SGA
Sustainable Growth Advisers

Q1 2020 Emerging Markets Growth Commentary

Highlights

- *SGA's Emerging Markets Growth portfolio returned -18.2% (gross) and -18.5% (net) in Q1 2020 compared to -23.6% for its primary benchmark the MSCI Emerging Markets Index; during the same period the MSCI Emerging Markets Growth Index returned -19.3%.*

- *The portfolio depreciated in value during the quarter, but generated strong relative returns as markets experienced significant volatility and weakness due to the global spread of the COVID-19 virus.*

- *Market volatility rose to historic levels a month after markets hit new highs; the increased volatility created opportunities for our approach to growth investing, consistent with the return pattern we have experienced over time.*

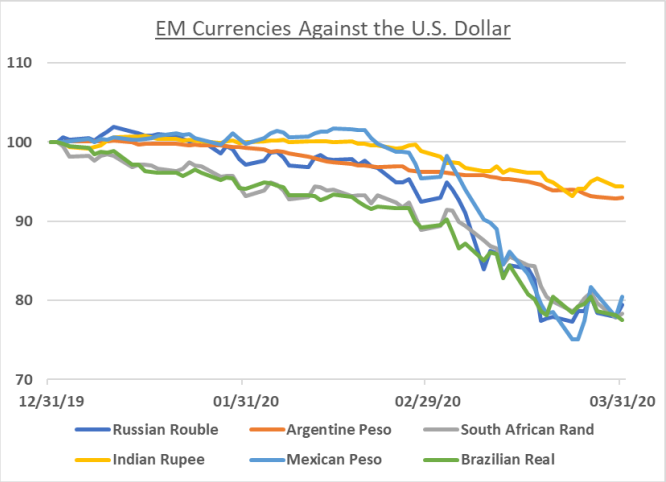
- *Sector allocations contributed significantly to returns due to the portfolio's lack of exposure to Energy, significant overweights in Consumer Discretionary and Consumer Staples, and an underweight to Financials. Stock selection also contributed positively, driven by selection in Consumer Discretionary, while selection in Consumer Staples detracted from returns.*

- *A new position in Budweiser APAC was initiated and the portfolio's positions in Abbott and Shoprite were liquidated. Positions in AIA Group, CP All, Universal Robina, Yum China and others were added to on weakness, while positions in JD.com, MercadoLibre, Sanlam and others were trimmed.*

- *With a gradual and staggered economic recovery expected across the world, we strongly believe that the superior business quality of our companies (better pricing power, recurring revenues, more predictable earnings growth, strong cash flow generation, and solid management teams) will be rewarded by wary investors in the years ahead.*

Market Overview

SGA's portfolio returned -18.2% (gross) and -18.5% (net) in Q1 versus -23.6% for the MSCI EM Index. While we are never happy to report negative returns, the portfolio better protected client capital amid significant global market weakness due to the COVID-19 pandemic. The MSCI EM Index declined 33.7% peak to trough (1/17 – 3/23), before rising 12.0% to finish the quarter down -23.6%. Market volatility surged over the period given the rise in uncertainty as the coronavirus spread beyond China's borders. In a flight to safety, investors pulled $96 billion from emerging market stocks and bonds during the period, which along with falling global trade and plunging commodity prices put significant downward pressure on emerging market currencies.



Source: FactSet.

Governments in developing countries responded to the pandemic in different ways, some placing more stringent restrictions on their populations than others. China's early and draconian efforts contrasted with responses in Latin America. In Mexico, the government didn't mandate closures until weeks after the virus had begun to spread, while in Brazil, restrictions varied significantly by state and hospital systems became strained. In South Korea aggressive testing and monitoring efforts benefited the government's attempts to limit the spread. In India, a strict 8-week lockdown has been announced as concerns grew about the virus' spread.

As economic dislocations multiplied around the world, economic activity in China showed early signs of improvement as the government gradually rolled back restrictions, providing some relief for investors. Asian markets performed best, led by relative strength in China, while markets in Latin America and emerging markets in Europe trailed significantly given their greater dependence on commodities and cyclical industries.

Index Name	Q1 2020
MSCI AC Asia	-17.7%
MSCI AC Asia Pacific	-19.3%
MSCI USA	-19.8%
MSCI World	-21.1%
MSCI AC World	-21.4%
MSCI EAFE	-22.8%
MSCI AC World ex USA	-23.4%
MSCI Emerging Markets	-23.6%
MSCI Europe	-24.3%
MSCI EM Latin America	-45.6%

Source: MSCI, FactSet.

While the near complete curtailment of commerce due to the virus is a severe headwind to all companies in the near-term, central banks applied unprecedented monetary accommodation while governments announced significant new fiscal stimulus to place a floor underneath economic activity and enhance the eventual rebound. Despite such stimulus efforts, weak safety nets, poor health care systems, and already high debt levels in many developing economies threaten to worsen the downturn and slow an eventual rebound. Weak and uneven growth in developing economies seems more likely moving forward as these economies gradually rebound. While broad-based economic growth is scarce, uncertainty high, and visibility low, our research continues to identify select companies that are able to grow their revenues and earnings through the tough times with greater predictability and visibility. Taking advantage of market stress and volatility to invest in attractively valued high quality secular growth companies not only provides a greater level of protection during difficult environments such as these, and as we have seen historically, but also sets the stage to reap the benefits of capital compounding over the course of a full market cycle.

A Note on Portfolio Liquidity

In periods of crisis where global assets are indiscriminately liquidated, the need for liquidity is paramount. This applies to issues of trading liquidity as well as company liquidity. As providers of listed global equity portfolios, liquidity has always been fundamental to our approach which centers around the importance of free cash flow.

In our search for business 'quality', high-profitability does not suffice; we will only invest our clients' capital in companies that are able to translate profits into free cash flows. These 'cash-flow compounders' are generally characterised by low levels of debt and strong balance sheets; in other words, they are in control of their destiny. In fact, many of the companies on our Qualified Company List are in a financial position of net-cash and are able to use periods of dislocation to build market share and expand margins while their competitors are forced into a position of defence. The underlying liquidity of our companies, combined in a portfolio with prudent diversification across securities, regions, industries and secular growth drivers, translates into a lower risk portfolio.

Performance Attribution

Not surprisingly, given the strict lockdowns in large parts of China during the period due to the coronavirus, and its subsequent spread around the world, economic activity experienced unprecedented disruptions leading to the underperformance of more economically sensitive sectors. Energy, Financials, Materials, and Industrials performed the worst. Given China's early and draconian interventions, the country seemingly fared better than other countries in containing the virus' spread, leading to a relatively less severe fall in Chinese stocks as investors anticipated a quicker recovery. A dramatic plunge in oil prices to an 18-year low following a dispute over production cuts between OPEC, (primarily Saudi Arabia) and Russia also contributed to increased uncertainty and volatility during the period. This disagreement led to a price war between the countries which is likely to negatively impact other oil producers as well. The precipitous decline in oil prices and the subsequent dislocations expected led the Energy sector to be the worst performer for the quarter. Given the significant rise in volatility and investor preference for more predictable growth prospects, the market environment was largely favorable to higher quality financial characteristics during the period.

Stock selection contributed positively to relative returns during the quarter, driven primarily by selection in the Consumer Discretionary sector and positions in JD.com and TAL Education. Selection in Consumer Staples detracted from returns due primarily to positions in Ambev and FEMSA. Sector allocations contributed significantly to returns due to the portfolio's lack of exposure to Energy, significant overweights in Consumer Discretionary and Consumer Staples, and an underweight to Financials. An underweight to Communication services detracted from results. From a country perspective, stock selection drove the portfolio's relative outperformance, with selection strongest in Argentina and Mexico, while selection in South Africa detracted.

Largest Contributors

TAL Education, the leading K-12 after-school tutoring services provider in China, was the largest contributor to returns in Q1. While schools were closed and the Chinese population was in lockdown during the pandemic, TAL managed to move its students in offline learning centers to online programs in a seamless manner. Moreover, as the market leader in pure online education, TAL was able to gain significant consumer mindshare at low marketing cost due to the lockdown situation given that all offline tutoring centers were closed and students had to migrate online. As a result, TAL stock outperformed both broad Chinese equities as well as its offline tutoring peers. With the pandemic situation easing in China and schools slowly reopening, we expect TAL to continue take market share from smaller operators who were forced out due to the extended period of the lockdown, leveraging its offline and online channels. We continue to see attractive long-term growth runways for TAL amid further industry consolidation, and a strong and growing customer base of millennial parents willing to spend more on their children's educations. We trimmed the position on strength during the period and maintained an average weight in the company at quarter end.

JD.com, a leading Chinese e-retailer, was the second largest contributor during the period. JD's strong brand reputation, superior delivery capabilities driven by its logistics network, and high service quality contributed to impressive fiscal Q4 results despite a difficult environment. As Chinese consumers placed their trust in JD to deliver critical health and medical related products, the company was able to take additional market share during the period. Also contributing to its strong results was its ability to better manage inventory. JD's fiscal Q4 results were highlighted by 25% GMV growth and encouraging new user growth as the company added 18 million new users. The company also guided 10%+ revenue growth in Q2 which is better than peers. We continue to view JD's long-term growth opportunity favorably given its strong position in Chinese e-commerce, driven by its trusted and strong brand, superior delivery capabilities and excellent service quality.

Unicharm, a leading Japanese provider of nonwoven fabric and absorbent materials, baby care, feminine care, adult incontinent care, and pet care products, was the third largest contributor for the period. Its shares held up better given the more essential nature of its products, which are used on a daily basis and need to replenished frequently. Additionally, its shares benefited from its strong position in masks, where it has a 25% market share in Asia, given the increased demand following the coronavirus outbreak. We continue to see an attractive growth opportunity for Unicharm moving forward given its innovative products, strong brand image and quality, local manufacturing capabilities and strong relationships with local distributors.

Tencent and **Shandong Weigao** were the fourth and fifth largest contributors to performance.

Largest Detractors

HDFC Bank was the largest detractor from portfolio performance for the quarter. The company's stock was pressured by, what we consider to be, indiscriminate selling in cyclical sectors such as financials in India by foreign investors. The bank currently remains flush with liquidity and will only emerge stronger after the crisis. We do expect that earnings growth in the coming quarters will be lower given reduced economic activity as India takes steps to address the Coronavirus issue. We also expect that non-performing assets will grow in the coming quarters but given the bank's aggressive reserving practices over the last year, we consider this issue to be manageable, and continue to feel comfortable with the drivers of the company's long-term thesis.

Sanlam was the second largest detractor from performance as stocks in South Africa came under pressure given the global pandemic risk and the likelihood that an eventual spread of the virus to Africa would pose a strong headwind to the company's business. That said, the company reported a better second half of 2019 and provided an interim update that speaks to the strength of their insurance business until February before the situation evolved into a pandemic. They also provided an update of various capital requirements and we do not expect any stress on the company's liquidity. There will be an impact to their investment units as equity markets decline and credit spreads increase, but we expect these to be manageable without causing any funding mismatch. To this end, the company is maintaining their dividend for 2020 which currently yields 6%. We reduced the target weight to an average weight position during the quarter.

Brazilian brewer **Ambev** was the third largest detractor for the period as its business was negatively affected by far reaching pandemic containment measures including shelter in place rules and business closures across geographies. The decline in the consumption of its products due to these dislocations negatively impacted the company's stock price. Despite a strong balance sheet and an increasingly attractive cash-flow based valuation we worry about the company's exposure to the mainstream beer market as consumers are likely to trade down during this period of stress. Additionally, the significant drop in the Brazilian Real is likely to create considerable cost inflation

and pose a headwind in the near-term. We lowered our target to a below-average weight and are evaluating whether the business remains one of our best ideas when we look out over our 3-5-year investment horizon.

CP All and **Trip.com** were the fourth and fifth largest detractors from performance.

Portfolio Changes

Turnover during the quarter was higher than average given the significant increase in market volatility experienced. We initiated a new position in beer production company Budweiser APAC, while liquidating positions in Abbott and Shoprite, as we identified opportunities with greater investment potential over our 3-5-year time horizon. Additionally, we trimmed positions in JD.com, MercadoLibre, Raia Drogasil, TAL Education and others on relative strength, and purchased additional shares in AIA Group, CP All, FEMSA, Universal Robina, Yum China and others on relative weakness.

Purchases

We initiated a below-average weight position in **Budweiser APAC**, the largest and fastest growing beer company in the Asia Pacific region, at an attractive valuation following a significant retracement in the stock price due to COVID-19 related pressures on the business. The company produces, imports and sells a portfolio of more than 50 owned or licensed beers including global brands such as Budweiser, Stella Artois and Corona, and local brands such as Harbin (China), Cass (Korea) and Haywards 5000 (India). The premium and super premium segments combined represent approximately 50% and 75% of Budweiser APAC's volumes and revenue, respectively. The company's principal markets are China, South Korea, India, and Vietnam. Budweiser APAC has significant pricing power. In China for example, the company's Budweiser and Harbin brands are the largest and fourth largest beer brands by volume and have considerable brand equity. Price points for the premium and super premium beer categories are 2.5-5x versus that of the core and value segments, and gross margins are 5-9x greater. As a result of its skew towards premium and the brand equity of its portfolio, the company's operating margins are 2.5-5x its competitors. Beer is a relatively stable category with frequently recurring consumption. Further, the company's premium and super premium categories have proven to be more resilient to moderations in economic growth as consumers seek out products that offer more in terms of flavor, strength and variety, and treat beer consumption as an affordable luxury. The company should be able to generate mid-single-digit volume growth and high-single-digit revenue growth over the long-term, supported by economic growth in emerging markets and growth in premium. The premium segment represents just 12% of the China market versus a global average of 22% and 30-37% in Europe. The company also has aspirations to expand via acquisition in South Asia. While pressures on the business in China stemming from a significant decline in consumer traffic at bars and restaurants due to the temporary closures related to the COVID-19 crisis were considerable in Q1, including an 80% decline in sales in February, more recent data suggest the situation is improving and we believe the business will rebound significantly by later this year. Among the risks we are monitoring with Budweiser APAC are a potential second wave of COVID-19 cases later in 2020, increases in competition, changes to local tax regulations and changes in consumer preferences among alcoholic beverage alternatives.

Sales

The portfolio's position in **Abbott** was liquidated during the quarter. The company held up relatively well amid market weakness caused by the COVID-19 pandemic and we used market volatility to reallocate capital to companies with more attractively valued growth opportunities over our 3-5-year investment horizon.

South African retailer **Shoprite** was also sold from portfolio. We are concerned that the company's non-RSA operations continue to remain a negative counter to the more favorable parts of the business, thereby possibly pushing out our growth thesis for the business further. With the complexity of the non-RSA business rising, lower cash productivity and higher debt, our expectation for growth in the future has declined. At this stage, the stock's valuation appears very attractive and we would not be a surprised by a short-term recovery. However, based on our analysis, the company's growth opportunity for the long-term has changed and there are more concerns regarding management's ability to successfully manage the increasing complexity of the business. We therefore reallocated the capital to other higher confidence growth opportunities.

Summary

There is tremendous uncertainty in the short-term over what course the virus will take and the toll it will impose on populations around the world. We expect that the recovery will be gradual and staggered as nations are impacted by the virus to different degrees and rebound from it over time. In times like this, we think it is important to focus on the things we do know and our longer time horizon. We do know that

unprecedented monetary and fiscal stimulus is being applied globally to support consumers and businesses. While the impact of the stimulus is not likely to have a significant effect on economic activity in the short-term as long as widespread shelter-in-place rules and quarantines exist, they will gradually have a positive effect as the rules are lifted. We also expect that there will be pent up demand for some products and services. In our analyses of companies, we have tried to be conservative in our estimates, using a three month shut down in activity as the base case and a gradual resumption in activity following that.

Consistent with our longer-term investment horizon, we are focused on evaluating how our businesses will fare during the pandemic itself, but also more importantly on how they will resume their growth as business activity improves in the post pandemic period. Each business on our Qualified Company List and in our portfolios has a solid financial position to assist it during the global shutdown, but each also has its own unique growth drivers which we expect to propel its sales and earnings growth as economic activity gradually returns to normal. The key business quality variables we seek will help distinguish these businesses from others which will have a more difficult time rebuilding. At the same time, our focus on taking capital from portfolio holdings that have held up better and offer less attractive valuations, and reallocating the capital to other more attractively valued businesses that offer superior growth potential in the coming 3-5 years should position the portfolio well for future appreciation. Over the coming three years, the portfolio is expected to generate 18.2% earnings growth compared to 10.6% growth for the MSCI EM, while offering a 3.4% cash flow based enterprise yield which, by historical standards, is an attractive level.

We wish you good health as we all work our way through this period, and look forward to being able to speak with you about any questions you may have on the portfolio.

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