# Emerging Markets Commentary

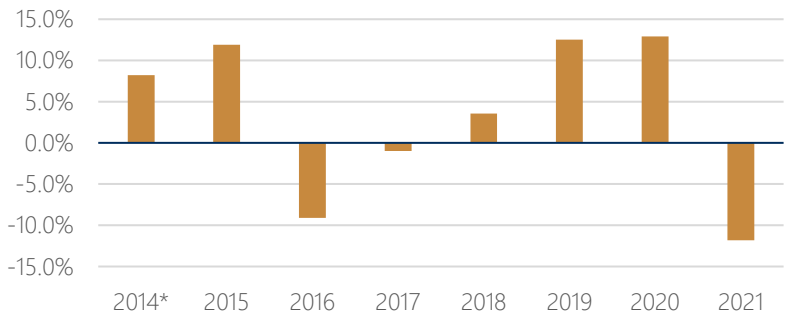
Q4 2021

SGA
Sustainable Growth Advisers

## Performance

SGA's Emerging Markets Growth portfolio returned -9.7% (gross) and -9.9% (net) in Q4, compared to -1.3% and -2.1% for the MSCI EM Index and the MSCI EM Growth Index, respectively. For 2021 the portfolio returned -14.4% (gross) and -15.1% (net) compared to -2.5% and -8.4% for the MSCI EM Index and MSCI EM Growth Index, respectively.

**SGA Emerging Markets Growth Relative Performance**




**Partial year*
*Source: SGA, FactSet*

## Highlights

- A combination of unfavorable market trends and weakness in select portfolio holdings negatively impacted the portfolio's relative returns in Q4 and for 2021.
- New positions in PayTM and Abbott were initiated, while positions in Tencent and WuXi Biologics were liquidated. Several other positions were trimmed on strength, including Bank of Central Asia, Infosys, and Wal-Mart de Mexico, while others were added to on weakness, including Country Garden Services, Huazhu, MercadoLibre, Shandong Weigao, and XP.
- The portfolio is estimated to deliver 16% revenue growth and 23% earnings growth over the next three years, much higher than broad markets, with greater predictability and stronger quality characteristics.
- Co-Founder Gordon Marchand has announced that he will retire from the firm at the end of Q2 2023 as he turns 68 years old. Further details regarding the change are provided at the end of this commentary.

Relative performance in Q4 was negatively impacted by two primary factors:

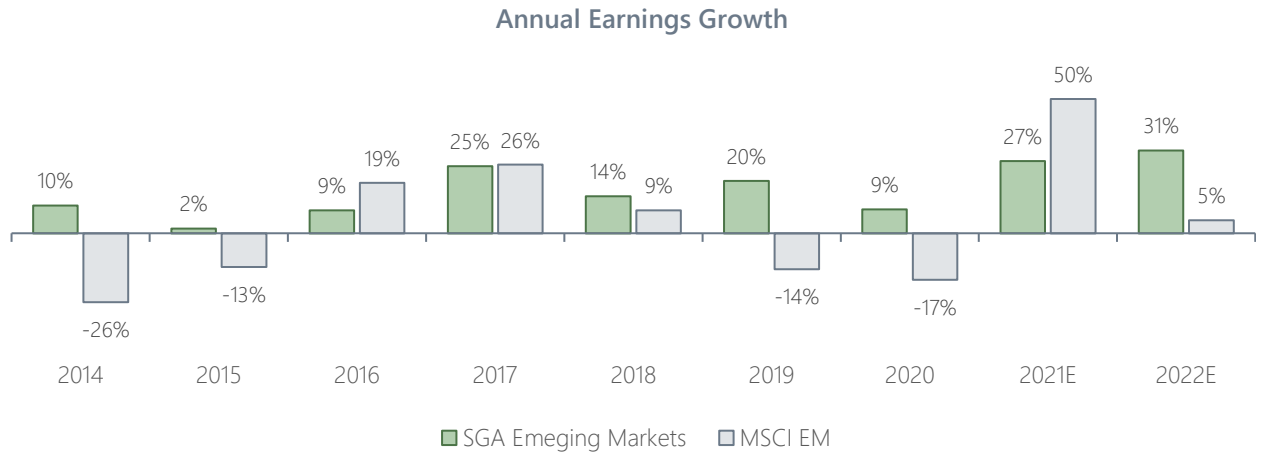
1. Market leadership was narrow with Semiconductor companies outperforming by a wide margin, and strong returns in Tech Hardware, Telecom and Auto stocks. Our lack of exposure to these more economically sensitive areas of the market cost the portfolio 2% of relative return for the period.
2. Weakness in select portfolio stocks, driven by what we deem to be short-term issues. A correction in the portfolio's Latin American holdings XP and MercadoLibre on macro concerns tied to inflation and monetary tightening cost 2% of relative return. COVID-related disruptions and uncertainty weighed on the portfolio's Chinese consumer services stocks Yum China, Huazhu Group, and Trip.com, while ongoing uncertainty about the Chinese government's medical equipment procurement policies weighed on Shandong Weigao, costing the portfolio nearly 3% of relative return.

## Inflation, Monetary Tightening, COVID and China Impacted Markets in Q4

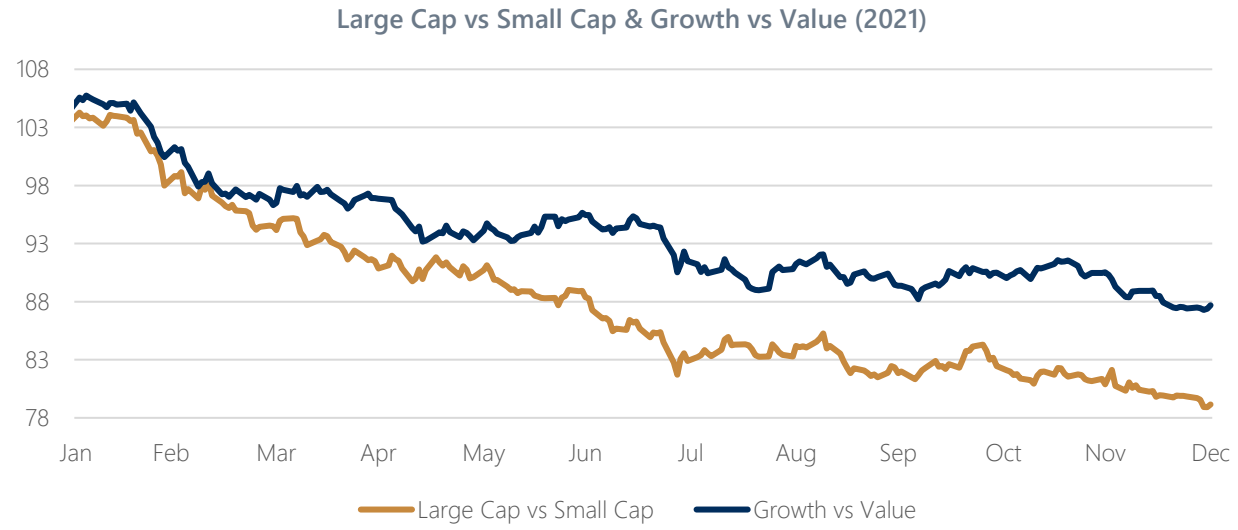
While inflation, monetary tightening, and COVID-related concerns contributed to a weak backdrop for Emerging Markets during the quarter, pockets of strength could be found in cyclical areas such as Semiconductors, Tech Hardware, and Auto stocks. The worst performing region in Q4 was EM Europe, a top performer through Q3, as geopolitical tensions in Russia and moderating energy prices weighed on sentiment. Latin American markets, led by Brazil, performed poorly given a worsening inflation backdrop and central bank tightening which has driven a material decline in 2022 growth expectations. Chinese and Hong Kong markets were negatively impacted by rising COVID cases in China and new lockdowns in addition to lingering regulatory uncertainty. In contrast, markets in Taiwan, Indonesia, and Mexico were among the better performing during the period. The Taiwanese market benefited primarily from strength in Semiconductors while Indonesian and Mexican markets benefited from declining COVID cases and improving economic environments.

## 2021's Cyclical Rebound Expected to Moderate

Emerging Markets faced a challenging backdrop in 2021 as new and disruptive COVID outbreaks and slow vaccination rollouts led to temporary economic dislocations amid a broader global rebound. In addition, the Chinese government's "Common Prosperity" campaign and regulatory crackdown drove significant dislocations in targeted industries in China and weighed heavily on investor sentiment for especially larger Chinese companies. Despite these headwinds and the underlying dispersion in country and regional performance, the broad market was driven by a significant rebound in more cyclically sensitive companies and smaller cap stocks which benefited from the rebound in global economic activity and recovery in corporate profits. Earnings growth for the MSCI EM Index at +50% was the highest on record since 2004 after having declined -17% in 2020. The more predictable and sustainable growth companies in the SGA EM portfolio did not benefit as much from the cyclical rebound in 2021 as portfolio earnings grew less than the market at +27%. However, this followed more resilient performance in 2020 when the portfolio grew earnings by +9%. Companies in the Telecom, Semiconductor, and Energy industries performed best in 2021 posing a headwind for the SGA portfolio given a lack of exposure to these industries. In contrast, areas typically better aligned with our focus on quality and growth performed poorly highlighted by the significant underperformance of companies in the Consumer Services, Retailing, and Health Care Equipment industries. The changing regulatory landscape in China along with continuing disruptions from the government's zero-tolerance COVID policies were key drivers of weakness for many companies in these industries. With profit growth expected to moderate in 2022 and beyond from unsustainable levels in 2021 and the lagged impact of monetary tightening likely to slow economic activity, we expect the greater predictability, consistency, and above-average growth prospects of our companies to be increasingly rewarded by investors moving forward.

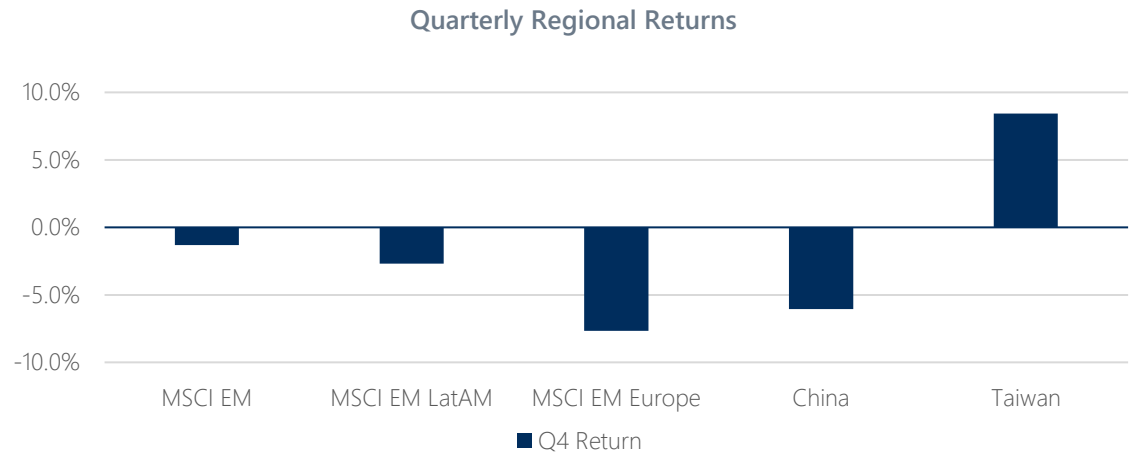



*Source: FactSet*

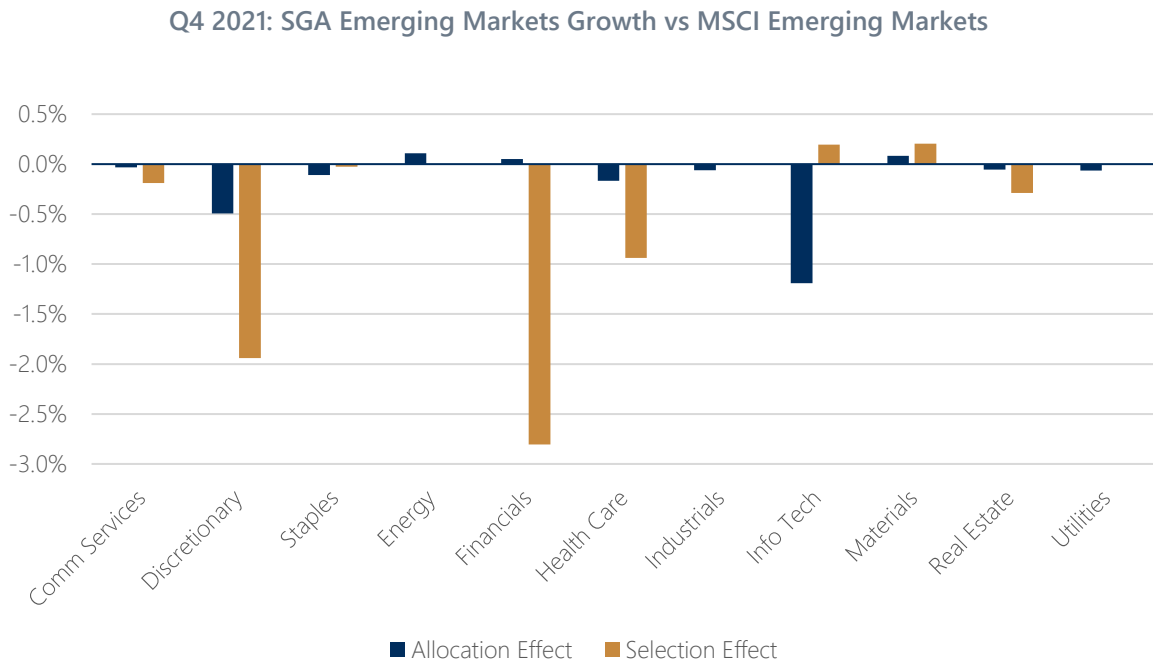



*Source: FactSet*

## Market and Portfolio Attribution




*Source: MSCI*




*Source: FactSet, MSCI*

## Largest Detractors

**XP** was the largest detractor from performance as the stock was negatively impacted by significant weakness in Brazilian equities due to ongoing COVID pressures. Brazilian equities declined 6.5% in Q4 and 17.4% for 2021. The stock also endured a significant liquidity event by Itau, a pre-IPO investor at the beginning of Q4. Despite the perceived macro headwind, the company reported gross revenues up 50% year-over-year with adjusted net income up 82%. The company added over one thousand independent Financial Advisors over the quarter, beating expectations, and its take rate remained attractive and consistent at 1.3% with its credit card business maintaining growth momentum. We continue to expect the company to invest in its growth and added to the position on weakness during the quarter.

**Shandong Weigao** was the second largest detractor driven by continued uncertainty around the impact of the Chinese government's VBP (value-based purchasing) program. The issue is not new and has been a key driver of the stock's weakness in recent quarters. We continue to believe that the changes in government policy in this area will eventually lead to a positive outcome for a scaled incumbent such as Shandong Weigao. We expect that these changes will lead to higher volume growth and reduced distribution expenses, which will offset price compression for its products. Over the long-term we expect a net positive outcome for Shandong Weigao; however, there may be some near-term earnings headwinds. Initial data points are confirmatory to our thesis as Shandong Weigao is winning 90-95% of new bids through this centralized procurement process and added 400 new customers during the first half of 2021. While we view Shandong Weigao's longer-term growth prospects favorably, we recognize that uncertainty around government policies may continue to weigh on sentiment and its stock price in the near-term.

**Fast Retailing** was the third largest detractor from performance. Fast Retailing was negatively impacted by continued pandemic-related headwinds, which weighed on the retailers results in 2H 2021 in key South-East Asian markets, and a cautious outlook from management for the first half of 2022. We view these issues as transient and were comforted by the continued strong results delivered in the important Greater China region where sales and operating profits grew 17% and 50%, respectively, in 2021. With the pandemic restricting in-store traffic, the company saw increased e-commerce penetration as online sales in its International Uniqlo business rose 20% in 2021. We continue to view the growth opportunity for Fast Retailing favorably as the company expands its presence in Greater China, North America, and Europe, leveraging its supply chain and scale advantages in addition to its innovative capabilities in material use and marketing.

**Yum China** and **Huazhu Group** were the fourth and fifth largest detractors from performance.

## Largest Contributors

**Infosys** was the largest contributor to portfolio performance for the quarter despite weakness in the Indian equity markets as the company reported earnings which exceeded estimates. Net income rose +12% year-over-year with broad based revenue growth across various segments. The company raised its full year guidance. We were pleased with the company's reported margins given rising inflation and the higher wages it must pay. While the company's backlog is solid, we will be monitoring the pipeline closely as this will be critical in driving continued strong growth moving forward.

**Wal-Mart de Mexico (Walmex)** was the second largest contributor to performance during the period as the retailer delivered accelerating same-store-sales growth across its markets along with good progress on key initiatives. Same-store-sales grew 6% in Mexico and 12.5% in Central America, both accelerating on a 2-year stacked basis, while total sales and operating profits grew 6.5% and 8%, respectively. Ecommerce sales continued to grow rapidly and is on pace to reach a double-digit share of total revenues by 2024, up from less than 5% today. We continue to be impressed by Walmex's execution and strategic initiatives as the company is investing in technology, distribution, and people, which should support growth and customer value over the long-term. New initiatives such as the Walmart Pass and Walmart Fulfillment Services are both showing promising results. While we remain optimistic about the growth outlook, we trimmed the position on strength and valuation considerations during the quarter.

**Bank of Central Asia (BBCA)** was the third largest contributor to performance. BBCA benefited from an improving Indonesian economic backdrop as COVID cases continued to decline following a severe wave hitting the country during the summer months. BBCA's Q3 results were in line with expectations despite a still tempered loan growth environment. Core profits grew 12% on the back of improved provisioning. Asset quality remains strong and we expect the bank to return to its longer-term target of high-single digit loan growth and deliver attractive growth over our 3-5 year investment horizon. BBCA benefits from 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.

**Asian Paints** and **Budweiser Brewing APAC** were the fourth and fifth largest contributors to performance.

## Portfolio Activity

Portfolio turnover was average in Q4 with new positions in PayTM and Abbott initiated and positions in Tencent and WuXi Biologics liquidated. Several other positions were trimmed on strength, including Bank of Central Asia, Infosys, and Wal-Mart

de Mexico, while and others were added to on weakness, including Country Garden Services, Huazhu, MercadoLibre, Shandong Weigao, and XP.

## Sold Positions

The portfolio's position in **Tencent** was liquidated during the quarter given regulatory concerns. However, we continue to evaluate the attractiveness of its growth opportunity over our 3-5 year investment horizon.

The position in **WuXi Biologics** was liquidated during the quarter given valuation concerns and increased risk around the company's ability to do business with U.S. companies, which comprises nearly half of revenues today.

## New Positions

A new position in Indian payments company **PayTM** was initiated during the quarter. PayTM has become ubiquitous with digital payments in India in recent years and is an aspiring super app company building out a double-sided platform servicing both consumers and merchants and an ecosystem with significant growth opportunities ahead given India's underbanked population. The company has over 114 million annual transacting users and over 21 million merchants on its platform. PayTM added a significant number of smaller 'mom and pop' retailers and consumers to its ecosystem over the last five years given the accelerated shift to digital payments driven by the demonetization efforts of the Indian government and the COVID pandemic. Today more than 70% of its revenues are derived from its take rate on digital payments and transactions and about 25% comes from cloud and commercial services. The remaining portion of revenues are driven by financial services such as its lending business, wealth management, and insurance offerings. We see a tremendous long-term opportunity ahead for PayTM given the under-penetration of financial services in India and the company's unique position to leverage its mobile payments platform to grow its offerings in lending, wealth management, and insurance to further enhance the stickiness of its platform.

Among the risks we are monitoring for PayTM are changes in the competitive environment and regulatory backdrop which could negatively impact merchant-discount-rates (MDR) and the company's ability to expand its financial services business. While we expect some pressure on MDR's over time, a greater-than-expected expansion and penetration of the Indian Unified Payments Interface (UPI) network, a government facilitated real-time payments system, could negatively impact its ability to monetize payments.

A position in **Abbott**, a globally diversified healthcare company operating in over 150 countries and generating about 40% of their revenues from Emerging Markets, was initiated. The company operates through four major segments: medical devices, nutrition, pharmaceuticals, and diagnostics. Given its strong internal R&D capabilities and strategic acquisitions, Abbott has positioned itself favorably in attractive growth markets in multiple areas of healthcare, including continuous blood glucose monitoring, structural heart disease, diagnostics, and branded pharmaceuticals. Most of Abbott's businesses have high barriers to entry. Thus, while there are pressures from healthcare budget constraints, competition is limited in number to those with research and development capabilities. We expect new product launches and continued cost optimization to enable Abbott to manage its margin structure. A majority of Abbott's portfolio provides recurring revenues as its products are used on a recurring basis or address diseases that are chronic and increasing in prevalence on a population basis. The rise in chronic diseases and increasing demand from developing health care systems provides Abbott with ample room for growth. Abbott has an attractive footprint in Emerging Markets across its portfolio spanning from nutrition products, branded pharmaceuticals, diagnostics, and medical devices. With a portfolio of products that are wide ranging, Abbott is well-positioned to benefit from increasing consumption of healthcare in Emerging Markets, with a strong balance sheet and diversified market exposure that enables it to withstand volatilities in single markets.

Among the risks we are monitoring for Abbot are changes in the competitive landscape within key growth markets and its ability to withstand healthcare pricing pressure through new and innovative product launches. Lower-than-expected growth in Emerging Markets could negatively impact the company's longer-term growth trajectory. Adverse changes to regulatory environments in key Emerging Markets could negatively impact Abbott's branded pharmaceutical business. The company has recently benefited from COVID testing. Thus, we expect them to face near-term growth headwinds. However, underlying core trends remain intact.

## Summary

Emerging Markets declined in Q4 as ongoing COVID headwinds, inflation, monetary tightening, rising geopolitical tensions, and continued China uncertainty weighed on sentiment. The strong performance of companies in more cyclical areas such as within Semiconductors, Tech Hardware, and Autos combined with weakness in select portfolio holdings weighed on the portfolio's relative return during the period. Over the course of 2021, the increase in earnings expectations for companies, especially those that are more economically sensitive, caused more cyclical stocks to outperform as economies across the world rebounded off pandemic lows. The SGA EM Growth portfolio trailed the broader market during this period in what has traditionally been a more challenging market environment for our approach. With broad-based profit growth expected to moderate in 2022 from the unsustainable levels seen in 2021, we expect the greater predictability, consistency, and above-average growth prospects of our companies to be increasingly rewarded by investors. With more than 20% of the portfolio trading 40%+ below their 2021 highs, we see very attractive absolute and relative return potential in the portfolio today and are excited about the opportunity moving forward. Over the next three years we expect the portfolio to deliver 23% annual earnings growth, well ahead of the 8% expected for the MSCI EM Index. Given the portfolio's strong growth and quality profile along with an attractive cash flow-based valuation, we view the portfolio as well-positioned for an environment with more moderate economic and profit growth.

## Organizational Update

We also want to formally announce that Gordon Marchand, one of SGA's three co-founders, has announced his retirement from the firm on June 30, 2023, upon turning 68 years old. Gordon will continue with his primary and back-up research coverage through the end of 2022. SGA's team approach to portfolio management and research, combined with the gradual nature of our transitions, will ensure continuity as Gordon gradually reduces his direct involvement. Gordon will remain an active member of the Investment Committee and thereby provide input to the team until his retirement on June 30, 2023.

Please let us know if you would like to discuss Gordon's plans or the portfolio's positioning in more detail. We thank you for your continued confidence in our team and wish you all the best for a happy and healthy New Year!

# Sustainability Report

Q4 2021

SGA Sustainable Growth Advisers

We engaged with **Amazon**'s ESG team over the quarter for an update on ESG items with a focus on carbon and modern slavery risks.

In many ways, Amazon has taken a leadership role in addressing the global challenge of minimizing carbon emissions. For example, in 2019 Amazon co-founded The Climate Pledge—a commitment to reach net-zero carbon emissions by 2040, 10 years ahead of the Paris Agreement. Subsequently, Amazon launched the Climate Pledge Fund in 2020, a $2bn venture capital style fund to invest in companies that are developing decarbonizing technologies. While the company deserves credit for their efforts, we think there is more that they can and should be doing. As such, we engaged with the management on the topic of their net-zero emissions commitments, especially in terms of their timeline and interim goals. Regarding timeline, we challenged the company to strive for a more aggressive target than 2040 but gained a greater appreciation for their reliance on future advancements in renewable energy and other technologies to enable their goals which are difficult for the company to predict. Second, we urged the company to adopt interim science-based targets ("SBTs") for emission reductions. As a reminder, we support SBTs as they provide tangible, well defined interim targets validated by and independent third-party association.

The risks of modern slavery within Amazon's business are real with over 1 million employees and a supply chain that spans every corner of the globe. Over recent years, Amazon has made inroads into increasing the priority and transparency of these issues. Amazon has publicly mapped all suppliers who produce Amazon-branded apparel, consumer electronics, food and beverage, and home goods products. The company also partners with local NGOs and initiatives such as the Better Cotton Initiative, amfori and SEDEX, to minimise supply chain risks by leveraging their local experience and knowledge. Amazon publicly releases supplier assessment data, including the details of audits, and in 2020 Amazon conducted over 4,700 audits.

Where identified, high-level findings must be remediated before production; for medium-level issues, suppliers must show they are working towards remediation, and low-level issues are monitored by Amazon for continuous improvement. In 2020, 940 issues were identified that required correction within one year. While we are generally pleased with the policies and infrastructure Amazon has in place to oversee the supply chain of its branded goods, oversight of the company's third-party sellers is a concern of ours given a higher risk of modern slavery as a result of a lack of control and transparency into these sellers' operations and more limited use of audits. While we recognise the challenges given the enormous depth and breadth of their third-party supply chain, we encouraged Amazon to take greater responsibility for their third party business.

We engaged with management of **Disney** over the quarter for a broad discussion on ESG items.

We discussed recent positive updates to the governance of Disney, including 1) the separation of the CEO and Chairman role through the election of Susan Arnold as Chairman; 2) lowered CEO compensation to address concerns of a less-tenured CEO; and 3) nomination of a new head of ESG, head of compensation and head of legal. In addition, management compensation is now based 70% on financials, and 30% on a qualitative assessment which includes factors such as diversity & inclusion. We proposed management reconsider the incorporation of more specific, ESG goals into management compensation.

On the environmental front, Disney has committed to achieving net-zero Scope 1 & 2 greenhouse gas emissions by 2030. We view this target as ambitious given the exposure of physical assets in the form of amusement parks, cruise ships and others. Management plans to firstly flatten the emissions growth curve by pursuing sustainable design for new facilities, and then decarbonise existing assets as well as leverage natural climate solutions and carbon credits. We expressed disappointment on the lack of inclusion of Scope 3 emissions in the company's net-zero targets and it was clear that management have more work to do in this arena. They are currently working to map their Scope 3 emissions, a large task at hand, and hope to set a science-based target by the end of this year. We encouraged Disney to prioritise their control and understanding of Scope 3 emissions as they must be addressed to meet the Paris accord. Naturally, significant investments will be required to meet these ambitious targets and minimise the environmental risk of operations, and in turn, deliver long-term operational benefits. We have accounted for these capital requirements in our financial modelling of the company and will continue to follow the dynamic closely.

Lastly, we discussed the modern slavery risks specifically within Disney's supply chain of licensed merchandised goods. Disney is one of the world's largest licensors with brands spanning Walt Disney Studios, DisneyPixar, Marvel, ESPN and more. Given the company's broad exposure to Tier 1, 2 and 3 suppliers, Disney takes a risk-based approach to auditing suppliers with the vast majority of audits conducted by 3rd parties in high-risk areas. If corrective issues are identified, suppliers are given one chance to remedy the issue before termination of the relationship. Audits currently prioritise the health and safety of the manufacturing environment and while forced labour is an area of audit, it is not currently a significant feature. Disclosures into Disney's supply chain are limited and the company has opportunities to increase transparency, particularly into its' Tier 2 and 3 suppliers. We encouraged management to take action and publicly map these supply chains; we will continue to monitor the company's progress in these areas of risk.

During a recent meeting with management of **Linde**, one of the world's largest industrial gas companies, we revisited the company's carbon targets established in 2019 following the Praxair merger. We have previously expressed our disappointment in the lacklustre targets and encouraged the company to take a leadership role in moving towards more sustainable production. We urged management to set an absolute reduction goal and set a path to carbon neutrality by the Paris Accord 2050 goal. Since the 2019 target was based on carbon emissions per unit of operating profit, recent margin expansion catapulted the company to reach their carbon targets, despite absolute carbon emissions actually increasing over this period. Management have now set an absolute science-based target of 35% reduction in Scope 1 & 2 emissions by 2035 and committed to meet carbon neutrality by 2050. We believe this is a positive move in the right direction; however, we acknowledge that these optimistic goals are unlikely to be achieved without the support of government (in the form of subsidies and carbon taxes) and significant improvements in technology. On a related note, blue and green hydrogen is a promising growth opportunity for Linde, which could open the door to huge growth opportunities in the future. Given the stage of the technology and economics, it is challenging to predict this growth with a fair degree of confidence.

We engaged with management of **Meta Platforms** (previously Facebook) over the quarter to discuss the recent claims made by the Wall Street Journal article regarding the platform's adverse impact on users' health. Since publication, management has strongly denied the claims stating that the articles were a mischaracterization of the company's internal research and highlighted their investments to improve the safety and health of their users. Management also refuted claims that the company benefits from hate speech and drew our attention to the decrease in the incidence of hate speech over recent quarters. While our engagement with management on this topic added little incremental value to our assessment of the social risks associated with the platform and we continue to believe that Meta has a lot of work to do on rectifying matters associated with platform misuse and user wellbeing, we do believe the company is moving in the right direction to address these issues. Ultimately, we believe social media platforms form an essential service in digital society. While there are clear risks associated with its misuse, we believe the benefits to society far outweigh the risks. Lastly, we took the opportunity to provide some suggestions to improve corporate governance at the firm, including:

1. Move to an annual 'say on pay' advisory vote;

2. Provide more specific disclosure around the expenditures for Board member personal security and provide a third-party independent assessments of need;

3. Provide more data on platform abuse, civil and human rights risks, child sexual exploitation, gender/racial pay gaps, and political advertising; and

4. Appoint an independent Board chair.

## Proxy Voting Summary Q4 2021

| | Number of Resolutions | For | % | Against | % | Abstain | % |
|---|---|---|---|---|---|---|---|
| U.S. Large Cap Growth | 35 | 32 | 91% | 3 | 9% | NIL | 0 |
| Global Growth | 67 | 64 | 96% | 3 | 4% | NIL | 0 |
| International Growth | 21 | 21 | 100% | NIL | 0 | NIL | 0 |
| Emerging Markets Growth | 31 | 31 | 100% | NIL | 0 | NIL | 0 |
| Global Mid-Cap Growth | 21 | 21 | 100% | NIL | 0 | NIL | 0 |

*Source: SGA, Broadridge, ISS*

## Carbon Risks

| | Carbon Emissions | Total Carbon Emissions | Carbon Intensity | Weighted Average Carbon Intensity |
|---|---|---|---|---|
| SGA Global Growth | 13 | 12,975 | 73.7 | 60.4 |
| MSCI ACWI | 78.9 | 78,924 | 198.4 | 151.5 |
| SGA Relative Exposure | -84% | -84% | -63% | -60% |
| SGA U.S. Large Cap Growth | 9.1 | 9,073 | 61.8 | 58.6 |
| Russell 1000 Growth | 7.5 | 7,472 | 49.3 | 30.5 |
| SGA Relative Exposure | 21% | 21% | 25% | 92% |
| SGA Emerging Markets Growth | 22.5 | 22,515 | 55.9 | 49.4 |
| MSCI EM | 235.5 | 235,453 | 418.3 | 329.2 |
| SGA Relative Exposure | -90% | -90% | -87% | -85% |
| SGA International Growth | 21.7 | 21,684 | 83.5 | 88.6 |
| MSCI ACWI ex-USA | 140.9 | 140,876 | 234.5 | 194.4 |
| SGA Relative Exposure | -85% | -85% | -64% | -54% |
| SGA Global Mid Cap | 11.4 | 11,410 | 57.1 | 41.9 |
| MSCI ACWI Mid Cap | 156.1 | 156,086 | 284.7 | 230.2 |
| SGA Relative Exposure | -93% | -93% | -80% | -82% |
| | t CO2e / $M Invested | t CO2e | t CO2e / $M Sales | t CO2e / $M Sales |

*Source: SGA, MSCI. Carbon data includes Scope 1 and 2 emissions.*