SGA
Sustainable Growth Advisers

Q3 2018 Emerging Markets Growth Commentary

Highlights

- *SGA's Emerging Markets portfolio returned -1.0% (gross) and -1.3% (net) in Q3 2018 compared to -1.1% for its primary benchmark the MSCI Emerging Markets Index; during the same period the MSCI Emerging Markets Growth Index returned -5.4% and the MSCI ACWI with EM Exposure Index returned -2.6%*

- *Emerging markets trailed developed markets by a wide margin on concerns tied to rising interest rates, reduced liquidity, currency issues, rising oil prices and trade tariffs*

- *Larger cap value stocks with more debt, low returns on equity and no earnings outperformed; market backdrop a headwind for our approach*

- *The Energy sector led the Index by a wide margin, followed by Materials and Industrials, while the Consumer Discretionary and Health Care sectors performed worst*

- *The portfolio benefited from strong stock selection, while sector allocation detracted. Selection was strongest in the Consumer Discretionary, Information Technology, and Health Care sectors*

Performance

SGA's Emerging Market portfolio returned -1.0% (gross) and -1.3% (net) in the third quarter of 2018 while its benchmark, the MSCI Emerging Market Index, returned -1.1%, the MSCI Emerging Market Growth Index returned -5.4% and the MSCI ACWI with EM Exposure Index returned -2.6%. Consistent with the return pattern we would expect, year-to-date the portfolio has returned -0.5% (gross) and -1.3% (net) compared to -7.7% for the MSCI Emerging Markets Index, -10.9% for the MSCI Emerging Markets Growth Index, and -7.8% for the MSCI ACWI with EM Exposure Index. The high-quality business characteristics and strong growth profile of the portfolio has historically resulted in strong downside protection while maintaining attractive participation in strong up markets.

Continued Weakness in Emerging Markets

Rising interest rates, ongoing trade tensions, the strong U.S. dollar, rising oil prices and weakening global economic growth combined to negatively impact emerging markets again in Q3. Stocks most reliant upon a continuing global economic expansion underperformed. The Turkish and Greek markets declined double-digits (in USD terms) in the quarter while markets in China and South Africa also performed poorly. In contrast, the Mexican market rebounded following the country's presidential election in which left-wing favored candidate Andrés Manuel López Obrador (AMLO) and his party won, but not with the super-majority needed to alter key economic reforms put in place by the prior administration. More moderate rhetoric by the president-elect following the election also served to calm investors. An agreement between the U.S. and Mexico on a revised NAFTA accord benefited Mexican equities later in the quarter. Argentina, another country which has seen its currency plunge recently (down more than 50% against the U.S. Dollar), is facing economic difficulties and news of a historically large IMF bailout package did not restore investors' faith in the country's economic outlook, negatively impacting Argentinian equity returns.

South Africa's economy weakened further and officially entered recession, its first since 2009. One measure of unemployment has climbed above 37% and efforts to narrow a ballooning budget deficit through higher value-added taxes has hurt consumer spending. In addition, the Rand has depreciated 12.5% against the U.S. Dollar this year putting further strain on the economy. As investors fear a prolonged economic downturn, an increasingly volatile currency, as well as populist rhetoric from political leaders, South African equities have been among the worst performers year-to-date. While the macroeconomic environment remains unfavorable in South Africa, we have continued confidence in the long-term secular growth outlook for the portfolio's two South African holdings, Shoprite and Sanlam, whose business fundamentals have shown resilience through tough economic environments in the past and are beneficiaries of long secular growth tailwinds in the region.

China officially reported 6.7% Q2 GDP growth, slightly lower than Q1's 6.8%, but it is likely that trade related weakness tied to tariffs recently imposed will have a greater impact on growth over the remainder of the year and into 2019 unless a trade agreement with the U.S. is reached. Weakness in Chinese manufacturing worsened in Q3 with producers of cars, machinery and other products ceasing expansion in September and exports falling to their lowest levels in two years. Output from large state-owned manufacturers continued to weaken as well. While the manufacturing, or older, side of the Chinese economy faces increasing difficulty, the newer service side of its economy continues to generate more attractive growth. The indirect impact of tariffs on the services economy remains less clear. However, we continue to see selective areas where we expect domestically driven secular growth to remain steadier. The Chinese government's ability to reverse course on more restrictive monetary policies and add stimulus to the system

through easier credit and increased government spending will likely support growth in the near term. However, while the long-term potential of the Chinese economy remains very compelling, already high debt levels are a concern worth monitoring.

Key Performance Drivers

Strong stock selection in the Consumer Discretionary, Information Technology, and Health Care sectors contributed most positively to returns during the quarter, while selection in the Materials and Financials sectors detracted. Sector allocation effects hurt relative returns, driven by the portfolio's overweights in the underperforming Consumer Discretionary and Consumer Staples sectors as well as an underweight in the strongly performing Energy sector. The portfolio continued to exhibit its characteristically strong downside protection during the weakness in emerging markets stocks experienced in August and September. Over the year-to-date period, the portfolio has captured only 52% of the downside for the MSCI EM Index. Since the portfolio's inception on August 1st 2014, it has captured only 66% of the Index's downside.

Largest Contributors

Amazon's shares continued to rally in Q3, following a solid second quarter earnings release in July. The company's dominant leadership positions in e-commerce and cloud computing, along with high growth in its advertising revenues and a growing Prime membership customer base provides the company with long runways of growth combined with significant visibility. The company's cloud computing division, Amazon Web Services (AWS), grew 49% in the second quarter and is now a $24 Billion business for Amazon. Advertising revenues also showed continued strength. Our research continues to indicate a strong growth opportunity for the company especially in emerging markets, however we remain cognizant of its higher-than-average cash-flow based valuation level and have actively managed our position size accordingly.

MercadoLibre posted mixed Q2 results, but the stock rose following the report as the company guided toward renewed profitability in the second half of the year and investors looked beyond a trucker strike and increases in freight costs in Brazil. Solid and improving growth in Argentina, Mexico, Chile and Columbia helped offset weaker results in Brazil. We expect the company to continue to balance between improving profitability and growth over the next couple years, focusing on driving its scale and competitive advantages in logistics and payments as opposed to solely margin accretion. Over our 3-5 year investment horizon, we expect the company's focus on payments and more broadly FinTech, including merchant credit and creating a regional payment alternative to credit cards (akin to Ant or Wechat payments), to offer an even more lucrative opportunity than e-commerce. We see additional opportunity for margin improvement for the company when it decides to more seriously begin leveraging its advertising potential, similar to what Alibaba and Amazon have done, and continue to be impressed by management's execution across e-commerce and payments. We maintained an above average weight in the position, while trimming on strength during the quarter.

Wal-Mart de Mexico (Wal-Mex) was the third largest contributor to performance in the quarter, benefitting from a rebound in the Mexican equity market following results of the presidential election in which left-wing favorite AMLO's victory fell short of the super-majority required to reverse the economic reforms of the prior administration, as well as the successful resolution of NAFTA trade negotiations with the US. During the quarter the company also posted solid Q2 results, albeit it slightly below consensus expectations but in line with ours, and continued to execute well in a difficult market environment in Mexico. Revenues and profits increased about 8% and 14% respectively. Comparable store sales growth easily outpaced the market, marking the 14th consecutive quarter of outperformance versus peers. Top-line strength was driven by improving e-commerce sales and new store growth. Margin growth remained limited. Results were hurt by disappointing sales growth in Central America due to macro weakness in Costa Rica and increasing political unrest in Nicaragua which should prove temporary. Over the longer-term, we continue to see Wal-Mex benefiting from a strong competitive moat in the regions it serves and a strong management team that has proven highly resilient in the more volatile markets they participate in.

Sinopharm and **Visa** were the fourth and fifth largest contributors respectively to performance.

Largest Detractors

A common denominator among the key detractors this quarter was their exposure to China. The Chinese stock market declined -7.5% amid rising trade tensions with the U.S. and fears over how long the impasse would last and its likely effect on the Chinese economy and businesses who derive a significant amount of their sales from exports. Despite near-term uncertainty over trade issues, we continue to see select unique long-term growth opportunities in China which are being painted with a broad brush amid the current fears.

New Oriental Education (EDU) shares were negatively impacted by the general weakness of the Chinese stock market resulting from rising concerns over the likelihood of a trade war between the U.S. and China, and the impact it could have on the growth of the Chinese economy and businesses. With 15% of EDU's business catering toward students who take English language tests such as the GRE and GMAT for pursuing a degree in the U.S., further deterioration in the relationship between the two countries could suppress such demand. In addition, concerns over new government regulations aimed at tightening licensing requirements for K-12 tutoring providers to discourage less qualified teachers, and banning subject competitions, negatively impacted private education stocks in China. News of stricter licensing requirements and a lowering of the burden on Chinese students is not new, and the change in focus appears to us to be a stricter enforcement of existing regulations as opposed to setting tougher requirements for tutorials. As EDU is not involved in subject competitions, the company is not likely to be impacted by a change in subject competition rules, and we consider concerns related to stricter regulation to be unwarranted, as regulation may actually prove helpful to EDU by accelerating industry consolidation and removing many smaller providers. We added to the position on weakness, maintaining an above-average target.

In addition to downward pressure on its stock from broad-based weakness in Chinese markets, **JD.com** was negatively impacted early in September on a report that the company's CEO Liu Qiangdong was arrested in the United States. While Liu was released without charge, and he and JD.com officials deny any wrongdoing, the investigation is ongoing and may add an additional overhang to the stock pending its resolution. The business was also impacted by the softening consumption trend in China since 2H 2018, especially in its biggest categories, home appliances and electronics. JD.com continues to invest in their independent logistics business and artificial intelligence (AI). While these investments will impact cash flow in the near-term, they will benefit the development of JD.com's third party business and expansion into offline categories such as grocery, in the long-term. The company is ahead of their competition in the logistics space, where the market is still fragmented and there is the opportunity for consolidation. JD.com is lagging competitors however in cloud development, and rather than making large investments in this space moving forward, they are developing it as an addition to their logistics and AI capabilities. While JD.com continues to improve their positioning in the future of Chinese retail, competition remains strong and current investments will pressure margins in the near-term. Balancing this, we maintained a below-average weight position in the portfolio.

Ctrip.com reported a better than expected quarter amid fears over reduced outbound travel from China due to currency impacts and trade tensions, as well as increased competition from (Alibaba's) Fliggy unit and Meituan (which recently became public). Travel volumes remained healthy with attractive hotel, airline ticketing and packaged tour revenue growth. Customer-centric initiatives put in place by management (i.e. refunding travel expenses in cases where visa applications had been denied and an expanded hotel rewards loyalty program) are expected to differentiate the company from more purely transactional travel platforms and lead to stronger customer retention and loyalty. Management guidance was stronger than expected with margins expected to improve and easier comparable sales now that it has been a year since the government mandated changes to the bundling of insurance and other value-added services to air tickets. We remain cautious on the Chinese macro-economic backdrop given trade issues and regional slowing, as well as due to increasing competition to Ctrip from Alibaba and others. Given significant opportunity to further penetrate lower tier cities, continued improvement in domestic and outbound travel infrastructure (such as high-speed rail and more flights), growing numbers of travelers with higher disposable incomes and travel visas, we see Ctrip being able to build on its strong reputation and economics.

Tencent and **Amorepacific** were the fourth and fifth largest detractors respectively from performance.

Portfolio Changes

Portfolio turnover was limited during the quarter with no new positions added or any positions liquidated. We took advantage of volatility and added to several positions on weakness including Alibaba, Asian Paints, HDFC Bank, New Oriental Education, Shoprite, Sinopharm, Tencent, and Yum China (later trimmed on strength related to buy-out rumors). We trimmed positions on strength in Fast Retailing, Infosys, MercadoLibre, and Mondelez.

Outlook

Much of the weakness in Emerging Markets this quarter was macro driven, as emerging markets are seen as the losers in a prolonged U.S. – China trade war as well as highly sensitive to further interest rate rises and currency volatility. While broad geo-political and macro-economic forces dominated the headlines in Q3, our emphasis remains on deep, long-term focused, bottom-up company research. If we identify high quality sustainable growth businesses with strong pricing power, truly recurring revenue streams and long-term growth runways,

and buy them opportunistically, our portfolios should, if history is any precedent, provide the long-term capital appreciation our clients expect, regardless of the short-term swings in sentiment and macro fluctuations. Broad trends often paint swaths of companies the same regardless of their underlying fundamental characteristics or long-term growth opportunities. The downward price pressure seen across emerging markets this year provides us with the chance to leverage our deep research and longer time horizon to invest in attractive long-term secular growers at attractive prices. We are confident that our opportunistic approach to managing concentrated portfolios of the highest quality long-term growth businesses we can find, is the best approach to ensuring less volatile growth streams and attractive absolute and relative returns over time.

Today, this portfolio is forecast to generate 19.5% earnings growth over the coming three years versus 12.6% for the MSCI EM Index, with significantly higher cash flow generation, better profitability, less debt, and an attractive cash-flow-based valuation. While high momentum stocks have driven market performance over the last few years, our approach has continued to take profits in these more expensive holdings and reallocate the capital to other more attractively priced high growth opportunities. The diversity and quality of our secular growth businesses and their attractive valuations makes us highly confident in the portfolio's outlook and we look forward to speaking with you in more detail about it.

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