FSSA INVESTMENT MANAGERS

Global Emerging Markets Equities

This is the third investor letter for the FSSA Global Emerging Markets Focus Strategy since its launch in November 2017. In this letter, we will discuss our investment approach, process, strategy, positioning, and other matters we think are relevant to investors. As always, should you have any questions or feedback, we would appreciate hearing from you.

People and franchise

People form the DNA of any business. Getting the right people to lead a business is essential for execution, alignment and long-term success. That said, long-term success does not depend on just the management team – the quality of the franchise is equally important. While a good management team can ensure the continued success of a strong business by executing well and making the right decisions (operationally, capital allocation, respecting other stakeholders' interests, etc.), it is hard – even for the best management teams – to overcome the decline of a weak franchise. If the problem is the horse, even champion jockeys will not win the race.

As long-term investors, we look for franchises with strong competitive advantages, attractive market positions and persistent growth opportunities. These features ultimately determine a company's ability to generate free cash flows (or owner's earnings for banks), which in turn create value for the shareholders of these assets. While historical returns and track record are important inputs in our assessment of the quality of a business, they are, after all, historical. The ability to create value in the future is just as important.

Looking for high returns and strong balance sheets

When analysing companies we look at a range of factors. Some of these would be indicators of quality, such as the return on invested capital (ROIC) and gearing (the ratio of a company's debt to equity). For financial companies, it would be return on assets (ROA) and leverage. The first two indicators tell us something about the quality of the business model, whilst the last set reflects the strength of the balance sheet.

Non Financials	Nov 2017	Dec 2018	1H 2019
ROIC	23.6 %	18.7 %	28.3 %
Gearing	0.5x	0.3x	-0.5x

Financials	Nov 2017	Dec 2018	1H 2019
ROA	2.4 %	2.2 %	2.0 %
Leverage	8.6x	9.2x	9.2x

Source: FSSA Investment Managers

Looking at the table above, we remain confident in the quality of our holdings. The aggregate level of ROIC for the non-financial part of the portfolio has been consistently high; and the current 28.3% indicates that for every dollar our companies invest into operations, the payback period is less than 4 years, which we view as very attractive.

A good example would be our holding **Clicks**, the South African pharmacy chain, which we believe to be one of the most attractive investment opportunities in the country. Central to the investment case for any high ROIC business is the ability to re-invest capital at continued high returns, as this is what drives the growth in free cash flow (FCF) – and this is where Clicks stands out. Over the past five years, the company has delivered an average ROIC of more than 40%, indicative of a payback period of less than 2.5 years each time it opens a new store. The result has been strong cash generation over the same period.

Indeed, we believe Clicks' growth potential (and its ability to deploy incremental capital at high returns) is significant. Today, the group operates 680 stores, mainly in South Africa, but penetration rates are still low (50 stores per million people versus 200 in developed

markets). The sector remains dominated by independent 'mom-n-pop' operators, from which Clicks continues to grab market share every year. These attractive growth metrics, combined with an excellent management team (headed by Clicks veteran Vikesh Ramsunder, who has been with the company for 26 years), makes us confident that Clicks will continue to deliver strong results in the coming years.

Returning to the table above, it is also reassuring to see that the gearing of our holdings is negative, which implies that, in aggregate, our holdings have a net cash position. While a healthy balance sheet does not seem to be greatly appreciated by market participants today given the low-interest rate environment all over the world, its importance should not be underestimated. A strong balance sheet can be a decisive factor in downturns, providing an opportunity to gain market share, invest in capacity or even to acquire struggling competitors at attractive levels. Similar to Hemingway's description of the process of going bankrupt (first gradually, then suddenly), we are firmly of the view that financial prudence will make a sudden comeback one day.

Equally, when looking at our holdings in financials, we remain confident in the strength of their franchises. The aggregate ROA of these companies is 2% which, combined with the aggregate leverage of 9x, implies that our bank holdings produce close to 20% ROEs on average. While the leveraged nature of banks makes the business model inherently more risky than a non-leveraged company, we find comfort in the long-term track record of our holdings. The banks we have invested in are, for the most part, plain vanilla banks, characterised by having strong deposit franchises and consumer/retail-oriented loan books. Most importantly, they are known for their risk-aware, countercyclical management teams, which helps to ensure low levels of stress throughout the cycle. If we were to look at how our financials holdings have managed during previous cycles, they have on average generated a ROA of 2.4% and compounded book value per share (assuming dividends reinvested) at 15% in US dollar terms since 2007 – despite the global financial crisis in 2008-09 and a substantial slowdown in many emerging markets in 2014-16.

Our largest holding in the financials category, **HDFC Bank** in India, is a good example of this consistency. Over the past 15 years, the bank has generated an average ROA of 1.6%, ROE of 18% and compounded its book value at 21%. The main reason behind this impressive track record is, first and foremost, a strong deposit franchise (HDFC Bank has more than 5,000 branches across India and 50 million customers), which has given HDFC Bank a funding cost advantage. The second reason is a diversified loan book focused on retail customers, which has generated high, risk-adjusted yields without incurring the same amount of stress most other corporate lenders in India have experienced.

The ability to avoid stress and asset quality problems is where the bank and its long-time CEO, Aditya Puri, has performed better than most other peers globally. Since 2007, non-performing loans (NPLs) have steadied at an average rate of 1.3% and has never exceeded 2%. This has allowed HDFC Bank to grow earnings and book value per share at a high and consistent rate, without the usual volatility seen in other banks whose earnings profiles follow the ebbs and flows of cyclical credit costs.

While HDFC Bank has grown phenomenally over the years and now commands a 9% market share in India, we believe there are still substantial opportunities to capitalise on – especially in non-urban areas which account for 40% of the economy and 65% of the workforce. To quote Puri from a meeting with him mid-year: "India feels like its 1994 all over again [just after India introduced financial reforms and issued banking licenses for the first time to private players such as HDFC Bank]. Back then the opportunity was in the cities; today it is in the rural areas!"

IT and new investments

Moving on to the current positioning and some of the changes we have made during the period in review, the topic of IT and new technology is increasingly discussed when we meet with the management teams of our holdings. Whether it is a more traditional company (a so-called 'old economy' business) or a company which has based its primary business on IT, almost every annual report we read now has a dedicated section on technology and how the company uses it. Not surprisingly, some of the largest companies in emerging markets today (based on market capitalisation) are technology-related companies – such as Samsung Electronics, Tencent and Alibaba. While we do not own these companies in the portfolio, we are firmly of the view that technology is essential to sustaining competitive advantages for almost every business. Even in the least developed countries we have visited, IT plays a critical role in many facets of the economy, including transacting with customers, managing supply chains, and promoting new products.

Still, having a positive view on the utility of the industry does not necessarily mean that technology companies form a substantial part of the portfolio. We approach these companies as we do with any other – looking for strong management teams and great franchises – and in this regard, it has never been clear to us which companies would be the long-term industry winners, especially when it comes to technology hardware. Unlike its dominant Western peers which tend to own most of the intellectual property within the industry, most of the technology hardware companies in emerging markets are usually positioned in the lower part of the value chain, without meaningful pricing power or a sustainable competitive advantage – making them unfit for long-term investing.

For the larger internet companies, we believe the scale of their operations and their large market capitalisations makes it difficult for them to continue to expand at previously high growth rates. As we have seen many times before, extremely large companies often struggle to grow. Indeed, empirical evidence from the US suggests that entering the Fortune 50 is one of the best indicators for constrained future returns. In the years after inclusion, companies would, on average, see real growth slow to 1% and in many cases, even turn negative. While the growth slowdown of the BATs (Baidu, Alibaba and Tencent) might not happen as rapidly as the average Fortune 50 company, the direction should be clear; and is a good reason to be cautious. And that is even before discussing regulation, questionable governance and alignment, which we believe are more reasons to stay on the sidelines (although we will leave that discussion for another day).

Yet, ignoring IT and internet companies altogether would in our opinion be a mistake. Investing is often about finding the diamonds in the rough and we believe one such example would be our holding **Mercado Libre**, the Latin American e-commerce company. Over the last two decades, Mercado Libre has built the leading marketplace platform in the region, which attracts more than 50 million users each year. The company is well known for offering the largest range of products at more affordable prices than its peers, which in turn attracts more users to its platform. Its scale has meant that the company has been able to invest ahead of peers in a broad range of value-added services (such as financing via MercadoPago, shipping via MercadoEnvios, advertising, off-platform payment solutions, etc.), that has not only grown its overall market share, but has also expanded the addressable market.

At the time of our initial investment, Mercado Libre was far from being constrained by the law of large numbers. The company's market cap was 2.5% of Alibaba's, despite having an addressable market of roughly 40% and none of Alibaba's corporate governance issues. In fact, we would rate the management at Mercado Libre as being among the best in the region. The company has an excellent track record of growth and the management is well aligned with minorities. KPIs are long-term orientated, variable compensation vests over six years and the company has only one share class (Marcos Galperin, the founder and CEO, owns 8%) with equal voting rights. That said, over the past two years, the company has rerated substantially and now trades at 14.5x Enterprise Value-to-Sales (EV/Sales), compared to 3.5x for Amazon and 7.3x for Alibaba. At these levels, much of its attractive long-term growth prospects seem to be reflected in the price; we have, accordingly, been trimming our position.

Elevated expectations however, is not the case for **51job** in China and **Despegar** in Argentina – two other internet-based companies with quality management teams and franchises which were added to the portfolio in the first half of the year. 51job was founded in 1998 and is the number one online job search platform for white-collar roles in China, with more than 130 million registered *résumés*. Due to its established reputation and strong brand, an estimated 50% of new entrants to the workforce in China register their *résumé* with 51job every year. This in turn attracts major enterprises to use 51job as their main online recruitment resource, resulting in a virtuous cycle for the platform. In addition, the online nature of the business means that it is inherently asset-light with little working capital and capital expenditure needs, thus creating a profitable and highly cash generative business. Its ten-year average profit-to-FCF conversion was 140%, the last three years' net working capital was negative and the preceding five-year average ROIC was more than 100%!

The company continues to be led by its founder, Rick Yan, who still owns 21% and is the second-largest shareholder after Recruit Holdings from Japan (a significant position in our Japan strategy). The latter, which runs the globally-successful Indeed job search franchise, has been a passive but supportive long-term shareholder of the company. We had the chance to speak with Mr Yan recently and were impressed by his knowledge of overseas markets and his long-term vision for the company. In 2013, he predicted a shift in the dynamics of the job market in China and subsequently made two strategic changes: to focus only on the best enterprise customers for recruitment and to invest more in its HR services offering. Fast forward to today, with a slowing economy and more competitors in the recruitment space, these decisions seem to have been sensible. While its revenues may be cyclical, 51job has a defensive balance sheet with more than USD1.4 billion of net cash currently on its books – one of the key things we look for in cyclical companies. We took advantage of weak sentiment to purchase 51job at an attractive 6% FCF Yield (or 6x EV/Sales) and an ROIC of over 100%. We look forward to being long-term shareholders in this quality company.

Our second addition within the technology space is Despegar, the leading online travel agency (OTA) in Latin America, with more than 300,000 hotels on its platform and 10 million bookings annually. The company, which was founded by three Argentine friends in 1999, is now the market leader in 19 out of the 20 Latin American markets that they operate in. A key characteristic of the online travel industry is the 'winner takes all' network effect – consumers tend to use platforms with the widest selection of hotels and flights at the most attractive prices, while suppliers want to offer their services on sites that have the largest audience. As the market leader in the region, Despegar possesses all of these advantages.

Besides the network effect, larger companies have the advantage of scale, as an OTA requires significant investments in advertising and technology which smaller competitors cannot afford. Expedia is the largest shareholder (14% stake) and the two have a strategic partnership to share inventory, which benefits both. It expands Despegar's offering to customers travelling to the US and Europe, and

to Latin America for Expedia. Currently, just 35% of travel bookings in the Latin America region are made online, but we expect this to increase over time as online bookings are cheaper, more convenient and provide customers with more options. The sector is likely to consolidate as the larger players become stronger (as seen in other markets), which should benefit Despegar as the market leader.

The cash generative nature of OTAs makes them highly attractive investments and Despegar is no exception. The business requires little capital expenditure (mainly office supplies, servers and computers) and generates decent margins, as operators take a cut of each booking made. Hence, ROICs are high and FCF tends to be higher than net income. The same features show up in the balance sheet, which is equally as strong. At the end of June, Despegar had 40% of its market capitalisation in cash (all of which is in US dollars).

While the current economic conditions in Latin America are not easy to navigate, we consider valuations to be (very) attractive. Following the recent turmoil in the region, Despegar's share price has fallen by almost 70%. However, we believe that investor concerns are overdone. While Argentina in particular is rather challenging, it is merely 20% of the business – and Despegar has managed to grow in Latin America despite the difficult environment. The business is currently valued at 0.85x EV/Sales, but there is not much FCF as the company is following the same playbook as other successful OTAs – focusing on gaining market share and building out its long-term sustainable competitive advantage (scale and the network effects), which will then be followed by monetisation. From our recent interactions with the management team, we believe Despegar could generate EBITDA[1] margins of 20% in five years, which is in line with global OTAs. This would put Despegar on an EV/EBITDA of only 3.4x, assuming the management reach their margin targets, but without additional sales growth (which we believe is an overly conservative assumption, given the attractive growth prospects). The combination of a strong franchise, capable management team and attractive valuation should bode well for long-term minded shareholders, despite the current challenging environment.

The final new addition to the portfolio is **Colgate India**, which was purchased earlier this year. Having been present locally in India since 1937, this 51%-subsidiary of Colgate Palmolive occupies a leading position in India's attractive oral care category. Through its entrenched Colgate brand, which occupies the number 1 spot across the country, the company has for several years been ranked the "Most Trusted Brand" in oral care and is endorsed by more than 70% of all Indian dentists. A relentless focus on brand building (Colgate spends around 15% of sales on advertising and promotion, significantly more than peers), combined with a strong distribution advantage (reaching 240 million households across India via 6 million points of sales), has cemented Colgate's dominant position of more than 50% market share – roughly 3x that of its nearest competitor, Unilever.

For any FMCG[2] category, growth can usually be explained by some combination of the following three conditions: increasing penetration (more consumers use the product), increasing consumption (existing consumers buy more) and premiumisation (consumers upgrade to value-added products which command higher unit prices). We believe Colgate India should continue to benefit from all three trends in the coming years.

Firstly, toothpaste penetration in India is yet to reach 80%, meaning that around 250 million people still do not brush their teeth using modern oral care products. Secondly, the potential to capture additional consumption in other categories represents a huge opportunity. Globally, Colgate has a significant presence in personal care categories such as skincare and deodorants, which have not yet been introduced in India. We believe that the company will, over time, utilise its massive distribution network and strong brands to launch more products in India. And finally, Colgate India has benefitted from consumers trading up/premiumising in line with overall income growth and spending patterns, due to the strength of its brand. This is a trend we expect to continue for many decades to come. As it stands today, the average Indian spends just one US dollar on oral care products each year. This compares to around USD4 in China and USD11 in Brazil.

Over the past five years, Colgate India has maintained operating margins at around 21%, supported by its strong pricing power and the introduction of new, higher-margin products. This has allowed Colgate India to generate ROICs of more than 50% while growing cash flows at more than 15% (5-year CAGR[3]), which we consider attractive for an FMCG company. Maintaining profitability at current levels is a clearly stated policy for the management team; and as neither the company's brands nor its market share are likely to face substantial rivalry, we believe this looks achievable. On top of that, Colgate India has a solid balance sheet and has been debt-free over the past two decades, driven in part by a negative working capital cycle. For Colgate India, its distributors pay cash prior to delivery, whilst the company only pays its vendors after a quarter or so (its 5-year average cash conversion cycle is minus 34 days). The senior management team at Colgate India, like many multinational (MNC) subsidiaries, is well educated and has worked in various emerging markets. The current CEO, Ram Raghavan, has been with Colgate since 1997, previously running Colgate's businesses in China and Brazil.

[1] Earnings before interest, tax, depreciation and amortisation
[2] Fast-moving consumer goods
[3] Compound annual growth rate

This experience is invaluable to ward off potential competitive threats and to spot emerging opportunities. The company's board is dominated by independent directors and the overall standard of corporate governance is high. In our view, this combination of excellent stewardship, a strong franchise and good future growth prospects makes Colgate India an attractive long-term investment opportunity. At purchase, Colgate India was trading at a 2.8% FCF yield and a ROIC of 51%.

Three divestments

To fund the purchase of 51job, Despegar and Colgate India, we divested the Chinese appliance company **Midea**, the Argentinean bank **Supervielle**, and the Indian logistics company **Container Corp of India**. As a reminder, we have a self-imposed cap of a maximum of 45 holdings in the strategy. For every new investment we make, a company with a less favourable outlook would typically be divested. The buys and sells do not have to be matched from within the same country or sector, but we have found this rule to be invaluable over the years, as it is much easier to buy a company than to sell one (from a behavioural perspective). By having a limit on the number of companies in the portfolio, the embedded selling discipline reinforces the stock selection process and strengthens the level of conviction in the portfolio. Other reasons for selling might be the deterioration of a company's investment case (management or franchise risk) even if there is no replacement.

Returning to the subject, we sold Midea to fund the purchase of 51job. Midea is the dominant household appliances company in China, occupying the first or second position in eight major product categories in the domestic market. The company has been privately owned since market reforms kicked off in the early '80s and has one of the more sensible and capable management teams in China, with a long track record of strong execution, an open mind, and an honest attitude to mistakes. However, whilst we admire the good qualities that Midea has, we recognise that it is fundamentally a cyclical business. It is inherently correlated to the Chinese property market and its products are discretionary by nature. With increasing aggression from a major competitor and following significant gains in the share price in the first quarter (and therefore less attractive future return prospects), we took advantage of the situation and divested the company.

The Argentinean bank, Supervielle, was divested at the start of the year after meetings with the management team left us unconvinced that the bank would be able to deal with what is clearly a more difficult economic environment. As a niche bank, mainly focused on retail and consumer lending in the Greater Buenos Aires area, Supervielle is also the provider of social security payments to senior citizens – a source of stable, low-cost funding that has boosted the bank's margins and profitability despite its sub-scale size. However, with close to 100% of Supervielle's business exposed to the Argentinean economy, we believe that Despegar is the better choice and more able to navigate the current challenging environment, given its more diversified business (80% of operations are outside Argentina), stronger balance sheet (more than 40% of its market cap in net cash) and an equally attractive valuation.

The last divestment we made over the period was Container Corporation of India (Concor), the largest rail-based container transportation company in India with a near monopoly in the market (around 80% market share). While originally founded as a state-owned enterprise, the government has sold down its ownership stake to 60%. Today, Concor is an independently-run company, stewarded by a professional management team. Concor has 83 container terminals spread across the country and close to 300 rakes (groups of coaches), with its container terminals in close proximity of railway sidings and leased from the Indian railways on a long-term basis. This represents a substantial barrier to entry, as it is extremely difficult for the competition to match its network, let alone its capital costs – evidenced by the fact that Concor has maintained its dominant market share since the sector opened up for competition in 2007.

Still, competition from road freight has increased in recent years, which has resulted in pedestrian volume growth for Concor. That, combined with increasing capital expenditure ahead of a new multi-billion dollar railway infrastructure project (a dedicated freight corridor) and potential regulatory risk around the pricing formula for using the railway infrastructure, has made us question our initial investment thesis. At the time of divestment, Concor was trading at a FCF Yield of 2.0%; that is, on a less attractive valuation than Colgate India, which has, in our view, much better long-term prospects.

Trade wars and ESG

Most of the recent commentary about China has been dominated by two words: trade war. The stock market, understandably, has reduced its valuations of export-oriented industrial companies in China quite significantly. **Yum China**, the KFC and Pizza Hut operator in China and one of our key holdings, has been caught in the crossfire too. Originating from the US, there are fears abound on economic nationalism and that Chinese consumers would turn their back on KFC and Pizza Hut. However, judging by Yum China's operational performance since the trade war broke out last year, there is nothing to suggest that such apprehensions are warranted. In the first two quarters of this year, Yum China reported healthy sales growth of 12% and 3% respectively for the KFC and Pizza Hut brands.

Perhaps this should not come as a major surprise. Unlike other MNCs that launched in China without localising, Yum China has been led and managed out of China from the outset, with great autonomy from its US parent. Headed by CEO Joey Wat, who has been with the company since 2014, the company now has 460,000 employees with close to 100% of the workforce from mainland China, Hong Kong and Taiwan (with a couple of Singaporean and Malaysian staff in the head office). The company is widely praised for its distinct local menus (even the signature fried chicken is adapted for the Chinese taste), restaurant designs and advertising campaigns. Another competitive advantage for Yum China is the sheer scale of the company. With more than 8,750 restaurants across 1,200 cities and a 6% market share (roughly the same market share as the second to fifth ranked players combined), Yum China is essentially the market leader in a highly fragmented market.

The size of Yum China's operations creates a kind of leverage over suppliers and landlords, which is in addition to its significant infrastructure advantage. The company has 20 logistics centres across the country and a large department mapping out sites and location development, which its competitors cannot rival. More importantly, Yum China owns and operates 75% of all its KFC stores and 99% of its Pizza Hut stores. While the owner-operator model is clearly more capital intensive compared to the franchise model, it gives Yum China a greater ability to exercise control of the entire value chain on matters such as quality consistency, user experience and food safety – all critical factors in the still underpenetrated restaurant market in China. Yum China has spent the last 30 years building this advantage, which would take a long time (if not near impossible) for a competitor to replicate.

Unsurprisingly, these advantages are reflected in the margins. Despite paying a 3% franchise fee to Yum Brands, Yum China commands some of the highest operating margins in the world among quick service restaurant (QSR) operators. Significant negative working capital is another benefit of Yum China's business model. The company receives cash from its customers but pays suppliers with a lag, which has provided a source of funding that, historically, has been able to cover most of its capital expenditure and store expansion program.

The outcome of all these variables is a ROIC of more than 42% – one of the highest among any other QSR operator we have come across. As the market is still vastly underpenetrated (restaurants per capita is substantially below emerging market peers, with chain restaurant brands representing less than 12% of the total), we believe that there is plenty of growth for Yum China to ensure solid cash flow expansion for the foreseeable future.

That said, how is Yum China viewed through the lens of other stakeholders? We need to weigh up management quality and franchise strength in the context of a world which increasingly looks toward a broader set of stakeholders, and not purely on profit maximisation and shareholder value. While none of our strategies are explicitly-labelled "ESG", nor do we have a specific sustainability mandate (see our recent FSSA Investment Letter – Our Approach to ESG), we have always integrated environmental, social and governance analysis into our investment process by focusing on stewardship and the belief that quality managers and good governance should – in itself – ensure that environmental and social concerns are rightfully addressed.

As such, our approach is focused on identifying companies which are either well placed from a more holistic stakeholder perspective or should benefit from making that transition over time (possibly, with our engagement). As a consequence, we ask two simple questions: 1) What does a best-practice ESG profile look like for the company in question? and 2) Would we as investors and owners be aligned with that vision? To answer the first question, we take a deep dive when looking at the company, to evaluate its strengths and weaknesses from an ESG perspective and assess what, if anything, is required for the company to become best practice. The second question then addresses the economic impact and gauges whether we would benefit as an owner from the intended changes.

By these measures, Yum China is by no means perfect today. One can argue that there is still too much paper and plastic waste in its restaurants; its menus have high levels of sodium, sugar and fat; there are potential risks with food safety; and so on. However, as investors, we believe that we are well aligned with Yum China's attempts to move in the right direction. Reducing plastic and waste should lead to lower costs – thereby benefitting margins. Broadening the menu and introducing healthier options allows Yum China to address a wider segment – which could lead to more traffic and optimised store metrics. And, by sourcing more responsibly, supply chain risk should be lowered and food safety/quality concerns should be diminished – which reduces reputational risk and should improve sales in the long run.

Reassuringly, from several interactions with the management on these matters, the company is aware of these issues and, we would argue, are at the forefront of this development in China. Since 2017, the company has published a detailed Corporate Social Responsibility (CSR) report on an annual basis – and it is more than just words and flashy headlines. Since the CSR program was first adopted, Yum China has reduced paper and plastic consumption by 9,000 tons per annum, introduced kids' menus in KFCs and Pizza Huts in line with the Chinese Nutrition Society's guidelines for healthy and nutritious food for school-age children, and donated more than RMB180mn to the China Foundation for Poverty Alleviation, which provides nutritious school meals. The company has also built modern kitchen facilities and increased education on nutrition. We very much welcome these steps and continue to engage with the company on further improvements.

Having said that, we are wary of businesses where the return profile would decline drastically if they had to move to best practice – chemical and mining companies would be obvious examples in an emerging market context, where supervision and enforcement are weak. Whilst these companies can generate decent returns and cash flows, this is unlikely to reflect the full cost of their operations when considering all of their stakeholders – the health impact on employees working in deep mines, water contamination and poisoning from poor waste management systems, etc. If these industries were forced to clean up their act, we would expect their performance to be significantly poorer, as was the case with chemical companies in the US some 30 to 40 years ago. These companies became low margin businesses overnight when regulations changed and they were asked to pay for cleaning up the waste they produced. For the same reasons, we do not invest in tobacco, gaming or weapons manufacturers, where the fundamental business model would be challenged if they had to focus on a broader set of stakeholders.

Outlook

While the outlook for emerging markets and the global economy is perceived to be weakening in the short term, we remain optimistic about the long-term prospects for our holdings. Whilst headwinds such as currency fluctuations, trade tensions and increased geopolitical risk might continue for some time, we believe these are transitionary in nature and should eventually stabilise.

However, one question we are frequently asked relates to our investment style: what would happen to the performance of our portfolio if a more substantial repositioning into so-called 'value stocks' were to take place? The first thing we would say is that we believe the "value" vs. "growth" distinction is somewhat redundant. As many before us have pointed out, growth is a fundamental part of the value of a business – not a separate feature. The term "value investing" doesn't make much sense to us either – the mainstream definition of value investing is to buy companies which appear cheap on accounting measures, such as price-to-earnings or price-to-book, and avoiding stocks which appear to be expensive on the same basis. However, these metrics are often a poor proxy of the true underlying value of a business. Thus, we believe this methodology is incapable of determining whether an investor is indeed obtaining value in their investment.

However, returning to the subject, relative risk has never been a great concern of ours. If the long-term fundamentals of a company are not compelling, or if we don't believe that there is sufficient alignment (index representation or not), we will not invest. Even if it implies that we will lag behind the broader market in the short run. While hope can triumph experience temporarily, we doubt that perceived 'value companies' (Chinese state-owned banks, for example) will become high returning compounders without any asset quality concerns, any time soon. Or that Korean Chaebols will start treating minorities in a fair and transparent manner. Or that Asian hardware technology companies in the lower parts of the value chain will build out competitive advantages that would make them fit for long-term investing.

Our holdings, on the other hand, enjoy strong competitive advantages, defensive balance sheets and growth opportunities, which we believe makes them well positioned to generate attractive risk-adjusted returns over the long term – even if the global environment should become more challenging. That said, whether these bottom-up fundamentals will be reflected in share price performance in the short run is, of course, anyone's guess.

In this letter, we have tried to cover points which we thought might be of interest to the strategy's investors. If there are any questions or feedback concerning the strategy, our approach or operations, we would welcome hearing from you. Thank you for your support.

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