Emerging Markets Commentary

4Q 2020

SGA
Sustainable Growth Advisers

Performance

SGA's Emerging Markets Growth portfolio returned 18.1% (gross) and 17.8% (net) in Q4, compared to 19.7% for the MSCI EM Index and 16.8% for the MSCI EM Growth Index. For the year 2020 the portfolio returned 31.2% (gross) and 29.8% (net), compared to 18.3% for the MSCI EM Index and 31.3% for the MSCI EM Growth Index. The portfolio performed in-line with our expectations over the course of the year; protecting capital as markets sold off on pandemic-induced weakness, and keeping pace during the significant market rally which ensued.

12/31/2020	*SGA - Gross*	*SGA - Net*	*MSCI EM*	*MSCI EM Growth*
QTD	18.1%	17.8%	19.7%	16.8%
1-Year	31.2%	29.8%	18.3%	31.3%
3-Year	15.2%	14.0%	6.2%	10.3%
5-Year	16.3%	15.1%	12.8%	16.2%
Inception	11.7%	10.5%	5.4%	9.1%

Source: Factset, MSCI, SGA

Highlights

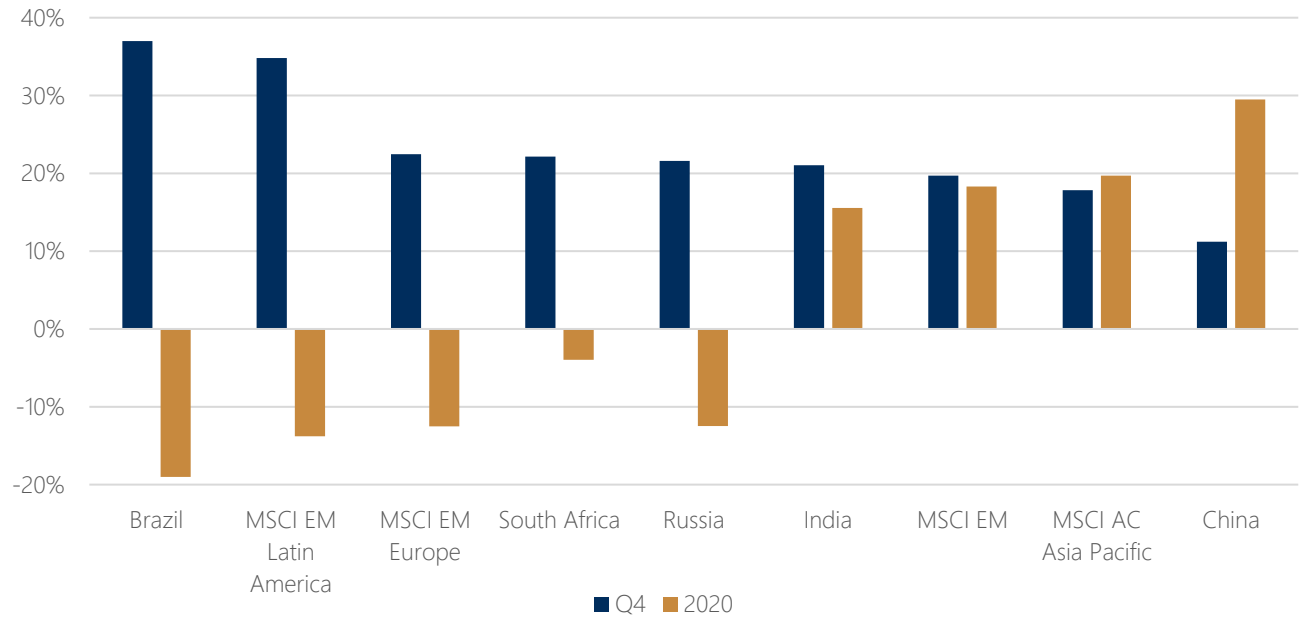
- SGA's Emerging Markets Growth portfolio returned 18.1% (gross) and 17.8% (net) in Q4 2020 compared to 19.7% for its primary benchmark the MSCI Emerging Markets Index; during the same period the MSCI Emerging Markets Growth Index returned 16.8%. For the year 2020, the portfolio returned 31.2% (gross) and 29.8% (net) compared to 18.3% for the MSCI Emerging Markets Index and 31.3% for the MSCI Emerging Markets Growth Index
- Emerging markets outperformed Developed markets for the quarter as investor sentiments around the global economic recovery improved given positive COVID-19 vaccine developments. A weakening U.S. dollar also benefited stocks in international and emerging markets
- Portfolio turnover was below average during the quarter, with a position in Universal Robina liquidated and no new positions initiated
- The portfolio remains well-positioned to generate higher revenue and earnings growth than the MSCI EM Index over the coming three years with greater predictability and sustainability

The Market Sees Better Days Ahead

Amid a global viral pandemic with massive human and economic implications, rising geopolitical risks and widespread government imposed lockdowns to curtail the virus spread, emerging markets generated strong returns on the expectation that 2021 would be a better year. Expectations for the approval of multiple new vaccines to battle the virus, unprecedented massive monetary accommodation by world monetary authorities and new fiscal stimulus from governments around the world stoked optimism and led to strong returns. Economically sensitive sectors outperformed, particularly in the "Post-Vaccine" rally beginning in early November following the approval of Pfizer's COVID-19 vaccine and the expectation that others would soon follow. A weaker U.S. dollar on expectations that the U.S. Federal Reserve is likely to keep interest rates low for the foreseeable future along with the potential for added fiscal stimulus in the U.S. was another positive for emerging markets.

Investors expressed significant optimism and drove stock prices higher, discounting much of the rebound in corporate profits which may occur as the virus is eventually brought under control. However, significant risks, which could have a major impact on markets, still remain. These include rising debt levels as a percent of GDP, uncertainty over the pace of vaccinations and the spread of new variants of the COVID-19 virus, rising geopolitical risks in the Middle East (Iran) and Asia, and changes occurring in China with the country's more aggressive stance with regard to the South China Sea, Hong Kong and Taiwan.

MSCI Emerging Markets Index Returns



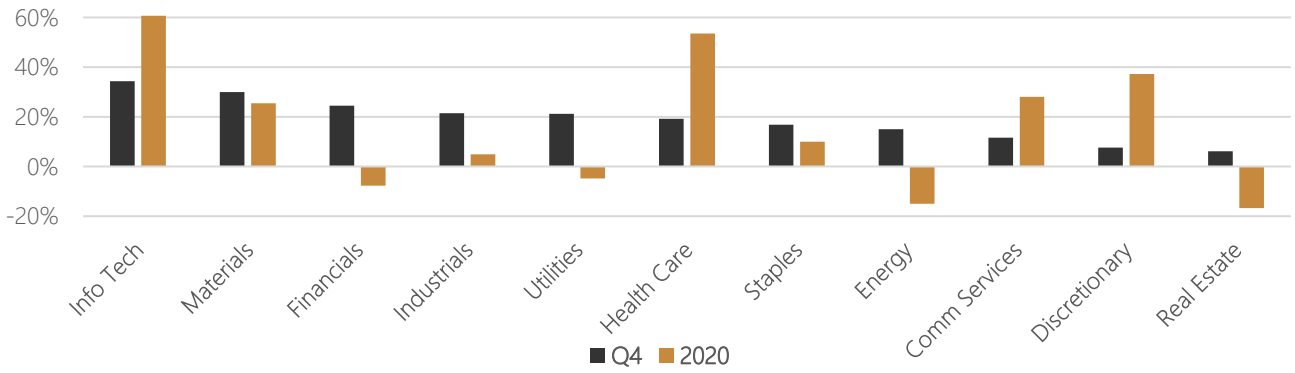
Source: FactSet, MSCI

Market Attribution

For the quarter, and year, Information Technology was the best performing sector, while more economically sensitive sectors such as the Materials, Financials, and Industrials rebounded strongly in Q4 given rising optimism and risk appetites. Real Estate, Consumer Discretionary, and Communication Services lagged behind during Q4's strong rally, despite the latter two being among the better performing sectors for the year. Consistent with the surge in optimism, regions and countries within emerging markets that had suffered most from the pandemic outperformed during the quarter with Latin America and Emerging European markets providing the strongest quarterly returns despite very weak returns for the year.

A rotation into smaller-cap, lower quality, value-oriented companies in November and their subsequent strong rally created a headwind for our approach. Our focus on only the highest quality, cash flow generative, predictable growth companies and, as a result, a lack of exposure to more economically sensitive companies which generally don't possess the predictable revenue generation, pricing power or sustainable long-term growth attributes we seek was a key driver of the portfolio's relative shortfall during the quarter.

MSCI Emerging Markets Index – Sector Returns



Source: FactSet, MSCI

Portfolio Attribution

For the quarter, stock selection effects continued to contribute positively to relative returns with the portfolio's holdings in the Consumer Discretionary, Health Care, and Financials sectors contributing most driven by strong returns from MercadoLibre, WuXi Biologics, and HDFC Bank. Stock selection in the Information Technology sector detracted most given broad-based index strength in that sector combined with weakness in the portfolio's position in XP, a Brazilian brokerage platform. Residual sector allocations were the key source of relative underperformance during the quarter driven primarily by the portfolio's overweight in the underperforming Consumer Discretionary sector, and an underweight in the strongly performing Information Technology sector. In addition, the greater optimism around global growth drove strong returns in cyclicals and lower quality companies, posing a headwind to our approach.

For the year, the portfolio's outperformance was driven by both positive stock selection and residual allocations. Stock selection accounted for roughly two-thirds of the outperformance for the year. Selection in Consumer Discretionary was strongest, followed by Health Care, and Communication Services, driven by strong returns from MercadoLibre, JD.com, WuXi Biologics, Shandong Weigao, and Kakao Corp. The portfolio's overweight to the Consumer Discretionary sector, which was one of the best-performing sectors in 2020, contributed positively to relative returns, as did a lack of exposure and underweight to the poorly performing Energy and Financials sectors. Underweights in the strongly performing Information Technology and Communication Services sectors as well as an overweight in the Consumer Staples sector detracted from relative returns.

Largest Contributors

Indian financial institution **HDFC Bank** was the largest contributor to portfolio performance during the quarter as it benefited from strength in financials due to expectations for an improving global recovery, as well as a solid report that showed the bank's asset quality remaining relatively intact despite macro weakness. This could lead to an earlier than expected normalization in their provision for bad loans, which would be viewed positively by investors. The company's growth appears to be recovering to pre-COVID-19 levels across many segments of its operations. Its balance sheet remains strong and we were pleased with their previously reported loan and deposit growth. We trimmed our above-average weight position in HDFC on strength during the quarter after having added to the position on weakness earlier in the year.

LatAm e-commerce leader **MercadoLibre** was the second largest contributor to returns during the quarter following a Q3 earnings report which showed an impressive acceleration in growth combined with operating margin improvement and continued strong progress in its logistics and shipping efforts. In USD terms the company's revenues grew by 85%, total payments volume and GMV grew by 90% and 62% respectively, while operating margins rose to 7%. The company's significant investments and initiatives in its logistics network is not only improving service levels but also reducing costs given scale efficiencies and a reduction in their dependence on national carriers. Other positive developments included a significant increase in repeat purchase behavior and higher retention rates. We continue to see attractive growth opportunity ahead for MercadoLibre and have maintained an above-average weight position, however we trimmed the position on strength during the quarter.

Leading biotechnology platform **WuXi Biologics** was the third largest contributor to returns during the period as investors reacted positively to the company's strong new project momentum, accelerated pipeline and backlog, as well as its raised 2021 sales guidance. WuXi continues to leverage its technology advantage and development speed to win new projects and also take later-stage projects from competitors. WuXi announced in October it had added 4 external-transfer phase III projects while adding 34 new projects to its pipeline bringing the company's total integrated projects to 312. As a result of this strong momentum, its 3-year backlog rose to $1.4B, up 56% from 1H20. The company is executing well on an attractive longer-term growth opportunity, expanding capacity aggressively to meet current and future demand. The COVID-19 pandemic has delayed some projects, although this has been somewhat offset by rising COVID-19 related projects. We see the company being well-positioned to capitalize on secular trends around outsourcing drug development and manufacturing as well as further industry consolidation. We maintained an average weight position, trimming on strength and valuation during the quarter.

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

Largest Detractors

Chinese e-commerce leader **Alibaba** was the largest detractor from performance during the quarter despite a solid report, due to a series of interventions by the Chinese government regarding the ANT IPO, the Ant lending model, and antitrust concerns about the Alibaba platform. For the quarter, revenues were up 30% year-over-year, and earnings per share rose 43% year-over-year due to strong Ant results, solid cloud growth and narrowing losses in new retail, logistics and other earlier life-cycle businesses.

A speech by Jack Ma calling for significant reforms to the Chinese financial system seemed to provoke the Chinese government and led to the government pulling the Ant Financial IPO the day before pricing and announcing new regulations which will increase credit constraints for Ant. As a result of these developments, we purchased shares at lower prices but did reduce our target position in the company due to higher regulatory and governance risks. We expect to see Ant's credit growth impacted by stricter capital constraints which will likely impact growth from the segment looking forward. However, we expect that holding Ant accountable for its credit risk will be positive in the long-term, forcing Ant to more actively diversify its revenue streams toward insurance and digital services which are higher quality businesses given their greater predictability.

Later in the quarter, the Chinese government announced an anti-trust investigation of the company focusing on the company's "two-choose-one" practice which had essentially forced merchants to sell exclusively on the Alibaba platform. This practice is no longer in use at the company and e-commerce has become quite competitive in China reducing the likelihood that this specific issue will meaningfully impact Alibaba's short to intermediate-term earnings outlook. Additionally, regulatory authorities established a framework intended to ensure that a realignment between government interests and the operations of companies such as Alibaba would occur.

Based on our analysis, the significant decline in Alibaba's stock price is more due to the longer-term uncertainties over whether the new framework and the Chinese government will allow Alibaba to grow and further expand its opportunity-set as had been anticipated, or lead to the government seeking more significant control of that growth. Based on our evaluation of the issue, we believe that China needs companies like Alibaba to drive innovation and technology development, as well as to help in building domestic consumption which will assist the country in reducing its dependence upon exports and, in turn, other countries. With the events of November and December, Chinese regulatory authorities have made their point clear with regard to what is expected in terms of Alibaba's operating framework and where its focus needs to be in aligning with government policy. We have seen similar situations in the past including with Tencent, where the government exerts its influence, but then allows the companies to continue to grow in an acceptable manner. We expect a similar outcome here despite the recent increase in regulatory risk. Given the stock's valuation and our expectations for continued above average growth, we purchased additional shares in Alibaba on the recent weakness leveraging our longer-term 3-5-year investment horizon.

After-school tutoring leader **TAL Education** was the second-largest detractor from performance following a Q3 earnings report which fell short of lofty consensus expectations. While the company reported 21% revenue growth, driven by 88% growth in its pure online offering xueersi.com and 8% offline growth, both fell short of consensus expectations. The company continues to invest aggressively in its online expansion, however a slowing recovery in its offline business concerned some investors. Our research continues to indicate an attractive longer-term growth opportunity for TAL given its strong industry position and online leadership. We added to the position on weakness during the quarter.

Brazilian brokerage platform **XP** was the smallest contributor to performance during the period despite reporting strong Q3 results. The company continues to grow at impressive rates, highlighted by 55% revenue growth, 61% assets-under-custody growth, and 72% growth in active clients. The growth trajectory of the business remains strong and the company is still early in its growth opportunity given that incumbent banks still hold 90% of the market share, presenting a significant runway for growth as the company continues to take share, driven by its superior technology and product selection. An unexpected equity offering during the quarter, which led to roughly 5% dilution, weighed on its shares. According to the company, the proceeds will be used to support growth initiatives such as new product offerings, accelerated marketing efforts, its capital markets business, as well as provide capital for potential acquisitions. We continue to view XP's longer-term growth opportunity favorably and added shares on weakness during the quarter.

CP All and **Hauzhu Group** were the second and third smallest contributors to performance.

Portfolio Activity

Portfolio turnover was modest during the quarter with the portfolio's position in Universal Robina being fully liquidated, and several positions trimmed on strength including those in Unicharm, Fast Retailing, WuXi Biologics, HDFC Bank, Yum China, MercadoLibre, and Asian Paints. Positions in Shandong Weigao, CP All, Huazhu Group, Budweiser APAC, TAL Education, Kansas City Southern, XP, Alibaba, and Tencent were added to on weakness.

Sold Positions

Philippine food and beverage company **Universal Robina** was liquidated from the portfolio given lower confidence in the company's growth opportunity and higher conviction in other and more attractive growth opportunities within the portfolio where we could redeploy the capital.

Summary

2020 was an extraordinary year where the markets generated tremendous returns despite unprecedented human and economic dislocations. It underlined the old adage "never fight the Fed" as massive monetary accommodation and fiscal stimulus was applied around the globe to cushion the blows from the pandemic. Much good news has been priced into stocks over the course of the rallies in Q3 and Q4 despite the massive economic challenges of 2020. 2021 market returns are likely to depend heavily upon the ability of governments to quickly vaccinate large portions of their populations to achieve the "herd immunity" needed for societies and businesses to return to normal.

We are pleased to say that our fundamental research effort has never been stronger as we continue to identify unique secular growth businesses in the emerging markets that offer significant growth premiums relative to the market. While our focus on key business quality drivers and our valuation discipline steered us away from businesses that don't generate meaningful free cash flows, and this affected relative returns in Q4, we are more confident than ever that this approach is allowing us to build a portfolio of attractively valued secular growers that will produce reliable returns for our clients well into the future.

Focusing on pricing power, recurring revenues and long duration sustainable growth opportunities while minimizing valuation risk has served our clients well over the years and is particularly timely today given the tremendous rise in stock prices experienced in 2020 against a very uncertain backdrop. Regardless of the ensuing macro-economic environment or how quickly COVID-19 vaccination programs advance, we are confident in the portfolio's ability to generate superior revenue and earnings growth over the coming years.

We wish you the very best for a healthy and happy 2021. We look forward to speaking with you about the portfolio and its positioning in more detail.