SGA
Sustainable Growth Advisers

Q1 2019 Emerging Markets Growth Commentary

Highlights

- *SGA's Emerging Markets Growth portfolio returned 16.3% (gross) and 16.0% (net) in Q1 2019 compared to 9.9% for its primary benchmark the MSCI Emerging Markets Index; during the same period the MSCI Emerging Markets Growth Index returned 12.0%*

- *The portfolio's stock selection in the Consumer Discretionary sector contributed most to relative performance over the period, while the portfolio also benefited from an overweight in the Consumer Discretionary sector and underweights in the Financials, Industrials, and Materials sectors*

- *Selection in the Consumer Staples detracted modestly, as did overweights in the Consumer Staples and Health Care sectors, and underweights in the Energy and Information Technology sectors.*

- *The portfolio's positions in Amorepacific and Baidu were liquidated*

Performance

SGA's Emerging Market portfolio returned 16.3% (gross) and 16.0% (net) in the first quarter of 2019 while its benchmark, the MSCI Emerging Markets Index, returned 9.9%, the MSCI Emerging Markets Growth Index returned 12.0%.

A Strong Market Rebound

Emerging markets trailed the developed markets during Q1's strong global equity rally after outperforming during the Q4 market selloff. Global markets performed strongly in January with the rebound in stocks being initially driven by cyclical stocks, and those hardest hit in Q4, but the cyclical rebound gradually ran out of steam, as worries over slowing global economic growth re-emerged. Large cap growth stocks and those with higher quality characteristics regained their leadership. For the quarter, Consumer Discretionary stocks performed best, followed by Real Estate. The Information Technology and Energy sectors also lead the index. Non-U.S. Developed Markets outperformed Emerging Markets by a small margin.

China reported its weakest economic growth in 2018 in nearly three decades, while its exports declined an estimated 21% in February, and imports were down 5.2% on a year-over-year basis. However, Chinese equities generated the second-best returns for the quarter, behind Colombia, given signs of possible movement toward a trade deal with the U.S., and more recent data points indicating that the significant stimulus being applied by the Chinese authorities including lower interest rates, increased lending and increased deficit spending over the last year, were beginning to have some positive effect.

In Mexico, ongoing uncertainty over the economic policies of President Andres Manuel Lopez Obrador, together with rising concerns over the likelihood of U.S. Congressional approval of the recently negotiated U.S. Mexico-Canada Agreement negatively impacted Mexican stocks for the quarter. Meanwhile, South Africa's economy continued to face uncertainty after slipping briefly into recession in late 2018 with unemployment remaining high, further depreciation in the Rand, and more corruption scandals within the ruling African National Congress party. With new national elections scheduled for May, and the country plagued by rolling blackouts which have negatively affected every sector of the economy, investor concern over future growth prospects and stability in the country hurt stock prices and negatively impacted the portfolio's holdings in Sanlam and Shoprite. Similarly, uncertainty in India over upcoming elections, and whether current Prime Minister Modi will be re-elected given a united front by the opposition, weighed on Indian markets early in the quarter.

Key Performance Drivers

The portfolio's outperformance was driven primarily by strong stock selection. Selection was strongest in the Consumer Discretionary sector, while selection was positive across all other sectors except for Consumer Staples which detracted modestly. An overweight to companies in the Consumer Discretionary sector benefited relative returns, while the portfolio's underweights in more cyclically sensitive sectors such as the Industrials and Financials sectors also benefited relative results. Overweights in the Consumer Staples and Health Care sectors detracted from relative returns, as did underweights in the Information Technology and Energy sectors.

Largest Contributors

Latin American e-commerce leader **MercadoLibre** reported solid operating results for the quarter, beating consensus expectations. In particular, operating margins returned to break-even levels during the quarter and the company's burgeoning FinTech initiatives continued to post strong growth. While there was continued deceleration in its Brazil operating results tied to the ongoing impact of rising shipping costs associated with the Correios (Brazilian Postal service) price hike implemented early last year, the company will be lapping those

comparisons in short order. Furthermore, the company's effort to diversify away its reliance on Correios continues to make progress as 17% of shipments are now using MercadoLibre's logistics network, and delivery times continue to improve. Despite rising competition, we continue to see MercadoLibre's long-term growth opportunity as very attractive given the still low e-commerce and digital payments penetration still present in Latin America and the company's strengthening position in the market. We trimmed our position in the stock on strength given valuation and maintained an above-average position in the company.

Chinese online travel agency **Ctrip.com** benefited from better-than-expected Q4 2018 results and Q1 2019 guidance during the quarter. The company delivered 18.5% net revenue growth and 3.5% EBIT margins, while guiding for 18-23% net revenue growth and ~14.5% EBIT margins in Q1, much better than consensus expectations. Concerns about China's economy and the impact of trade tensions on Chinese travel had weighed on Ctrip's stock price, however its recent results illustrate the company's resiliency and ability to successfully navigate a more difficult macro environment. We continue to evaluate the company's revenue visibility, the potential impact of rising tariffs and any major slowing in growth on Chinese travel metrics. However, we do see an attractive growth opportunity for Ctrip given its scale advantages as one of the largest sources of Chinese overseas travelers, which provides it with the ability to negotiate attractive deals globally with various airlines and hotels. The fact that less than 10% of China's population currently takes advantage of outbound travel despite passport issuance growing quickly provides additional long-term growth potential for the firm. We maintained an above-average weight position during the quarter.

China's largest private educational provider **New Oriental Education** reported better than expected Q2 FY 19 results with revenue up 34% (in RMB), along with better than expected margins due to lower sales, marketing and capital expenses. The company also increased its guidance for revenues and margins for the second half of 2019. With ongoing capacity expansion and investments in teaching content, continued positive momentum in its classroom business, heavier regulation leading to increased industry consolidation, and benefits from China's move toward national (as opposed to regional) standardized testing, we continue to see attractive long-term growth opportunities for the company and we maintained an above-average weight position.

Alibaba and **AIA Group** were the fourth and fifth largest contributors respectively to performance.

Largest Detractors

South African retailer **Shoprite** reported slightly better than expected results after reducing guidance earlier in the quarter. Results were negatively impacted by temporary accounting related and currency issues. We expect that devaluation in Angola has run much of its course with its currency now trading at 75% of the black-market rate as opposed to only 40% a year ago. We continue to look for 10% earnings growth over the next three years for Shoprite despite the current economic weakness in their home South African market, and see attractive growth opportunities as the macro-economic backdrop in Africa stabilizes and the company continues to take advantage of new opportunities to expand its footprint in other areas of the continent. Additionally, we believe the company's decision to purchase its founder's voting shares bodes well for improved corporate governance at the firm despite expected short-term dilution. We purchased additional shares of the stock during the quarter on weakness, maintaining an average weight position.

Japanese retailer **Fast Retailing** failed to keep up with the sharp rebound in Asian stock prices during the quarter given that they did not participate in the downside in Q4 of 2018. There were also some short-term concerns over weather related sales trends at Uniqlo Japan and the impact from slowing growth in China which is an important area of expected future growth for the company. We continue to look at the company's long-term opportunity as it takes advantage of greater growth in China and other parts of Southeast Asia, and gradually adjusts and builds its presence in the lucrative U.S. market. We maintained a below-average weight position in the stock during the quarter.

Amorepacific was the third largest detractor from portfolio returns and the portfolio's position was liquidated after we became increasingly concerned that its earnings growth recovery would be slower than we had expected. The company's domestic business is currently under pressure due to increased competition and the lack of good prestige makeup brands, resulting in a reduction in profits, and a greater reliance on the success of Amorepacific's international business. It will take time to restructure the domestic business and while we expect the international business to continue its recovery as the THAAD missile defense related geopolitical headwinds with China abate, the company is investing heavily to launch into new markets such as North America, the Middle East, and Southeast Asia, likely tempering the recovery in profits. Slowing Chinese growth and less confident consumers are also likely to impact the resurgence in the company's growth. While we expect that Amorepacific will eventually succeed in their

globalization efforts, we redeployed the capital to other higher confidence secular growth candidates.

Sanlam and **Sinopharm** were the fourth and fifth largest detractors respectively from performance.

Portfolio Changes

Portfolio turnover was below the portfolio's average with no new positions added during the quarter and the sale of positions in Baidu and Amorepacific. We added to positions in AIA Group, Wal-Mart de Mexico, Shoprite, CP All and TAL Education, and trimmed our positions in Amazon and MercadoLibre.

Sales

As detailed above, **Amorepacific** was sold from the portfolio and we redeployed the capital to other higher confidence secular growth candidates.

Baidu was sold from the portfolio following their Q4 report which showed steady revenue growth but declining profits. Revenues were up 28% with Baidu Core up 20% and iQiyi up 46%, however operating margins were down due to iQiyi's drag and increased traffic acquisition and marketing costs. Marketing costs were up 64% year over year and Baidu is increasing investments to spur growth in areas such as short and flash video content, news feed, and mobile wallets, where they are already behind market leaders. Given that 2019 is expected to be an investment year, and waning confidence in management's ability to sustain growth and market share in an increasingly competitive environment, we liquidated the position and reallocated the capital to other companies with a more sustainable growth profile.

Outlook

The portfolio participated strongly in the rebound of global equity markets in Q1, outperforming its benchmark by a wide margin. More economically-sensitive companies assumed leadership briefly in January amid renewed optimism over future global growth opportunities, but leadership quickly transitioned back to growth stocks with higher quality in February and March. While macro-economic forces continued to play a large role in widely varying price movements and emotions in the market, we continue to focus on our bottom-up fundamental research process; seeking to identify high-quality secular growth companies that are able to deliver predictable and sustainable growth in revenues, earnings, and cash-flows over the long-term, while investing only in those that are attractively valued on our cash-flow based metrics.

We continue to believe that we are in the early stages of a fundamental transition in the markets where increased volatility and greater differentiation between businesses will be more widely apparent. There will undoubtedly continue to be variations in market sentiment influenced by macro-related issues, but as global economic growth continues to moderate, we strongly believe the outlook for high quality businesses that can grow their revenues and earnings sustainably, regardless of the macroeconomic backdrop, is particularly attractive. Over the next three years, we expect the company's in this portfolio to generate 16.9% revenue growth and 19.0% earnings growth relative to 4.4% and 8.9% revenue and earnings growth projected for the broad EM equity market as measured by the MSCI EM Index.

We thank you for your continued confidence in our team and our approach and look forward to answering any questions you may have.
