SGA
Sustainable Growth Advisers

Q2 2017 Emerging Markets Growth Commentary

Highlights

- *SGA's Emerging Markets portfolio returned 8.9% (gross) and 8.6% (net) in Q2 2017 compared to 6.3% for its primary benchmark the MSCI Emerging Markets Index; during the same period the MSCI Emerging Markets Growth Index returned 9.4% and the MSCI ACWI with EM Exposure Index returned 5.4%*

- *Emerging markets outperformed developed markets; Europe and Asia were the best performing regions*

- *Large cap growth leadership continued; business quality factors were generally positive as companies with earnings, and higher returns on equity performed better*

- *Technology and Consumer Discretionary sectors outperformed while all other sectors underperformed; Energy sector the weakest due to renewed concerns over building oil inventories*

- *SGA's performance benefited most by stock selection in the Financial sector and an overweight to the Consumer Discretionary sector; while stock selection in Technology and a significant overweight to Consumer Staples detracted the most*

- *Positions in Tencent, Amorepacific, MercadoLibre and JD.com were trimmed on strength and new positions in Sanlam and Raia Drogasil were initiated*

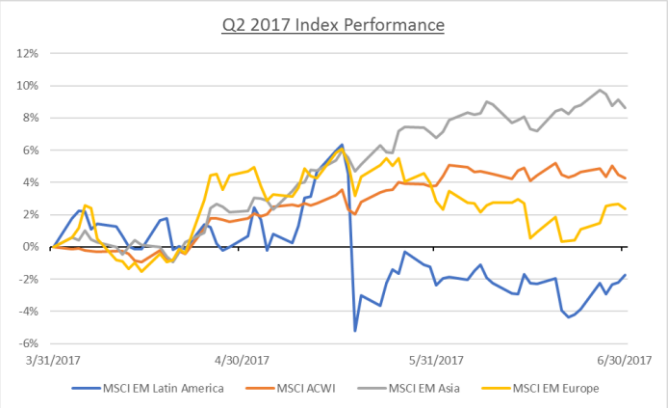
Performance

SGA's Emerging Market portfolio returned 8.9% (gross) and 8.6% (net) in the second quarter of 2017 while its benchmark, the MSCI Emerging Market Index, returned 6.3%, the MSCI Emerging Market Growth Index returned 9.4% and the MSCI ACWI with EM Exposure Index returned 5.4%.

	Q2 2017	YTD 2017	1-Year	Since Inception
SGA Emerging Markets Growth (Gross)	8.9%	20.1%	20.7%	5.6%
SGA Emerging Markets Growth (Net)	8.6%	19.5%	19.4%	4.5%
MSCI EM	6.3%	18.4%	23.7%	0.4%
MSCI EM Growth	9.4%	23.5%	26.0%	3.1%
MSCI ACWI with EM Exposure	5.4%	17.0%	23.6%	1.3%

Emerging Markets Outperformed

The top performing markets in Q2 were located in Europe, with Greece the strongest at +33% followed by Austria (+22%), Hungary and Turkey (+19%) and Denmark (+15%), benefiting from less concerns about a Eurozone breakup, and a stronger Euro. In contrast, commodity focused countries were weakest with Qatar down 11%, Russia declining 10%, Brazil down 7%, Chile down 2% and Australia down 2%.



Source: FactSet

The continued outperformance of emerging markets during the quarter reflected greater comfort by world markets in the stability of the global economy and its ability to accelerate growth. Improved economic data in Europe, a pickup in U.S. growth albeit from a low level in Q1, and still attractive official growth reports in China mitigated fears over structural impediments to improved emerging market growth. The U.S. dollar continued to weaken relative to most major currencies. This benefited emerging market economies flush with dollar denominated debt.

In China, GDP growth in Q1 was reported at 6.9%, the fastest growth the economy has achieved since Q3 2015. The improvement in growth was supported by significant government infrastructure spending which began in 2016. Despite the upbeat quarter, however, we continue to be cautious given that economic data continues to point to slower growth in China. Slowing retail sales, fixed asset investment, vehicle sales growth and money supply growth all point to softer growth given government steps to deleverage, increase interest rates and tighten lending standards.

In South Korea, geopolitical concerns tied to North Korea and China receded as the country elected Moon Jae-in as its new President who campaigned on a more conciliatory approach to both countries. While serious security concerns remain and the U.S. will unlikely abandon its efforts to reign in North Korea's nuclear capabilities, investors pushed the South Korean market 10% higher during the quarter.

In Latin America, Brazil's new president faced increasing pressure over corruption charges leading to more political

instability and likely negatively impacting its already weak economy. In Q1, Brazil's economy broke out of an 8-quarter long recession and grew 1.0% on a quarter-over-quarter basis (preliminary), boosted by agriculture, which grew 13.4% and contributed all of the growth in Q1.

Key Performance Drivers

Strong absolute returns in the market were driven by investor expectations for improving global economic growth. Despite, more confidence on the part of investors, larger cap stocks outperformed small caps and higher business quality characteristics including higher returns on equity, and earnings generation outperformed. Sector allocations and stock selection benefited portfolio performance with an overweight to the strongly performing Consumer Discretionary sector and the lack of exposure to the weakly performing Materials sector helping most. A significant overweight to the Consumer Staples sector, which trailed overall index performance, detracted from the portfolios relative returns. Stock selection was strongest in the Financials and Industrials sectors and weakest in the Technology sector.

Largest Contributors

Leading Chinese internet, media and mobile application company **Tencent** reported a strong first quarter with revenues up 55% and profits growing 37%, up from +32% in Q4. The company's personal computer and mobile gaming businesses posted attractive growth, above our expectations. Deferred revenues in the PC business grew 58%, indicating that the group can likely maintain its strength for the balance of the year as the associated revenues should be recognized over the next few quarters. We expect higher revenues from the gaming segment to help cover incremental investments by the company in video content, and continuing to build their payments and cloud computing businesses, which each grew by over 100% in the latest report. Our positive view of the company's future prospects are also enhanced by the opportunity we see in their ability to build higher advertisement loads in their businesses, similar to what Alibaba, Facebook and Google have already done. This flexibility from being able to lever increasing advertising loads provides Tencent with the significant ability to continue to grow their revenues and earnings as they invest in future growth opportunities for the business. While we continue to be impressed by Tencent's management team and the financial control they have exhibited, we trimmed our position in the stock based on valuation, but it remains at an average weight position given its attractive long-term prospects.

E-commerce leader **Alibaba's** core and cloud businesses turned in solid Q4 FY17 operating reports despite higher than expected spending which negatively impacted margins and a higher than expected tax rate. The company's Taobao and Tmall businesses posted 17% and 29% GMV growth respectively, while mobile user growth continued to grow about 24%, reaching over 500 million mobile users, with revenue per mobile user growing by 46%. Alibaba's cloud computing business reported 874,000 customers, up about 70% on a year-over-year basis and is the leading cloud platform in China. Despite price cuts, revenues for the business grew by 103% year-over-year, and the business is close to profitability on an adjusted EBITDA basis. The company continued to invest heavily in the business as Alibaba is focused on extending its lead and capitalizing on the vast market opportunity present. Our view of the business and its future prospects continued to be positive, with management executing well and the company continuing to build its operating edge in the growing Chinese markets it serves, and expanding into growing markets such as Southeast Asia.

JD.com, China's largest retailer with over 150 million active users, benefited from its strong brand reputation for authentic goods and its tremendous scale in purchasing power and posted a strong earnings report for Q1 with sales and active customers growing 40% and profits growing about 60%. We were pleased that the company expanded its margins considerably during the quarter, although we do not look for comparable improvement for the remainder of the year. Cash generation continued to be highly attractive with the business generating over $2 billion in cash flow over the trailing four quarters. We maintained a below average weight in the stock given its higher valuation, but continue to see the company as having significant long-term opportunity from its current level given the fact that Chinese consumption as a percent of GDP remains only at 36% and on-line shopping as a percent of overall retail sales is just 10-13%.

Kansas City Southern and **MercadoLibre** were the fourth and fifth largest contributors to portfolio performance during the quarter.

Largest Detractors

Russian retailer **Magnit** was the largest detractor from portfolio performance again in Q2 following its report of weak operating results amid increased competition and continued sanction and oil induced weakness in the Russian economy. Higher inflation continues to outstrip gains in pension and wages further squeezing retail customers. In parallel, competition from X5 continued to increase as the company aggressively opened new stores across Russia's major cities. With Magnit located more

outside urban areas which have been somewhat less impacted by the economic downturn, the company has had to resort to more promotional activity to attract distressed customer and refurbishment related investments to compete with X5, both of which have negatively impacted margins.

From our perspective, Magnit continues to be highly efficient due to its vertical integration, logistics and meaningful scale benefits which provide it with superior margin structures and more attractive pricing power relative to peers. Magnit is accelerating store openings and store refurbishments to regain momentum in their market share gains, while making changes to mid-level managers and incentives to better motivate management. We expect such changes at the company level, along with a gradually improving macroeconomic backdrop as oil prices eventually stabilize at higher levels, to improve the company's sales and profitability in the coming year. To this end, the Q2 report reflected a sequential uptick in basket size. While our thesis for the company has been extended, we expect that over the long term, Magnit and X5 will gain share from other subscale grocers and X5 has already captured the low hanging fruit. Now that X5's margins are closer to Magnit's, its ability to gain share from Magnit should be more limited. We continue to expect management's focus on improving execution and leveraging the company's scale advantage to stabilize margins and sales of like-for like products.

Reservoir description, production enhancement and reservoir management provider **Core Labs** was the second largest detractor from returns in Q2. The price of oil fell on continued concerns over excess oil supply and slower than expected U.S. oil inventory declines negatively impacting Core Lab's stock price. While U.S. oil inventories continue to be the center of much focus given their greater transparency and frequency of data, oil inventories in most OECD countries have actually been declining while U.S. imports from OPEC nations have remained at historically high levels. Until more recently, U.S. oil inventories had declined at an accelerated pace year-to-date, virtually eliminating the oil inventory surplus over year ago levels. Continued excess supply and potentially weaker demand remain concerns in the market over the near term, but over the longer-term, several energy companies and consultancies are already warning of underinvestment and the potential for supply shortfalls, and the inability of shale alone to offset production declines.
We remain positive on Core Labs' ability to help production companies maximize output from their existing wells and benefit from gradual improvement in oil exploration activity. The company has reduced its cost structure, as have many of their clients, and is well positioned to benefit from any increases in capex spending moving forward both from U.S. unconventional shale players and global energy companies. Energy companies are beginning to gradually expand their capex budgets but are increasingly seeking to improve returns on their spending, and service companies such as Core Labs are in the position to offer higher value-added services that meet those needs. While we believe our thesis for improving equilibrium between oil supply and demand remains on track today, and that oil companies will increasingly need to adopt technologies and practices that improve their returns, we acknowledge that markets are very fluid, and we continue to monitor events to ensure our expectations are being met.

Indian software company **Infosys** reported a weak March quarter with sales in its retail segment down 3% on a quarter-over-quarter basis. Weakness and several bankruptcies in the retail industry have negatively impacted their business there. The weakness in this area has also carried over to the company's FY 2018 revenue guidance. In contrast, the company's Banking and Financial Services, Communications and Manufacturing business segments reported revenue growth that was in line with expectations. Overall, our thesis remains intact with the stock trading at an attractive valuation with improved growth likely as Brexit concerns from last year turn into new business opportunities as companies adapt their businesses to the new arrangement once more clarity is reached. The retail segment as such is relatively small for the company and therefore the impact of its decline on the overall results is limited. In parallel, retail businesses are also increasingly automating their operations for enhanced efficiency and this offers Infosys an increased opportunity from those that survive in the current difficult retail environment.

Sanlam and **Ambev** were the fourth and fifth largest detractors from portfolio performance during the quarter.

Portfolio Changes

Turnover in the portfolio for the quarter was below-average with two new positions added and several trimmed. New positions in Raia Drogasil and Sanlam were initiated. Positions in Tencent, Amorepacific, MercadoLibre and JD.com were trimmed on strength.

Purchases

Raia Drogasil, the largest drug store chain in Brazil with 1457 stores and approximately 13% market share, was added to the portfolio. The company is expected to benefit from growth in the Brazilian pharmaceutical market, as well as market share gains from continued square footage growth. The retail drug store market in Brazil is still highly fragmented and economics

favor large chains over independent stores, allowing for consolidation of the market in Raia Drogasil's favor. The company's scale provides pricing power over small independent competitors when dealing with pharmaceutical companies. Raia Drogasil sells personal care and over-the-counter products in addition to drugs, and all of these sales are recurring in nature and result in a recurring volume of return traffic to their stores. The company should also benefit from a significant tailwind from the expected growth of the pharmaceutical market in Brazil, driven by changes in demographics and income levels.

After strong performance in 2016, 2017 is expected to present a more difficult environment for Raia Drogasil due to the potential for governmental drug price increases to lag inflation, and for wage increases to lead inflation. Our research shows that despite these challenges, Raia Drogasil will remain the leader in the growing Brazilian drug store market given its scale advantage and pricing power, and we expect it to benefit from a secular, macroeconomic tailwind as Brazil's economy gradually emerges from recession. We initiated our position in the stock at a below-average weight.

South African financial services conglomerate **Sanlam** was added to the portfolio this quarter. The company operates in 47 countries with approximately three-quarters of its income being generated by its life insurance business, and the balance spread across general insurance, investment management, credit & structuring and other businesses. Sanlam has a history of maintaining capital at sound levels while being able to extract attractive dividends from its life business, and its management team has remained stable with its CEO and CFO both having grown with the group over the years. Sanlam generates a high level of repeat revenues due to the long-term nature of the life insurance they sell. 75-80% of their income is considered repeat business. The company also benefits from favorable demographics in most of the markets they serve, excluding South Africa. Insurance penetration is relatively low in most of their markets, allowing them to generate attractive growth given their dominant position. This strong position also provides them with better pricing power in many markets, and helps them attain improved economies of scale. South Africa's market is more mature, but the level of coverage is fairly low and insurance products have traditionally been used more as investment products. Accordingly, an attractive opportunity remains in terms of increasing coverage levels among those already insured, in addition to extending coverage to lower income segments of the population which may not currently have coverage. We also expect the company to benefit from regulatory changes which are expected to result in lower commissions being charged which should enhance its cash flows, as well as further consolidation in its markets as smaller players depart the otherwise saturated South African market.

We initiated a below-average position in the stock and expect to build it opportunistically moving forward. Among the risks facing the company, we remain focused on the political uncertainty, the possibility of lower interest rates in South Africa as inflation eases and the impact on the income generated on shareholder capital, as well as potential adverse regulatory changes which could impact Sanlam's business. On the latter, we believe they are in a position to work with regulators and influence the nature of changes rather than simply being on the receiving end of regulatory change.

Summary

Emerging markets outperformed developed markets during the quarter on preliminary signs of improving economic data in Europe and parts of Asia, and belief that the global economy would grow sufficiently to allow the improvement to continue. While structural problems and geopolitical issues continue to pose a threat to many emerging economies, attractive valuations and the ability of these economies to grow at faster rates over the long-term have attracted investors as growth in the U.S. has disappointed. Like our U.S., Global and International portfolios, SGA's emerging markets portfolio continues to generate significantly greater sales and earnings growth than its index benchmark. As of the quarter end, the portfolio was forecast to generate revenue and earnings growth of 15.2% and 24.6% respectively, compared to 7.6% revenue growth and 14.9% earnings growth for the MSCI Emerging Markets Index over the next three years. With monetary policies in the U.S. and Europe gradually becoming less accommodative, slowing growth, and the likelihood of further de-leverage in the Chinese economy after its Fall Communist Party National Congress, we expect attractive business quality, stronger pricing power, highly recurring revenue streams and long runways of growth to continue to be valued by investors in the emerging markets.

We thank you for your continued interest in our team and portfolio.

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been reduced by the amount of the highest published fee that may be charged to SGA clients, 1.1%, employing the Emerging Markets Growth equity strategy during the period under consideration. Actual fees charged to clients may vary depending on, among other things, the applicable fees schedule and portfolio size. SGA's fees are available upon request and also may be found in Part 2A of its Form ADV. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. Upon request, free of charge, SGA can provide a list of all portfolio holdings held in SGA's Emerging Markets portfolio for the past year. Past performance is not indicative of future results.