Polen Global Emerging Markets Growth

Portfolio Manager Commentary - June 2020

Summary

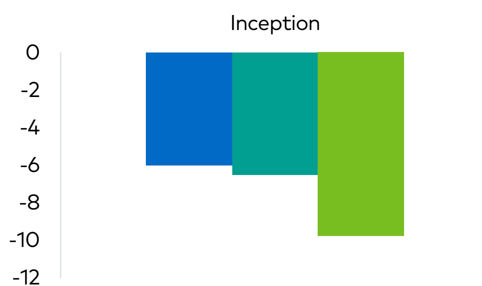
- Emerging markets equity indices roared back in the second quarter, erasing nearly all losses of the first quarter. Markets seem happy to look past the short term medical and economic headwinds the pandemic is posing, and instead focus on the recovery ahead.

- The Polen Global Emerging Markets Growth Composite Portfolio (the "Portfolio") performed in line with the market returning 17.78% gross of fees in the quarter versus the MSCI Emerging Markets Index (the "Index") return of 18.09%. Almost every holding recorded positive performance, reflecting the breadth and scale of the rally. For the year-to-date period, the Portfolio is down -6.01% gross of fees versus -9.77% for the Index.

- While confidence in the long-term outlook seems to have returned, we recognize that emerging markets face very real challenges in the coming months. That said, we believe rising emerging market populations entering the middle class should remain an enormous and attractive opportunity for businesses for years, if not decades.

- Regardless of how the coming quarters play out, our investment strategy remains unchanged. We seek to own approximately 30 of the highest-quality businesses in emerging markets and believe that, over time, they can outpace their competitors and command above-average share of rapidly growing industry profit pools.

Seeks Growth & Capital Preservation (Performance (%) as of 6-30-2020)



	Qtr	YTD	Inception
Polen Global Emerging Markets Growth (Gross)	17.78	-6.01	-6.01
Polen Global Emerging Markets Growth (Net)	17.50	-6.50	-6.50
MSCI Emerging Markets	18.09	-9.77	-9.77

The performance data quoted represents past performance and does not guarantee future results. Current performance may be lower or higher. Periods over one-year are annualized.

The commentary is not intended as a guarantee of profitable outcomes. Any forward-looking statements are based on certain expectations and assumptions that are susceptible to changes in circumstances.

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Commentary: Crisis? What Crisis?

Emerging markets equity indices roared back in the second quarter, with the MSCI Emerging Market Index (the "Index") rising 18.09%, erasing almost all of the first quarter's losses. The Polen Global Emerging Markets Growth Composite Portfolio (the "Portfolio") performed in line with the market, returning 17.78% gross of fees for the quarter. Almost every holding recorded positive performance, reflecting the breadth and scale of the rally. For the year-to-date period, the Portfolio is down -6.01% gross of fees versus -9.77% for the Index. As far as 2020 is concerned, we are almost back to where we started.

Markets seem happy to look past the short term medical and economic headwinds the pandemic is posing, and instead focus on the recovery ahead. Though we find this apparent bout of market long-termism rather unusual, we feel that the long-term fundamentals of the emerging market asset class remain incredibly favourable. Over the next decade, hundreds—perhaps billions—of consumers are expected to escape poverty and join the consuming classes.

We believe the opportunity for businesses that can provide consumer-relevant products and services in emerging markets is enormous and should persist for years, if not decades.

Yet, confidence in the long-term outlook should not blind us to the very real challenges that the pandemic will pose to emerging market countries in 2020. Lockdowns at home and abroad look set to impose material headwinds. Those economies that rely on exports, whether it be commodities, finished goods, or tourism, will likely see a significant deterioration of their balance of payments. Whilst weakening currencies may alleviate some of this effect, a weaker currency also increases the burden of foreign-denominated debt. Over the last decade, there has been a proliferation of foreign currency debt in certain economies.

Meanwhile, domestic lockdowns have ground economic activity to a halt. Most emerging market economies lack the means or the credibility to spend or print their way out of trouble, and some level of bankruptcies and financial fallout is inevitable. For better or for worse, the can cannot be kicked down the road.

The IMF forecasts that emerging market GDP will contract by -3.0% in 2020. That compares to 2008/9 when GDP continued to rise by nearly 3.0% through the crisis. Indeed, we think it is likely that 2020 will mark the first year of economic contraction since the term was widely adopted.

The fallout, sadly, will likely be felt most keenly at the bottom of the pyramid. It is the less specialized vehicle drivers, factory workers, and roadside shopkeepers who have had their economic activity most curtailed. This fact can be seen most forcefully by April unemployment estimates in India, which forecast that 120 million people had lost their jobs that month. With figures of that scale, it is sobering to reflect just how many livelihoods are being affected.

Thankfully, it seems, the recovery is underway, with lockdowns easing across most of our investable universe. Yet, uncertainty concerning the pace and strength of the recovery pervades. It is likely that it will take many months for the economic adjustments to work their way through the system, and we expect that understanding just how emerging markets have navigated these troubled waters may not be clear until mid-next year.

Seeking to Invest in the Best

Regardless of how the coming quarters play out, our investment strategy remains unchanged. We own, in our opinion, a collection of 30 of the highest-quality businesses in emerging markets with the following characteristics: deep competitive moats, highly cash generative business models, solid balance sheets, and great management teams. We believe that, over time, they will outcompete their competitors and earn their right to an above-average share of rapidly growing industry profit pools. It stands to reason that, during these stressed market conditions, the process of the strong getting stronger should only be accelerated. Often, a crisis can be a period of opportunity for a great company.

The macro environment has been and will likely remain challenging for some time. As companies report their second quarter numbers, we will get further indication of just how tough things have been. Even so, we have been pleasantly surprised by some of the initial guidance we have received from some of our holdings.

Latin American e-commerce retailer **Mercado Libre**, reported USD revenue growth of 38% in the first quarter, an impressive performance given the near 20% currency depreciation headwinds it faced. During the month of April, the height of the crisis, online sales growth actually accelerated. In India, sales for biscuit manufacturer **Britannia** increased 24% during the April/May period. One might assume an element of consumer hoarding in these sales numbers; nonetheless, it is an achievement for the company to be able to meet this increased demand given the operational challenges faced during the very strict national lockdown. During the quarter, Vietnamese electronics retailer **Mobile World** was able to record 11% year-on-year revenue growth for the year-to-date period ending in May, despite multiple weeks of store closures. While the company was a detractor in the Portfolio, these business results are encouraging.

As we hear more from our companies over the coming weeks and months, we are confident that we will continue to be impressed by how they are performing during these times, turning short-term dislocations into an opportunity to further enhance their competitive advantages.

Portfolio Activity

We made one new addition to the Portfolio during the quarter, Russian internet search engine **Yandex**. Those familiar with the business model of Alphabet will recognise many similarities between the companies. Like Alphabet, Yandex has a dominant and highly attractive core search operation, which has sustained many years of solid top-line growth and generated healthy cash flows. These cash flows have been used to further enhance Yandex's algorithmic leadership and build out an AI-focused ecosystem. In addition to search, it runs a third-party digital advertising service, maps, smart speaker, cloud, music, and even taxi services and self-driving cars. Yandex is increasingly relevant across several aspects of Russians' daily lives. We believe we will see many more years of healthy double-digit earnings growth for the business.

We have spent significant time analysing the strength of Yandex's competitive moat. When it comes to well-capitalised and highly competitive challengers, Alphabet could be considered the most formidable. But to our knowledge, Yandex is the only company worldwide to have outcompeted Google in a fair battle. Despite all of Google's synergistic advantages and near global monopoly, including importantly Chrome and Android, Alphabet has been unable to dislodge Yandex as Russia's undisputed leader in search.

To accommodate Yandex, we trimmed two of our Indian holdings, **HDFC Bank** and **Bajaj Auto**. Both companies are wonderful businesses, in our opinion, but both are likely to face material headwinds in the coming months. HDFC Bank is a leading bank in India with one of the strongest balance sheets in the sector, but we think completely avoiding the systemic financial sector fallout is unlikely. Bajaj Auto, which is one of India's leading two- and three-wheel vehicle producers, likely will struggle to recover sales in an environment where credit availability is scarce and consumer demand is soft. Furthermore, it has material exposure to Nigeria, which sadly, in our view, is becoming un-investable.

We liquidated our position in Indonesia's largest and dominant home improvement retailer, **Ace Hardware**. Like it is in most geographies in the world, the home improvement category can be an attractive investment. Ace has delivered attractive results over recent years, compounding earnings and total shareholder returns by 22% and 26% over the last decade. The company has benefitted from a lack of domestic competition, which has enabled it to enjoy rich margins in excess of 13% net. These are high returns for any bricks-and-mortar retailer, but particularly for a retailer that does indeed sell bricks and mortar.

As always, excessive returns attract competition. So far, thanks to its sizeable scale benefits and logistical advantages, Ace has managed to remain dominant in physical retail. However, we believe e-commerce will likely become a competitive headwind, as one of the outcomes of the pandemic could be a dramatic acceleration in the adoption of online retailing in Indonesia. Unlike other hardware retailers, Ace is more vulnerable to online retail competition, as roughly 50% of its sales come from smaller household appliances. These types of products are typically the bread and butter of an e-commerce player.

Furthermore, most of Ace's stores are smaller-format locations based in shopping malls. We expect footfall in these outlets to be under significant pressure in the short term. Even after the coronavirus crisis fades into the distance, we believe it is unlikely that a mall-focused store footprint will be an optimal structure for a DIY retailer to compete with online retailers. Ace will likely have to adapt to a larger format, more DIY offering. We think Ace has a good chance to emerge as the leader in the e-commerce DIY space. But we expect it will be a tricky journey, and Ace will likely have to adapt much faster than we or the company imagined.

In short, we feel that the investment case in Ace Hardware has been compromised by the pandemic as 1) the long-term risk e-commerce poses to its household appliance retail segment has been meaningfully accentuated, and 2) in the more immediate term, same-store sales numbers in the next two years are likely to be under severe pressure. If we are right, in the short, medium and long terms, operational deleveraging will likely mean that the bottom-line impact of lost sales will be severe.

Team Update

During the quarter, Pamela Macedo joined the Emerging Markets Growth Team as a Research Analyst. Pamela is a native Portuguese speaker and, in her spare time, enjoys horse riding and reading investment books.

In June, we officially opened our London office in Austin Friars. We are all looking forward to welcoming visitors once things have returned to normal. May that be sooner rather than later.

Thank you for your interest in the Polen Global Emerging Markets Growth strategy. Please do not hesitate to contact us with any questions.

Best,
Damian Bird

Experience in High Quality Growth Investing

Damian Bird, CFA
Head of Team, Portfolio Manager & Analyst
11 years of experience

Historical Performance

	Polen (Gross) (%)	Polen (Net) (%)	MSCI Emerging Markets Index (%)
3 Months	17.78	17.50	18.09
YTD	-6.01	-6.50	-9.77
Since Inception (01-01-2020)	-6.01	-6.50	-9.77

Returns are trailing through 6-30-2020. Annualized returns are presented for periods greater than one-year.
Source: Archer.

Past performance is not indicative of future results. Returns are presented gross and net of management fees and include the reinvestment of all income.

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The MSCI Emerging Markets Index captures large- and mid-cap representation across 26 emerging markets countries. The MSCI Emerging Markets Index is maintained by Morgan Stanley Capital International. It is impossible to invest directly in an index. The performance of an index does not reflect any transaction costs, management fees, or taxes.