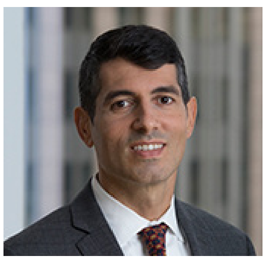
GW&K INVESTMENT MANAGEMENT

PORTFOLIO MANAGER Q&A | JANUARY 2020

EMERGING WEALTH EQUITY STRATEGY

THOMAS A. MASI, CFA
Vice President
Portfolio Manager
BA, MBA, Rutgers University



NUNO FERNANDES, CFA
Vice President
Portfolio Manager
BS, University of Porto, Portugal

INVESTMENT TEAM

- 18 investment professionals averaging 26 years experience
- Portfolio managers average 30 years experience
- Research team organized by sector analyzes companies in emerging and developed markets
- Seasoned analysts are multilingual and come from varied cultural backgrounds

Q&A WITH TOM MASI & NUNO FERNANDES

Historically, emerging market stocks have been very volatile and have often underperformed. What's the case for investing in emerging markets and why should investors invest now?

Mr. Fernandes: In the last 30 years, emerging markets – especially the larger emerging market countries – have made important reforms to their fiscal and monetary systems. These reforms have resulted in a very attractive investment landscape in which private investment has increased significantly, and productivity and efficiency gains have grown consistently, year after year. This, in turn, is reflected in consistent, sustainable real wage increases, the basis for consumption.

Mr. Masi: This is significant. In a world where growth is scarce, emerging markets represent the last great frontier for investors. We expect the shift to consumption growth – associated with a rising middle class around the world – will not only drive earnings well above average, but also investment returns, over the next 10-20 years for well-positioned companies. In fact, we believe emerging market equities will likely outperform other asset classes over the next 5-10 years by returning as much as 10% annually. We don't see this as a stretch. Economists are forecasting that emerging market middle class consumption will exceed global consumption by 2050. We mean to continue to capitalize on this long-term, global growth trend.

All emerging market strategies are not created equal. In fact, your strategy is called the Emerging Wealth Equity Strategy. How is it different from other emerging market strategies?

Mr. Masi: Unlike other emerging market strategies, we invest in best in class companies that are winning the mindshare and wallets of consumers. Plus, we manage a concentrated portfolio with conviction. We have a long-term orientation. In addition, we have developed a proprietary universe of emerging wealth companies serving the emerging market consumer. With this focus, we have not only been able to generate top quartile performance among our universe of peer managers for the three, five and seven year annualized periods, but also for the year ending December 31, 2019.

What type of investor is your strategy best suited for?

Mr. Fernandes: We believe our emerging wealth strategy is well suited for both institutional and individual investors. In addition to giving both types of investors an opportunity to diversify and capture emerging market returns, it gives them an opportunity to invest with best-in-class franchises capturing that growth.

Your strategy has the greatest concentration of holdings in China. What kind of opportunity are you seeing there?

Mr. Masi: The opportunity for consumption growth in China is extraordinary. You have 1.4 billion people. You have income that has grown annually in excess of 10% for the past 10 years. You have a declining savings rate and you have companies that are in multiple sectors that can supply products that are going to be in demand by their consumers. We think that the consumer in China will power growth for the next three decades. China is already the largest market in several categories, including automobiles, electric vehicles, digital payments and luxury goods, to name just a few. But China's growth in travel, education, healthcare and entertainment is still in the early stages of a multi-year growth trend.

To give you an idea of the magnitude of how dramatically things are changing in China, for example, last year there were 1600 marathons run in China. In 2010, there were only 13 marathons in China. This dramatic increase in the number of marathons in China alone is changing the demand for athletic gear. By the way, last year in the U.S. there were less than 700 marathons.

China's pace of growth has declined steadily, from double digits to mid-single digits, and now the country is locked in a trade war with the U.S. Is that a concern when looking for investment opportunity in China?

Mr. Fernandes: No, not at all. China is in the midst of transitioning from fast growth – which has been financed by debt – to lower growth fueled by domestic consumption. We see earnings growth driven by domestic consumption as higher quality growth. We also see current trade negotiations with the U.S. as a way to reset boundaries and rules between the two largest economies in the world. In the end, this will be mutually beneficial to both China and the United States.

India is another country you like. What kind of investment opportunity are you seeing under Prime Minister Modi?

Mr. Fernandes: In our opinion, India is in the early stages of achieving its growth potential due to the reforms that have been put in place in the last ten years. Modi's economic policies are a continuation of this reform policy, designed to transition India from a cash and informal economy to a more modern economy. We are finding interesting investments in important areas such as food away from home, banking and fintech, travel, entertainment, housing, autos and two-wheelers.

Are you seeing opportunity in Brazil, Russia and South Africa? When will it be time to invest in South Africa?

Mr. Masi: The challenge of commodity rich countries such as Brazil, South Africa and Russia is that they failed for the most part to embrace reforms during the good days of the commodity boom and are now faced with low growth and fiscal challenges. The downturn of the commodity cycle surprised these countries and it will take time for them to develop new industries and catch up economically. Additionally, the equity markets there offer relatively limited investment options outside the commodity space.

What about Latin America? Are you seeing opportunity there, or is there too much political turmoil?

Mr. Fernandes: Of all Latin American countries, Mexico has the best consumption trends. This is due, in part, to its proximity and successful integration with the U.S., and, in part, driven by a new administration focused on raising the incomes of its population. Peru and Chile have pockets of opportunity, but Brazil has farther to go, in terms of embracing reforms, while equity markets are already pricing in good news. Finally, countries like Venezuela and Argentina will likely take a very long time to recover from past policy mistakes.

Interest rates are in negative territory in many parts of the world. What would happen to your portfolio if interest rates in the U.S. approached those levels?

Mr. Masi: Contrary to what many people think, we do not believe interest rates are going down due to the risk of a recession. We believe low rates are a reflection of a low growth and a low inflation environment leading, in turn, to scarcer and scarcer investment opportunities. Emerging markets, in general, and emerging wealth, in particular, are the only areas globally offering earnings growth, and thus likely to outperform other asset classes in the medium to long-run.

What do you look for in a holding? What distinguishes your thought process from other emerging markets investors?

Mr. Masi: We are focused on companies with a long runway of earnings growth; companies that have a value added product or service. And finally, we look for companies with a gap between them and competitors. In other words, a sustainable competitive advantage. What really distinguishes us from other managers is that we are not distracted by a benchmark, macro factors or temporary trading opportunities.

Mr. Fernandes: In the end, our decision making is relatively bold and can be seen in the percentages we've allocated to our top 10 holdings.

Can you give an example of a stock that illustrates your investment approach?

Mr. Fernandes: AIA is an insurance company which has operated in China for the past 100 years. Insurance is underpenetrated in China and is a high priority for the government and consumers. AIA is best-in-class in terms of culture, agents, product offerings, capital structure, and investment policies. The runway for growth for AIA can be measured in decades.

Mr. Masi: Another example that comes to mind is Trip.com (formerly Ctrip), the Priceline of China. Trip.com incorporates many best-in-class practices while serving a population of 1.4 billion people. Chinese consumer incomes of US$10,000 today have a long runway for growth as travel is a high priority for them.

How do you manage the risks inherent in investing in emerging markets?

Mr. Fernandes: First, we aim to manage risk at the security level by forecasting a downside scenario for every investment. We ask, what can go wrong? We quantify the individual company risks as well as industry risks. We also focus on high quality companies benefiting from the growing middle class in emerging markets. We pay close attention to corporate governance and factor it into our price target and investment decision. Finally, we have a strong sell discipline that helps us properly manage through difficult market environments.

You take a bottom-up approach to stock selection, so you're focused on the fundamentals of a company. What role do macro events play in your thinking as stock pickers?

Mr. Masi: Peter Lynch, former Fidelity Investments portfolio manager said, "If you spend 13 minutes analyzing economic and macro forecasts, you have wasted 10 minutes." Generally speaking, this is a good quote to keep in mind when thinking about macro-economic and currency forecasts. It's the underlying business and valuation that matters.

So, macro plays almost no role in our stock selection process. To the extent that macro events cause individual companies to overreact, we will take advantage of that opportunity to buy stocks that are well positioned for the long run.

Investing in emerging markets will shift from picking countries and currencies which have not added value to investing in companies. This is the distinguishing feature of the Emerging Wealth Equity Strategy.

Mr. Fernandes: And, as we mentioned before, we aren't distracted by the benchmark or short-term opportunities. We really want to position our portfolio for long-term growth in the best franchises we can find.

Do you kick the tires of the companies you invest in?

Mr. Fernandes: We definitely kick the tires. We visit the countries where we have investments, but it's more than that. It's also having meaningful and frequent direct communication with the management of the companies we invest in. We also look at a company's competitors and speak with them to understand what they're doing. We have people who are in the local markets that we can tap into. And we'll also go and meet with actual customers to see how they view the products of the companies we invest in.

How has the strategy performed?

Mr. Masi: Our strategy began in March 2011. Since that time, we have outperformed the benchmark by 370 basis points each year on an annualized basis as of December 2019. For calendar year 2019, we have generated a return of 30%, outperforming the benchmark by over 1,000 basis points.

Can you point to anything over 2019 that particularly surprised you?

Mr. Fernandes: There are always surprises in a portfolio of roughly 50 stocks. Sometimes investments in companies work out much better and faster than we initially expect. Sometimes fundamentals disappoint us and we need to address those methodically. That has been our experience since we began running this strategy in March 2011. Over the years, the positive surprises have exceeded the negative surprises.

Mr. Masi: I think one of the biggest surprises over 2019 was the dramatic shift from tightening to easing – not only in the U.S., but around the world. The key question is if it's temporary or something sustainable. We think it's more likely that it's sustainable and asset prices around the world have not yet completely adjusted.

What do you see ahead for 2020? Do you think it will be a good year for your strategy, and more broadly, emerging markets? Is there anything that especially excites you?

Mr. Masi: We believe emerging market equities will begin a period of multiple expansion. In the same way there has been a "grab for yield" in the fixed income markets, we believe there will be a "grab for growth" globally in the equity markets. In this regard, emerging markets equities stand out. We don't think it will be long before investors begin to realize emerging markets are the most attractive area for future growth. And why not? Emerging market stocks are inexpensive, trading at 11.5x earnings. The sustainability of low interest rates and low inflation will play an important role in how stocks are valued globally in the years ahead. Emerging market investors, including ourselves, are in the early stages of understanding what this means for the valuation of companies with a long-term sustainable growth rate. We believe our strategy will stand out both in relative and absolute returns over the next two years.

Mr. Fernandes: We think a prolonged period of low global growth and low interest rates will lead to premium valuations for those companies benefiting from rising per capita income in emerging markets. Growth is scarce globally. We believe the only place for growth in the world is emerging markets.

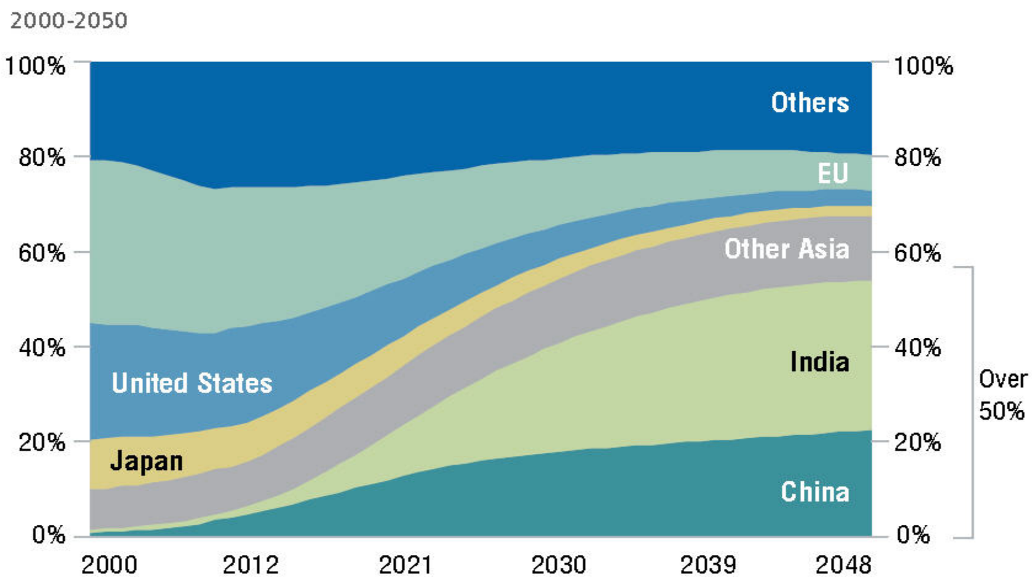
How do you work together as co-portfolio managers?

Mr. Masi: Nuno and I are very passionate about the Emerging Wealth concept. From the beginning, we believed this strategy represented what is one of the most compelling opportunities for higher returns in emerging markets. We each bring a passion for learning and a willingness to look at each investment opportunity from multiple perspectives. We ask "what if" questions frequently. Our research is meticulous. We not only challenge every opportunity, we challenge every holding. So, it will come as no surprise that we have lively debates about management teams, cultures around the world and what constitutes a good business. Our approach has served us well. Our decision making is based on informed convictions and the mutual regard that Nuno and I have for each other's analysis and opinions. We expect to continue to generate strong performance in the years ahead.

Do you both invest personally in your strategy?

Mr. Fernandes and Mr. Masi: Absolutely! We believe in our strategy and have been investors in it from the beginning.

EM MIDDLE CLASS CONSUMPTION TO EXCEED 50% OF WORLD CONSUMPTION BY 2050



Source: The Emerging Middle Class in Developing Countries, OECD 2017
Middle class is defined as households with annual per capita incomes between US$3,500 and US$35,000 in purchasing power parity terms. This range does not account for points at which a country's discretionary spending increases internally.

This is arguably the **most powerful secular investment trend** in the world. We seek to benefit from this trend by owning **best in class businesses**, anywhere in the world, that have **material exposure to the growth of the middle class in emerging markets.**

Disclosures