021. It was the second strongest trailing one-year return, on a rolling basis, during the past decade (only March 2020-March 2021 was stronger). As a result, investors have once again started to take notice of the strength in foreign stocks. According to Jefferies Research, inflows into global funds were the second highest ever during Q2 2021, only surpassed by those in Q1 of this year. Outside of U.S. equities, inflows were the strongest to China ($19B), Japan ($16B), and Hong Kong ($12B). Europe recorded new equity purchases of $46 billion, while emerging markets were nearly $15 billion. Not surprisingly, we are having more conversations with financial advisors who are beginning to increase exposure to international equities. We have previously explained the important role that the U.S. dollar (USD) has in shaping foreign equity returns. In the most simplistic explanation of this relationship, in an environment where the USD is strong, domestic equities tend to outperform. When the dollar is weak, emerging and developed market stocks outside the U.S. tend to outperform. During the past quarter, the U.S. Dollar Index was essentially flat (the dollar weakened by 0.1%) but has appreciated by nearly 3% on a year-to-date basis. Dollar strength has weighed on international equities in terms of relative performance when compared to domestic stocks for much of the past decade. However, our forecast remains in support of a weakening USD. We believe the year-to-date strength will begin to fade, thus providing a tailwind for stocks domiciled outside the U.S.

At the end of June 2021, the dividend yield for the MSCI World ex-U.S. Index was 2.4%, a full percentage point above the S&P 500. As recently as March 2020, the dividend yield for the MSCI World ex-U.S. Index was 4% versus the S&P 500 yield of 2.3%. The most significant contributing reason for the drop in the yields of the international indices since March of last year is a result of regulation on banks. Specifically, the supervisory board of the European Central Bank recommended that banks, under their supervision, refrain from paying cash dividends to shareholders to ensure that capital on the balance sheets of financial institutions was commensurate with the COVID-induced risks on their bank loans. As conditions continue to improve and more clarity emerges, it seems likely that the dividend payments will resume this fall. These payments should materially increase the yield on international benchmarks, thus providing income-oriented investors with a desired and welcomed result. Another byproduct of the coronavirus pandemic was the significant drop-off in earnings experienced by companies throughout the world. In 2019, the MSCI World ex-U.S. Index, according to Bloomberg data, had earnings per share of $107.07. This figure fell to $57.03 last year. Should current 2021 estimates hold true, earnings are expected to jump to $140, which would be the most profitable year for developed market company earnings since 2007.

Encouragingly, the anticipated and dramatic improvement of earnings is unfolding against a backdrop of a somewhat disjointed response to COVID-19 in many developed markets. Despite the appearance of outright mismanagement in many corners of the globe, recovery from the pandemic continues to intensify. In its latest economic update released on July 7, 2021, the European Commission upgraded its estimate of GDP to 4.8% this year from the most recent estimate of 4.3%, and the 2022 GDP forecast was revised to 4.5% from 4.4%. While China and the U.S. have recovered to levels of economic activity experienced before the coronavirus, most of the world still has much work to do to regain pre-pandemic levels. The delayed recovery in places such as Japan, Europe, and most of the emerging market economies can actually work in the forward-looking favor of international equity investors. Capital Economics, in its most recent macroeconomic forecast, expects GDP growth in foreign developed markets, as well as in emerging economies, to exceed that of the domestic market. The domestic growth forecast is over 4%, while Germany (+5%), the United Kingdom (+5.5%), and emerging markets (+5.1%), for example, are all projected to outperform the U.S. in 2022. Should the current path to improving conditions remain in place, investors will have the opportunity to capitalize on the bright future for international investing.

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## Quarterly Trading Summary

In late March, Canadian Pacific Railway (CP) and Kansas City Southern (KSU) agreed to merge. At that time, the potential merger of these two companies had no direct impact on the International Growth portfolio. However, that changed in April when our portfolio holding Canadian National Railway (CNI) made an unsolicited (higher) offer for KSU. Our investment team had a cautious but favorable opinion of the initial offer, but, after a few weeks of back-and-forth, CNI increased its offer to acquire KSU. The KSU Board of Directors deemed CNI's new offer to be superior, broke off talks with CP, and entered into a new merger agreement with CNI. Following the latest offer, we determined that the combination of regulatory pressures and delays, increased debt, potential divestitures, and time required to implement and benefit from structural changes created too many near-term headwinds. Therefore, the decision was made to sell CNI, a position held since Q4 2018.

In mid-May, we sold China-based delivery company ZTO Express. While package volume has risen substantially in China over the past several years, so has the competition to deliver those parcels. In an effort to take market share, ZTO management made the decision to sacrifice margin. The result of this decision saw the average selling price, per package, decline by 20% in Q4 2020. Accordingly, earnings estimates have been adjusted downward through fiscal year 2022 by an average of 20%. Longer term, the decision to pursue a larger slice of the Chinese package delivery market could pay off for ZTO. However, the near-term margin destruction and revenue decline were reasons to exit the position and deploy the proceeds in a more attractive alternative holding, Vale S.A.

Vale S.A. is a Brazilian mining company, and nearly 80% of its product mix is iron ore-related. As such, the company is well-positioned to benefit from a return to global growth and increased infrastructure spending following the pandemic. From a top-down perspective, the purchase of Vale increased the allocation to emerging markets and raised the Materials sector allocation to an overweight position. From a bottom-up, company-specific standpoint, Vale trades at a discount versus the mining peer group on an EV/EBITDA basis, generates significant free cash flow, and offers investors a dividend yield of nearly 2% (whereas ZTO paid no dividend). Additionally, by being domiciled in Brazil, Vale could become a beneficiary of the ongoing trade dispute between China and Australia.

The late June purchase of Canadian-based industrial aviation training company CAE replaced Canadian National Railway in a same country/same sector swap. CAE operates three business units: Civil Aviation Training Solutions; Defense & Security; and Healthcare. We are very familiar with CAE as the company has been a holding in our International Developed strategy since 2019. Primarily, CAE builds flight simulators used worldwide by many of the largest airlines to train pilots. CAE able to maintain EBITDA margins during the COVID-19 downturn, and moving forward we expect the company to benefit from multiple tailwinds. Globally, air travel demand continues to improve following the worst of the pandemic, causing airlines to bring back pilots from furlough. As this process transpires, pilots will need to be re-certified using simulators before returning to the cockpit of actual aircraft. The Boeing 737 Max aircraft is in the process of being re-certified around the world, and Gulfstream is adding new general aviation platforms. These developments will also benefit CAE as pilots will need to get certified to fly these planes. Longer-term air travel demand should continue to rise globally, creating more opportunities for CAE. The stability of CAE's business combined with its ability to leverage earnings as travel demand grows make this an exciting new addition.

## Performance Review

International developed market equities continued their strong performance during the second quarter of 2021 and recorded the third best January-June index level returns (+9.9%) over the past decade. The MSCI World ex-U.S. Index posted a return of 5.6% during the second quarter, while the Confluence International Growth strategy was up 7.6% (gross of fees) during the same period. On a year-to-date basis, International Growth was up 10.0% (gross of fees) versus 9.9% for the benchmark. [*Net-of-fees returns for the same periods were +6.8% QTD and +8.4% YTD. See disclosures on p.4 for fee description; actual investment advisory fees may vary.*]

Growth stocks returned to favor over the past three months as the MSCI World ex-U.S. Growth Index outperformed the MSCI World ex-U.S. Value by 4.0% (+7.7% versus +3.7%). An additional aspect that provided a tailwind for our large cap, high-quality, growth-oriented portfolio was the reemergence of "Quality" in terms of style leadership as equities within the MSCI EAFE Quality Index, a close substitute as there is no World ex-U.S. Quality Index, recorded a return of 9.6% during the past three months.

The two best-performing countries within the portfolio on an absolute basis were Denmark (+21.6%) and France (+18.1%), and the worst returns were recorded by Japan (-6.3%) and Sweden (-3.9%). From a sector standpoint, Materials (+17.2%) and Consumer Staples (+13.4%) were the strongest sectors during the quarter, while Communication Services (-1.7%) and Energy (+3.8%) were the weakest.

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## Performance Review continued...

The top contributors and detractors during the quarter:

| Security | Avg Weight (%) | Contribution (%) |
|---|---|---|
| **Top 5** | | |
| Shopify Inc. | 3.56 | 1.06 |
| DSV Panalpina A/S | 4.62 | 0.85 |
| LVMH Moët Hennessy Louis Vuitton | 4.17 | 0.71 |
| Novo Nordisk A/S | 2.50 | 0.58 |
| L'Oréal S.A. | 2.92 | 0.48 |
| **Bottom 5** | | |
| Melco Resorts & Entertainment Ltd. | 0.68 | (0.13) |
| Tencent Holdings Limited | 2.46 | (0.14) |
| Canadian National Railway Company | *Sold* | (0.18) |
| Sony Group Corporation | 3.65 | (0.31) |
| Komatsu Ltd. | 1.48 | (0.33) |

*(Contribution data shown from a sample account, based on individual stock performance and portfolio weighting)*

## What We Are Watching

As we navigate our way through the months of summer, there are many different topics we are closely watching as each or all could have a significant impact on investment returns as well as portfolio construct. The delta variant of the coronavirus continues to hamper economic recovery and create risks to forward-looking projections. Large economies, including Japan, Spain, India, and Brazil, and many others, continue to struggle with the rapid spread of the virus. Elsewhere, inflationary pressures have begun to percolate via a combination of factors, including supply chain shortages and disruptions, dearth of available workforce, rising commodity prices, rapid reopening of many economies, and scarcity of some goods. While we expect near-term price increases, our longer-term view remains that inflation will subside as global macroeconomic conditions stabilize and the virus headwinds abate. The late September German federal election, which will determine the individual to replace current Chancellor Angela Merkel, will be important to observe, considering Germany's significant role in shaping European politics. As of this writing, *Politico* has Merkel's hand-chosen successor and chairman of the Christian Democratic Union, Armin Laschet, as the frontrunner. Mr. Laschet is followed by Annalena Baerbock (Green Party) and Olaf Schulz (Social Democrats). Any candidate winning the election other than Laschet would be, at this stage, considered a surprise.

Globally, the regulatory environment continues to evolve in a manner that provides government leaders with more control over what happens at a corporate level. The G20 is contemplating the implementation of a minimum global tax. On July 8, President Biden signed an executive order instructing government agencies to make necessary reforms to benefit consumers in agriculture, pharmaceuticals, technology, and other areas. This is an attempt to promote competition and could unsettle domestic equity market leadership, namely the FAANG stocks. Elsewhere, President Xi in China has continued his assault on large technology companies by introducing forced regulation, denying mergers, scuttling IPOs, creating a new regulatory framework, and changing how companies can operate within areas including education. One overarching theme among these topics is that global leaders continue to make known their desires to develop technology domestically in an effort to dissuade foreign influence. The Confluence macroeconomic team recently published a two-part *Weekly Geopolitical Report* entitled "Taiwan and the Risk of Deglobalizing the World's Semiconductor Industry" (**Part I**, **Part II**) that details the possibility of important changes on the horizon. A link to these ***Weekly Geopolitical Reports***, as well as a multitude of other research and reports from Confluence Investment Management, can be found on our **website**.



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(as of 6/30/21)

| 10 Largest Holdings | Weight |
|---|---|
| Shopify Inc. | 4.3% |
| Taiwan Semiconductor Manufacturing | 4.1% |
| DSV Panalpina A/S | 4.1% |
| Accenture plc | 3.8% |
| Sony Group Corporation | 3.5% |
| Aptiv PLC | 3.3% |
| Icon plc | 3.2% |
| LVMH Moët Hennessy Louis Vuitton | 3.1% |
| Waste Connections, Inc. | 3.0% |
| L'Oréal S.A. | 3.0% |

| Sector Allocation | Weight |
|---|---|
| Information Technology | 23.2% |
| Financials | 13.8% |
| Industrials | 12.9% |
| Consumer Discretionary | 12.6% |
| Health Care | 11.2% |
| Materials | 9.7% |
| Consumer Staples | 9.6% |
| Communication Services | 4.7% |
| Energy | 1.5% |
| Cash | 0.8% |

| 10 Largest Countries | Weight |
|---|---|
| Canada | 17.0% |
| Ireland | 13.9% |
| Japan | 9.3% |
| Switzerland | 7.9% |
| Denmark | 6.8% |
| United Kingdom | 6.8% |
| France | 6.0% |
| China | 4.4% |
| Singapore | 4.1% |
| Taiwan | 4.1% |

The listing of "10 Largest Holdings" is not a complete list of all stocks in the portfolio or which Confluence may be currently recommending. Application of the investment strategy as of a later date will likely result in changes to the listing. Listings of countries and holdings do not represent all of the countries/stocks currently or previously owned in the portfolio or which Confluence may be currently recommending. Sector/country weightings and holdings of individual client portfolios in the program may differ, sometimes significantly, from these listings. Contact Confluence for a complete list of holdings.

All investments carry a certain degree of risk, including possible loss of principal. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager. Equity securities are subject to market risk and may decline in value due to adverse company, industry or general economic conditions.

## Performance Composite Returns (For Periods Ending June 30, 2021)

| | Pure Gross-of-Fees[1] | Net-of-Fees[2] | MSCI World ex-US |
|---|---|---|---|
| Since 10/1/99 | 7.1% | 3.9% | 4.7% |
| 20-Year* | 8.0% | 4.8% | 5.9% |
| 15-Year* | 7.2% | 4.0% | 4.5% |
| 10-Year* | 7.3% | 4.1% | 5.7% |
| 5-Year* | 14.0% | 10.6% | 10.4% |
| 3-Year* | 14.4% | 11.0% | 8.6% |
| 1-Year | 34.8% | 30.8% | 33.6% |
| YTD | 10.0% | 8.4% | 9.9% |
| QTD | 7.6% | 6.8% | 5.6% |

**Average annualized returns*

| Calendar Year | Pure Gross-of-Fees[1] | Net-of-Fees[2] | MSCI World ex-US | Difference (Gross-MSCI World ex-US) | # of Portfolios | Composite Assets (000s) | Total Firm Assets (000s) | Composite 3yr Std Dev | MSCI World ex-US 3yr Std Dev | Composite Dispersion |
|---|---|---|---|---|---|---|---|---|---|---|
| 1999** | 26.6% | 25.6% | 17.4% | 9.2% | 131 | $48,987 | - | N/A | N/A | N/A |
| 2000 | (15.0%) | (17.6%) | (13.4%) | (1.7%) | 58 | $15,193 | - | N/A | N/A | 3.0% |
| 2001 | (18.1%) | (20.5%) | (21.4%) | 3.3% | 42 | $7,128 | - | N/A | N/A | 1.1% |
| 2002 | (17.9%) | (20.4%) | (15.8%) | (2.1%) | 32 | $4,654 | - | 17.1% | 16.1% | 0.7% |
| 2003 | 40.2% | 36.1% | 39.4% | 0.8% | 26 | $4,642 | - | 18.1% | 17.7% | 0.9% |
| 2004 | 18.7% | 15.2% | 20.4% | (1.6%) | 25 | $5,004 | - | 15.4% | 15.3% | 1.1% |
| 2005 | 18.2% | 14.7% | 14.5% | 3.8% | 25 | $6,651 | - | 12.1% | 11.3% | 0.5% |
| 2006 | 29.5% | 25.6% | 25.7% | 3.8% | 35 | $11,866 | - | 11.6% | 9.5% | 1.1% |
| 2007 | 23.4% | 19.7% | 12.4% | 10.9% | 49 | $16,292 | - | 12.5% | 9.7% | 2.9% |
| 2008 | (37.8%) | (39.6%) | (43.6%) | 5.8% | 76 | $14,221 | - | 20.7% | 19.5% | 1.5% |
| 2009 | 31.8% | 27.9% | 33.7% | (1.8%) | 114 | $28,437 | - | 23.0% | 23.9% | 2.1% |
| 2010 | 13.2% | 9.9% | 8.9% | 4.3% | 168 | $60,558 | - | 24.3% | 26.3% | 1.3% |
| 2011 | (11.4%) | (14.1%) | (12.2%) | 0.8% | 253 | $80,988 | - | 20.1% | 22.3% | 0.6% |
| 2012 | 16.1% | 12.7% | 16.4% | (0.3%) | 254 | $94,222 | - | 17.6% | 19.0% | 0.6% |
| 2013 | 19.1% | 15.6% | 21.0% | (1.9%) | 291 | $113,801 | - | 14.4% | 16.0% | 0.6% |
| 2014 | (1.7%) | (4.6%) | (4.3%) | 2.6% | 177 | $88,982 | - | 11.4% | 12.7% | 0.7% |
| 2015 | (2.1%) | (5.0%) | (3.0%) | 0.9% | 191 | $81,898 | - | 11.5% | 12.3% | 0.4% |
| 2016 | (5.1%) | (7.9%) | 2.7% | (7.8%) | 113 | $39,444 | - | 12.0% | 12.3% | 0.7% |
| 2017 | 25.2% | 21.4% | 24.2% | 1.0% | 62 | $28,303 | - | 11.1% | 11.7% | 0.8% |
| 2018 | (13.5%) | (16.1%) | (14.1%) | 0.6% | 30 | $15,707 | $5,486,737 | 11.7% | 11.1% | 0.2% |
| 2019 | 30.1% | 26.3% | 22.5% | 7.6% | 24 | $14,419 | $7,044,708 | 12.5% | 10.8% | 0.3% |
| 2020 | 20.6% | 17.1% | 7.6% | 13.1% | 25 | $15,512 | $6,889,798 | 18.0% | 18.1% | 0.4% |

**Portfolio Benchmarks**

***MSCI World ex-U.S. (Net) Index*** – Free float-adjusted market capitalization index designed to measure developed market equity performance, excluding the U.S. Performance results presented net of estimated foreign withholding taxes on dividends, interest and capital gains. *(Source: Bloomberg)*

*(Prior to March 31, 2020, the S&P/BNY ADR Index was shown as a secondary benchmark. This index was removed to simplify the presentation, being less widely recognized and relevant than the primary benchmark. An index is unmanaged and does not incur management fees, transaction costs or other expenses associated with separately managed accounts. It is not possible to invest directly in the index.)*

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The International Growth Strategy was incepted on October 1, 1997, and the current International Growth Composite was created on May 1, 2018. Performance presented prior to May 1, 2018, occurred while the Portfolio Management Team was affiliated with a prior firm and was independently verified for the periods of 10/1/1999 through 12/31/2017. The Portfolio Management Team members were the primary individuals responsible for selecting securities to buy and sell. Composite performance is typically net of foreign withholding taxes on dividends, interest income and capital gains with some exceptions based on custodian treatment. Confluence Investment Management LLC is an independent registered investment adviser. Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Past performance is not indicative of future results. The U.S. Dollar is the currency used to express performance. Returns are presented gross and net of all fees and include the reinvestment of all income.

[1] Pure gross returns are shown as supplemental information to the disclosures required by the GIPS® standards.

[2] Net of fee performance was calculated using the highest applicable annual bundled fee of 3.00% applied quarterly. This fee includes brokerage commissions, portfolio management, consulting services and custodial services. The Confluence fee schedule for this composite is as follows: 0.60% on the first $500,000; 0.55% on the next $500,000; and 0.50% over $1,000,000. There are no incentive fees. Clients pay an all-inclusive fee based on a percentage of assets under management. The collection of fees produces a compounding effect on the total rate of return net of fees. Bundled fee accounts make up 100% of the composite for all periods. Actual investment advisory fees incurred by clients may vary. Wrap fee schedules are provided by independent wrap sponsors and are available upon request from the respective wrap sponsor.

A complete list of composite descriptions is available upon request. Policies for valuing investments, calculating performance, and preparing GIPS Reports are available upon request. The annual composite dispersion is an equal-weighted standard deviation, using gross-of-fee returns, calculated for the accounts in the composite for the entire year. Prior to year-end 2018, the annual composite dispersion was an asset-weighted standard deviation calculated for accounts in the composite for the entire year. The three-year annualized standard deviation measures the variability of the composite gross returns over the preceding 36-month period. The International Growth Composite contains fully discretionary International Growth wrap accounts. The International Growth portfolio invests in U.S.-listed shares of large capitalization, growth-oriented, non-U.S. companies from developed markets with up to 25% from emerging markets. **Results shown for the year 1999 represent partial period performance from October 1, 1999, through December 31, 1999. N/A-Composite Dispersion: Information is not statistically meaningful due to an insufficient number of portfolios in the composite for the entire year. N/A-3yr Std Dev: Composite does not have 3 years of monthly performance history.

***Individual holding performance and contribution methodology as well as a list of every holding's contribution to the strategy can be obtained by contacting Confluence.*** *Material is published solely for informational purposes and is not an offer to buy or sell or a solicitation of an offer to buy or sell any security or investment product. Top 5 contributors/detractors reflects the strategy's best and worst performers, based on each holding's contribution to the sample account for the period stated. Holdings identified do not represent all of the securities purchased, sold or recommended. Sector and country allocations represent a portion currently or previously held in a representative (model) portfolio invested in accordance with the stated investment strategy. Information is presented as supplemental information to the disclosures required by GIPS® standards. Opinions and estimates are as of a certain date and subject to change without notice. Investment or investment services mentioned may not be suitable to an investor and the investor should seek advice from an investment professional, if applicable. Past performance is no guarantee of future results. Investing in securities involves the risk of loss of the amount invested that investors should be prepared to bear. There can be no assurance that any investment objective will be achieved or that any investment will be profitable or avoid incurring losses.* ***Indices:*** *The MSCI World ex-U.S. Index is shown as additional information. This index is unmanaged. An investor cannot invest directly in an index. It is shown for illustrative purposes only & does not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance.*

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