Lazard International Strategic Equity Portfolio

Commentary

1Q 2025

Market Overview

• Driven by Europe, and helped by stronger currencies, International equities rose strongly

• International outperformed the US by the largest quarterly amount in more than two decades

• European defense spending and potential German fiscal spending are significant and contributed to strong European returns

• Tariff concerns are contributing to higher inflation expectations

• Amidst higher rates, Value significantly outperformed as banks extended their run within financials, followed by other outperforming sectors like energy and utilities

• Quality significantly lagged the market during the last two quarters

Led by European corporate fundamentals, increasing optimism around fiscal stimulus, and strengthening currencies, International equities staged the largest quarterly outperformance of the US in over two decades.

Valuations have been very inexpensive for International equities and in need of a catalyst. International equities experienced two this quarter. The first catalyst had nothing to do with the current geopolitical drama unfolding. DeepSeek, a Chinese artificial intelligence (AI) company burst onto the scene in January suggesting it could offer open-source, high performance AI models at a fraction of the cost of traditional AI giants. This new entrant to the AI race is causing competitors to pause and re-evaluate how much they spend on training AI models and investors to rethink the valuations they are willing to pay for AI-related companies. While the concentration of the US market remains significantly tilted to many of these AI-related companies whose stretched valuations are dependent on continued significant investment spend, this new entrant has called some of that into question. As a result, global investors began to shift money from the very expensive US market to much less expensive International markets.

Soon after the DeepSeek competitive revaluation, the newly inaugurated US administration began to implement its tariff policy. Initially, this new trade policy negatively impacted the targeted countries, but it then began to increase inflation expectations while also decreasing confidence in economic growth, leading some to express concern we may be entering a period of economic stagflation.

The shift in geopolitics continued as the US administration appeared to step back from its role of providing defense support for European allies. At the same time, Friedrich Merz, winner of the German election, has pledged to focus on European cooperation. His spending and investment plan for Germany stands in stark contrast to the historic fiscal conservatism of German governments. The relatively low level of German public debt has enabled Merz to pivot and potentially provide much-needed fiscal stimulus to Europe's largest economy. Coupling the potential for a multi-year increase in fiscal stimulus in Germany, targeted at transport, communication, digital and power infrastructure, with a significantly higher level of targeted defense spending across Europe, some investors hope this is the fiscal unification moment that Europe has needed.

The geopolitical volatility and shift in relative growth rates between the US and Europe has also moved bond markets and raised expectations for higher future rates.

Relatively higher bond yields (the discount rate for equities), coupled with lower expectations for growth in traditional Growth sectors such as technology and consumer discretionary, have driven a significant move toward Value (where the investment horizon is usually shorter) and away from Quality (where the investment horizon is usually longer). Within financials, the banking industry continued its extraordinary run of performance leading the EAFE Index by 11% during the quarter and 31% over the past year. Other traditional Value sectors such as energy and utilities also outperformed during the first quarter.

In this shifting environment of higher rates and slower growth expectations, Quality companies lagged Value by a wide margin. While the fundamental earnings power of certain quality companies we own continues to rise more than the market, the derating of the valuation has been significant. Over the past six months, international quality investors have seen two of the worst five quarters for Quality since 1998.

Portfolio Review

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ASSET MANAGEMENT

During the first quarter, the Lazard International Strategic Equity Portfolio rose 5.1% (net of fees), lagging the MSCI EAFE Index which rose 6.9%. The investment philosophy of the Lazard International Equity Platform is one of Relative Value where we contrast a company's level and trajectory of financial productivity with its valuation. We believe that businesses with higher and more sustainable levels of financial productivity are deserving of higher valuations. We seek to buy companies at relatively inexpensive valuations compared to the level of returns they generate.

This is a flexible strategy, both in market capitalization as well as sector and regional composition and resulting portfolio characteristics. The Portfolio management team has been positioned in higher quality investments (17% premium in ROE) with relatively inexpensive valuations (6% premium PE). As large cap stocks had significantly outperformed small and midcaps for some time, the team had found numerous small and midcap ideas that exhibited attractive relative value characteristics, albeit with a higher degree of cyclicality. Entering 2025, our exposure to these stocks was higher than it has been for a decade. Risk exposure in the Portfolio was skewed to benefit from stable to lower interest rates. This positioning proved premature as lower-quality large cap stocks, and those benefitting from the value style, outperformed the most.

Style headwinds had been significant during the COVID-era, and we had expected them to subside. We also anticipated the market to be driven more by fundamentals. While that had been happening, albeit erratically and with a bias towards value, during the first quarter our stock selection could not offset this very strong move toward value.

Negatives

The Portfolio's overweight to Quality posed the biggest headwind to performance.

• The Portfolio had an overweight to the commercial and professional Services as well as the consumer services industries, both of which are generally made up of numerous asset-light, highly financially productive businesses. In the strong value rally this quarter, these were among the two worst performing industries and our overweight cost us a significant amount of performance.

• Within the information technology sector, the Portfolio's overweight to the semiconductor and technology hardware & equipment industries, which tend to be more rate sensitive, detracted from relative returns.

From a stock specific perspective, Puma fell 47% during the quarter and hurt performance.

• Based in Germany, Puma (0.0% weighting in the Portfolio) is a global sports brand which designs, manufactures and sells sporting goods, footwear, and apparel. Shares declined after the company pre-released fourth quarter results. While sales growth accelerated, it came in slightly below consensus expectations and 2025 margin targets were pushed back. The sales miss was largely driven by a deceleration in growth in Latam, one of Puma's most profitable markets where weaker macro impacted demand, as well as a softer recovery in China. The margin target Puma previously set at its investor day in February of last year, was based on macroeconomic and external factors remaining stable. Since then, external factors have moved against Puma, with freight rates significantly increasing, the USD strengthening further (following the US election), China macro remaining under pressure, and new US tariffs a possibility. This broke our investment thesis, and we exited the Portfolio's position.

Positives

Stock selection in banks positively contributed to relative returns.

• UniCredit is a highly cash generative Italian bank run by a well-respected management team focused on improving profitability and unlocking shareholder value. Shares rose after the company reported fourth quarter results, where Net Interest Income (NII) beat consensus expectations. Other highlights included the 9 billion 2024 Euro distribution of profits and 15.9% Common Equity Tier 1 (CET1) ratio, which measures a bank's ability to withstand financial shock by comparing the bank's core capital to their risk-weighted assets. We trimmed the Portfolio's position following a period of strong performance.

• Piraeus is a Greek commercial bank. Shares rose after the company reported fourth quarter results, where performing loan growth came in ahead of consensus expectations at 12%. Later in the quarter, the company formally announced the acquisition of a 90% stake in Ethniki, the leading P&C (Property & Casualty) insurer in Greece. This was a well flagged deal, and the shares rose on the back of the news. We view this deal as a wise use of capital as it is value accretive (should lift ROE 1%), provides revenue diversification, and also helps build managements track record to the investor community. We added to the Portfolio's position, believing the shares offer attractive relative value trading on a 0.7 BV (Book Value) with a supportive economic backdrop.

Stock selection in the consumer staples sector positively contributed to relative returns.

• Carlsberg is a global brewer based in Denmark. Its beer brand portfolio includes flagship brand Carlsberg, Tuborg, and Kronenbourg/1664 Blanc, and it also owns the international rights for Brooklyn, has a strong non-alcoholic portfolio, and owns many local champion brands. Carlsberg has number one and two market share positions in the majority of markets in which it operates. Shares rose after the company reported FY 2024 results and initiated 2025 guidance ahead of consensus expectations. Free cash flow was strong at €9.8 billion, compared to €4.8 billion last year, driven by higher net profits and improved working capital. Carlsberg was able to deliver at the high-end of its guidance, which was raised during last year despite the very difficult macroeconomic backdrop in China and weather-related headwinds in Western Europe. Market share performance was solid across the board, especially in China. These results support of our investment thesis.

Outlook

• We believe heightened geopolitical uncertainty is likely to persist, and may result in slower investment and consumption

• As slower growth and higher inflation fears increase, we expect quality companies will be well positioned to resume leadership

• The historical magnitude of the underperformance of quality suggests the style may outperform going forward

• The drivers of US outperformance are diminishing or reversing

• European fiscal stimulus plans should provide continued tailwind for European equities

• International valuations remain very attractive compared to US

Tariffs and defense spending were major points of discussion in the first quarter. Company managements attempted to determine what tariffs mean for their businesses. From sales demand, to pricing, to margins – this new policy affects many facets of investment planning and decision making. In the near term, the likely outcome will be management teams remain cautious and wait to see how the situation sorts out. In the meantime, that may mean sales and profits could be negatively impacted. We have been speaking with all of our companies trying to learn how these new policies will impact their businesses.

One likely outcome of these new policies is slower growth and rising inflation. In this environment, initially investors reached for precious metals as a real asset store of value, and we have seen gold and silver rally substantially in the first quarter. Banks also rallied significantly as they are also viewed as a beneficiary as interest rates rise, increasing their net interest margins and investors believe loan demand will remain robust as businesses seek to capitalize on the inflationary environment.

What happens from here? We believe that companies with stronger pricing power will more likely be able to pass along higher costs to their customers without seeing demand deteriorate and will likely have a higher probability of maintaining their margins. Companies with the widest moats, the highest financial productivity and the opportunity to reinvest for growth should resume leadership. During the past six months, Quality businesses derated and underperformed by more than 5%. In the past quarter century, every time quality underperformed by that magnitude or more, it outperformed in the subsequent period. We believe companies that can organically grow earnings while maintaining margins and profitability will be leaders going forward and therefore, we expect history to repeat.

Since the Global Financial Crisis, the global equity market returns have been led by the US. Initially that had much to do with how quickly US companies recovered from the GFC, but more recently the outperformance of US equities has been largely attributable to three key factors: Dollar strength, the concentration and outsized impact of the Magnificent 7, and these two factors combined to help drive the valuation of the US market to extraordinary levels.

Currently, we believe all three of these factors are reversing or diminishing and we think International Equities can continue to outperform. The strength experienced by the US dollar after the November election has all but reversed. Tariff implementation and new plans for potential European Union fiscal stimulus have combined to strengthen International currencies. While the significant concentration of the US market has not diminished, the impact of the Magnificent 7 on earnings for the US market has.

Rapidly increasing European defense budgets coupled with the potential for significant German fiscal stimulus could act as an accelerant on the positive change in relative earnings growth rates for Europe compared to the US.

With the valuation discount of International equities still near all-time wide levels, we think International equities are currently well positioned to outperform.

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