SGA
Sustainable Growth Advisers

Q4 2018 Emerging Markets Growth Commentary

Highlights

- *SGA's Emerging Markets Growth portfolio returned -10.6% (gross) and -10.8% (net) in Q4 2018 compared to -7.5% for its primary benchmark the MSCI Emerging Markets Index; during the same period the MSCI Emerging Markets Growth Index returned -8.2% and the MSCI ACWI with EM Exposure Index returned -7.8%*

- *Emerging markets outperformed developed markets after trailing significantly in Q3; the Brazilian and Indian markets were strong while the Chinese market declined*

- *Large-cap and value companies outperformed early in the quarter before trends reversed; the reward to business quality metrics was mixed*

- *Utilities and Real Estate provided the only positive returns in the index; Financials held up well, while the Health Care and Consumer Discretionary sectors performed worst*

- *The portfolio's stock selection in the Consumer Discretionary and Consumer Staples sectors, as well as a significant underweight to Financials, detracted from relative performance*

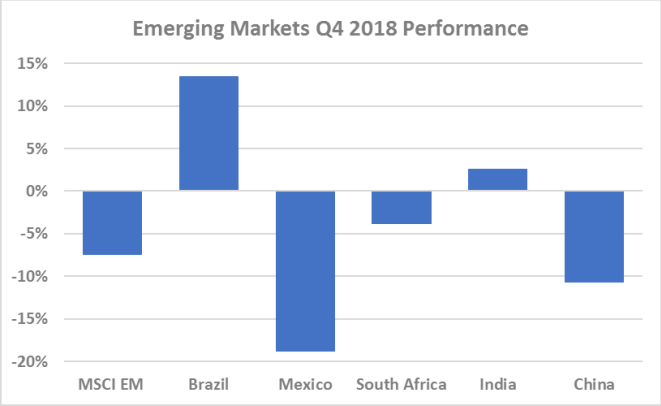
Performance

SGA's Emerging Market portfolio returned -10.6% (gross) and -10.8% (net) in the fourth quarter of 2018 while its benchmark, the MSCI Emerging Market Index, returned -7.5%, the MSCI Emerging Market Growth Index returned -8.2% and the MSCI ACWI with EM Exposure Index returned -7.8%. Consistent with the return pattern we would expect, in 2018 the portfolio returned -11.0% (gross) and -12.0% (net) compared to -14.6%, -18.3% and -15.0% for the MSCI Emerging Markets, Emerging Markets Growth, and ACWI with EM Exposure indices respectively. The high-quality business characteristics and strong growth profile of the portfolio has historically resulted in strong downside protection while maintaining attractive participation in rising markets.

Emerging Markets Outperform Despite Rise in Volatility

Fears over slowing global growth, rising trade tensions between the world's two largest economies, slumping commodity prices and indications from the fixed income markets that higher interest rates are likely to slow economic activity in the U.S. led to sharply higher global volatility and declining equity markets. Emerging markets outperformed as several of the developing markets which had been under more pressure in recent quarters rebounded. Brazil was the best performing market in the ACWI and one of only seven countries in the index to generate a positive return for the period. Others, including South Africa, which had seen significant weakness for the year, held up quite well, experiencing only a marginal decline.

In China, economic growth slowed and we expect it will likely continue to do so on a secular basis to a more sustainable mid-single digit growth rate. The economy's tremendous size, its transition to a more domestically focused, consumer driven economy from an investment and export driven economy, and continued friction from trade conflicts are likely to contribute to the slowing. Massive stimulus applied by the government in 2018 ranging from interest rate cuts and auto tax reductions to lower mortgage rates and increases in government spending will likely moderate the slowing to a degree. This stimulus should also benefit their larger trade partners.



Source: FactSet

Indian markets finished the quarter in positive territory due to a significant recovery in stock prices in November following October's broad selloff in emerging market equities. Concerns over the impact of rising oil prices and currency fluctuations had pressured equities earlier in the year, given the economy's reliance on oil imports. With oil prices tumbling, Indian equities found relief to finish the year stronger, benefiting our holding in HDFC Bank.

Mexican equities were among the worst performing within the ACWI as the announcement by president-elect "AMLO" that he was considering scrapping Mexico City's $13B airport project raised investor concern about his administration's unwillingness to honor current business contracts and potential to take further populistic actions which could hurt investors and growth in the country. In contrast, the Brazilian market was the best performing in the ACWI for the quarter, rallying as far-right

candidate Jair Bolsonaro won the country's presidential election vowing to restore social order and safety, generating greater confidence in a more pro-business, pro-growth free market agenda which investors expect to benefit the troubled Brazilian economy.

Key Performance Drivers

Stock selection detracted from relative returns due to weak selection in the Consumer Discretionary and Consumer Staples sectors. Selection contributed most to results in the Materials and Financials sectors. Sector allocation effects also detracted from returns. A significant underweight to Financials and significant overweight to Consumer Discretionary stocks detracted most, while the portfolio benefited from a significant overweight to Consumer Staples and an underweight to the Information Technology sector.

Largest Contributors

Indian financial services company **HDFC Bank** benefited from the better performance of the Indian stock market relative to other emerging markets. HDFC continues to capitalize on an improving Indian economy and a desire on the part of the country's growing middle class for more efficient banking services relative to what is available through India's traditional national banks. With its funding largely supported by lower cost retail deposits and expenses related to corporate overhead growing at a slower pace than revenues, we continue to see an attractive opportunity for an improving return on equity. Despite the volatility in global markets, Indian consumers are less levered traditionally and remain relatively insulated thus far, and the bank's results during the quarter were steady on all metrics as anticipated. Accordingly, we trimmed the position on strength in Q4, while maintaining the portfolio's above-average weight in the company.

Asian Paints also benefited from the better performance of the Indian stock market in Q4. The company is positioned to achieve +20% profit growth over the coming years due to their capacity expansion in the south and government efforts to increase the permanent housing stock. While this will not provide a short-term benefit, over our 3-5 year investment horizon, a large base of re-painting opportunities will be created, further insulating Asian Paints from the cyclicality of residential construction. The ability to recapture inflation costs with price raises in 2019 and 2020 should help to improve margins. We maintained an above-average weight position in the company given their secular growth opportunity.

Mondelez outperformed the market in Q4 as the company again delivered steady, but moderate growth, boosted by significantly higher, and accelerating, growth rates in emerging markets. Organic revenue growth was just ahead of consensus estimates despite the effects of lingering malware issues and difficult year-over-year comparisons, and management also raised their full year sales guidance. Mondelez achieved higher than expected margin expansion and reiterated their 2018 guidance for double-digit EPS growth. The company also reaffirmed 2019 guidance, despite the year being labelled as a semi-investment year at their earlier analyst day. While Mondelez has been able to deliver consistent results, we took advantage of the increase in market volatility during the quarter to reallocate capital invested in the company to other higher growth opportunities which had become more attractively valued.

Sanlam and **Yum China** were the fourth and fifth largest contributors respectively to performance.

Largest Detractors

Global E-commerce and cloud computing leader **Amazon** reported strong profitability across its businesses with higher margins in its key Amazon Web Services (AWS) business, as well as lower than expected losses in its burgeoning international businesses. However, the stock declined on the report as sales were a little lower than the street consensus due solely to weakness in international sales and what some considered to be cautious guidance. Despite the performance this quarter, the stock is among the top contributors for the year. We were pleased to note that sales in all of Amazon's other business segments were in line with rather high expectations. Likewise, we were pleased with the company's advertising growth and indications that operating margins in its AWS unit may have been an all-time high despite continued price cuts. We have been disciplined in managing our position size in Amazon given its extraordinary strength over the past few years. We fully realize that Amazon will not beat expectations and raise guidance every quarter, however we remain highly optimistic about the company's future growth opportunities.

Despite the relative strength in emerging market equities in Q4, Chinese equities posted weak returns. Leading Chinese travel company **Ctrip.com** was negatively affected by the weakness in the Chinese stock market and concerns surrounding future economic growth. The potential for more cautious consumers to cut back on discretionary spending and for depreciation of the Yuan to deter outbound travel, which is Ctrip's most profitable segment, weighed on the stock price. These fears grew further following the company's Q3 report which, while

better than expected, included Q4 guidance that was significantly worse than expected, citing Q4 EBIT margins of 0-1% and continued margin pressure for the next few quarters, and the stock subsequently declined nearly 20% following the report. The company's weak margin guidance also raised concerns that the competitive landscape was becoming increasingly challenging due to new entrants Meituan and Fliggy.

Despite near-term, macro-driven concerns, Ctrip remains in a dominant competitive position. They have over 200 million monthly active users including 90 million outside of China, and 80% of Ctrip's transactions are with repeat customers who spend more each time they utilize the service. A large portion of Ctrip's user base is under 35 years old, and their fastest growing demographic is users under 29. Outbound travel growth is outpacing the industry and Ctrip also has the highest market share in high-speed rail packages, which continue to gain prominence due to infrastructure investments by the Chinese government in rail development. All of these factors help provide Ctrip a significant moat against new competitors. Given their still dominant position in a secular growth industry, we utilized weakness tied to current macroeconomic concerns to raise the portfolio's position in the company to an above-average weight.

Alibaba was the third largest detractor from portfolio performance during the quarter. In addition to overall negative sentiment surrounding Chinese stocks, Alibaba actively managed near-term expectations lower. This was due in part to weaker customer spending due to macro concerns, as well as the tweaking of ad formats, user interface changes on their Taobao app, and continued investment spending. Alibaba reduced Q4 guidance by 4-6%, however they also showed mobile monthly active user growth of 21% and active buyer growth of 23%. Despite weaker consumption, the company continues to expand its market, and long-term monetization opportunities, and we maintained an above-average weight position in the company.

New Oriental Education and **Baidu** were the fourth and fifth largest detractors respectively from performance.

Portfolio Changes

Portfolio turnover was above-average during the quarter as we used the increase in market volatility to establish new positions and add to positions in high conviction companies. Nestle, Shandong Weigao, and TAL Education were added to the portfolio, while positions in Heineken, Yum China and Mondelez were liquidated. Target weights were raised in AIA Group and Ctrip.com, while positions in HDFC Bank, Nike and Tencent were trimmed.

Purchases

We reinitiated a position in **Nestle** based on expectations for improving earnings and cash flow growth of the company over our 3-5 year investment horizon, combined with an attractive valuation. CEO Mark Schneider moved into his position in late 2016 and took steps to enhance the operating performance of Nestle, replacing leaders of underperforming businesses, cutting headcount where needed, including management, and consolidating cost centers. With improvements in operating profit margins already occurring and enhanced revenue growth expected by 2020, our research points to a gradual transformation taking place at Nestle which could allow the company to generate high-single-digit earnings growth and double-digit cash flow growth. While about 5% of the company's slower growing revenues have been replaced with more strategically consistent and faster growing businesses, much work remains as they take steps to optimize their business mix. Nestle generates a substantial portion of their revenues from emerging markets, and achieving their growth rate goals in these regions is key to the company achieving their overall growth goals. Acquisitions such as the recent Starbucks packaged food purchase offer additional incremental growth. Global leadership positions in pet care, nutrition and bottled water, which comprise about 80% of profits, provide a strong mid-single-digit growth base as they cull slower growth, poorer fitting business units such as U.S. confectionary, Gerber Life and possibly Nestle Skin Health.

Among the key risks we will be focused on are the ability of CEO Mark Schneider to continue to affect positive change in Nestle's established company culture. Continued steps toward rationalizing underperforming businesses and replacing them with higher growth opportunities which build on Nestle's core operating strengths will be important. With a diverse multi product, international business such as Nestle, currency and commodity cost fluctuations will affect short-term results and need to be evaluated in a longer-term context, but may provide opportunities to add to the investment.

With the stock underperforming by a wide margin in 2017 and early 2018, Nestle offered a cash yield of 4% plus a dividend yield of 3%. Accordingly, we took advantage of the underperformance and attractive valuation given the positive changes occurring at the company, and leveraged our longer time horizon to initiate an average weight position.

Shandong Weigao is a leading medical device company in China selling medical consumables and orthopedic implants. The population in China is aging rapidly as a result of the country's long policy of limiting one child per family. Healthcare in China has significant room to grow in order to meet the needs of its rapidly aging populace. Shandong Weigao is actively conducting research and development and launching new products to upgrade their portfolio; continuing to move from a more commodity-oriented portfolio to one incorporating more specialized products with higher barriers to entry and greater pricing power.

Consistent with China's strong preference for local businesses, we expect Shandong to be an important player in the expansion of the Chinese health care system. While in the past we have had some concern over management incentives at the company, with the listing of founding shareholders' shares on the Hong Kong exchange which were previously unlisted, we believe that management's incentives are now more properly aligned with that of public shareholders. Key members of management continue to own more than half the company. Other risks include the possibility of government policies that curtail or restrict the use of medical devices or reduce pricing, and the ability of the company to retain key talent in a highly competitive environment.

Given the secular growth potential in the Chinese health care market, Shandong Weigao's investment in portfolio upgrades, and their position in the industry as a dominant, and local competitor, we initiated an average weight position in the company.

TAL Education is the leading K-12 after-school tutoring services provider in China. It offers tutoring services to K-12 students covering various academic subjects, including mathematics, physics, English, and Chinese. The company provides services primarily through small classes, including Xueersi Peiyou, Firstleap, and Mobby, which typically have a maximum of 12 to 60 students per class for different grades. The company also provides one-on-one premium tutoring services under the Lezhikang name. In addition, the company has been growing online K-12 tutoring offerings to penetrate into lower tier cities and to meet the increasing demand for online education in major cities. TAL is also growing its capability in overseas education and consulting through acquisitions. In 2016, it acquired Firstleap, a company that provides all-subject tutoring services in English to students aged two to fifteen, and Shunshun Liuxue, which provides consulting services for overseas studies and test preparation courses.

TAL's brand name, which is well recognized in China especially for its high-quality tutoring service in math, large scale, and technological capabilities provide the company with significant pricing power. In cities like Beijing and Shanghai, parents often register their children in advance to secure a spot with TAL. Its strong brand allows the company to charge premium prices and pay their teachers better, which enables the company to attract top teaching talent and continuously improve teaching content. TAL's business is more insulated from economic swings given the prioritization of education during downturns as well the intense competition for access to top universities in China. Secular tailwinds provide long runways of growth for TAL, as well as our other private education holding, New Oriental Education. These include consumption upgrade driving increasing demand for K-12 tutoring services, continued industry consolidation as larger players dominate in technology and teaching resources, and tightened education regulations increasing the barriers to entry. The two companies combine for just 5% of total market share and both stand to gain from further consolidation within the fragmented industry.

A potential risk for the company is further regulation changes that may increase the costs of operation and discourage market demand. To prevent this, TAL has been adjusting its curriculum and operations to meet the government requirements, while improving its operation flexibility to balance growth and profitability. We took advantage of a valuation opportunity to establish a below-average weight position in the company.

Sales

Our position in **Heineken** was sold during the quarter given lower conviction in the company's growth opportunity due to potential margin pressures as the company faces higher input costs and as a greater portion of the company's incremental growth is now coming from lower margin rural areas in certain key markets. While the company is expected to offset these pressures to an extent, the recent increase in market volatility provided us with the opportunity to add to higher conviction secular growth positions at more attractive valuations.

Given the rise in volatility, further weakness in Chinese markets, and relative strength in **Yum China** shares, we used the opportunity to reallocate the capital from the portfolio's position to other more attractively valued, higher conviction growth opportunities.

As mentioned previously we liquidated our position in **Mondelez** given more attractive opportunities.

Outlook

As volatility rose in Q4 in response to increased uncertainty over global macro-economic and geo-political issues, we took advantage of widespread share price reductions by initiating positions in three high quality secular growth businesses which had previously looked less attractive due to valuation. We also added to existing positions in high conviction strong secular growth businesses we already owned. This increase in volatility is consistent with what we have been expecting as the period of unprecedented monetary accommodation around the world gradually winds down and concerns over trade tensions and slowing global growth build. Just as the discipline to carefully manage position sizes in strong growth businesses amid investor optimism is critical, the willingness to capitalize on volatility is also critical. In such times, our fundamentally focused bottom-up research and 3-5-year time horizon, empower us to opportunistically increase positions in strong secular growers that are temporarily valued more attractively. With a Qualified Company List of the highest quality global secular growth businesses we can identify we are well prepared for continued volatility in the market. While Q4 witnessed a rise in market volatility, we strongly believe that we remain in the early innings of what will be an extended period of higher volatility globally as investors gradually adjust to higher interest rates, ongoing trade tensions, and slowing global growth. We expect such an environment to lead to greater differentiation between businesses and significant opportunities to generate attractive relative returns for our clients' portfolios through disciplined stock picking. At year end, the portfolio had an enterprise yield of 3.4%, meaningfully higher than the 2.9% seen at the beginning of 2018. Its three-year forecast of revenue and earnings growth were 15.7% and 19.1% respectively, well above that of the MSCI Emerging Markets Index. This attractive valuation, combined with the higher business quality characteristics of the portfolio companies, including strong cash flow generation, low debt and robust margins, makes us highly optimistic regarding the opportunity in the portfolio looking forward.

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