4th February 2019

GuardCap Emerging Markets Equity Fund

To our investors:

The team at GuardCap has been managing emerging markets equities in a variety of investment vehicles for a number of years. 2018 was the second full calendar year for the UCITS version of our emerging markets equity strategy. Like last year, we are writing to our unitholders and publishing this letter on our website for others who are interested.

2018 in brief

2018 was a reminder that what we are trying to achieve is not easy. We aspire to be long-term investors in a small number of high quality emerging market-focused companies and we found our resolve tested on more occasions than we might have liked during the year. This is the challenge that comes with a concentrated, long-term investment approach in the region. It is also what makes it worthwhile. If it were easy, then everyone would be doing it.

2017 had been the best year in terms of total returns since 2009. The start of the new year saw a headlong rush into the asset class, with the first 20 trading days of 2018 delivering a return of 9.9%, representing an annualised return of more than 200%. This marked the high point. By the end of 2018, the MSCI Emerging Markets Index had fallen by almost 15% from its starting value and by more than 22% from its peak.

Industry-standard measures of volatility, such as the VIX Index, had low readings in 2017 and high readings in 2018. The reality, as we see it, is that stocks were volatile when they were going up in 2017 and volatile when they were going down in 2018. Volatility is ever-present in equity markets, especially so in emerging markets.

Volatility exists because equity market participants are trying to value companies using incomplete information and they have an opportunity to strike multiple valuations on every single trading day. The information deficit in emerging markets is greater because the factors that determine the value of a company are less predictable and exhibit higher variability. Forecasting is inherently more difficult. Things that you might take for granted in developed markets – rule of law, political stability, a steady currency, free movement of capital – cannot always be relied upon. At a company level, additional complications often arise. Matters such as shareholder rights, management incentives, the quality and accuracy of company reports, tend to be more problematic - in aggregate – in emerging market economies than in developed market economies. Businesses are typically less diversified, so if one particular factor goes in their favour or against them, then a company's fortunes can rapidly change and the share price follows.

Consider the extreme example of Argentinian equities. In 2017, there was widespread optimism about the economic reforms in Argentina under President Macri and his government made headlines when it raised almost $3bn in 100-year debt. The market rallied by more than 150% in US dollar terms from the January 2016 trough to the January 2018 peak and MSCI subsequently announced that it would promote Argentina from frontier market to emerging market status. However, optimism has quickly turned to pessimism. The Argentine peso fell by more than a third against the US dollar during the first 6 months of 2018 and the IMF stepped in to fund a bail-out. The main equity index declined by 60% in US dollar terms from its January peak to the end of 2018. Two steps forward, two steps back.

Our approach to these challenges

Given these challenges, why bother with emerging markets at all? It ultimately comes down to growth. We expect emerging market economies to grow faster than developed market economies for the foreseeable future. The region is at an earlier stage of its economic development and has greater scope for economic growth primarily because it is starting from a lower base than the developed world. Despite its shortcomings, the region has – for the most part - the right socio-political, economic and demographic profile to be able to close the gap. It follows that we expect emerging markets companies to offer some of the best opportunities for capital and income growth.

We recognise that we have very little ability to forecast short-term changes in economic cycles, currencies or politics. As an investor in the region, you cannot avoid these risks altogether but you can mitigate them. We look for companies with diversified sources of revenue. We prefer companies with exposure to secular growth trends and less exposure to business cycles. We avoid excessive financial leverage. We value good management and good corporate governance standards.

As a consequence we are selective. Our portfolio holds a small number of companies that we think are capable of sustaining profitable growth over a number of years and are available to purchase at an attractive valuation. It ended the year with investments in 26 different companies.

The index is flawed

The emerging markets index is very different to our portfolio, with 1125 companies represented in MSCI's version as of the end of 2018.

The returns from the index have been disappointing over a number of years, especially when compared to the index returns of slower growing, developed markets. Over a 10-year period, the average annual real GDP growth rate has been 5.1% for emerging markets compared to 1.3% for developed markets[1]. The table below compares the compound annual growth rate of the emerging markets index compared to the developed world index over the last 5 and 10 years[2]. The outcome for emerging market equities has been lower shareholder returns despite superior economic growth.

	MSCI Emerging Markets Index	**MSCI World Index**
5 years	1.7%	4.6%
10 years	8.0%	9.7%

An index is, of course, only as good as the companies it contains. Few emerging market companies have turned the economic advantages of the region into sustained growth in shareholder value.

2018 was notable for being the year that China A-shares were first included in the MSCI Emerging Markets Index. China A-shares is a catch-all term for equities listed on Chinese exchanges such as Shanghai and Shenzhen. Foreign investors' access to these shares was historically limited to asset managers who had been granted a licence and given a quota to buy shares under the Qualified Foreign Institutional Investor System (QFII). Getting authorised was a challenge and there were various restrictions on capital mobility once you had a quota. In recent years, QFII has been superseded by Stock Connect, which allows foreign investors to access certain A-shares via the Hong Kong Stock Exchange subject to a daily limit but with significantly fewer restrictions on capital mobility.

It was the introduction of Connect that prompted MSCI to begin partially including China A-share equities in its Index, weighting them at 5% of their free-float adjusted market capitalisation, which itself

[1] IMF, Emerging and Developing Countries / Advanced Economies, Annual Real GDP Growth (%), 2008-2017
[2] MSCI, total shareholder returns in US dollars, dividends reinvested net of withholding taxes, to 31/12/18

is adjusted for foreign ownership restrictions. The result of this complex contrivance was that A-shares accounted for less than 1% of the MSCI Emerging Markets Index by the end of 2018. This doesn't seem like a lot but it has added approximately 230 new companies to the index, a 25% increase. MSCI has proposed increasing the weighting factor to 20% during 2019, which will quadruple the A-share representation. At the same time, it is consulting on widening the net to a larger number of locally listed Chinese shares, including mid-caps and the mostly hi-tech companies listed on the ChiNext board of the Shenzhen Stock exchange. You can see where this is leading. A 100% weighting of the 230 or so A-shares currently included in MSCI's Index would immediately raise the A-share proportion to well above 10%. This is before we even start thinking about the thousands of other Chinese equities listed on domestic exchanges.

We find that there are some good A-share companies and potentially some attractive investment opportunities. However, an obstacle many will encounter is that most A-share companies do not file English language accounts, meaning that the vast majority of investors whose funds track the relevant index would struggle to understand what these companies do, should they ever wish to. This begs the question as to whether the reported data from A-share companies is of sufficient quality. Moreover, does the inclusion of all these companies improve the index? For us, the addition of a significant number of companies to an already highly diversified index reinforces our view that a selective, focused approach is the best way to capture the region's potential.

Performance

For the twelve months to 31 December 2018 the GuardCap Emerging Markets (UCITS) Fund USD I Share Class returned -20.8%. This compares to a return of -14.6% for the MSCI Emerging Markets Index. Since inception, the USD I Share Class of the Fund has produced a return of +13.8% compared to an index return of +19.1%.

As we wrote last year, the returns from the Fund will inevitably follow a different pattern from those of the Index, which now contains more than forty times the number of equities in the Fund. The Fund's returns will not necessarily be more volatile than the returns from the Index, given the underlying quality of the businesses that it owns. But returns will certainly diverge from year to year - as they have done in 2018 - depending on the annual progress of earnings at our companies and whatever happens to be in fashion (or out of fashion) at any point in time. In 2017, the fund finished ahead of the benchmark. In 2018, it finished behind. Whether the fund is ahead or behind of the benchmark, we will make mistakes along the way. Over the course of many years, however, we expect the earnings of our companies - in aggregate - to march higher, comfortably outgrowing the average and affording better investment returns than the Index.

Not all of our investments are listed on emerging market exchanges but we look for companies that enjoy above-average growth because they sell into emerging markets or have a competitive advantage because they are located in emerging markets. Of the Fund's NAV at the end of the year, approximately 66% was invested in companies that are represented in the MSCI Emerging Markets Index, 32% was in companies that are not represented in the index and 2% was in cash. Considering the portion that is invested in non-index companies, approximately 5% of the NAV was invested in companies that are potentially eligible for inclusion but are not currently part of the index for whatever reason. This was the case for our holdings in Indonesia's Matahari Department Store and Mexico's Becle. In addition, MSCI continue to categorise MercadoLibre - Latin America's largest e-commerce company and a 5% position in the Fund - as a developed market company.

One happy consequence of the ever-present volatility in emerging markets is that you get more buying opportunities. During the course of the year, we have taken the opportunity given to us by lower prices to improve the growth and quality profile of the portfolio at attractive valuations, as we see it.

Examples of the Fund's investments

Like last year, we thought that we would provide more detail on the Fund's investments. This time we revisit Frutarom and focus on Samsonite, which has an interesting history and had an eventful 2018.

Frutarom / IFF

We said a fond farewell to our shareholding in Frutarom in the latter part of 2018. Frutarom had been the largest position in the team's portfolios for a number of years and we wrote about it in some detail in the last letter. One of the emerging market funds managed by GuardCap that began in 2003 ('Aurora') was invested in Frutarom for more than a decade. During 2018, the company agreed to be acquired by its larger US-based competitor International Flavors & Fragrances (IFF). Over the previous decade, Frutarom's revenues and earnings per share grew at a compound annual rate of 14% and 19% respectively and its shares appreciated more than ten-fold. It has been an excellent example of the benefit of long-term, compound earnings growth and we are sorry to see it go, albeit at a decent valuation.

We received roughly two-thirds cash and one-third IFF stock for our Frutarom shares. We reinvested some of the cash in IFF but it is a smaller position than we owned in Frutarom. Following the deal, we estimate that IFF will have around half of its sales in emerging markets, meeting the fund's criteria for inclusion in the portfolio. Moreover, the two companies are remarkably complementary, which should produce the desirable combination of increased sales opportunities and improved profitability.

Samsonite International

Samsonite is listed in Hong Kong and sells its products all over the world. It is one of the most diversified companies in our portfolio in terms of the number of countries that it sells into. Like most companies with a global reach, the biggest market for its product is the US and its fastest growing markets are in Asia and Latin America. It meets our criteria for inclusion because the vast majority of its production takes place in developing countries, primarily China and Hungary. It is similar in this way to Samsung Electronics, also a portfolio company, which manufactures in emerging market countries and sells its product into developed and developing countries. For both companies, a major part of their competitive advantage depends on the location of their production in lower cost emerging countries. We first bought Samsonite's shares for our emerging markets strategy in 2016.

Samsonite traces its origins to the Shwayder Trunk Manufacturing Company founded in Denver, Colorado in 1910 by bag salesman Jesse Shwayder. One of the company's first products was called 'Samson' after the Biblical character with superhuman strength. The Samsonite brand was introduced in 1941.

After diversifying into furniture and briefly acquiring the exclusive rights to distribute LEGO in the US, the founding family sold out in the 1970s to conglomerate Beatrice Foods. In the following decades, ownership passed from conglomerate to private equity to public markets and back to private equity. The company was saddled with debts, underwent bankruptcy proceedings and had to be recapitalised on more than one occasion. Despite these hindrances, Samsonite established and maintained its position as the world's most popular luggage brand. The most recent restructuring occurred in 2009 when debts of more than $1.5bn were written down. Tim Parker was appointed as CEO and in 2011, the rehabilitated company listed on the Hong Kong Stock Exchange with more than $1bn in sales and net cash on its balance sheet.

It is only really since 2010 that the company has had an appropriate financial structure, enabling it to capitalise on the growth opportunities available to it. Global travel is a secular growth industry and the global luggage market is fragmented. Samsonite is the market leader yet its share is still relatively small, estimated to be around 20%. It has been gaining share in recent years, growing its mid-market Samsonite brand and value-focused American Tourister brand at above-industry rates. In 2016, it acquired the higher-end Tumi brand, which had built a profitable luggage business in the US. It is developing TUMI's product range and expanding its distribution, with Asia a major focus. These three brands have more than $3bn in sales.

Samsonite faces challenges as well. Its channels of distribution are changing as retail stores lose share to e-commerce. New luggage brands, operating mostly online, are emerging. Expansion into product categories such as rucksacks and handbags have been less obviously successful. US tariffs on products manufactured in China impose a new cost of doing business. These, however, were secondary concerns for the stock market in 2018. The main reason for the stock falling by more than a third during the year was a report released in May, by short seller Blue Orca, which made a number of very serious allegations about the company's audited financial results.

The smoking gun that Blue Orca had identified was that Samsonite's CEO since 2014 had historically embellished his educational credentials, referring to himself as Dr Ramesh Tainwala on occasion, although he had never attained a doctorate degree. Tainwala was replaced and the board published a comprehensive response to Blue Orca's other allegations, adequately addressing the issues raised.

We find that the modus operandi of high profile short sellers is to throw as much mud as possible in the hope that some will stick. No matter that most of the allegations in Blue Orca's 48-page report were unfounded. The disclaimer is long and full of caveats. Short sellers such as these have become more active in the Hong Kong market in recent times, often operating from the US where they sit at a safe distance from the local market regulator. They target liquid equities where they can trade in and out of short positions with relative ease. They claim that the shorted stock is worth zero or a fraction of its current valuation but often settle for a much smaller turn before closing their position. We think their approach is highly questionable and raises the risk of losses for other participants, especially retail investors.

At the end of 2018, Samsonite's shares were trading close to HK$20, similar to the low levels that it touched in 2014 and 2016. On our forecasts, the valuation of the company is at its lowest level for more than 5 years. Although its debt load is higher following the Tumi acquisition, we do not think that it is excessive. We consider Samsonite to be a better business today than it was before the acquisition and we see the potential for materially higher earnings over the coming years. We added to our shareholding during 2018 and it accounted for 5% of portfolio value at year-end.

A small number of investments benefiting from the emerging markets opportunity

The experience of running this Fund for the last two years has reminded us of what we already knew, that genuinely active investing is difficult. Managing a concentrated portfolio means taking a very different approach from more diversified portfolios and broad market indices. As the example of Samsonite shows, we often face large share price movements in positions that account for a significant percentage of our portfolio. These price fluctuations can make us look like geniuses at times and idiots at other times. We are neither.

We believe that investing for the long-term in a small number of excellent businesses is a sensible approach to the emerging markets opportunity. Buying the shares of these companies when they are out of favour is usually the right thing to do. We hope that time will prove us right.

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