SGA
Sustainable Growth Advisers

Q2 2020 Emerging Markets Growth Commentary

Highlights

- *SGA's Emerging Markets Growth portfolio returned 22.2% (gross) and 21.9% (net) in Q2 2020 compared to 18.1% for its primary benchmark the MSCI Emerging Markets Index; during the same period the MSCI Emerging Markets Growth Index returned 22.1%.*

- *The portfolio delivered attractive absolute and relative returns as markets rebounded in Q2, with the portfolio erasing nearly all of the losses incurred during the Q1 weakness. Year-to-date the portfolio has returned -0.1% (gross) and -0.6% (net) compared to -9.8% for the MSCI Emerging Markets Index and -1.5% for the MSCI Emerging Markets Growth Index.*

- *Stock selection drove the portfolio's outperformance during the period, while sector allocations detracted marginally.*

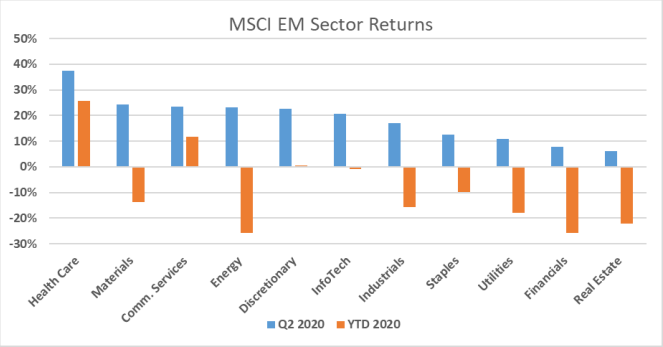
- *New positions in Kakao and Kansas City Southern were initiated, while positions in Ambev and Heineken were liquidated. Positions in AIA Group, Asian Paints, Budweiser APAC, HDFC Bank and Infosys were added to on weakness, while positions in Huazhu Group, JD.com, MercadoLibre, and Shandong Weigao were trimmed on strength.*

- *Given the superior business quality and predictability of our companies, the portfolio is expected to generate significantly greater revenue and earnings growth than the MSCI EM Index over the coming three years despite significant uncertainties over the pandemic, economic growth, and other uncertainties.*

Performance

While global markets posted strong absolute returns for the quarter, developed markets continued to outperform emerging markets given the continued uncertain backdrop facing the global economy. SGA's Emerging Markets Growth portfolio returned 22.2% (gross) and 21.9% (net), outperforming its primary benchmark the MSCI EM Index, which returned 18.1% for the quarter. Despite better economic data emerging over the period, especially in China, the continued toll of the COVID-19 pandemic on many developing economies, and the lack of visibility around the path to recovery drove an uneven rebound.

Companies in the Health Care sector performed best over the period driven by strength in medical equipment and service providers, which benefited from a rise in demand due to the COVID-19 pandemic. The Materials sector was the second-best performing sector over the period, with chemical producers and companies engaged in metals and mining benefiting from rising investor optimism and improving economic activity in many countries. Energy companies also rebounded strongly as oil and energy markets stabilized following the collapse of oil prices in Q1. Companies in more defensive sectors such as those in the Consumer Staples and Utilities sectors lagged. The Financials sector also lagged given a depressed interest rate environment weighing down growth prospects for many banks and other financial services companies. The Real Estate sector was the worst performing sector over the period.



Source: MSCI.

Continued Uncertainty but Hope

With continued uncertainty over the path of the COVID-19 pandemic and associated economic weakness, the International Monetary Fund (IMF) lowered its forecast for World GDP growth to -4.9% for 2020. The Fund drastically lowered its forecast for India to -4.5% growth, down from nearly +2% in April. Latin America and South Africa, which face severe recessions, are expected to see their GDPs decline by 9.4% and 8% respectively. In contrast, China is expected to deliver 1% growth, benefiting from its early draconian lockdowns to contain the spread of the virus, and signs of a faster recovery. Emerging markets as a group are expected to contract by 3% in 2020 according to the IMF, their first contraction in at least 60 years. Meanwhile, the World Bank forecasted World GDP to decline by 5.2% in 2020, marking the fourth deepest recession since 1900 and the worst since World War II.

Given continued sporadic regional virus outbreaks, fluctuating re-opening plans and persistent fears over a second wave, we continue to expect elevated volatility in global equity markets to persist. Such volatility has historically created opportunities for our approach to growth investing and we see the current situation as no different with the portfolio well positioned to

provide the predictable and sustainable revenue, earnings, and cash flow growth investors tend to seek in periods of economic uncertainty.

Performance Attribution

With corporate profit growth expected to plunge in 2020, growth stocks outperformed value stocks as investors sought businesses that could generate attractive earnings growth despite widespread economic weakness. Developed Markets outperformed Emerging Markets despite strong performances by South Africa and Brazil. China's market lagged during the rebound, however it remains among the top-performing markets year-to-date.

Source: MSCI.

Within the portfolio, strong stock selection drove outperformance, while residual sector weightings detracted marginally. Selection in the Consumer Discretionary, Health Care, and Financials sectors contributed most driven by positions in MercadoLibre, Shandong Weigao, and Sanlam. Selection in the Communication Services and Industrials sectors also contributed positively to results due to newly established positions in Kakao and Kansas City Southern. In contrast, selection in Materials and Consumer Staples detracted from results due mainly to positions in Asian Paints, Wal-Mart de Mexico, and Raia Drogasil.

Largest Contributors

Latin American e-commerce and Fintech company **MercadoLibre** was the largest contributor to portfolio performance. The company posted mixed, but better than expected Q1 results, and provided highly bullish Q2 data that propelled the stock higher. The company's results were buoyed by a COVID-19 induced acceleration in growth as consumers turned increasingly to e-commerce. At the same time, management reduced marketing spending, strengthening margins. Brazilian revenue decelerated, as approximately one-third of its merchant listings needed to be pulled due to an inability to fulfill orders due to the virus. Weakness in Brazil, however, was more than offset by strong results in Argentina, Mexico, Chile and Columbia illustrating the attractiveness of MercadoLibre's Latin American model. Significant progress in logistics with 50% of shipments now traveling on its own network versus only 2% two years ago, as well as improvements in its fulfillment capabilities and better inventory control, enhanced the company's results and points to further gains looking forward. We were also pleased to see the company's Fintech offerings, merchant payment, mPOS, QR and asset management, all executing well despite the virus-induced slowdown seen in late March. This speaks to the strength of their disruptive business model and the potential in their FinTech opportunity moving forward. We trimmed the position on strength, but maintained an above-average weight in the portfolio.

Chinese medical device company **Shandong Weigao** was the second largest contributor to performance during the quarter. The stock benefited from continued improvement in execution at the company, expectations that China's new government tendering process will benefit large scale companies such as Shandong Weigao, and a greater likelihood that the company will benefit from an increasing share of China's rising health care expenditures at the expense of foreign firms. In addition, the company's strong research and development pipeline and improving governance as management and shareholder interests become more aligned due to the listing of the company's previously unlisted H shares should benefit the stock over our 3-5-year investment horizon. We maintained an average weight position in the company, trimming on recent strength.

Leading Chinese e-retailer **JD.com** was the third largest contributor to performance during the period. JD continued to benefit from its superior logistics and delivery capabilities and high service levels, adding 25 million new users during the most recent quarter, while gaining further market share from its competitors. Revenues grew 21% in Q1 while operating margins improved as the company contained marketing and IT spending over the period. While we recognize the increasingly competitive e-commerce market in China, we continue to view JD's growth prospects favorably given its well-respected and trusted brand, superior delivery capabilities and excellent service qualities which are supporting an attractive growth outlook. We maintained an average weight position in the company, trimming on recent strength.

Tencent and **Fast Retailing** were the fourth and fifth largest contributors to performance.

Largest Detractors (And Smallest Contributors)

Brazilian brewer **Ambev** was the largest detractor from performance during the period. The position was liquidated early in the quarter given our concerns about the company's growth prospects. The lack of visibility around a recovery in the consumption of its products given significant exposure to on premise locations, such as restaurants and bars, and also the mainstream beer market, from which consumers are likely to trade down during this period of stress, led us to re-allocate the capital to higher conviction growth opportunities.

Global brewer **Heineken** was the second largest detractor from performance during the quarter. Just as the case with Ambev, Heineken's business has been negatively impacted by shelter-in-place rules and business closures across geographies. The decline in consumption of its products due to these dislocations was evident in the company's Q1 Trading Update, which indicated volume declines of 20%+ in March, while operating profits declined nearly 70% during the quarter. Heineken announced a list of measures taken to strengthen its liquidity position, including EUR 1.5B in new financings, cuts to capex, as well as the decision to skip its interim dividend payment. With sales from on premise establishments curtailed and facing continued uncertainty, along with lower visibility around longer-term growth drivers, we decided to liquidate the position and re-allocate the proceeds to higher conviction growth opportunities.

Leading Brazilian drugstore retailer **Raia Drogasil** was the smallest contributor to performance during the period. A weak macroeconomic environment and a falling Brazilian Real weighed on its shares. Despite an uncertain environment, the company delivered strong first quarter results, helped by consumers stocking up ahead of COVID-19 lockdowns. Revenues grew 25%+, EBITDA grew 37%+, and same-store-sales grew at an impressive 15.5%. We do expect the company to report softer results in the second quarter as Brazil continues to battle the coronavirus, however we also see Raia benefiting from its significant scale advantage, taking market share as smaller competitors are suffering. Raia's advantage is driven by its strong distribution network, good inventory control, improving digital capabilities, and a strong balance sheet. While we expect near-term results to be weak, longer-term we see the drugstore retailer well-positioned to continue gaining share, growing its store base and capitalizing on an attractive market opportunity.

Asian Paints and **Wal-Mart de Mexico** were the second and third smallest contributors to performance.

Portfolio Changes

Portfolio turnover remained elevated during the quarter as we continued to take advantage of opportunities arising from the more volatile market environment. We improved the portfolio's growth profile and visibility, liquidating positions in brewers Ambev and Heineken while initiating positions in Korean super-app company Kakao and railroad operator Kansas City Southern. Positions in AIA Group, Asian Paints, Budweiser APAC, HDFC Bank and Infosys were added to on weakness, while positions in Huazhu Group, JD.com, MercadoLibre, and Shandong Weigao were trimmed on strength.

Purchases

A new position in Korean super-app company **Kakao** was established during the period. The company enjoys a dominant position in the Korean mobile messenger market through its Kakao Talk app, which has 45 million domestic monthly average users and a 96% market share. Given its dominance in its mobile messenger app the company has been able to expand into adjacent mobile-based services such as payments, taxi hailing, gaming, music streaming, and paid content, where in many instances it has developed similar dominance. The company benefits from its significant scale and network effects which are underpinned by its hold on Korean mobile messaging traffic. The Kakao app and its mobile ecosystem have become an integral part of its users' daily lives, making its platform highly relevant for mobile advertisers. Kakao's captive user base and scale provides the company with significant pricing power allowing its core business to generate attractive and growing margins. As the company has expanded and invested in new businesses such as payments and taxi hailing, its operating margins have declined, however, we expect margins to improve over time as the company gains more scale, and the necessity for further investments subsides. We see significant growth runways for years to come across its various product lines, but we are particularly enthusiastic about its growth potential in mobile advertising, digital payments, e-commerce, and paid content.

Among the risks we are monitoring for Kakao are the company's ability to continue to monetize its vast user base while not negatively impacting user experience. Execution, especially in newer businesses including digital banking and payment, is critical for future success. Lastly, we are closely following the rate of investments and the risk of these rising in the future, which would adversely affect the company's margins and free cash flow generation.

Kansas City Southern (KSU) was purchased in the portfolio on weakness due to concern over weak economic activity tied to the COVID-19 pandemic. The company's integrated U.S. and Mexican operations are strategically focused on the growing north-south freight corridor connecting key commercial and industrial markets in the central U.S. with major industrial cities in Mexico. KSU generates nearly 50% of revenues from its Mexican operations. Its business is well diversified with about 25% of its revenues tied to transporting Industrial and Consumer products, 20% to Chemicals and Petroleum, 19% to Agricultural and Minerals and 17% to Intermodal business.

The company offers attractive pricing power, being able to consistently realize price increases higher than inflation due to the duopolistic nature of the North American rail industry and continued highway trucking cost inflation. The company's implementation of Precision Scheduled Railroading concepts has enhanced the productivity of their equipment and margins further, and we expect that serving clients in a timelier manner will lead to incremental new business. With the company being deemed an "essential service", the recurrence of its revenues is higher than seen with other more economically sensitive businesses. With cross-border trade continuing to grow as well as rising Mexican industrialization, we see attractive sustainable growth for KSU in refined gas, intermodal, plastics and chemical/industrial products.

Among the key risks we are monitoring for KSU are the regulation it faces relative to pricing, labor relations and safety both in the U.S. and Mexico. Competition from other rails as well as trucking and cargo shipping also pose a risk, although we see trucking as least likely to pose a threat other than the possible implementation of autonomous trucking. While a risk, current technological limitations as well as the likely difficulty in obtaining regulatory approval for autonomous trucking reduce its potential to threaten our thesis over our 3-5-year investment horizon. Indeed, we see the potential for autonomous railroading as more likely, and this would further enhance the company's margin structure and long-term profitability. Finally, while the company's products are largely consumed on a regular basis regardless of the macro economic environment, some of its traffic is more economically sensitive.

Sales

As mentioned above, the portfolio's positions in brewer's **Ambev** and **Heineken** were liquidated during the period given lower conviction in their growth opportunities and visibility around a recovery in the consumption of their products. We re-allocated the capital to more attractively valued growth opportunities in Kakao and Kansas City Southern.

Summary

Given the Global COVID-19 pandemic, widespread economic dislocations impacting consumers, and uncertainty over a second wave and the development of treatments and vaccines, we expect the path forward to be filled with wide variations of optimism and disappointment, as well as continued market volatility. The recovery process is likely to be staggered and long as different countries take different paths to managing the crisis, and as testing and contact tracing continue to gradually expand.

Given this backdrop, and with monetary authorities around the world indicating continued accommodation over the next few years, we see attractive opportunities for the stocks of companies with more predictable earnings and cash flow streams, and long runways of growth, exactly the types of companies in which we invest. As such, we believe the portfolio is well positioned to continue its strong performance with the companies in the portfolio expected to generate 15.7% revenue and 20.7% earnings growth over the coming three years while the MSCI EM Index is expected to generate 3.5% and 8.6% revenue and earnings growth respectively. Although absolute valuations are elevated versus the beginning of the year, the spread between the risk free rate for the U.S. 10-year Treasury and the portfolio's Enterprise Yield has actually widened, thereby keeping valuations quite attractive on a relative basis. In addition to this still attractive relative valuation, we continue to see tremendous opportunity for our portfolio businesses as they provide the growth and safety that investors are likely to seek in these uncertain times. We thank you for your interest in our team and look forward to answering any questions you may have.

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June 2020 Sustainability Report

Firm Update

With society increasingly recognizing and addressing the issue of racial injustice in the US and across the globe, we thought it important to publish our SGA Core Value Statement and reiterate our longstanding commitment to actively cultivating a diverse workforce and contributing to a fair and better world. From the beginning, our mission was "to add value for our clients, employees and the communities we operate in", and we recognize that that we must continuously try to better understand the issues facing our world to be effective agents for positive change. The full text of our statement is available on our website.

During the quarter we finalized our new engagement with MSCI, including a subscription to the company's ESG Research, portfolio benchmarking and greenhouse gas analysis services. We expect MSCI to enhance several key components of our investment process, including improved identification and analysis of ESG-related risks and opportunities for companies on our Qualified Company List. We also expect MSCI to assist with identifying prospective new ideas, the benchmarking of client portfolios through an improved ESG lens, and the enhanced analysis of the performance of companies across key environmental considerations such as GHG emissions.

Also during the quarter, we updated our proprietary Portfolio Opportunity Scoring system to better rate the net ESG-related risks and opportunities to each company on our Qualified Company List and prospective new ideas. The updated system leverages our multi-year historical record of proprietary ESG scores and commentary while adding a more detailed scoring mechanism. The system follows our "Identify", "Assess", "Model" and "Engage" framework and factors in not only the raw ESG risks and opportunities to a business, but also management's ability to mitigate the identified risks and/or capture the opportunities.

While there are many third party ESG research services, including MSCI, that offer their own ESG scoring systems, none are completely compatible with our bottom-up, sector-indifferent approach to analyzing investment opportunities. In addition, as with all other aspects of our investment process, while we seek input from various respected sources, we ultimately apply our own judgement. Our proprietary ESG score serves several important purposes in our investment process, including, 1) representing an important reference point to check our theses and agendas regarding management engagements and our financial models, 2) providing an important input into the determination of risk category designations and therefore discount rates applied in our valuation system, and 3) providing an important input into our proprietary Portfolio Opportunity Scoring system which serves as a check on our portfolio management-decision making.

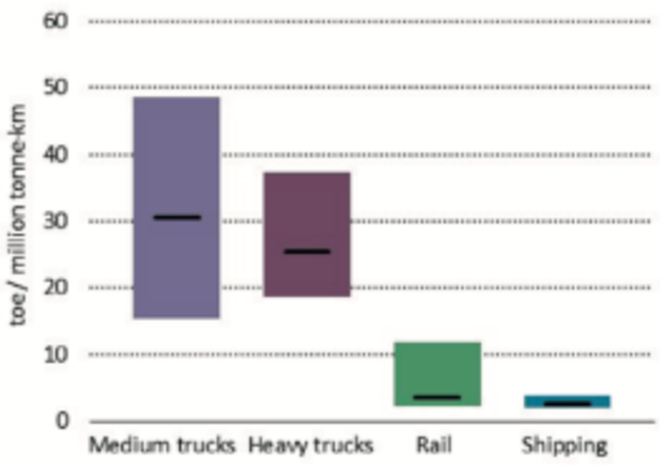
Rails – an ESG friend or foe?

We recently made an investment in two freight-hauling railroad companies, Union Pacific and Kansas City Southern, across select client portfolios. Given the heavy emissions of the transport industry and nature of the goods transported, we identified the risk of regulatory change (namely carbon taxes) to the sustainability of long-term earnings growth of these companies.

The transport sector – cars, trucks, planes, trains & ships – is one of the largest sources of GHG emissions across the globe. It is estimated the sector contributes to roughly 30% of total emissions. As such, decarbonizing the sector is a key objective of global policymakers.

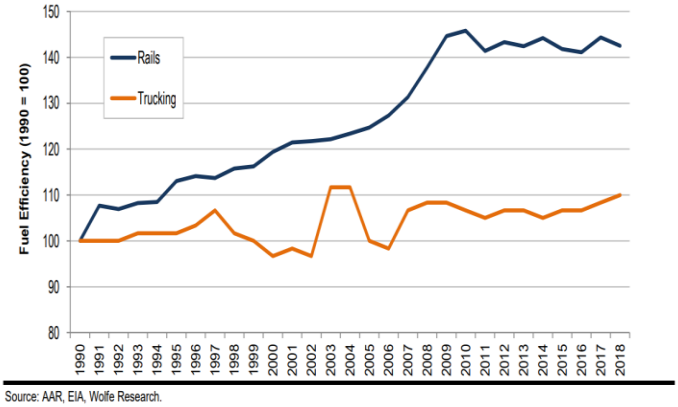
Upon our assessment of the environmental impact of these companies, we learned that rails are among the most carbon efficient modes of transport. According to Wolfe Research, rails are around 3-4x more fuel efficient than trucks and 100x more fuel efficient than aircraft. Furthermore, rail fuel efficiency has increased dramatically since the early 1990's with opportunities for further gains as fleets move from diesel to electric power.

Chart 1. Energy intensity of freight transport (2017), in tonnes of oil equivalent (toe) per million tonne km transported.



Source: IEA 2019

Chart 2. Rail vs Truck Fuel Efficiency over Time



Source: AAR, EIA, Wolfe Research.

We believe the rail sector plays a vital role in containing the GHG emissions of the transport industry into the future and herein lies the premise for a powerful secular growth opportunity. Should shippers increasingly prioritize ESG considerations, in conjunction with greater advocacy of rails by global policy makers, demand for rails could increase markedly as freight is moved off the roads and onto the tracks.

Engagement with MercadoLibre

MercadoLibre is a leading e-commerce and digital payments provider servicing Latin America, namely Brazil, Argentina and Mexico. On a recent call with management we discussed some of the company's strategic ESG initiatives and shared our feedback. Decarbonizing operations is a clear area of focus; management is working on a number of projects including a transition towards an increasingly electric fleet, greater use of recyclable packaging and carbon offset initiatives such as reforestation. On human labor risks, the company's online marketplace – where a large number of third-party merchants retail their goods – presents challenges. While the company has addressed the issue of supply chain sustainability throughout their first-party and private label markets, we believe the process of monitoring third-party merchants is lacking and have encouraged management to take more ownership and accountability across all levels of their supply chain. We continue to engage with the company on this matter and consider this to be a long-term dialogue.
