GEM EQUITIES
HALF-YEAR PORTFOLIO UPDATE
JANUARY 2018

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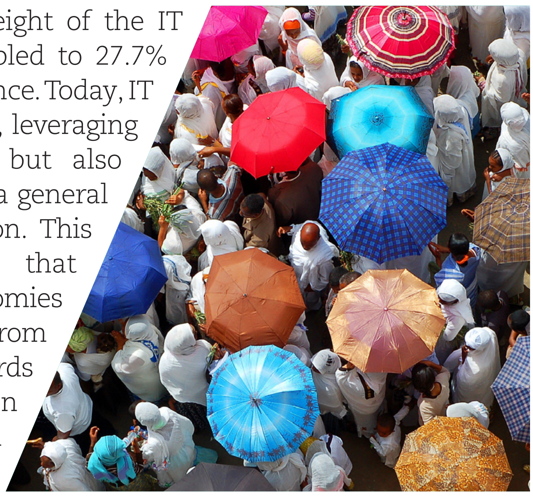
— Over the past nine years, the weight of the IT sector in the MSCI Emerging Markets index tripled to 27.7%, backed by strong EPS outperformance

MARKET OVERVIEW

The past year has been a good one for Comgest's GEM strategy with the highest absolute gains in seven years despite the complicated outlook in January following the U.S. election of President Trump. The portfolio also managed, uncharacteristically, to keep up with the strongly performing MSCI Emerging Markets (MSCI EM) index. This is particularly noteworthy since index gains were narrowly driven by around 50% of the return coming from the information technology (IT) sector, and led by three IT stocks that we do not own. Good fortune in stock picking explains the resilience of key positions in China, South Africa, Korea and Taiwan – significantly outperforming our expectations and the market.

The 2017 emerging markets rally was much different from previous ones. Nearly half of the 2017 price performance as well as earnings growth was driven by the IT sector. In contrast, cyclical sectors such as raw materials and energy drove performance of the asset class in previous upcycles. The new central role of IT reflects the increasing weight of emerged emerging economies, notably in North Asia, which are knocking on the door of the high-income club of nations. To drive tangible productivity improvements these economies have developed powerful IT sectors that are helping them transition from smokestack to consumer, services and high tech. At the same time, general enthusiasm surrounding "all-things internet" also partly explains their newfound dominance, including the visible expansions in the multiples of Tencent (27x to 40x P/E NTM), Alibaba (23x to 27x P/E NTM) and TSMC (13x to 16x P/E NTM).

Over the past nine years, the weight of the IT sector in the MSCI EM index tripled to 27.7% backed by strong EPS outperformance. Today, IT represents a much broader sector, leveraging not just corporate investment, but also consumer demand while playing a general incubating function for innovation. This long-term trend demonstrates that these emerged emerging economies are not likely to back away from the development path, i.e. towards greater reliance on consumption and services over investment and manufacturing.



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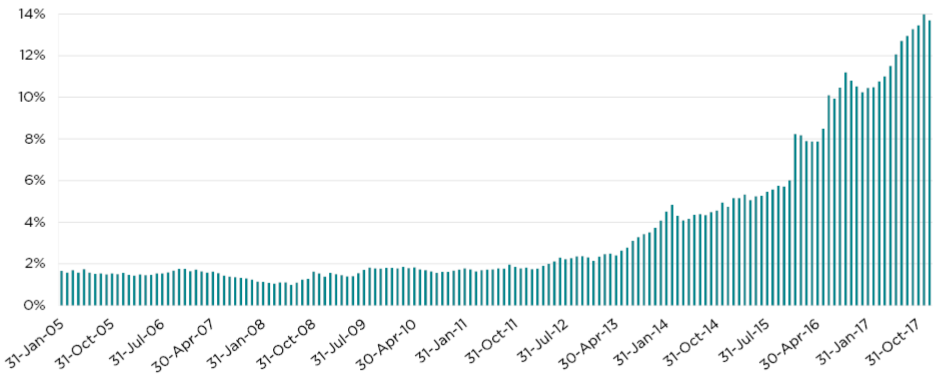
However, it is prudent to remember that things do not change overnight and that trees do not grow to the sky, contrary to what Mr. Market appears to assume. For example, do we really appreciate the disruption that e-Commerce causes in retail today? When looking at current brick-and-mortar retailers and e-Commerce companies in China, it seems as though the future will be 100% online. Yet we know that it won't. It took e-Commerce close to two decades to make a tangible impact on consumer habits – grabbing a bit more than a 10% retail market share globally. So, yes, e-Commerce has made a tangible impact, but this took much longer than analysts made us believe two decades ago. That might – again – leave room for disappointment.

— The software and services industry group has *quintupled* over the past four years to 14%

Given that the weight of the software and services industry group has quintupled over the past four years to 14%, this may well be a case of "too much, too soon". Particularly as the risk of setbacks is real; dilution from what seems to be increasingly random investments and the potential for much tighter regulation should be considered. In addition, the high concentration of investor positioning in IT today means rotation into other sectors including "old economy cyclicals" such as energy, commodity and industrials as well as the financials is plausible at some juncture during 2018.

Figure 1. MSCI EM - IT Sector Weight: Software and services quintupled over last four years



Source: Factset, MSCI

A more prominent and broad IT sector is good news for Comgest's stock pickers as successful innovation raises entry barriers and triggers structural growth trends. China, for example, is now the largest market globally for robot sales, has the highest number of internet users on the globe, is third in global patent applications, has the highest number of university graduates in science, technology, engineering and mathematics (STEM) fields, and is the largest exporter of high value-added products. There is a host of innovation via the internet, but also in industrial and consumer applications, which has been a fruitful soil for our stock picking in recent years.

That being said, after strong performance and some re-rating of our

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— **Current market sentiment reflects an "everything looks good" backdrop:**

1) **Global economic growth is enjoying its strongest and broadest synchronised upswing in a decade;**

2) **Liquidity conditions remain very supportive; and**

3) **Corporate profit growth is decent, while equities look somewhat cheap compared to bonds**

stocks in both China and IT (resulting in capital re-allocation towards other areas), we now inadvertently find ourselves with portfolio weights which only match, or are somewhat below, that of the index for the first time in years. As this is solely a result of our bottom-up conviction, it highlights Comgest's discipline in trying to manage the overall risk-reward of the portfolio over time. In broader terms, the current market sentiment reflects an "everything looks good" backdrop that can be summarised via the following observations: 1) global economic growth is enjoying its strongest and broadest synchronised upswing in a decade; 2) liquidity conditions remain very supportive; and 3) corporate profit growth is decent, while equities look somewhat cheap compared to bonds. Within emerging markets, these dynamics are further supported by a monetary policy cycle which is, selectively, more accommodating than in developed markets (e.g. rates are still falling in Russia, Brazil and, potentially, in Mexico and South Africa). There is also incrementally higher growth in EPS and an attractive valuation case relative to developed markets.

On the other hand, if the above is consensus, then it pays to ask what may be amiss. The "glass half empty" case can be summarised as follows: the developed markets economic cycle is increasingly mature as reflected by a flattening yield curve. Liquidity conditions are peaking as several central banks move to reverse ultra-loose policies. Most financial assets are expensive relative to history. In emerging markets, domestic growth outside of Asia, while recovering, remains tentative. With a plethora of elections dominating the political landscape in 2018, progress on reform is questionable.

Since the MSCI EM bottomed in H1 2016, EPS growth has roughly matched price appreciation, resulting in mostly unchanged valuations. The asset class thus continues to trade at a trailing P/E roughly in line with the average of 15x since 1995 – a 30% discount relative to developed markets. Consensus expectations of 13.5% EPS growth for the asset class in 2018 slightly lag behind the consensus earnings growth estimates of 14% for the portfolio's holdings. Meanwhile, earnings momentum is robust as 2018 EPS consensus expectations for the MSCI EM crept up by 5% over the past three months and 15% over the past 12 months.

PORTFOLIO POSITIONING AND COMPANY SPECIFIC NEWS

As far as the portfolio is concerned, discussing today's positioning is worth a bit of historical perspective. Around 2011, we started more decisively to consider the internet industry as an interesting way to capture spending by the middle class. We invested in a range of businesses including **Naver**, **Yandex**, **Naspers**, **Tencent**, **Baidu**, and **Mail.ru**, all of which were strong, fast-growing franchises. As we built on these positions in subsequent years, this segment of the portfolio eventually reached a meaningful percentage and led us to be inadvertently overweight in the IT sector versus the index.

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For the past three years, however, our weight in IT has remained roughly stable. In addition, we have been disciplined in taking profits when valuations became rich, even if the prospects for growth remained promising. This has usually worked in our favour, but has occasionally proved expensive, e.g., we consider our early sale of Tencent to be our biggest investment mistake in the last three years. Thankfully, we offset this misstep with our successful purchase of **NetEase**. **Hangzhou Hikvision** likewise proved to be a very successful IT stock in the portfolio.

One result of our discipline is that the portfolio now is underweight in IT vis-à-vis an index spurred by Tencent and **Alibaba**. In our view, concentration and high expectations are clear risks for index investors in 2018. For instance, 33% of the MSCI China index is Tencent and Alibaba. As we pointed out above, there is a real risk of setbacks given the pace and scope of the IT rally. An index concentration in two (or three) IT stocks makes a review of the portfolio's performance seem paradoxical. Over the past three years (CY2014-2017), IT stock picks contributed approximately 60% to the absolute performance in the portfolio. Our IT stock picks returned 74% over the past three years (a performance CAGR of 20%). Yet this sector has been a marginal detractor to relative performance of the portfolio during the years of 2014-2017. This is another way of pinpointing concentration risk within the IT sector.

Profits taken from strong performers within IT have been re-invested in companies across a range of industries. While some money was invested back in IT, a large share went towards an unusual Comgest choice: financials, and to be more accurate, mainly life insurance companies that benefit from a rapidly growing demand for their services by a large and growing middle class across Asia, EMEA and Latin America. The life insurance industry tends to gravitate towards competitive concentration, while highly personal products make digital disintermediation or disruption more difficult. A strong offline distribution footprint through exclusive agents and/or banks, which all our insurers offer, is and will stay an important element of success. Due to low interest rates, valuations are attractive despite fast core operational growth.

— **Why does Comgest have fairly high exposure to insurance in emerging markets versus none in developed market strategies?**

Why do we have a fairly high exposure to insurance in emerging markets, when we do not have any in our developed market strategies? Firstly, emerging markets insurers witness much stronger premium growth than developed market insurers as the middle class in emerging markets grows dynamically and insurance penetration is low. The key to this is that many members of this demographic are buying protection for the first time. Penetration levels are exceptionally low in many countries across Asia, Latin America and Africa. As an example, gross written premiums in the Chinese life insurance market grew with a CAGR of 15% over the past decade and are expected to sustain similar levels for at least another decade. Secondly, the level of profitability when measured operationally in underwriting profits and ultimately ROE is high for emerging markets insurers. This is true both in absolute terms and when compared to

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developed market insurers as the emerging market insurance market is less mature, fragmented and competitive than developed markets.

A second, smaller segment within our financials exposure is exchanges. Competition in this category is also quite limited and growth – although tough to predict accurately by line – is well supported by the increasing sophistication of the underlying economies and financial systems. In many places, especially in EMEA and Latin America, exchanges are now attractively valued following difficulties in recent years. Businesses such as **B3** or **Moscow Exchange** enjoy high barriers to entry and strong free cash flows since vertical integration into registration, clearing, settlement and custody services raise recurring revenues – typical hallmarks of quality growth that Comgest seeks and appreciates.

— Comgest's Emerging Markets portfolio currently has the highest exposure to financials in 15 years

Consequently, Comgest's Emerging Markets portfolio currently has its highest exposure to financials in 15 years. While this may seem odd given previously discussed concerns around the cycle or global levels of debt, this exposure should be considered within the context of a two billion strong population of GEM middle class. This is a class experiencing continuous income growth, yet having little insurance in place to protect their new and improved living standards. As per Comgest's style and discipline, we have emphasised companies with conservative balance sheets, i.e., those with acceptable leverage and minimal exotic investments as well as visible profit growth predominantly from steady increases in underwriting activities.

RECENT PORTFOLIO CHANGES

As in previous years, turnover during 2017 remained quite low at less than 20%. Nevertheless, a number of new names did enter the portfolio, as indicated below.

IT outsourcing company, **Cognizant**, is incorporated in the US, but has 85% of staff and 90% of assets in India. While global in nature, the business is strongly rooted in Asia. As cyclical industry headwinds appear to be settling, we expect that EPS growth could steadily accelerate in coming years based on the company's current strong competitive position in healthcare and other verticals. Capital management initiatives supported by high, free cash flow are a further attraction. Current low valuations are reflective of more subdued growth during past years, but pay little credit to a distinguished long-term track record or of rising requirements for technology investments across most industries.

Kroton Educacional is Brazil's dominate private education provider. Founded in 1966, the company has rapidly grown both organically and via acquisitions, and today mainly provides post-secondary education to over one million students across the country on campuses and via the internet. Comgest has long held the company in our Latin America and GEM Promising Companies portfolios after share price volatility related to

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a rejected merger with competitor Estacio provided us the opportunity to buy it. Notwithstanding the ever-present regulatory risks in this sector, the structural growth outlook remains highly promising due to the contrasting balance between an aspirational middle class and a cash-constrained government.

We exited positions in **Cielo**, the Brazilian payments solution provider, following strong performance and as changing regulations lowered the prospects for growth, as well as **Heineken** due to valuations. We also exited **Bharat Heavy Electrical** after a prolonged period of disappointing growth and changing environmental standards that may further unsettle its prospects.

OUTLOOK

Considering the mixture of positive and negative factors discussed above, current emerging markets valuations seem fair, but also suggest that future performance may be determined by a) the ability of companies to further expand earnings, and b) changes in the external environment. In our view, expectations are not particularly aggressive: consensus forecasts show the MSCI EM to deliver 13.5% EPS growth in 2018 led by consumption-driven sectors such as IT, consumer discretionary and healthcare. Comgest's portfolio is not exposed to banks, materials, energy or food and staples retailing, which are expected to grow below-average EPS, in the mid-to-low single-digits.

— Consolidation in equities look plausible at some point in 2018, while greater volatility may well turn out to be a defining feature of the coming year

That said, short-term equity markets seem overbought. The fact that we have record highs in the bull/bear and put-call ratios as well as record lows in implied volatility suggests a certain amount of complacency in the system. At the same time, the >1100% increase in the price of Bitcoin during the past 12 months can be read as a lack of confidence in conventional money, but looks more like a repeat of the tulip mania of 1620 (and similar follies of greed) to us. Regardless, consolidation in equities look plausible at some point in 2018 and while it would seem premature to expect the next economic downturn, greater volatility may well turn out to be a defining feature of the coming year.

Following strong gains, but conservative management of the growth versus valuation trade-off, the portfolio at the end of 2017 has experienced no significant further re-rating. Thus, although valuations are at a slight premium to historic averages, they remain quite reasonable relative to quality stocks elsewhere. There may also be some comfort in the portfolio's prospective growth, which is 15% p.a. for the next five years based on our own estimates for the Comgest's GEM strategy holdings.

Is such long-term growth realistic? While clearly not a "sure thing", we believe it's possible based on our holdings of companies in different sectors, as well as the balance between ongoing contribution from a number of current core contributors (such as **Ping An Insurance**, **Power**

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Grid, **Inner Mongolia Yili**, and **Hangzhou Hikvision**). This is in addition to a return-to-growth by a few companies that previously underwent a growth pause (including **China Life**, **MTN**, **Baidu**, and **BB Seguridade**). We believe this mix, combined with characteristically strong balance sheets and free cash flow, leave our portfolio well positioned to perform in what may prove to be a more volatile, but potentially still modestly positive return environment.

Wojciech Stanislawski
Analyst / Portfolio Manager

Wojciech Stanislawski joined Comgest in 1999 as a member of Comgest's Global Emerging Markets team and is today also a member of the Group's Investment Executive and Management Committees. In 2000 he was named as co-lead Portfolio Manager of Comgest's flagship Global Emerging Markets fund and today also co-leads a number of other strategies. In 2013 Wojciech was named Team Manager of the firm's Global Emerging Markets equity investment team, responsible for the daily supervision and management of the Portfolio Managers and Analysts. He also maintains responsibility for a number of Global Emerging Markets segregated mandates. Wojciech graduated from the Panthéon-Assas University in Paris with a joint Master's Degree in Business and Financial Management.

Emil Wolter
Analyst / Portfolio Manager

Emil Wolter joined Comgest in 2012 as an Analyst and Portfolio Manager covering Asian and Global Emerging Market equities. Initially working with Comgest's Singapore team before moving to the firm's Paris office, Emil has co-led the firm's flagship Global Emerging Markets, Asia ex Japan and Asia Pacific ex Japan strategies since 2014. Emil started his career in 1995, specialising in Asian and Emerging Markets equities since 1997, initially with Pictet Asset Management in London. He went on to head the emerging markets team at Polar Capital Partners in both London and Singapore. Based in Singapore, he was a Managing Director responsible for regional equity strategy at Royal Bank of Scotland and later held the same role at Macquarie Securities. He graduated from the University of London with a Bachelor of Science in Financial Economics.

Wolfgang Fickus, CFA
Member of the Investment Committee

Wolfgang Fickus is a graduate of the University of Cologne (Germany) with a degree in business administration (Diplom-Kaufmann) and studied at the London Business School. He also holds a CEMS Master's in international management and is a CFA® charterholder. Wolfgang began his career in 1995 at Paribas Asset Management Paris as a European-equity fund manager. In 2000, he moved to WestLB where he worked as an analyst for European technology stocks before becoming the Head of Mid- and Small Cap Research in 2005. Wolfgang joined Comgest in September 2012 and is a Member of the Investment Committee.

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