SGA
Sustainable Growth Advisers

# Q1 2017 Emerging Markets Growth Commentary

## Highlights

- *SGA's Emerging Markets portfolio returned 10.3% (gross) and 10.0% (net) in Q1 2017 compared to 11.4% for its primary benchmark the MSCI Emerging Markets Index; during the same period the MSCI Emerging Markets Growth Index returned 12.8% and the MSCI ACWI with EM Exposure Index returned 11.0%*

- *Emerging markets performed best followed by developed markets outside the U.S.; Emerging Asia, Latin America and Asia Pacific ex-Japan were the best performing regions*

- *Stock indexes generated strong absolute returns on investor optimism that global economic growth would strengthen, improved economic data in Europe and signs that recent populist movements may have peaked*

- *Strong pro-cyclical headwinds from Q4 2016 were replaced by broader large cap growth leadership; business quality factors were generally positive as companies with earnings, higher ROE's, and lower debt performed better*

- *Technology, Industrial, Consumer Discretionary, and Materials sectors outperformed while the Energy sector performed weakest due to concerns over building inventories and whether OPEC would respect previously announced production cuts*

- *SGA's performance was hurt most by an overweight to, and stock selection in, the Consumer Staples sector*

- *Shandong Weigao was sold to fund a more attractive growth opportunity in Sinopharm while a position in MercadoLibre was trimmed on strength and a position in Kansas City Southern was added to on weakness*

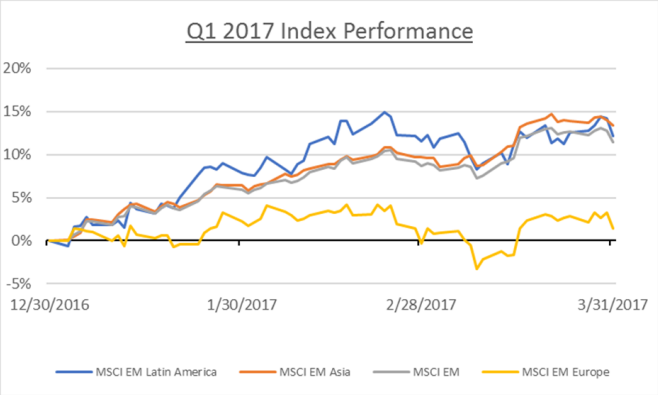
## Performance

SGA's Emerging Markets portfolio returned 10.3% (gross) and 10.0% (net) in the first quarter of 2017 while its benchmark, the MSCI Emerging Market Index, returned 11.4%, the MSCI Emerging Market Growth Index returned 12.8% and the MSCI ACWI with EM Exposure Index returned 11.0%.

| | Q1 2017 | 1-Year | Since Inception |
|---|---|---|---|
| SGA Emerging Markets Growth (Gross) | 10.3% | 12.4% | 2.8% |
| SGA Emerging Markets Growth (Net) | 10.0% | 11.2% | 1.7% |
| MSCI EM | 11.4% | 17.2% | -1.8% |
| MSCI EM Growth | 12.8% | 17.1% | 0.0% |
| MSCI ACWI with EM Exposure | 11.0% | 19.2% | -0.6% |

## Emerging Market Stocks Take the Lead

The top five performing markets in Q1 were emerging markets distributed across different continents around the world. Poland led the pack with a return of almost 18%, followed by India, South Korea, Mexico, and Chile. In contrast, developed nations including the U.S., Japan, Italy, the United Kingdom and Canada, among others, underperformed. Emerging Asia, Latin America and Asia Pacific were the strongest performing regions followed by Europe. Russia and Greece performed the worst during the quarter, with both economies under pressure.



Source: FactSet

The outperformance of emerging markets relative to developed markets during the quarter reflected increased comfort by world markets in the ability of the global economy to accelerate its growth. Expectations for improved stability and growth in Europe, a continuation of growth in the U.S. and recent strength in China mitigated fears over structural impediments to improved emerging market growth. The U.S. dollar weakened as concerns over rising U.S. interest rates moderated in Q1. Markets became less certain of the Trump administration's ability to implement new tax and regulatory reforms, and enact significant new infrastructure spending. The weaker dollar and reduced apprehension about the pace of future interest rate hikes also benefited emerging market economies flush with dollar denominated debt.

In China, the reversal of massive stimulus, implemented in late 2015 and 2016, which spurred a cyclical upswing in the Chinese and European economies, raised concerns over the sustainability of the recent advance. Weaker economic data

and moves by the government to reign in stimulus by raising short-term borrowing rates, tightening home mortgage and lending standards and increasing the auto sales tax gave investors pause. Chinese retail sales growth in January and February slowed to 9.5% year-over-year, a healthy figure by most standards, but did mask a 3-month average which fell to its lowest level in 13 years. Chinese personal income growth slowed to half the 13% year-over-year growth experienced between 2004 and 2012. While stimulus is being moderated and growth has gradually slowed, the Chinese economy continues to outpace most others globally and present selective opportunities in high quality businesses that can capitalize on that growth.

In South Korea, geopolitical concerns continued as consumers were shaken by a corruption scandal and ultimately the impeachment of President Park Geun-hye. The deployment of the THAAD missile defense system resulted in Chinese government intervention restraining Chinese tourist traffic to Korea as well as imports from Korea, in turn slowing economic growth and negatively impacting stock market returns for Korean companies dependent on sales to China and Chinese tourists.

In Europe, Dutch Prime Minister Rutte's victory over nationalist candidate Geert Wilders, polls showing French populist candidate Marine Le Pen's declining chances of winning the upcoming French presidential election, and victory by Angela Merkel's conservative party in German regional elections, moderated investor concerns of a nationalist wave sweeping Europe and threatening the Eurozone. Great Britain's triggering of Article 50 of the Lisbon Treaty to initiate its separation from the European Union was met with little trepidation in the markets. A weak Euro and a steeper yield curve prompting an acceleration in bank loans within the region, as well as signs of stronger economic activity in Europe buoyed investors. The March IHS Markit Purchasing Managers Index (PMI) for the Eurozone showed the strongest economic conditions in six years, while the U.S. Composite PMI fell to a six-month low.

In Latin America, it was reported that Brazil's economy contracted 3.6% in 2016 after contracting 3.8% in 2015. With the political landscape stabilizing after the turmoil surrounding the country's impeachment of its president in 2016, and early signs of improvement such as inflation declining to +6% from +10% in 2016, and meaningful improvement in a key central bank indicator of growth (the largest since 2010) evidence seems to be building that perhaps Brazil's economic landscape is turning the corner. Meanwhile Mexico saw consumer and business confidence declining further post the U.S. election on rising uncertainty over the country's trading relationship with its biggest export market. Mexico returned 16% for the quarter due in large part to currency swings (and returned 6% in local currency). While there is disparity across the region in terms of current and prospective economic growth, overall the region was among the best performers during the quarter based on early signs of potential improvement.

## Portfolio Summary

Strong absolute returns in the market resulted from investor expectations that global economic growth would improve driven by an acceleration in growth in the U.S. In contrast to Q4, which was led by a rally in lower quality, more cyclical value stocks, the market advance in Q1 was led by growth businesses with earnings, higher ROE's, and lower debt. However, small-caps again led as did higher beta stocks. Portfolio performance was negatively impacted most by sector allocations and stock selection in the Consumer Staples sector where it had a 22% overweight. Combined, the portfolio's performance was negatively impacted from this sector by over 2%, more than offsetting other positive effects in other sectors. Stock selection in the Financials and Consumer Discretionary sectors contributed most positively to performance.

## Top Contributors

Argentinian e-commerce company **MercadoLibre** reported another strong quarter of results with fourth quarter sales and profits exceeding consensus expectations as e-commerce sales grew despite continued weakness in Latin American economies. The company continues to take advantage of growing smartphone use and better internet coverage in the region to increase e-commerce sales, which are still at an early stage in Latin America, and only comprise about 4% of total retail sales in Brazil and 2% in Argentina. Our preferred measure of their progress, total items sold, grew 40% in Q4 as they did in Q3. Brazil sales grew 62% while Mexican sales growth accelerated to 47%, benefiting from free shipping. Total revenues grew 68% in local terms and 42% in U.S. dollar terms. We were pleased with the company's improved operating margins which came in at 25%, versus 23% in Q3 and 18% last year. These improvements came despite the company's decision to make an investment in free shipping in Mexico. We are cognizant of the likelihood that margin improvement may be impacted by decisions to more aggressively offer free shipping in other locations to continue to build demand. We continue to be impressed by management's ability to execute their business plan despite weak macroeconomics, and expect the company to benefit from long runways of growth in the future, but also are mindful that the stock's valuation is less attractive at the

moment, and trimmed the position as a result, maintaining a below-average position.

**WalMex** reported solid Q4 results with comparable store sales up 7.9% in Mexico and 5% in Central America, outpacing their competitors and consensus expectations. E-commerce sales increased 37% for the quarter, up from the 27% average for the year. Gross margins improved, benefiting profit growth. We expect 2017 to be another good year for WalMex as they continue to leverage their scale and operational expertise by investing in price, logistics and other capabilities to further extend their competitive advantages. We also expect WalMex to continue to pass through higher food inflation to customers, which should help support its margins and comparable store sales. While moderating GDP growth in Mexico and potential hiccups in U.S-Mexico trade relations pose threats, the company's business is geographically balanced throughout Mexico with more reliance on the central region of the country, and less on the northern region which could be affected more should trade relations between the U.S. and Mexico deteriorate.

Chinese travel company **Ctrip.com** reported sales and profits in line with expectations for Q4, but with indications that there may be further improvement in margins (up 16% versus 10% the prior year) moving forward. Management emphasized its focus on improving profitability in 2017 as well as using more technology to address customer needs, increasing automation and carefully managing headcount in order to accomplish it. We expect the company to continue to benefit from its scale, brand awareness, and unmatched customer service amid increasing Chinese tourist travel abroad. While growth has slowed in the Chinese economy, we believe significant potential remains for travel growth outside and within China, as lower tier cities begin to see the economic growth needed to spur increased travel by their citizens. Geopolitical tensions with China's neighbors have temporarily slowed growth in outbound tourism, while terrorist activity elsewhere in the world continues to be a threat to growth in their business. Given this, and the fact that Ctrip's core growth opportunity is likely well understood by investors, we have maintained a below-average position in the stock.

**Tencent** and **Shoprite** were the fourth and fifth largest contributors to portfolio performance in the quarter.

**Top Detractors**

Russian retailer **Magnit** was the largest detractor from portfolio performance in Q1 following its report of weak operating results amid increased competition and continued weakness in the Russian economy. Reinvigorated competitor X5 continued to open new stores aggressively across Russia's major cities putting pressure on Magnit's market position in certain regions. Higher inflation in Russia has outstripped gains in pension and wages further squeezing retail customers. While the country's economy was negatively impacted by declining oil prices in 2016 as well as economic sanctions due to its decision to occupy Crimea, the increase in oil prices in recent months should benefit Russia's economy. The company 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 plans to accelerate store openings and store refurbishments to restore momentum in their market share gains, while making changes to mid-level managers and incentives. Such changes at the company level, along with a gradually improving macroeconomic backdrop as oil prices stabilize at higher levels, should improve the company's sales and profitability in the coming year. We continue to evaluate the impact increasing competition is having on Magnit's business model and growth prospects looking forward, relative to other opportunities.

At the beginning of the quarter, **Fast Retailing** reported somewhat disappointing monthly comps in Japan, mostly affected by weather. After the company reported the quarter, investors began to realize that there would likely be continued FX headwinds in the reported numbers for the remainder of the year due to mark down on foreign assets due to the stronger yen. These factors have made it more difficult for the stock to recover from its initial weakness at the beginning of the quarter. Despite the stock's volatility, the business' underlying fundamentals are quite strong. In fact, the company reported a significant improvement in the margins of its international operations, growing to 15% now compared to 10% last year. Given the strength of the company's underlying operations, we increased our position size in the stock and continue to feel confident in the opportunity.

South Korean cosmetic company **Amorepacific** was the third largest detractor from returns in Q1. The company reported weaker than expected Q4 results with sales up about 7% amid political turmoil leading up to the recent impeachment of the country's President Park Geun-hye, as well as tension with China related to Korea's decision to allow the deployment of the THAAD anti-missile system, which resulted in China's decision to limit tourist travel to Korea. Domestic sales (32% of total sales) decreased 5% due to a sluggish South Korean economy and increased competition. Duty free sales, which account for 28% of total sales, grew a respectable 7%, and Asian exports (33% of total sales) grew 27%. While the Korean market is likely to stay weak in the near-term, the company has

already begun its transition away from domestic markets given that 60% of sales are coming from duty free and exports. The company considers the U.S. market a large opportunity for growth as well and plans to enter it in 2017. While duty free sales to Chinese tourists will suffer in the short-term, we look for the incident to pass and the impact to dissipate as other similar situations have in the past. We have maintained a below average weight in the stock.

**Core Labs** and **Mondelez** were the fourth and fifth largest detractors from portfolio performance.

### Portfolio Changes

Chinese medical device company **Shandong Weigao** was sold due to forced attrition during the quarter in order to fund a more attractive growth opportunity in Chinese pharmaceutical distributor Sinopharm. We actively trimmed our position in MercadoLibre where valuation had become less attractive, and added to our position in Kansas City Southern where we continue to see attractive opportunity particularly in the company's Mexican rail business.

### Purchases

**Sinopharm** is the largest pharmaceutical distributor in China with a nationwide network of sales representatives. The company benefits from high recurring revenues due to increasing demand for prescription drugs to treat chronic diseases resulting from demographic trends, increased urbanization, rising middle class wealth and increased government spending on healthcare. As the largest distributor in China, the company is well positioned to benefit from industry wide growth, with less volatility from government price cuts on specific drugs. Sinopharm's pricing power is driven by its superior scale and reach, which allow it to operate at more steady margins and control finance costs better than smaller competitors due to more negotiating power with pharmaceutical companies. While Sinopharm is not expected to grow outside China, the company will continue to enter new businesses that leverage its network, such as serving hospitals with miscellaneous services, growing its retail pharmacy network, and gaining market share from smaller distributors less able to operate successfully under the government's new "two-invoice" policy, which limits the number of invoices between medical device manufacturers and hospitals to a maximum of two.

While we expect attractive secular growth at Sinopharm over the next 3-5 years, we are well aware of potential risks to the thesis such as potentially adverse government policies which can create volatility and pricing pressure, efforts to keep prescriptions flowing mainly from hospitals as opposed to retail chains, hospital finances being pressured by government caps on reimbursements, and rising competition. Accordingly, we initiated a below average weight in the stock, and expect to build the position opportunistically moving forward.

### Summary

The market rally of Q4 continued through the first part of this quarter although the drivers of performance were different. Emerging market stocks assumed leadership from developed markets as investors began to question the ability of the new U.S. administration to enact the tax overhaul, infrastructure spending and regulatory reduction programs which had caused U.S. and other stocks to rally so strongly beginning last November. Greater comfort with the likely measured pace of U.S. interest rate increases, less concern over more harsh, protectionist trade policies by the Trump administration and signs of stabilization in Europe benefited emerging market stocks. While we are of the view that the global economy will improve modestly in 2017 we also believe that the euphoria following the U.S. election will continue to be tempered by the reality of governance. As such, periods of renewed optimism will likely be followed by disappointment amid harsh rhetoric. Volatility, which has traditionally been positive for the portfolio, is likely to pick up. We will continue to take advantage of opportunities to enhance the business quality, growth and valuation of the portfolio. With global economic growth likely to remain modest over the next few years, the superior predictability and sustainability of the growth of portfolio companies' earnings and cash flows should be rewarded. As of March 31st, the portfolio is forecasted to generate 14.5% and 24.1% revenue and earnings growth respectively over the next three years, while companies comprising the MSCI Emerging Market Index are expected to generate 8.4% and 14.3% revenue and earnings growth respectively over the same period. At the same time, the portfolio remains attractively valued based on our enterprise and discounted cash flow valuation metrics.

Thank you for your interest in our team and investment approach to emerging markets at SGA. We look forward to answering any questions you may have.

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*Results are presented gross and net of management fees and include the reinvestment of all income. The Net Returns are calculated based upon the highest published fees. The net performance has 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.*