Emerging Markets Commentary

1Q 2021

SGA
Sustainable Growth Advisers

Performance

SGA's Emerging Markets Growth portfolio returned 1.5% (gross) and 1.3% (net) in Q1, compared to 2.3% and 0.6% for the MSCI EM Index and the MSCI EM Growth Index respectively.

3/31/2021	*SGA - Gross*	*SGA - Net*	*MSCI EM*	*MSCI EM Growth*
QTD	1.5%	1.3%	2.3%	0.6%
1-Year	62.9%	61.6%	58.4%	63.8%
3-Year	14.6%	13.7%	6.5%	10.1%
5-Year	16.6%	15.6%	12.1%	15.5%
Inception	11.5%	10.6%	5.6%	8.8%

Source: Factset, MSCI, SGA

Highlights

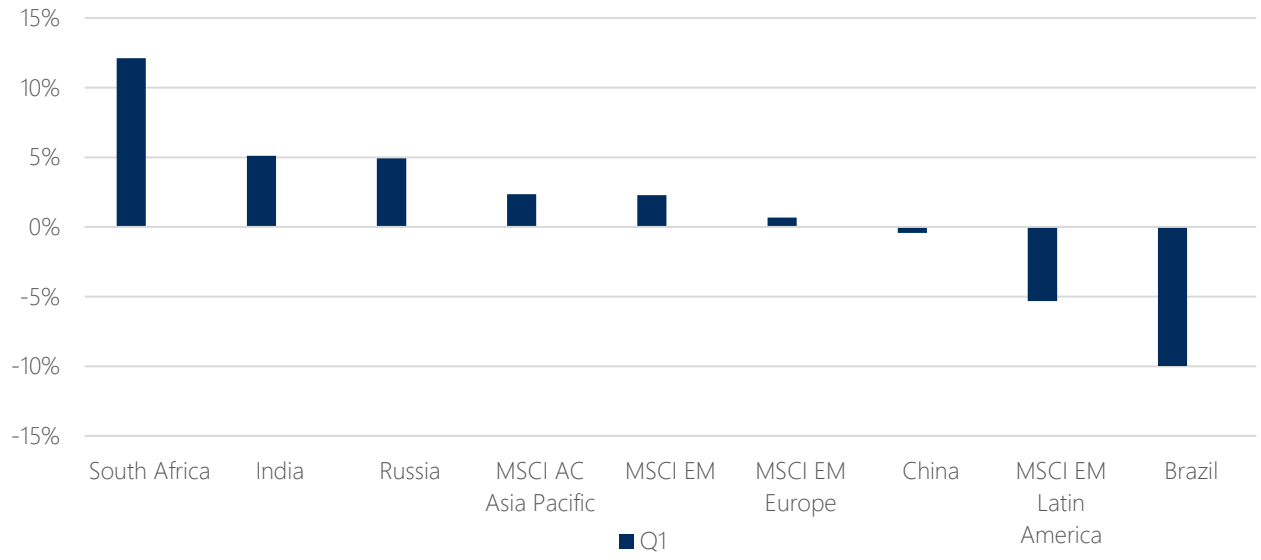
- SGA's Emerging Markets Growth portfolio returned 1.5% (gross) and 1.3% (net), outperforming the 0.6% generated by MSCI EM Growth Index but trailing the broader MSCI EM Index which returned 2.3% in Q1
- The portfolio's relative return pattern over the course of the quarter followed expectations, with the portfolio trailing initially as markets surged on continued optimism around the economic recovery, but outperforming later in the quarter as volatility and uncertainty led to weakness in the broader market
- A new position in Bank of Central Asia was initiated during the quarter; the portfolio's position in Visa was liquidated. Several other positions were trimmed on strength and others added to on weakness
- 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

An Improving Global Economy Lifts Economically-Sensitive Stocks While Rising Rates Weigh on Growth Stocks

Emerging markets finished the quarter higher despite significant intra-quarter volatility. Markets continued their breakneck pace from Q4 through the quarter's opening three weeks, driven by strength in media, internet, and e-commerce companies along with a rebound in more cyclical auto and semiconductor companies on the back of rising expectations for a global economic recovery. Following the initial period of strength, the market declined as concerns about higher interest rates in the U.S. and uncertainty around policy tightening in China weighed on sentiment. A confluence of other factors exacerbated the weakness; among them a global chip shortage, which derailed the rebound in auto companies, worrisome COVID-19 developments in Europe and Brazil, rising geopolitical tensions between China and Western countries, and further regulatory scrutiny around technology and internet companies in China.

While optimism around the economic recovery has lifted the stock prices of more economically sensitive companies, the pace of the recovery and the path forward is likely to depend on the successful deployment of COVID-19 vaccines and continued accommodative fiscal and monetary policies. We expect market volatility to persist as investors grapple with the dispersion in vaccine rollouts, uncertainty around the impact of new COVID variants, and uncertainty over the level of fiscal and monetary accommodation moving forward. As always, we continue to focus on the most predictable, high quality, cash flow compounders which benefit from long runways of growth, while only investing in those that are attractively valued on the basis of cash flows. We have great confidence in the ability of the portfolio companies to deliver attractive earnings and cash flow growth over the long-term with less volatility than the broader market.

MSCI Emerging Markets Index Returns

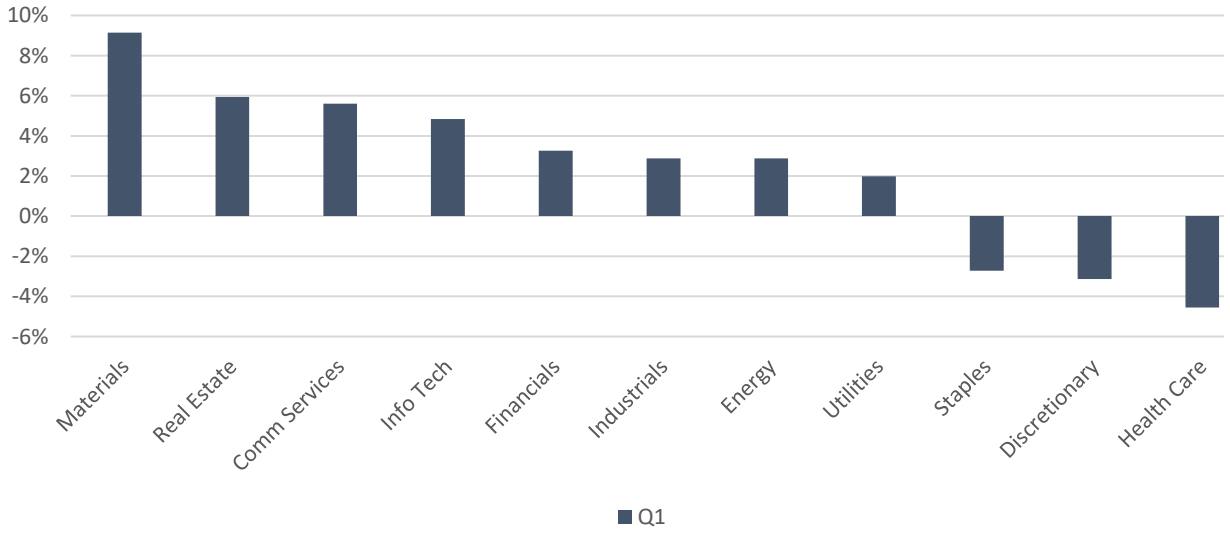


Source: FactSet, MSCI

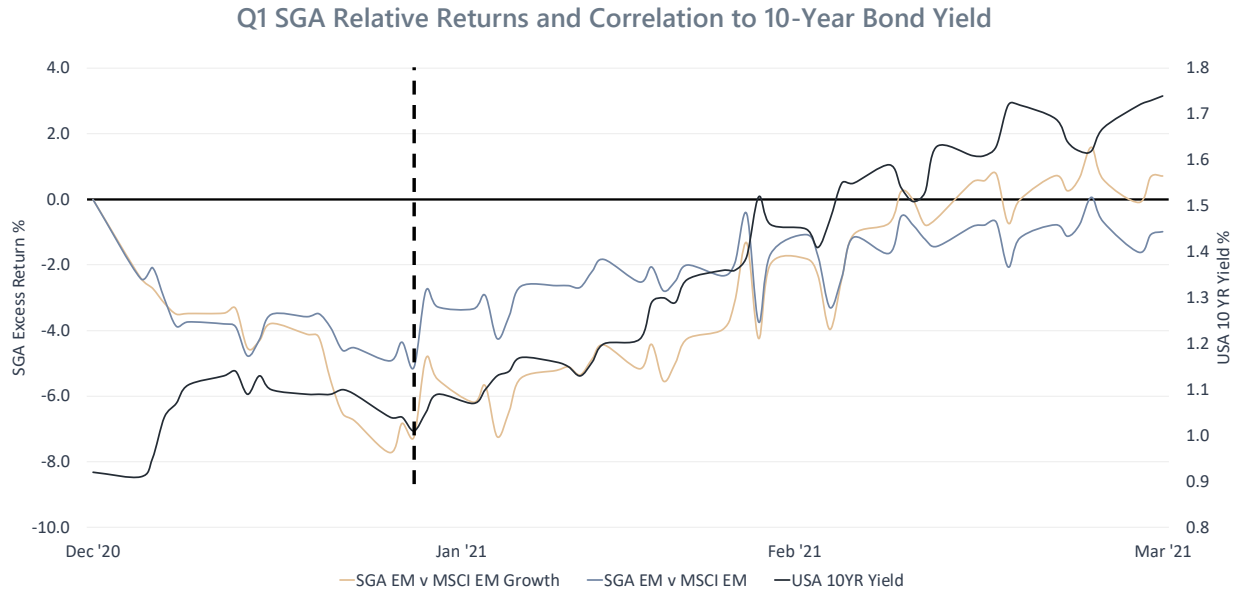
Market Attribution

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.

MSCI Emerging Markets Index – Sector Returns



Source: FactSet, MSCI

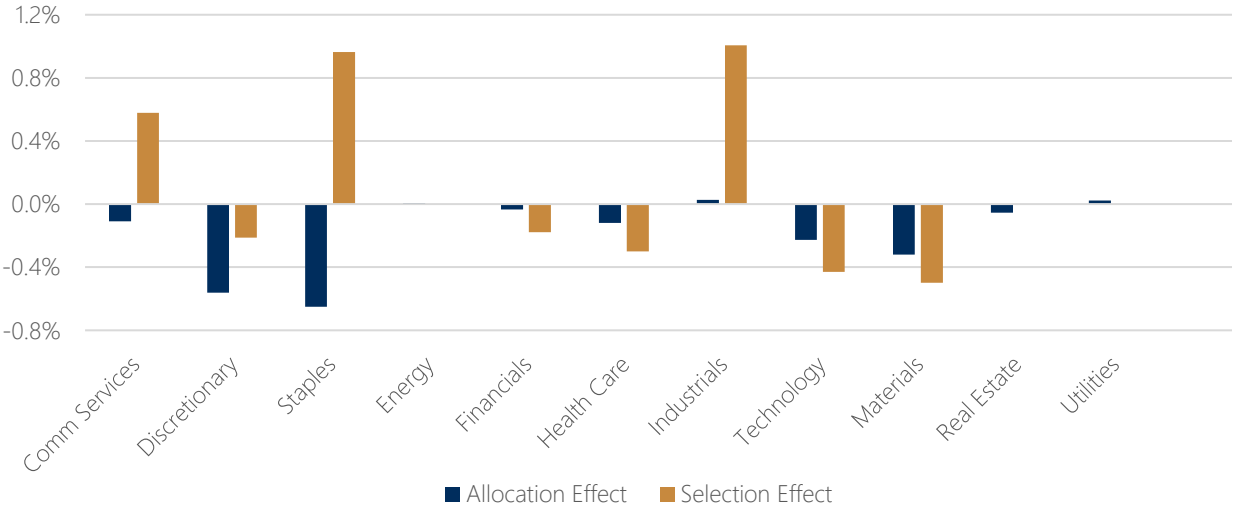


The performance figures shown are for the institutional share class of the Virtus SGA Emerging Markets Growth Fund, VESRX, relative to the MSCI EM Growth Index and MSCI EM Index.

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.

Sustainability Report

1Q 2021

SGA
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Nike: Sustainable Cotton

China is the world's largest cotton producer with 84% of its cotton sourced from the Xinjiang region. Following concerns over the prevalence of labor abuses in the region, many major brands have been associated with forced labor resulting in consumers calling for an end to the sourcing of cotton and yarn from the region. The situation complicates global supply chains; presenting challenges to transparency, access and auditing, while inflaming already fragile geopolitical relations. One of our portfolio companies, Nike, has found itself targeted by the Western media with accusations of profiting from the forced labor of the Uyghur people in the Xinjiang region, which we believe inaccurate.

Nike began to improve labor standards in contract factories over 20 years ago with a focus today on traceability at the raw material level. The company works closely with its suppliers, industry associations, brands and other stakeholders to map supply sources so it can have confidence materials are responsibly produced. With regard to cotton sourcing, 2020 marked the first year 100% of cotton used across Nike's product line was certified organic, recycled or Better Cotton (sourced through the Better Cotton Initiative). This represents approximately a 4x uplift in the amount of sustainable cotton used since 2015.

In response to the recent headlines, Nike has expressed concerns over reports of forced labor in the Xinjiang region and reaffirmed their previous statement (from over one year ago) that neither Nike nor its suppliers source products from the region. Furthermore, Nike has moved to dispel inaccurate reporting of its cotton supplier relationships and lobbying efforts. Nike does not have supply relationships with suppliers in China linked to forced labor in the region, including (i) Haoyuanpeng Garment Group, (ii) Qingdao Jifa Huajin Group, and (ii) Changji Esquel Textile, as has been inaccurately reported in the press. Its supplier Qindao Taekwang Group stopped hiring new employees from the region in 2019 and no longer has any employees there (verified by independent third-party audit). Additionally, Nike has not lobbied against the proposed Uyghur Forced Labor Prevention Act, or any other proposed forced labor legislation, as was inaccurately reported by the New York Times in December 2020.

In 2020, Nike strengthened its audit protocols related to the identification of risks related to potential labor transfer programs (including more frequent reviews and self-assessment requirements for supply chain participants) and continues to conduct ongoing due diligence with its suppliers in China to identify and assess potential risks relating to the employment of Uyghurs, or members of other ethnic minorities in China. China remains an important market for Nike, in terms of growth and profitability, and we will be closely monitoring the situation for any impact to sales from boycotts by Chinese consumers as a result of nationalistic support for Xinjiang cotton.

Know Your Supply Chain – Yum! Brands

The complexity of global supply chains today present increasing risks to global businesses given changing consumer attitudes, concerns over the sustainability of our environment and increasing geopolitical tensions. The path to supply chain transparency is fraught with obstacles, costs and requires a methodical transition. Any 'quick fixes' are likely to displace small farmers & producers and cause disruption to local economies. Corporates must work to continually improve the transparency of supply chains with careful consideration of the first-, second- and third-order effects.

Food companies are seeing heightened interest in their supply chains as discerning consumers demand to know where their ingredients come from, how they are sourced and the conditions and welfare of workers and animals. We recently spoke with the management of Yum! Brands, operator of the KFC, Taco Bell and Pizza Hut global franchises, as to how they are addressing their customers' concerns.

Yum! works with thousands of suppliers across food, beverages, packaging and equipment through the company's Office of Sustainability created in 2009. In recent years, the Office has increased its focus on several areas including the sourcing of animal proteins and forest stewardship with hand-picked ingredients including tomatoes and palm oil a key area of risk. In efforts to conduct supply chain sustainability risk assessments, in 2019 Yum! partnered with SEDEX – a leading ethical trade organization that works to ensure ethical standards are monitored and measured across global supply chains. SEDEX collects

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.