SGA
Sustainable Growth Advisers

Q4 2017 Emerging Markets Growth Commentary

Highlights

- *SGA's Emerging Markets portfolio returned 8.7% (gross) and 8.4% (net) in Q4 2017 compared to 7.4% for its primary benchmark the MSCI Emerging Markets Index; during the same period the MSCI Emerging Markets Growth Index returned 7.9% and the MSCI ACWI with EM Exposure Index returned 6.9%*

- *Emerging markets outperformed developed markets; Asia was the best performing region*

- *Small cap growth performed best; the reward to business quality was mixed as companies with higher returns on equity and earnings outperformed as did firms with higher levels of debt and higher betas*

- *Health Care sector performed best followed by the Discretionary and Materials sectors; Utilities and Telecommunications performed worst*

- *Strong stock selection was responsible for the portfolio's outperformance; selection in the Financials sector contributed most to SGA's relative performance followed by selection in the Consumer Discretionary and Technology sectors. Stock selection in Health Care detracted most from relative returns*

- *A new position in Heineken was added to the portfolio while positions in Ping An Insurance and Magnit were liquidated; positions in AIA Group and Shoprite among others were increased on weakness while positions in Baidu and Ctrip were trimmed*

Performance

SGA's Emerging Market portfolio returned 8.7% (gross) and 8.4% (net) in the fourth quarter of 2017 while its benchmark, the MSCI Emerging Market Index, returned 7.4%, the MSCI Emerging Market Growth Index returned 7.9% and the MSCI ACWI with EM Exposure Index returned 6.9%. For 2017, the portfolio returned 36.3% (gross) and 34.9% (net), while its primary and secondary benchmarks returned 37.3% and 46.8% respectively and the ACWI with EM Exposure returned 35.1%

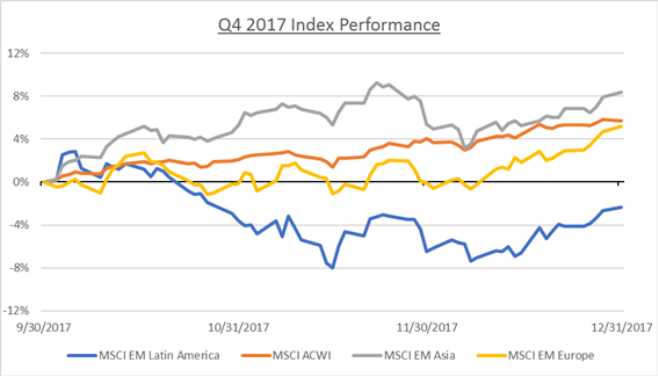
	Q4	1-Year	3-Year	Inception
SGA Emerging Markets Growth (Gross)	8.7%	36.3%	10.5%	8.7%
SGA Emerging Markets Growth (Net)	8.4%	34.9%	9.3%	7.6%
MSCI EM	7.4%	37.3%	9.1%	4.8%
MSCI EM Growth	7.9%	46.8%	11.9%	8.0%
MSCI ACWI with EM Exposure	6.9%	35.1%	9.3%	5.4%

Emerging Markets Outperformed on Rising Optimism

A favorable global backdrop with better than expected economic growth in the U.S., China and Japan encouraged investors to look beyond geopolitical challenges and rising interest rates in the U.S. Emerging markets, which are most levered to improving global economic growth, performed best amid the optimism. Markets in South Africa (+21.4%), Greece (+13.3%), India (+11.8%) and Korea (+11.4%) were strongest, with Asia being the best performing region. In contrast, markets in Latin America posted the lowest returns for the quarter after leading the emerging markets rally in Q3. Mexico (-8.1%) was the weakest country followed by the United Arab Emirates (-4.6%). Unlike Q3, when commodity rich markets as a whole performed best, in Q4 leadership was more country specific. South Africa benefited from greater certainty following the election of Deputy President Cyril Ramaphosa to be the new leader of the ruling African National Congress (ANC) after a bruising race that had cast doubt over future stability in the country. In Greece, after regaining access to capital markets in 2017, speculation that the country may exit the international bailout program after years of austerity, sparked investor interest. In India, Prime Minister Narendra Modi's ruling party pulled out a win in his home state of Gujarat, increasing the likelihood that key reforms would continue.

China's equity market returned 7.6% for the quarter, as its Q3 GDP grew at a better than expected rate of 6.8%. While monetary policy has tightened, interest rates have crept up, and lending standards have become more demanding, the deleveraging process has continued to be slow. Household debt remains low relative to many developed economies despite showing significant growth from approximately 30% of GDP in 2012 to 44% in 2017. With the completion of the Fall Communist Party Congress and the consolidation of President Xi's power base, investors became less concerned about the chances for meaningful economic deceleration in China.

In the Asia-Pacific region, South Korea's economy grew at its fastest rate in seven years in Q3 and its market was among the best performers in Q4 returning 11.4% and over 47% for the year. Continued positive economic data, some reduction in concerns over North Korea's missile tests, and indications that China may ease travel restrictions which had hurt many Korean businesses benefited South Korea's stock market.



Source: FactSet

Key Performance Drivers

Increasing optimism over global economic growth, and emerging markets in particular, benefited smaller cap, higher beta stocks while the reward to business quality was mixed with higher returns on equity, positive earnings and higher debt all outperforming. The Health Care sector (+16.6%) performed best by a wide margin during the quarter followed by stocks in the Consumer Discretionary (9.0%) and Materials (8.7%) sectors. Strong stock selection drove portfolio outperformance while sector weightings had minimal impact. Stock selection in the Financials sector contributed most positively to relative performance with positions in South African Financial conglomerate Sanlam having the largest impact and Hong Kong based AIA Group also contributing strongly. Stock selection in the Consumer Discretionary and Technology sectors also contributed positively to relative performance driven by strong returns in Japanese retailer Fast Retailing, global e-commerce leader Amazon, Chinese videogame and internet company Tencent and Argentine e-commerce leader MercadoLibre. Stock selection in the strongly performing Health Care sector detracted the most due to the portfolio's position in Chinese medical product distributor Sinopharm.

Largest Contributors

Japanese retailer **Fast Retailing** was the largest contributor to the portfolio's performance in Q4. The company reported full year earnings in October showing its overseas business was strong across the board. Revenue growth was strong with margins increasing everywhere, and the company guided to a continuation of these trends. On the domestic side of their business, management had earlier talked about increasing investments to improve inventory management. The comments caused concern among some investors who were worried that the company's margins may be negatively impacted in the short-term. When the company provided the guide for the next fiscal period, investors realized that the impact on near-term margins had been over-emphasized last quarter. Moreover, the company has continued to report good monthly comparable sales throughout the quarter for their domestic business. From our standpoint, these investments are positive for future profitability and the company has provided attractive 3-5 year growth targets. Fast Retailing remains focused on continued moderate growth at Uniqlo Japan and improving growth at Uniqlo International driven by rising opportunities in China, Southeast Asia and Europe, and the stemming of losses in their emerging U.S. business, which is already occurring. Consistent with our long-term outlook, we added to the position on weakness last quarter and maintained an average weight position at the end of the year.

Chinese video game and e-commerce firm **Tencent** was the second largest contributor to portfolio performance as the company reported strong results with user growth rising 16% to 980 million, revenue growth accelerating from 59% to 62%, and profit growth accelerating to 45%, the highest level in 12 quarters. Videogame revenues grew 48% with continued market leadership supported by a promising pipeline featuring two new games which have already generated over 20 million pre-registrants. We were pleased with the strong level of growth reported in this key segment but expect some moderation in the pace of growth as we model 2018-2019. Advertising revenues grew 48% led by increases in social advertising and we look for re-acceleration in the company's non-social ad growth in 2018 as Tencent completes the consolidation of its multiple ad-buying systems and enhances the ease with which customers can make purchases. Revenues from the cloud and payments businesses grew quickly, rising 143% as the company continued to increase its market share in the electronic payments business. Our research indicates continued attractive secular growth for the company as it begins to advance its advertising capabilities more and benefits from continued growth in its gaming and social media businesses as well as its burgeoning cloud, payments and international opportunities outside China.

LG Household & Healthcare (LGH&H) reported resilient Q3 results with 3% sales growth and 3.5% operating profit growth. Given a difficult backdrop of declining Chinese tourist traffic to Korea, and the negative impact this has had on duty free sales, the results were better than expected and an improvement from Q2. Household and beverages posted flat and 6% operating profit growth respectively, while beauty posted 2%+ operating profit growth. Duty fee sales recovered to 3%+ sales growth, after declining -26% in Q2, and mainland China sales (which comprise about 10% of beauty revenues) showed accelerating growth in Q3. LGH&H's stock performed well

given the results and what appears to be an improving relationship between China and South Korea which should bode well for continued growth in cosmetics sales to Chinese customers.

Global e-commerce leader **Amazon** and South African financial conglomerate **Sanlam** were the fourth and fifth largest contributors to performance respectively.

Largest Detractors

Magnit was the largest detractor from portfolio performance during the quarter. The company reported disappointing Q3 results with traffic down across all its formats, weak gross margins and continued strong competition. New store economics were disappointing as their new stores must now penetrate more areas where competitors such as X5 are already firmly entrenched. We envision increasing costs as the company makes major investments in new growth initiatives, remodeling and redesigning a number of its large stores to transition them to the new hypermarket format, focuses increasingly on acquisitions to augment its growth, and resorts to increased promotional activity in order to gain share. With the payback to such investments longer due to intensifying competition, increased M&A and rising capex and price investment costs, we determined that the thesis had become less tenable and redeployed the capital to other more attractive investment opportunities.

Chinese online travel agency **Ctrip** was the second largest detractor from performance in Q4 as it delivered a strong Q3 report but issued more conservative guidance for Q4 due to expectations for reduced cross-selling activity. Specifically, Chinese regulators asked Ctrip and other online travel agencies to cease automatically bundling travel insurance and other extras into ticket prices and travel packages. We expect this to be a temporary issue for Ctrip and see many ways in which they can exercise their profitability lever to compensate over the long-term. We continue to expect strong growth as the company benefits from its ability to reach customers directly via mobile, expands its services into lower tier cities and capitalizes on accelerating outbound travel by increasingly affluent Chinese consumers. The position was trimmed earlier in the quarter on strength and later bought back to target on weakness.

Baidu reported Q3 results that were in line with (revenues) or above (profitability) our expectations. However, Q4 revenue guidance was weaker than investors expected which caused the stock to decline significantly following the report. The expected weakness was due to short-term issues including the company's decision to not play any of its hit shows during the Communist Party Congress in October and costs associated with its disposal of Baidu Delivery. Despite limited near-term visibility, we continue to see Baidu's long-term advertising monetization opportunity as attractive, and expect the company to benefit from continued strengthening of its AI businesses and growth in its Newsfeed business. The position was trimmed earlier in the quarter on strength.

U.S. online travel company **Priceline** and Chinese pharmaceutical distributor **Sinopharm** were the fourth and fifth largest detractors from performance respectively.

Portfolio Changes

Portfolio turnover during the quarter was less than average. We initiated one new position in Heineken, the Dutch beer brewer, and liquidated positions in Magnit, Russia's largest food retailer, and Ping An Insurance, a Chinese insurance company. Weights in Baidu and Ctrip were also trimmed early in the quarter on strength while we raised positions in Shoprite and HDFC Bank as we took advantage of currency weakness in South Africa and concerns related to the ability of the Indian government to continue its economic reforms. A position in Hong Kong based AIA Group was also added to earlier in the quarter and Ctrip.com was bought back to target following weakness in the stock after the company's earnings report.

Purchases

Heineken is the second largest global brewer by revenue and the number one international premium beer brand. It serves over 70 countries with over 250 brands including Heineken, Amstel, Sol, Bohemia, Dos Equis, Tecate and Red Stripe. The company offers strong business quality and stable growth characteristics. It benefits from the relative stability of the global beer industry, a geographically diverse business, and regularly recurring consumption patterns across the world. The company's pricing power is augmented by the strength of its brands, with Heineken having the number one or number two brand in five of the top ten premium beer markets. Our research indicates the company is well positioned to benefit from higher than average margins in the premium and developing markets where it is working to strengthen its positioning further. Additionally, the company is targeting new growth opportunities in the cider, draft, craft and low or no alcohol product areas where its strong brand position with beer consumers should benefit growth. Finally, management has demonstrated a consistent ability to expand operating margins as a result of its cost savings programs. Accordingly, we initiated an average weight position in the stock during the

quarter on weakness and expect to build it opportunistically moving forward.

Among the risks we are monitoring with the stock, are competitive threats from the now merged ABI/SABMiller Company, relatively low growth in Western Europe, which comprises about 25% of its profits, the potential for special taxes to be levied in markets, and the strength in craft beers which continue to take market share from more traditional mainstream beers such as Heineken making it important for the company to continue its moves to strengthen its position in this and other more quickly growing areas.

Sales

Ping An Insurance (Ping An) was added to the portfolio to take advantage of its million plus professional agents selling Ping An's proprietary products, their enviable position in the quickly growing Chinese auto insurance market where they were a first mover, and growth in their bank which has taken established substantial loan loss reserves to address any future weakening in credit quality. With China's GDP growth surprising investors to the upside and global earnings growth showing some signs of improvement, the stock appreciated significantly and with valuation becoming less attractive relative to other opportunities on our Qualified Company List, we sold the shares and reallocated the capital.

As noted above, with a change in the original thesis for **Magnit**, we determined that other more attractive investment opportunities existed and redeployed the capital.

Summary

Q4 and 2017 were strong periods for emerging market equities as investors focused on improving global economic growth and increased asset flows to those economies most levered to the improvement. SGA's portfolio, which blends businesses domiciled in the emerging markets with those highly exposed to the economic growth in those markets outperformed for the quarter while generating an absolute return of +8.7% (gross) and +8.4% (net). For the year, the portfolio generated an absolute return of +36.3% (gross) and 34.9% (net) trailing the MSCI Emerging Markets Index by approximately 1.0%. The portfolio's return pattern is consistent with what we would expect in a period where optimism over economic and profit growth in the emerging markets was increasing. Consistent with all SGA portfolios, our focus is on providing attractively valued long-term cash flow and earnings growth while protecting client capital in weaker periods and participating strongly when optimism is widespread. In the majority of environments which fall in between these extremes, the portfolio's superior earnings growth, attractive business quality and valuation characteristics should position it well for attractive relative and absolute returns. As of December 31st, 2017, the three-year earnings growth forecasted for the portfolio was +20.1%, nearly double the +11.1% expected for the MSCI Emerging Markets Index over that same period. At the same time, the portfolio offered more attractive business quality with higher margins, less debt and better cash flow generation.

We continue to expect improving global economic growth in 2018 but remain cautious about the potential for rising interest rates in developed countries and geopolitical threats to moderate the current level of enthusiasm. With higher equity market valuations, stock volatility at historic lows and investor complacency widespread, we strongly believe that the portfolio's combination of superior business quality, attractive earnings growth and cash flow based valuation will be rewarded over the long-term as investors seek to invest in the attractive profit growth offered by the emerging markets, while keeping an eye on risk as well.

We look forward to speaking with you in more detail about the portfolio's positioning and performance.
