SGA
Sustainable Growth Advisers

# Q4 2016 Emerging Market Growth Commentary

## Highlights

- *SGA's Emerging Market Portfolio returned -8.0% (gross) and -8.3% (net) in Q4 2016 compared to -4.2% for its primary benchmark, the MSCI Emerging Market Index. During the same period, the MSCI Emerging Markets Growth returned -7.1%*
- *Emerging markets outperformed the MSCI All Country World Index (ACWI) in the period prior to the November 8th U.S. election, but underperformed afterwards and for the quarter as the U.S. dollar and interest rates rose quickly in anticipation of reflationary U.S. policies*
- *SGA's investment process faced a headwind with lesser quality businesses performing best in the quarter*
- *Despite the portfolio's underperformance, it's high business quality, superior forecast revenue and earnings growth, and greater predictability did not change; valuation did change with the portfolio's enterprise yield improving to 3.3%*
- *Alibaba was purchased during the quarter while Colgate-Palmolive and Schlumberger were liquidated; other positions were trimmed and added to based on the future opportunity they were deemed to present*

## Performance

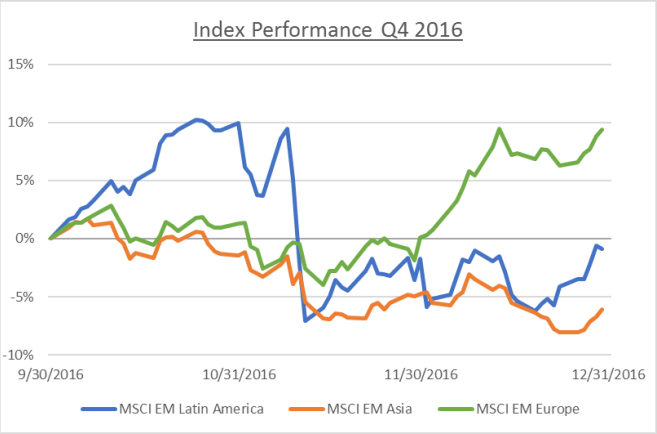
SGA's Emerging Market portfolio returned -8.0% (gross) and -8.3% (net) in the fourth quarter of 2016, while its primary benchmark, the MSCI Emerging Market Index, returned -4.2% and the MSCI Emerging Markets Growth Index returned -7.1%.

| | Q4 2016 | 1 Year | 2 Year | Since Inception |
|---|---|---|---|---|
| **SGA Emerging Markets Gross** | -8.0% | 2.1% | -0.5% | -1.0% |
| **SGA Emerging Markets Net** | -8.3% | 1.0% | -1.6% | -2.1% |
| **MSCI EM** | -4.2% | 11.2% | -2.7% | -6.3% |
| **MSCI ACWI with EM Exposure** | -3.1% | 11.7% | -1.7% | -4.8% |
| **MSCI EM Growth** | -7.1% | 7.6% | -2.3% | -4.9% |

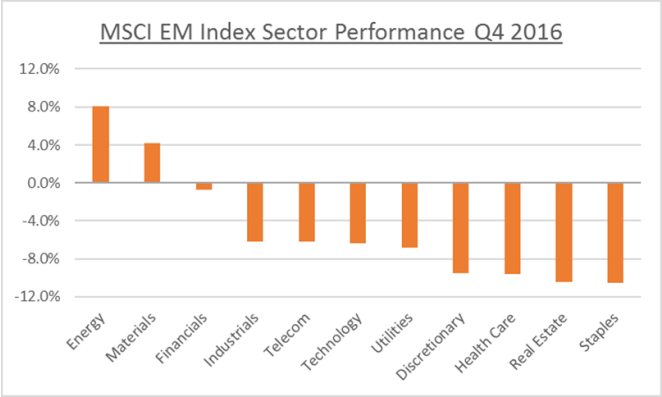
While weak relative performance in the quarter due to strong headwinds for our quality growth approach detracted from returns for 2016, portfolio performance over the two year and since inception periods remains strong. In a portfolio that is constructed based on opportunity instead of benchmark relative weights, and therefore looks very different from the benchmark, quarter-to-quarter relative returns are likely to vary widely. Over the long-term, given the portfolio's focus on critical business quality, secular growth and valuation factors, we expect it to provide the same superior earnings growth and reduced return volatility as SGA's Global and U.S. portfolios have over their respective lifetimes.

## Emerging Markets Underperformed Due to a Weak Second Half

Emerging markets outperformed developed markets in the first half of Q4, but dramatically underperformed following the November 8th U.S. election results, as U.S. interest rates rose making dollar denominated debt more expensive to finance, and fears of protectionism rose. Russian stocks performed best in the quarter, finishing up about 17% on the strength of higher oil prices and hopes that the election of Donald Trump in the U.S. may lead to a softening of economic sanctions and better relations between the two countries. In contrast, Chinese stocks finished the quarter down about 8.2% as the country posted GDP growth of 6.7% for the 3rd consecutive quarter, and massive stimulus applied by the Chinese government earlier in the year was removed. For the year, emerging markets outperformed developed markets on the strength of energy, materials and financial services stocks and the expectation that global growth was poised for improvement. Commodity driven economies such as Brazil and Russia performed best, returning 63.5% and 52.9% respectively, while Peru, Columbia and Thailand also performed strongly.

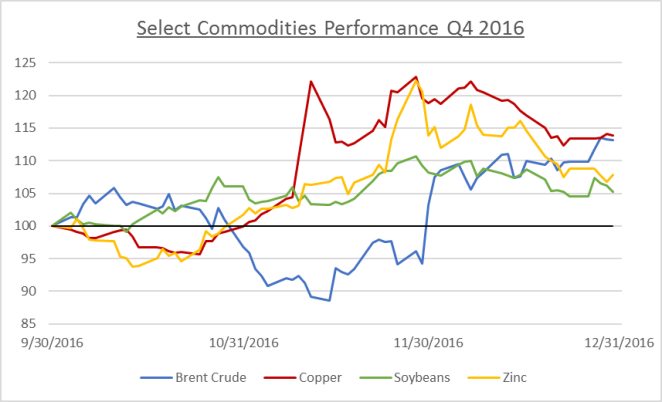


Source: FactSet



Source: FactSet

Increased geopolitical tensions in South Asia driven by North Korean nuclear tests and ballistic missile launches, and continuing concerns over China's militarization of newly created island outposts in the South China Sea and the potential threat they pose to the sovereignty of neighboring countries, put downward pressure on shares in South Korea where exports to China and Hong Kong represent 30% of total exports and 10% of GDP. Belief that Chinese government spending was set to decline, after it had accelerated from 8% growth to 22% growth in 2016, as the government tried to stimulate economic growth, put downward pressure on shares of companies around southeast Asia which are heavily dependent upon exports to the country. Even countries as far away as Brazil were negatively affected as an estimated 20% of that country's exports go to China and Hong Kong. Cautious consumers, weak labor markets, a budget deficit equal to 10% of GDP, a Real 33% above its 2015 low and a continued lack of trust in the country's political situation led Brazil's GDP to retreat by 3.3% in Q3 (reported in Q4).



Source: FactSet

Other emerging markets showing weakness included India and Mexico. Indian stocks declined about 8.0% for the quarter, and 1.4% for the year, as investors became impatient for more economic reform by the Modi government and the country undertook a demonetization program, aimed at taking counterfeit currency out of circulation and curbing the country's "black economy". The notes removed are used in an estimated 86% of all transactions in India, making the transition very disruptive to the economy in the short-term. Mexican shares also underperformed during the period, despite a relatively strong economic backdrop, on uncertainty over the strength of future manufacturing investment in the country given rhetoric by the incoming Trump administration and the potential for new trade barriers.

While the economic backdrop for 2017 appears weak in many emerging market countries, our interest in select businesses across these countries transcends the macro environment and is focused on the unique products and services the companies can offer consumers. A highly selective approach based on strong pricing power, recurring revenue streams and long runways of growth offers an opportunity to take advantage of macroeconomic weakness in emerging markets.

## Portfolio Summary

The SGA portfolio underperformed its benchmark in the fourth quarter as market trends were generally unfavorable for our quality growth approach to investing. Sector exposures accounted for about 80% of the portfolio's underperformance. Overweight exposures to the Consumer Staples and Consumer Discretionary sectors were responsible for a majority of the weakness. Value outperformed growth by a wide margin, companies with higher debt levels outperformed those with lower debt, companies with lower returns on equity outperformed those with higher returns on equity, and companies with no earnings outperformed those with earnings. The only factor beneficial to our approach was that larger capitalization companies outpaced smaller capitalization companies.

Stock selection detracted about 20% of the portfolio's shortfall during the quarter due mainly to selection in the Information Technology and Financials sectors. Offsetting weakness in selection in these sectors was strong stock selection in the Consumer Discretionary sector, and to a lesser extent in the Health Care sector.

## Top Contributors

**Fast Retailing** reported fiscal year results that were in-line with expectations, but demonstrated significant recovery in sales after weak winter sales due to warmer weather and a stronger

yen. In parallel, the company continues to expand their store base internationally, building their UNIQLO INTERNATIONAL and GU brands and capitalizing on their scale benefits. Steps are also underway to enhance the efficiency of the company's supply chain, unifying all steps from raw materials procurement, planning, design, manufacturing and sale into a new system. They expect these steps to improve the efficiency of incorporating customer feedback into products while also enhancing productivity and lowering costs. With focus now on improving results from the company's burgeoning U.S. operation, improving trends in other segments and the potential for a more efficient back office and supply operation which enhances productivity, we maintained our target while harvesting some of the appreciation gains.

**Magnit** was the second largest contributor to portfolio performance during the quarter, benefiting from a rally in Russian equities driven by a rebound in oil prices, a pickup in global growth, and hopes that the incoming Trump administration would ease economic sanctions. Magnit and other Russian food retailers also benefited in the fourth quarter from a rise in food prices which dipped in the third quarter, easing concerns of price competition among retailers. The company's third quarter results in October highlighted the issue as Magnit missed consensus expectations with weaker sales in part due to lower food prices and fewer store openings. Sales grew 14% year-over-year (in RUB) in the third quarter, while the gross margin declined to 28.1% compared to 29.0% last year and the net margin fell to 5.5% from 7.6% compared to last year. Store traffic was generally up in the quarter, however, the average purchase per customer was down and lower margin items accounted for a higher percentage of sales. The economic environment in Russia continues to be challenging as the current recession and high inflation have hurt consumers, leading to near-term pressures on Magnit's sales and margins and that trend could continue in the near-term. Despite these headwinds our research continues to indicate that the company's structural advantage over its competitors, above-average industry margins and a strong management team focused on profitability makes the company an attractive, high quality, growth company with strong long-term prospects.

**Schlumberger** reported in-line EPS growth and margins to go along with revenues that were consistent with expectations. However, its outlook brightened as oil prices rose due to stronger oil market fundamentals and OPEC's decision to reduce production from member states. Schlumberger's stock price benefited particularly in November following the U.S. election as investors expected energy-related companies to benefit from less stringent government regulation in the U.S. and more capex spending by producers looking to take advantage of higher oil prices. Schlumberger is in a stronger position exiting the weakness in the oil sector over the past year due to its ongoing acquisition activity, enhanced scale and long-term relationships with key producers around the world, and has publicly stated it can return to peak EPS levels on roughly half of the prior peak revenue levels.

**Core Labs** and **Mondelez** were the 4th and 5th largest contributors to portfolio performance in the quarter.

**Top Detractors**

**Amorepacific's** stock had a difficult quarter amid growing geopolitical tensions in the region. South Korea's announcement that it planned to deploy the THAAD anti-missile defense system amid increased nuclear testing by North Korea led to a chilling of relations with China, and subsequent decrease in tourist traffic. Lower tourist traffic to Korea is expected to impact the company's duty free channel sales in the 4Q. We expect the duty-free channel will remain volatile. However, Amore has already invested outside of the duty-free channel, in mainland China as well as other Asian countries, which are expected to continue to contribute to attractive growth over the long term. Additionally, Amore is expected to expand its presence in North America in 2017 with its successful brands. We increased the portfolio's position in the stock to an average weight during the quarter.

**HDFC Bank's** stock declined during the quarter following the demonetization announcement by the government of India banning 500 and 1000 RBI notes from circulation in the Indian economy. The move was intended to stem the use of large fake notes in illegal activities. India remains a cash based economy, making the immediate impact of the decision on consumers and the economy difficult. However, in the short-, to intermediate-term, the change increases the flow of low cost deposits into banks and has led to a reduction in lending interest rates. Demand for loans has also fallen off temporarily. However, over the longer-term, the impact of the move by the government should serve to strengthen the foundation of the financial system by eliminating fake currency and be positive for economic growth. While we expect the change to be positive for the Indian economy and HDFC over time, in the short-term, the reduction in lending will likely pressure results. Accordingly, we trimmed our position in the stock and expect to rebuild it should we get the opportunity to add to it again at lower prices.

**MercadoLibre** reported another strong quarter (FY Q3) with units sold growing 40%, which was slightly below the 45% seen in Q2 but well above the year earlier growth rate. Growth in

their Brazilian sales showed acceleration while sales growth in Argentina decelerated following the company's decision to require customers there to use its Pagos payment system. A similar fall-off in sales occurred in Brazil following the company's introduction of Pagos, but sales then reaccelerated as customers became more comfortable with the system. We expect a similar pattern in Argentina. Ebay's divestment of its stake in the company also took place during the quarter placing more shares temporarily in transition. While operating results were solid overall, the company's stock price was negatively impacted by depreciation in the Argentine peso and concerns over Amazon's entry into Mexico and the likely cost to MercadoLibre of competing there. We remain positive on the company's long-term opportunity and maintained an average position in the stock while acknowledging its current high valuation.

**Tencent** and **Ctrip** were the 4th and 5th largest detractors from portfolio performance in the quarter.

**Portfolio Changes**

During the quarter, we took advantage of significant volatility in stock prices and trimmed stocks on strength including Russia's largest food retailer Magnit, online travel leader Priceline.com, and Japanese retailer Fast Retailing. Likewise, we added to positions on weakness in Walmex, the largest retailer in Mexico and Central America, Amorepacific, and leading Philippine consumer food and beverage company Universal Robina among others.

During the quarter, we eliminated two positions and initiated one new position:

**Purchases**

Chinese e-commerce leader **Alibaba** was added to the portfolio in Q4. The company employs a successful 3rd party marketplace model which allows it to generate high margins and strong free cash flows as it benefits from the strong secular shift from bricks & mortar stores to online retail. This trend has been enhanced by the rapid increase in mobile usage and a major change in Chinese consumer behavior in favor of online shopping. Given the dominant size of its e-commerce platforms (Taobao and Tmall), and massive selection of inventory (with over 100,000 brands on its platforms), Alibaba benefits from significant scale from both its user base and merchants.

Retailers understand the unique position Alibaba is in and are willing to spend to get in front of their customers via advertising, search results and online storefronts. Alibaba benefits from strong recurring revenues, with over 440 million active buyers on its platforms and increasing engagement with the company's Taobao app (which is opened on average seven times per day while the length of time spent on the site is also growing longer). Additionally, we expect Alibaba to benefit from continued growth in online retail in China where consumption as a percent of GDP remains well below that of developed countries (36% versus 65% in the U.S.), and gradually across Southeast Asia and other regions (Russia, Brazil). We also see strong growth opportunities for the company in the quickly growing Cloud and Digital Media services markets.

While we expect Alibaba to be successful over our 3-5 year time horizon, it faces risks like any company we may invest in. Its well-publicized issue with counterfeit products being sold on its site must be effectively dealt with. Competition from JD.com and Tencent, who have continued to gain market share in e-commerce, poses a risk, as does the company's own investments in its mobile capability and fulfillment. Given the risks it faces, we initiated a below average weight position in the stock this quarter and expect to build it opportunistically moving forward.

**Sales**

**Colgate-Palmolive's** most recent quarterly results were generally in line with expectations, and the company continues to distinguish itself with mid-single-digit organic sales growth that is among the best in the industry. Strong organic sales growth (+6.5%) in the emerging markets, led by increased pricing in Latin America, contributed most to results while sales in North America were weakest due mainly to flat pricing. Management reiterated their full year guidance of 4-7% organic sales growth and flat EPS growth (double digit EPS growth ex-currency). As expected, they also introduced 2017 guidance including 4-7% organic sales growth and double digit reported EPS growth. While Colgate continues to meet all of the quality criteria we seek in businesses we invest in, it's future revenue and earnings growth opportunity is at the low end of the range of the businesses on our Qualified Company List. In addition, the renewed appreciation in the U.S. dollar following the Trump-election will weigh on 2017 earnings. As a result, we identified other emerging market focused businesses which offered more attractive future growth and current valuation so we eliminated the position from the portfolio.

Given the steep rise in oil prices and improved optimism for the energy group, we sold the portfolio's position in **Schlumberger** in December on strength given other stock opportunities that appeared more attractive at the time. We are cognizant that with the large rise in oil prices, U.S. shale producers will likely

ramp up production quickly (the number of rigs in the field has already risen) which could effectively cap any further price increases and eventually lead to lower prices as more oil flows. We maintained the portfolio's position in Core Labs, which has a more direct exposure to the quick response by U.S. producers to ramp up activity.

## Summary

While the prospects for meaningful improvement in global economic growth remain poor, and accompanying revenue and earnings growth are expected to remain scarce, commodity driven emerging economies benefited in Q4 amid rising oil prices, and increased optimism that pro-growth policies by the new Trump administration may lead to higher U.S. growth which could in turn benefit emerging economies. Even though we expect some improvement in growth in the U.S. due to lower tax rates, reduced regulation of business and new infrastructure spending, we are skeptical that global growth will feel an equivalent benefit, and we remain concerned that decisions pertaining to trade policy may in fact have a negative impact on emerging market growth moving forward. For this reason, we are more confident than ever in the opportunity offered by our Emerging Markets Growth portfolio which is focused on very select, unique businesses around the world that offer more predictable growth metrics despite growing uncertainty in the macro backdrop for such countries.

Today, our Emerging Market Growth portfolio offers forecast annual revenue and earnings growth over the next three years of 14.6% and 23.0% respectively versus the 7.5% and 9.4% expected for the MSCI Emerging Markets Index. While better business quality and higher sales and earnings growth are not rewarded every quarter due to changes in investor expectations and preferences, over time we remain confident that the unique businesses that generate such growth, in a much more predictable and sustainable manner, should be rewarded as hopes for cyclical recovery are eclipsed by understanding that the road ahead for global growth remains uncertain and treacherous making selectivity critical.

Thank you for your interest in SGA's Emerging Market Growth portfolio. We look forward to answering any questions you may have.

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