Lazard International Strategic Equity Portfolio
Commentary

3Q
2024

Market Overview

• International markets were strong during the quarter adding to gains for the past year

• Despite concerns about slowing economic growth, earnings estimates have proven resilient and continue to rise

• Chinese coordinated monetary stimulus drove stocks higher at the end of the quarter

• The yen rose 12.5% during the quarter as the BoJ raises rates

• Interest rate sensitive sectors (real estate / utilities) led while cyclical sectors (semiconductors / energy) significantly underperformed

• Low quality stocks outperformed by a wide margin during the quarter

International equities continued to rally in the third quarter and were supported by the combination of resilient corporate profits and lower interest rates. Despite an extraordinary rate hike cycle post COVID, corporate profits have remained not only resilient, but expectations in the market are also improving as we head into next year. After a strong earnings season during the third quarter, full year 2024 earnings growth expectations have risen to 10%. And consensus expectations for 2025 call for a similar level of earnings growth.

Despite this corporate profit resilience, valuations remain very much in line with history and at historic discounts to the US.

The market broadened during the third quarter to include more rate-sensitive sectors such as real estate and utilities but at the expense of some cyclical sectors like technology (semiconductors in particular) and energy.

The market also broadened from a regional perspective. Early in the quarter investors became nervous about the prospect for higher rates in Japan which led to a short-term plunge in Japanese equities as a result. The Japanese market has since recovered when measured in US dollars due in part to the Yen which strengthened 12.5% during the quarter.

Chinese equities rallied over 20% late in the third quarter after a long period of underperformance. The rally in this very inexpensive market was catalyzed by coordinated monetary stimulus from the central government. While previous iterations of policy stimulus did not have this effect, the deeply discounted valuations coupled with more significant policy coordination resulted in a strong move for equities.

Portfolio Review

During the third quarter, the Lazard International Strategic Equity Portfolio rose 5.5% (net of fees), lagging the MSCI EAFE Index (the "Index") which rose a strong 7.3%. Three factors contributed to this underperformance.

1. Low quality stocks outperformed high quality stocks by nearly 1,000 basis points

2. Semiconductors underperformed the benchmark by over 2,000 basis points and we remain overweight

3. Two high-conviction pharmaceutical companies underperformed

Our performance has historically faced more headwinds when the low-quality Value style dominates (such as late 2009, late 2016 and 2021/22). While the market environment characterized by style extremes has subsided somewhat over the past year, the normalization process has been erratic.

Some quarters have been dominated by low-quality stocks and the third quarter was one example of that. In developed markets, companies with low ROE outperformed those with high ROE by nearly 1,000 basis points – an extreme style shift in one quarter which typically doesn't last. Part of this was due to the fact that semiconductors, many of which are higher quality cyclicals with structural growth drivers and higher financial productivity, lagged the market by nearly 2,000 basis points.

Negatives

• Semiconductor overweight:

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o After having been among the leadership stocks in the first half of 2024, semiconductor stocks fell over 17% during the quarter, underperforming the market by nearly 25%. Our average 6% overweight to the industry cost nearly 200 basis points, more than the total underperformance of the strategy. In fact, stock selection within semiconductors was positive. We believe the inventory cycle for semis has troughed after unprecedented supply chain shortages during the COVID pandemic caused over-ordering by customers. We have analyzed what the next peak for this growth cyclical industry might look like and with the added layer of AI chip demand, we believe the next peak for semiconductors will come around over the next several years and significantly above the prior peak from 2022.

o Our largest investment in the industry is ASML (3.6% weighting in the Portfolio) which is the world's dominant provider of photolithography machines that are a critical step in the chip manufacturing process used to etch patterns onto silicon wafers forming circuits. Their EUV machines enable the production of smaller and more powerful/energy efficient chips. This helps manufacturers like Taiwan Semiconductor keep pace with Moore's Law which states that the number of transistors and computing power on a chip doubles every two years. The stock fell nearly 20% during the quarter. While this was generally in line with the semiconductor industry performance, it significantly lagged the 7.3% return of the MSCI EAFE Index. With significant exposure to Chinese demand, the stock lagged the market due in part to fears of an escalating US trade dispute. At this time, we think the risk associated with export control restrictions is factored into the price and we added to the Portfolio's position on the pullback.

• High-conviction investments in pharmaceutical companies cost roughly 125 basis points:

o Novo Nordisk (4.5% weighting) is the global leader in GLP-1 class of weight loss drugs. They manufacture and market Ozempic for type 2 diabetes and Wegovy for weight loss. After outperforming for the first half of the year, the stock declined 18% during the quarter after the company reported second quarter results that only slightly missed consensus estimates. In addition to a one-time rebate adjustment and some price pressure from mix shift, most of the miss was driven by Wegovy supply constraints, not a demand problem. The lower realized price in the second quarter was due to Wegovy expanding into Medicaid channels; not due to competition related pricing pressures. Wegovy is now in over 20 Medicaid states, compared to 5 in the first quarter of 2024. This is a market that competes on supply and prices are typically ~30% lower than commercial plans. Despite the second quarter being soft, Novo raised full year 2024 guidance for both sales and operating profit growth, to 22-28% and 20-28% respectively. We continue to believe the long-term opportunity in obesity remains significant and added to the portfolio's position on the pullback. We believe the obesity market will continue to grow and upcoming clinical trials could provide Novo with catalysts that solidify their lead in this rapidly growing market for years to come.

o Icon (3.1% weighting) shares declined 8% after reporting second quarter results. Icon is the second largest clinical contract research organization (CRO) and is domiciled in the United Kingdom. While EPS came in ahead of consensus expectations and full year guidance was raised, revenues came in below consensus expectations and full year revenue guidance was lowered. The revenue guidance cut can be attributed to a combination of delayed trial starts and currency headwinds, neither of which we believe impact the fundamentals of the company or our long-term investment thesis. We added to the position on weakness and believe that not only are budgets for clinical trials still robust, but the outsourcing of these trials to CROs will continue.

Positives

• Stock selection in Japan positively contributed to relative returns. While the Japanese market slightly underperformed the broad Index during the quarter on yen strength, stock selection was strong driving positive attribution.

o BayCurrent Consulting (1.4% weighting) is a consulting services company that is based in Tokyo. The company has a focus on IT strategy and digital transformation where Japan is far behind the rest of the world, so the growth outlook is strong. Shares rose after the company reported first quarter results where margins remained resilient despite the lapse of a large project. This should help dispel concerns of a potential margin reset and reinforces our belief that the concerns about margin and business model drift are unfounded. These results are supportive of our investment thesis, and we added to the Portfolio's position believing the stock offers attractive relative value.

o Kobe Bussan (1.1% weighting) is a Japanese supermarket similar to Costco in the United States, without the membership scheme. Shares rebounded, after underperforming in a weaker yen environment, after the company reported second quarter results where sales growth came in at +7.8%. (year-over-year). We added to the Portfolio's position on share price weakness earlier in the quarter.

o Based in Japan, Sanrio (1.4% weighting) owns, manages, and licenses an IP (intellectual property) portfolio of 450 characters. Some of the most popular names include Hello Kitty, My Melody, and Cinnamonroll. Shares rose after the company reported consensus beating first quarter results where operating profit came in 80% ahead of consensus expectations and the full year operating profit forecast increased by 24%. Strong licensing growth in North America and China, high margin areas, contributed to outperformance as did a strong recovery in their domestic theme park and retail businesses. We believe Sanrio remains attractively valued considering the high incremental returns associated with key growth drivers. We purchased Sanrio during the quarter.

o Shimadzu (1.3% weighting) is a Japan-based manufacturer of measuring equipment. Shares rose after the company reported results in August. Revenue growth came in ahead of consensus expectations. Notably, North America and China revenues improved sequentially, the US from -4% to 0% and China from -31% to -16%. Orders continued to improve with consolidated (ex-China) up +4-6% year-over-year and China up +20%. These results are supportive of our investment thesis, and we maintained the Portfolio's position.

• Stock Selection in the financials sector positively contributed to relative returns. Stock selection was particularly strong in Banks (Bank Leumi) as well as in Insurance (Aon).

o Bank Leumi (2.2% weighting) is a leading Israeli bank. Banks in Israel operate as an oligopoly and are now focused on improving returns after years of increasing regulations. Barriers to entry are significant as Israel's banking rules are very strict. Despite the escalating conflict in the Middle East, shares rose during the period after the company reported second quarter results. Nonperforming loans (NPL) declined, and the firm reported net write backs. These results are supportive of our investment thesis, and we maintained the Portfolio's position.

o Shares of Ireland-based global Insurance broker Aon (2.6% weighting) rose after the company reported second quarter results. Core margins came in at +10 bps year-over-year and organic growth in Aon's most valuable business, Commercial Risk Solutions, accelerated to +6% year-over-year from +3% in the first quarter. We are pleased to see the market is starting to look past the NFP acquisition and shift their focus back to fundamentals. As a broker and an asset-light company in a fairly consolidated industry, Aon generates strong returns on capital which we believe will be sustained due to strong pricing power and cash flow generation. These results are supportive of our investment thesis, and we maintained the Portfolio's position.

Outlook

• Geopolitical risks abound - Middle East, China, Russia, US elections, etc.

• Post COVID rate hike cycle is over as the Fed joins the ECB Bank in lowering policy rates

• International valuations at historic discounts vs lofty US levels

As the rate of inflation continues to fall and labor markets begin to weaken, central banks have become more unified in their effort to support global growth through lower policy rates. The Fed joined the ECB by lowering policy rates by 50 basis points (bps)at their September meeting, a slightly more aggressive move than consensus had expected. This policy shift could be supportive of quality cyclicals, which have underperformed, as the durability of competitive advantages, in our view, will become a critical differentiator as the market transitions to this new regime.

The Chinese equity market rose over 20% in the quarter, much of that in the last week. While the spark that lit the fire under Chinese stocks was coordinated monetary policy stimulus, the dry tinder that provided the fuel for the sharp rally was very cheap valuations. Rising valuations mean that expectations for corporate profit growth have also risen. We won't know whether or not the stimulus will have a meaningful impact on the Chinese consumer for some time as home prices continue to fall and consumer confidence is very weak. Valuations have moved higher off a low base, but earnings improvement remains an outstanding question.

Japan has been a market of heightened investor attention this year as increasing focus by corporate managements on improving their depressed levels of financial productivity has led to positive earnings growth and some expectation for valuation re-rating. While the BoJ has made it clear they want to raise policy rates amidst a backdrop of some structural inflation, it remains a difficult balancing act with a stronger currency. If Japan raises rates in a world where most central banks are lowering them, there is potential the Yen could strengthen too much, as was feared in early August when the Yen carry trade rapidly unwound and the Japanese equity market fell over 15% in a matter of days. While Japanese equities quickly rebounded, they ultimately underperformed the broader market in the third quarter and the year-to-date period. Our analysts and portfolio managers have spent considerable time in Japan meeting with companies over the past year, as we always do. When we identify high-quality companies with attractive valuations or companies with solid idiosyncratic prospects for improvement in financial productivity that has not already been captured in valuation by the market, we are happy to invest.

Geopolitical risks remain active, and likely always will. The outcome of the US Presidential election will be unpredictable and so will the winners' policy initiatives. We continue to expect the market to be more driven by fundamentals than style or macroeconomic factors going forward. As such, our portfolio is well balanced between different sources of alpha (compounders/ mispriced / improvers) enabling us to source relative performance from different areas of the market. Having this balance should enable stock selection to drive performance. We expect that outperforming stocks will broadly come from companies with strong pricing power, companies that can deliver in-line or better than expected margins and companies with less levered balance sheets. And the extremely discounted valuations for international stocks should provide support for international equities going forward.