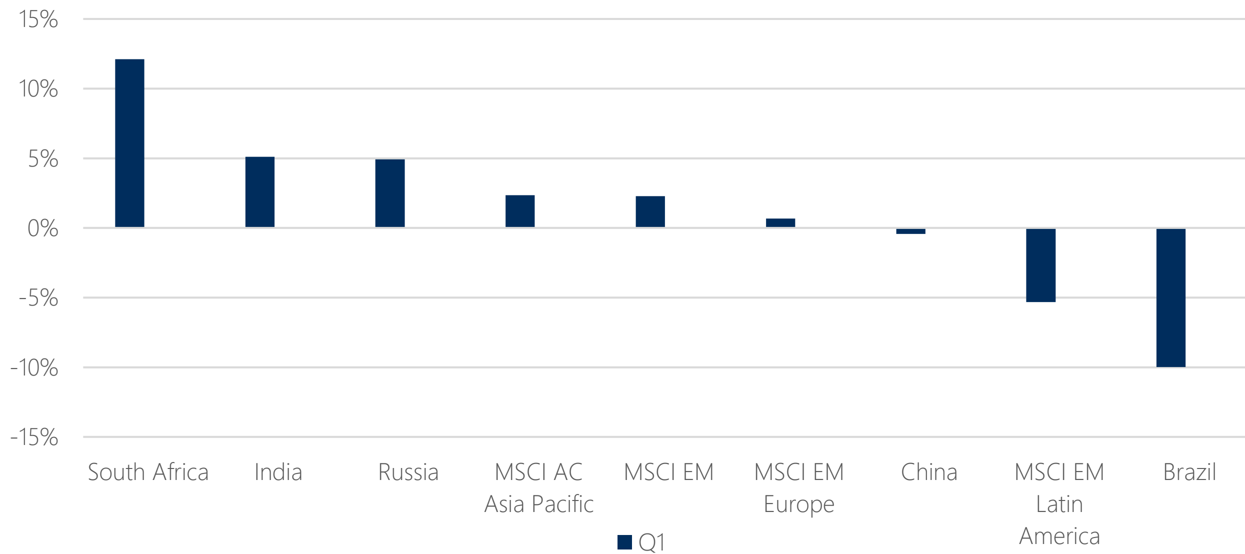
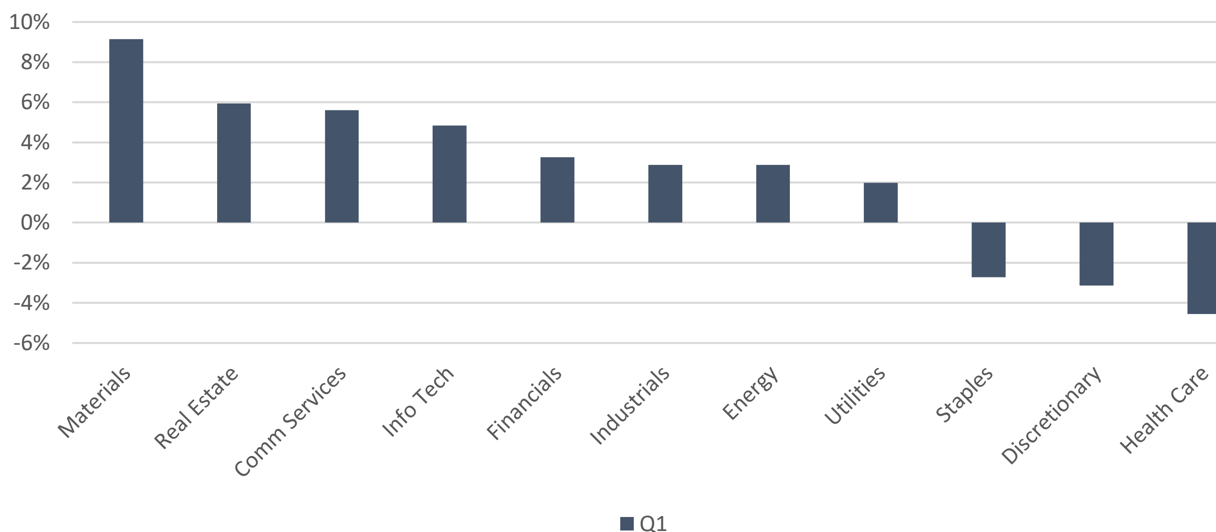


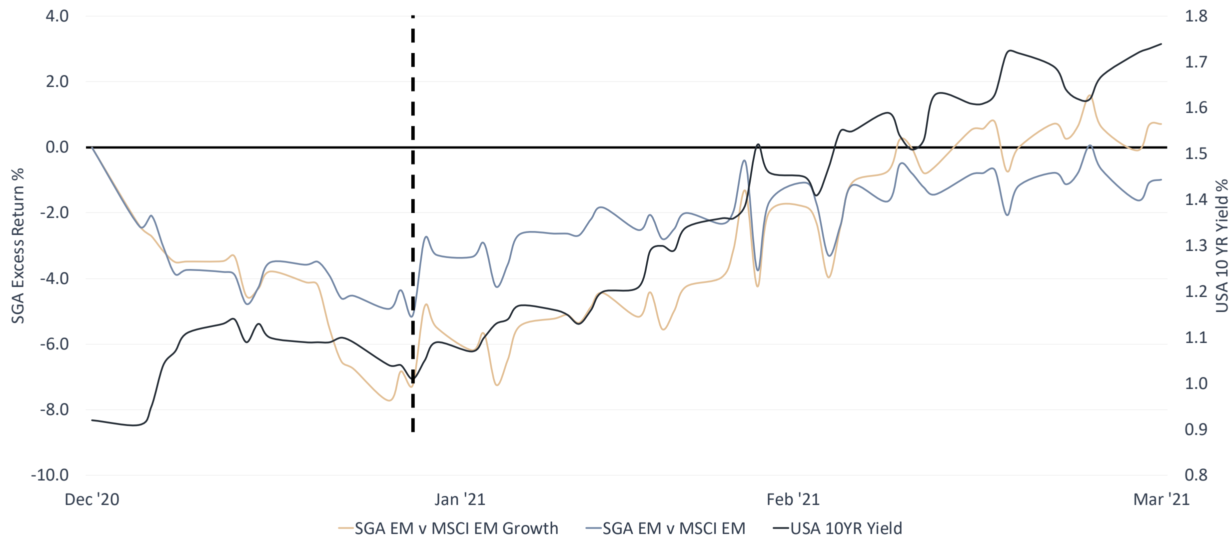
Source: FactSet, MSCI

Market Attribution

Index returns for the quarter were muted, however this masked periods of significant strength and weakness throughout the quarter. Initial strength in media, internet, and e-commerce companies along with strong performance in autos and semiconductors drove the MSCI EM Index up by more than 9% through January 25th, before higher interest rates and weakness in Chinese equities derailed the rally. From January 25th and through the end of the quarter, the MSCI EM Index declined by more than 6%. However, the weakness was most pronounced for faster growing companies as evidenced by the more than 10% decline in the MSCI EM Growth Index over the same period. The portfolio's performance pattern over the course of the quarter followed historical precedence as the portfolio trailed during the initial period, which was fueled by significant optimism and risk-taking, while outperforming during the subsequent period of market weakness.



Source: FactSet, MSCI

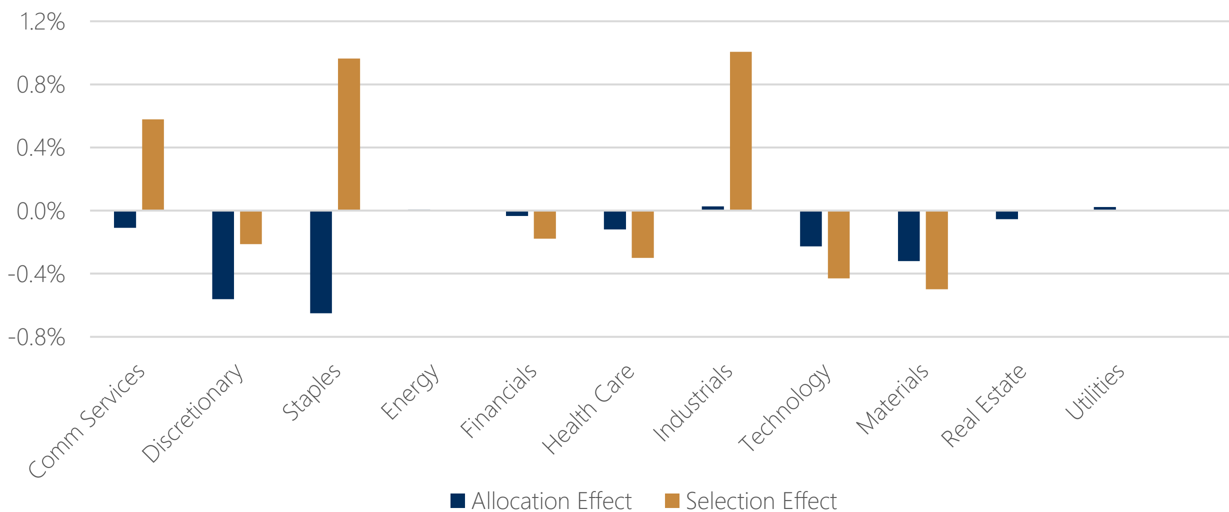


The performance figures shown are for the institutional share class of the Virtus SGA Emerging Markets Growth Fund, VESRX, relative to the MSCI EM Growth Index and MSCI EM Index.

Source: FactSet, MSCI

Portfolio Attribution

Stock selection effects contributed positively to relative returns in Q1, with selection strongest in Industrials, Consumer Staples, and Communication Services, driven by strong performance in Kansas City Southern, CP All, Wal-Mart de Mexico, and Kakao Group. Stock selection in Materials, Information Technology, Health Care, and Consumer Discretionary detracted given weakness in Asian Paints, XP, Shandong Weigao, New Oriental Education, and TAL Education. Sector allocations, which are purely a bi-product of our bottom-up approach, detracted from relative returns during the quarter with the portfolio's overweights to the Consumer Staples and Consumer Discretionary sectors and underweights to the Materials and Information Technology sectors detracting the most.



Source: FactSet, MSCI

Largest Contributors

North American railroad **Kansas City Southern** was the largest contributor to portfolio performance as the company received a $25 billion merger offer from Canadian Pacific Railroad which would create a company that would create the first freight railway network linking the U.S., Canada and Mexico. The deal faces scrutiny from U.S. regulators but with little geographic overlap between the respective rail networks of the two companies, both parties committed to it, and the ability for the new entity to help expedite and actually enhance service for customers, we consider the chances of approval to be good. This is further supported by the fact that a similar deal was approved in the late 1990's on a similar basis where it was determined that there was little negative impact on competition. Along with the chance to enhance service for shippers and thereby strengthen the new company's value proposition, we see the potential for meaningful synergies on both the top and bottom line for the company over our 3-5 year investment horizon. Given the increase in KSU's share price with the announcement of the deal, and the potential risk that it may not be approved, we took profits in the position but maintained an above-average weight at quarter-end.

Chinese hotel group **Hauzhu Group** (HTHT) was the second largest contributor to returns during the period given optimism around a recovery in travel and mobility. HTHT delivered better-than-expected revenue growth of 6% in its fiscal Q4 results and the company expects a strong recovery for the coming fiscal year guiding for 50-54% top-line growth. Travel restrictions and further lockdowns in January and February impacted results but the hotel group saw operating trends improving in March. HTHT's German subsidiary, Deutsche Hospitality (DH), continued to be pressured given lockdowns in Germany and travel restrictions across Europe. A new JV with property development firm Sunac for high-end hotel development was announced by HTHT, which is likely to add to its long-term growth potential. We continue to view HTHT as well-positioned to benefit from its scale, and superior brand and management capabilities in a fragmented industry with significant long-term growth potential. HTHT's hotels have maintained a 21% better overall occupancy rate than the China average, reflecting its competitive dominance. We trimmed the position back to our above-average weight target on strength during the quarter.

Thai Convenience store operator **CP All** was the third largest contributor to performance. The company posted an in-line Q4 report with comparable store sales impacted by more transient issues including lockdowns due to COVID-19, poor weather, and temporary government provided subsidies which could only be redeemed in traditional stores. Looking forward, the company expects to be able to grow comparable store sales in-line with GDP which should be in the 3-4% range. They also plan to open 700 more stores in 2021 as space becomes available while focusing on controlling staffing costs. Additionally, we see benefits from the company's continued expansion of 7-Eleven and Makro stores as well as O2O delivery initiatives and synergies from their acquisition of Tesco assets which closed in December of 2020. We maintained an above-average weight position in the company.

Trip.com and **Wal-Mart de Mexico** were the fourth and fifth largest contributors to performance.

Largest Detractors

Chinese after-school tutoring provider **New Oriental Education** was the largest detractor from portfolio performance in Q1 after announcements by government regulators led to increased concerns about how EDU and other private education companies may be impacted by new regulations. Following a review of the issue, we determined that the main tenets of our original thesis for EDU remained intact and that we expect the company to potentially benefit from the change in regulations which may lead to a further consolidated industry. We continue to see EDU as being well positioned to benefit from demand for higher quality education in China and purchased additional shares of the stock on weakness through the quarter.

Chinese after-school tutoring provider **TAL Education** was the second-largest detractor from performance during the period. TAL was negatively impacted by the same issues mentioned above for EDU, however in the case of TAL their exposure to the faster-growing online channel, where they have invested heavily and seen rapid growth added more concern around their outlook. We find it likely that new regulations will impact education companies' ability to advertise their online services as aggressively as has been the case, which could negatively impact TAL's future growth rate. However, given the heightened competition for online tutoring from emerging players and the significant capital expended on advertising to capture share, limitations on advertising would have a positive impact on margins and profitability. Ultimately, given TAL's strong brand and well-recognized service offerings we view the company as well-positioned to withstand potential regulations, which are likely to benefit scaled companies such as TAL and EDU. As with EDU, after extensive review and discussion we determined the main tenets of our thesis for TAL Education remained intact and purchased additional shares on weakness.

Chinese medical device **Shandong Weigao** was the third largest detractor from performance in Q1. Weakness in China's equity markets pressured the company's shares, but there were also concerns early in the quarter on whether the Chinese government's central procurement of medical consumables would negatively impact the company, as pricing on tendered products would be pressured. When the company reported their 2H20 results, Weigao reported that while there were some pricing pressures, they were able to take significant market share as a scaled player, overcoming the pricing pressure from the central procurement process. The company also returned to growth in the 2H20, as medical visits and procedures started returning, rebounding significantly from 1H20. Not all of the higher margin categories returned to growth, as biopsies and elective procedures remain below pre-COVID-19 levels. We expect demand for these procedures will return, and see significant potential opportunity for the company as it continues to build its portfolio of higher margin products, participates in the growth of health care services within China and begins to grow its business outside of China. We purchased shares on weakness during the quarter and maintained an above-average position.

Budweiser APAC and **Asian Paints** were the fourth and fifth largest detractors from performance.

Portfolio Activity

Turnover during the quarter was in line with our long-term average. A new position was initiated in Bank of Central Asia while the portfolio's position in Visa was liquidated. We trimmed several positions on strength during the quarter, including Fast Retailing, HDFC Bank, Huazhu Group, Tencent, Trip.com, WuXi Biologics, and Kansas City Southern. We added to other positions on weakness, including Shandong Weigao, New Oriental Education, and TAL Education.

New Positions

A new position in **Bank of Central Asia** (BBCA), the largest private bank in Indonesia, was initiated during the quarter. BBCA is a unique and high quality bank benefiting from secular growth drivers such as an underbanked population in Indonesia and favorable demographics. The bank has delivered attractive returns on equity over time despite low leverage and high capital ratios, given a persistently high net interest margin of ~6%. BBCA is the clear leader in transaction-based banking, including mobile and internet banking providing it with a significant competitive advantage. The strength of the bank's relationships and high CASA (current account savings account) ratio of around 75% drives its pricing power given the low cost of funding through these deposits. We see an attractive long-term growth opportunity for BBCA given a low penetration rate for traditional banking in Indonesia, and low household usage of banking and leverage, which we expect will rise over time as the economy develops further. We initiated a below-average weight position in the company during the quarter and will continue to build the position opportunistically moving forward.

Sold Positions

The portfolio's position in **Visa** was liquidated during the period and replaced with Bank of Central Asia given a more attractive and direct emerging markets growth opportunity.

Summary

The portfolio's return pattern over the course of the quarter was consistent with our expectations and history. As markets delivered exceptionally strong returns through the first three weeks of the quarter the portfolio delivered solid absolute returns but lagged on a relative basis. As higher interest rates and a shifting market backdrop subsequently drove a rotation out of higher-valued companies and markets declined, the portfolio protected capital and outperformed broader markets. While we continue to find attractively valued growth opportunities in select emerging markets companies and believe the global economic recovery provides a favorable backdrop for emerging markets, we expect the path forward to be volatile. Global vaccine supplies are steadily increasing, however wide dispersion pertaining to the progress of vaccination programs within countries and regions persist, which will lead to variations in the pace of economic recovery and normalization. In addition, continued uncertainty around the impact of variant virus strains, rising geopolitical tensions, and the potential for premature fiscal and monetary tightening might temper the recovery and lead to further volatility.

We continue to have high conviction in the portfolio's holdings as the businesses we look to invest in are less economically-sensitive and benefit from longer-term secular growth drivers leading to more consistent and predictable

growth in revenues, earnings, and cash flows over time. As we witnessed during this quarter's selloff, our cash-flow based valuation discipline is a driver of the portfolio's lower risk profile and helps mitigate downside participation. Over the next three years we expect the portfolio to deliver 17% and 25% growth in revenues and earnings respectively, outpacing the expected growth in the broader market, while providing stronger quality characteristics and an attractive cash-flow based valuation.

The opinions expressed herein reflect the opinions of Sustainable Growth Advisers, LP and are subject to change without notice. Past performance is no guarantee for future results. This information is supplemental and complements a full disclosure presentation that can be found with composite performance. The largest contributors and detractors are determined using a ranking of the absolute contribution to portfolio return by each security held over the period under consideration. The securities referenced in the article are not a solicitation or recommendation to buy, sell or hold securities. This commentary is provided only for qualified and sophisticated institutional investors. Results are presented gross and net of management fees and include the reinvestment of all income. The Net Returns are calculated based upon the highest published fees. The net performance has been reduced by the amount of the highest published fee that may be charged to SGA clients, 0.85%, employing the Emerging Markets Growth equity strategy during the period under consideration. Actual fees charged to clients may vary depending on, among other things, the applicable fees schedule and portfolio size. SGA's fees are available upon request and also may be found in Part 2A of its Form ADV. Upon request, free of charge, SGA can provide a list of all portfolio holdings held in SGA's Emerging Markets portfolio for the past year. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. SGA earnings growth forecasts are based upon portfolio companies' non GAAP operating earnings. SGA Emerging Markets Growth Composite inception is 8/1/2014. Past performance is not indicative of future results.

data on suppliers across the globe and shares this information with members of its association to encourage collaboration amongst businesses to improve working conditions in global supply chains. Yum! utilizes the SEDEX data to form risk assessments of its suppliers and identify those that need to make improvements to their workers' rights and conditions. Yum! audits its suppliers over 15-month periods with third-party audits utilized to provide an objective report of suppliers. Transparency into the company's audit results is an area where we will continue to advocate for improvement; the company does not share statistics on the number of suppliers that fail an audit or are cited for significant infractions, although they implied the number of incidents is low.

Yum's journey towards sustainable sourcing will be gradual, with progress dependent upon contributions from not only the company itself, but other stakeholders such as government agencies, NGOs and peer collaborations as well. We believe the company is on the right path with its policies, but we will be closely monitoring future developments and continue our engagement with management.

Other Noteworthy Items

Heineken is considering a 'Say on Climate' vote at future annual general meetings. Say on Climate is a new initiative to encourage companies to disclose emissions and produce reports on interim environment targets (5-10 years) that bridge the gap between shorter and long-term targets (e.g. 2050 carbon neutral). These reports would be subject to non-binding shareholder votes similar to Say on Pay - a very successful shareholder campaign.

Industrial gas provider **Linde** announced plans to build the world's largest PEM (Proton Exchange Membrane) electrolyser to supply green hydrogen throughout Europe. PEM electrolysers are currently one of the most cost-efficient ways to produce green hydrogen however the world is still some years away from producing large-scale, cost-efficient green hydrogen. As the costs of renewable energy and electrolysers decline over time, we expect green hydrogen to play a pivotal role in the transition towards a net-zero economy with applications across many industries, particularly refining and transportation. Linde is making strategic investments in the area today with the potential to serve a multi-billion-dollar market in the future. We have factored in a conservative assumption of this market to our long-term growth estimates for Linde however we will be watching this space closely.

The opinions expressed herein reflect the opinions of Sustainable Growth Advisers, LP and are subject to change without notice. The securities referenced in the article are not a solicitation or recommendation to buy, sell or hold securities. These materials are provided only for qualified and sophisticated institutional investors.