FSSA Investment Managers

December 2022



Quarterly Manager Views

FSSA Global Emerging Markets Equities Focus

Investment management is an industry where in the short run there is usually little relationship between process and outcome. In the long run, however, the link is very strong. Five years ago we launched the FSSA Global Emerging Markets Focus strategy. It has been an interesting time to invest in emerging markets — we have witnessed the tragic war unfold in Ukraine, increased geopolitical tensions between the US and China, panic over the election of leftist governments in Latin America, nationwide lockdowns in response to Covid-19 and a brief period during 2020/2021 where we began to question the sanity of markets (refer to our note on Growth Traps). Over this period, we have stuck to our long-established investment process, which emphasises bottom-up, benchmark-agnostic portfolio construction, with particular focus on the quality of management, the quality of franchise and, last but not least, valuation discipline.

We tend not to comment on performance in these letters, but as five years have now passed we think it an appropriate point to pause and take stock of the journey so far. A patient investor in our fund would have received an annualised return of 5.9%[1] (in EUR, net of fees) compounded over these five years. This is a touch disappointing and below what we expected when we set out five years ago. To be sure, it is more than the return from the benchmark index (MSCI Emerging Markets) which has returned 2.2% annualised through the same period. However, whilst we struggle to be satisfied by the absolute returns, we are encouraged by the underlying operational performance of our key holdings during this tough period. Indeed, in our opinion the strategy is very well positioned in terms of the potential of the underlying companies.

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- **The value of investments and any income from them may go down as well as up and are not guaranteed. Investors may get back significantly less than the original amount invested.**
- **Currency risk:** the Fund invests in assets which are denominated in other currencies; changes in exchange rates will affect the value of the Fund and could create losses. Currency control decisions made by governments could affect the value of the Fund's investments and could cause the Fund to defer or suspend redemptions of its shares.
- **Emerging market risk:** Emerging markets tend to be more sensitive to economic and political conditions than developed markets. Other factors include greater liquidity risk, restrictions on investment or transfer of assets, failed/delayed settlement and difficulties valuing securities.

For a full description of the terms of investment and the risks please see the Prospectus and KID for each Fund.

If you are in any doubt as to the suitability of our funds for your investment needs, please seek investment advice.

[1] For the FSSA Global emerging Markets Composite EUR, as at 30 November 2022

Composite Performance (EUR) to 30 November 2022

12m Rolling discrete periods to:	30 Nov 2022	30 Nov 2021	30 Nov 2020	30 Nov 2019	30 Nov 2018
FSSA Global Emerging Markets Focus Composite	-4.0	7.9	1.7	18.1	0.8
MSCI EM Index	-14.4	9.5	9.5	10.6	-3.9

These figures refer to the past. Past performance is not a reliable indicator of future results. For investors based in countries with currencies other than USD, the return may increase or decrease as a result of currency fluctuations.
The strategy performance figures is the weighted average performance of FSSA IM's funds that contribute to the strategy in question, is based on monthly performances and are net of a default annual management fee of 0.85%. Source: MSCI / First Sentier Investors. Since inception performance figures have been calculated from 30 November 2017 – 30 November 2022.

We are constantly trying to learn and improve our investment process. Naturally then, we felt it pertinent to reflect on the past five years and share our learnings.

"Time in" the market is more important than "timing" the market

This old adage, often quoted by Warren Buffet, has certainly been true for our strategy. It is rare to identify companies that have both a quality management team and a franchise that compounds free cash flows (or book value per share) at attractive rates for long periods of time. Where we have managed to find such companies, we believe the most important thing is to hold on and do nothing. Of the Top 10 contributors to fund performance over the past five years, six are companies we have owned throughout the period and three have been in the portfolio for around three years. MercadoLibre is a case in point – we have owned the company since inception of the strategy. As Latin America's leading e-commerce company, sales have grown nearly eight-fold over the past five years. However, given the fact that poorly-run e-commerce businesses can destroy value at breathtaking scale, we are firmly focused on the cash flows. In this regard too, the results have been impressive: free cash flow (FCF) has grown five-fold, from USD200m in 2017 to an estimated USD1bn in 2022. This has driven the 28% CAGR[2] total shareholder return over this period. In 2021, when we noticed that valuations had swung to an extreme (10x Enterprise Value-to-Sales!), we decided to take some profit off the table, which proved to be prudent as the share price then fell 70% from the peak. We have since bought back at lower prices and reinstated our previous position size.

Owning a quality company through a period of turbulence is a test of patience and conviction. For example, HDFC Bank, which has been a team favourite for nearly 20 years, has been undergoing a period of readjustment following the retirement of its founder CEO, Aditya Puri, after a successful 26-year stint. Over the past five years, the bank has compounded book value per share (BVPS) at its usual (stellar) pace of 20% CAGR, but valuations have de-rated owing to some short-term concerns. As a result, total shareholder return has been just 12% CAGR, which, whilst good enough on an absolute basis, should improve over the coming five years. Capitec, one of the leading banks in South Africa, is another example of a compounding machine. Despite the macroeconomic challenges in the country (more on that topic later), the bank has delivered 12% CAGR total shareholder returns over the past five years in USD terms. This has been driven by the highly profitable lending operation combined with a low-cost deposit base (the bank consistently earns an astonishing 5% return on assets). As a result, BVPS has grown at 17.5% CAGR over five years, underpinning shareholder returns.

For good quality companies, time becomes your friend. We will endeavour to find these kind of companies and hold them as long as possible.

Overwhelmed by macro

Our team has a long track record of investing in what many would deem to be difficult markets. In general, we have focused on finding companies that are able to withstand (perhaps even thrive) in volatile macroeconomic environments. However, in some rare instances, external macroeconomic issues can completely swamp even the best-run company. In this regard, it is worth recounting our investment in the Argentine bank Grupo Financiero Galicia. During 2017, our meetings with the CEO and several other members of the senior management team pointed to a culture that we liked and a franchise that was inherently strong – the bank had averaged 37% return on equity (ROE) for the previous 5-year period. More importantly, its performance was underpinned by a good deposits franchise (11% of all private deposits in the country). With the country electing a new leader, President Mauricio Macri, it seemed as if Argentina would regain its former glory and the issue of hyperinflation would finally be controlled. However, shortly after we made our investment, politics in the country took a dramatic U-turn (left turn?) and the economy, which had been improving, was destabilised yet again. Despite the bank performing well operationally, the intense currency headwind meant that we subsequently sold out of our position at a loss. This has been our single largest detractor since inception, costing us close to 250 bps of performance.

Another example of a mistake where we underestimated the macroeconomic headwinds was the case of AVI Limited, a leading consumer staples company in South Africa. In this instance, we were mainly attracted by the returns-focused CEO and his approach to capital allocation. The company had generated 25% returns on capital employed (ROCE) for the 10-year period prior to our investment and managed to deliver 25% during

[2] Compound annual growth rate

the 2017-22 period as well. However, the company was unable to grow faster than the currency was depreciating, leading to flat revenues and profit for over five years. It turned out to be what we refer to as a "weak compounder". This lack of growth meant that valuations were steadily de-rated and we eventually sold our position to fund better ideas elsewhere.

These have been expensive lessons, with the outcome being that we now systematically check and limit our portfolio exposure to so-called "high-risk" economies (simplistically defined as those with adverse macroeconomic conditions).

Stay disciplined

One area that is perhaps overlooked when it comes to investment performance are the mistakes that were avoided. During late 2020 and through 2021, we witnessed a global market mania that perhaps hadn't been seen for decades. There was a frenzy of initial public offerings (IPOs), most of which had dubious business models and sketchy financials. Meanwhile, valuations lost all relation with fundamentals as companies that were beneficiaries of Covid-induced work-from-home strictures were bid up to stratospheric levels. Most of the "stars" of this time were businesses that we call "Growth Traps". They are characterised by a business model wherein a constant supply of capital is needed to fund operating losses, as the profit pool of an established industry (such as advertising or retail) is transferred to customers. There is no evidence yet of such companies being able to capture the profit pool they have destroyed in their quest for scale.

In these phases, it is important to stay disciplined and not be enticed into overpaying for stocks. Our team helps us stay grounded and avoid mistakes in times like these. We have not participated in any IPOs for the GEM strategy over the past few years, most of which are now languishing below the listing price. Nor have we bought into flawed business models that promise a "path to profitability".

Conviction comes from thinking long term

The Covid-19 pandemic has dominated most aspects of life and business for nearly three years now, with places like China still battling the spread of the virus. Several of our holdings were also significantly challenged during the pandemic as the unprecedented lockdowns took its toll on their businesses.

For instance, the Mexican Starbucks operator, Alsea, had never experienced same-store sales declines of more than 4% prior to the pandemic, but during the second quarter of 2020, sales declined by 60-70%! For some of our travel-related companies, like Mexican airport operator Grupo ASUR, or the leading Online Travel Agent (OTA) in Latin America Despegar, the year-on-year sales decline was even greater, at 95%. The financial services companies we owned, such as Indian private-sector banks HDFC Bank or ICICI Bank, were also dealing with unprecedented circumstances whereby they didn't know if a majority of their borrowers would be able to make interest payments, given the national lockdown imposed in India during April-May 2020.

At this point, we took a step back and conducted a deep-dive review of our holdings. We had calls with management teams and re-evaluated their businesses. Fortunately, this gave us greater conviction in the longer-term trajectory of our holdings. The majority of them are market leaders in their respective industries and we realised that if they were struggling, their competitors would be even worse off. From our conversations, it became increasingly clear that when the lockdowns eventually ended, our holdings should have even higher market share and face less competition. Not only that, but because they were cutting costs (by renegotiating rental agreements and supplier contracts, and focusing on efficiency), operational leverage should result in an expansion of margins, which in many cases would outstrip their pre-pandemic highs. As such, even though the early stages of the pandemic were particularly challenging, we tried to look beyond the immediate situation — and we found some very attractive bargains, especially among Indian private-sector banks and Latin American restaurant and travel companies.

Overall, this period of volatility has kept us on our feet and truly tested our conviction in the long-term potential of the businesses we owned. We are now quietly hopeful that the next period will be quite rewarding for the strategy.

Stick to the process

As we look forward, we couldn't be more pleased with our team and the investment process that we have in place. Our emphasis remains on aiming to preserve capital and growing it sustainably, simple though it sounds. Over the more-than-30 years since the establishment of the FSSA team, the investment process has been honed continually, taking these and other painful lessons along the way to evolve the process accordingly. While the next five years are unlikely to look like the previous five, we will continue to work hard on delivering satisfactory returns to our clients.

Over the past five years, the strategy has been consistent in terms of the number of holdings and concentration of the portfolio. The quality of the franchises we own has also been steady, reflected in the ROCE they generate. As we come out of the pandemic and economies recover, especially in places like China and India, we expect increased prospects for growth. This shows up in the consensus estimates for the earnings of our set of holdings.

FSSA Global Emerging Markets Focus strategy	30 Nov 2017	30 Nov 2022
Number of holdings	37	41
Top 20 %	71%	73%
Median Net Debt to Equity (ex-Banks)	9%	-16%
Weighted average returns on capital employed (ROCE) %*	21%	22%
Weighted average 2-year expected earnings per share (EPS) CAGR**	11%	21%
Weighted average forward price-to-earnings (PE)**	22.4x	23.2x

Source: FSSA Investment Managers, Bloomberg. *Return on equity (ROE) for GICS Financial companies, and Pre-tax ROCE (i.e. earnings before interest and taxation (EBIT)/Capital Employed) for other portfolio companies. ** Based on Bloomberg consensus estimates.

Overall, this makes us very optimistic about the future of the FSSA GEM Focus strategy and that the best is still yet to come!

In this letter, we have tried to cover points which we think 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.

Source: Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at 30 November 2022 or otherwise noted.

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Appendix

This is the first page of our inaugural letter (from Q1 2018). While our name has changed (from "First State Global Emerging Markets Focus" to "FSSA Global Emerging Markets Focus"), the core traits underpinning the strategy remain the same:

Introduction

This is the first edition of what will be semi-annual updates for the First State Global Emerging Markets Focus strategy. In these letters, we will discuss our investment approach, process, strategy, positioning and other matters we think are relevant to our investors. We will always be available for any questions you may have but we have chosen this semi-annual format as our investment orientation is genuinely long term. We would usually have little to report on a more regular basis (be it daily, weekly or even monthly).

As the strategy was launched in the final quarter of 2017, our inaugural shareholder letter presents an ideal opportunity to describe our investment philosophy, and to outline what our investors can expect from us over time. We will also discuss the positioning of the strategy and some of the inherent biases of our approach. Finally – in what will be a recurring feature of the semi-annual updates – we will also highlight some of the investments in the strategy and lay out our investment theses for these companies.

Ground rules

In order to put the strategy and our positioning into context, it is appropriate to state our long-term objective as well as highlight some of the guiding principles underpinning the strategy. To begin with, our goal is to generate attractive, absolute returns for our investors by investing in the best businesses we can find in emerging markets and which, after cost, would be higher than the comparable market return over a three-to-five year time horizon.

Secondly, if one can talk about a competitive advantage in investment management, we believe that having a long-term investment horizon is certainly one of them. For us, investing is not about trying to predict which stocks will rise or fall next month or quarter, but, rather, is a non-speculative activity aimed at participating in the long-term value creation we believe the best companies can generate.

Thirdly, a critical part of our investment approach is our definition of risk, which we define as the possibility of the permanent loss of our investors' capital. Consequently, we look at risk at the company level – not relative to an index. Thus, when constructing the strategy, the benchmark is not the starting point. We have never considered indices based on market capitalisation to be good representations of the attractive long-term investment opportunities available in the market. Any reference to an index in these letters is made only with the intention of referencing or placing our performance in context – never for explicit benchmarking.

Fourthly, with respect to the geographical remit of the strategy, our definition of emerging markets seeks to expand the (somewhat arbitrary) MSCI classification through the addition of companies listed in countries classified as frontier markets. For instance, it has never made much sense to us why Pakistan is classified as an emerging markets country while Vietnam is classified as a frontier country. However, we will not invest in developed market businesses that have only partial exposure to emerging markets, as our intention is to only buy companies whose franchise is clearly focused on emerging markets.

And finally, we have a self-imposed maximum cap of 45 holdings in the strategy, with the total number of holdings usually within the 40-45 range. This relatively concentrated approach mitigates the risk of over-diversification, with the hard limit presenting a behavioral guardrail that ensures only high-conviction ideas earn their place in the strategy.

What we look for

Our investment philosophy is based on the simple belief that the best way to create wealth is to own the best businesses for the long-term. The best businesses to own are those which can deploy large amounts of capital at high, incremental rates of return and are stewarded by outstanding people. Within the team, we refer to these businesses as structural compounders. The typical characteristics of structural compounders are: above average sales growth and pricing power, strong cash flows and balance sheets, an outstanding management team and, ideally, formidable industry barriers-to-entry and predictable/stable competitive dynamics.

Often, these structural compounders can be found among the leading consumer, financial or industrial companies in the less developed parts of the world. Not only are penetration rates low for many goods and services, which provides a favourable long-term demand backdrop, but also, the high level of informality in many of these countries raises the barriers-to-entry substantially. This typically facilitates a benign competitive environment, allowing many dominant companies (with brand, distribution or scale advantages) to generate high margins and thus strong free cash flow, which in turn should lead to high returns for the owners of these businesses.

However, a key feature of our investment process is to assess not only the franchise strength of our holdings, but also the people running and controlling them. While a company's financial performance is in many cases more dependent on the quality of the industry than the quality of management, a weak or misaligned management team or a dishonest controlling shareholder can destroy any investment case. The primary trait that we seek in management teams is therefore stewardship – we will tolerate no uncertainty around management integrity and alignment, and strongly favour managers that balance the interests of all stakeholders, including the environment and society at large (an executive team that abuses one set of stakeholders is just as likely to do so where investors' long-term interests are concerned). Secondly, we look for great capital allocators – independently minded thinkers whose approach is long-term and at times countercyclical. Finally, and this is admittedly more intangible, we look for the right culture – management teams which can attract and retain employees and have a good track record of recruiting internally for senior positions, are some of the traits we look for.

The strategy

Our focus on structural compounders leaves us with some natural biases in the strategy. Although portfolio construction is purely the residual of our bottom-up approach, there are a few broad categories that are typical hunting grounds for us: Dominant consumer franchises, high quality financials, cash-generative industrials and outsider CEO's. In the following we will elaborate on these.