19th March 2018

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. 2017 was the first full calendar year for the UCITS version of our emerging markets equity strategy.

To mark the first anniversary, we are writing to our unitholders and publishing this letter on our website for others who are interested. As this is the first year of reporting, we have dedicated part of our commentary to explaining why we have started this fund and why we manage it in the way that we do.

Why an emerging markets fund?

By choosing to focus all of our efforts on investing in publicly-listed emerging market companies, we have attached our investing credentials and our future careers to a fairly specific part of the global investment opportunity set.

Why have we done this? Why limit ourselves, when we have the whole world to choose from?

The underlying reason is that 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. For the most part, the region has 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 over the next 25-30 years which, all being well, should see us through until retirement.

As we survey the investment opportunities available to us, we can identify certain companies operating in the region that appear to be very well positioned to deliver profitable growth over an extended period of time. Some of these companies are already global in their scope. Others have the opportunity to become national and regional market leaders and potentially the multi-national companies of tomorrow, especially as the region grows in economic importance. We think that by identifying and investing in these companies - many of which are at a relatively early stage of their development - and by holding their shares for a long time, we can benefit from the compounding of their growth over many years.

We believe that investing in these companies is something that is worth doing and this is why we have chosen to dedicate our investment research efforts, our own savings and hopefully the rest of our careers to pursuing these opportunities.

A selective approach to emerging markets

We think that it makes sense to be selective. This is for a number of reasons, many of which relate to the quality - in aggregate - of publicly-listed emerging market companies. Historically, state-owned companies have suffered from questionable capital allocation, minority shareholders have frequently suffered from poor corporate governance and resource-based industries - often prevalent in developing economies - have been characterised by deep cyclicality. Few emerging market companies have succeeded in turning the economic advantages of the region into sustained earnings growth.

Our starting point is those companies that enjoy above-average growth because they sell into emerging markets or have a cost advantage because they are located in emerging markets. We use the MSCI Emerging Markets Index as a benchmark but not all the equities that we invest in are included in the index. What is important to us is that they stand to benefit from the growth of emerging market economies and have the quality to provide certain protections to shareholders.

We look for the same things in emerging market-focused companies that we would were we investing anywhere else in the world. In short, we are seeking to identify businesses with excellent economics and the likelihood of materially higher earnings in five to ten years' time. We believe that as long as we do not overpay for these investments, the quality of the companies will help to provide a measure of capital protection while growth in profits and free cash flow will determine long-term returns. We find that undervaluation can occur because other market participants tend not to look out over such a long-term horizon, especially so in emerging markets. We aspire to be long-term investors in our companies because we think that better investment results follow when superior returns and growth compound year-in, year-out.

The fund is concentrated because there are relatively few equities that meet all of our criteria for growth, quality and valuation. And having fewer stocks suits us because we believe in investing with conviction in a portfolio of companies that we are capable of understanding and monitoring.

It is a portfolio that we, the managers, wanted to own and we could not find its equivalent. We hope that others will choose to invest with us.

Performance

For the twelve months to 31 December 2017 the GuardCap Emerging Markets (UCITS) Fund USD I Share Class returned +42.6%. This compares to a return of +37.3% for the MSCI Emerging Markets Index. Since inception, the USD I Share Class of the Fund has produced a return of +43.6% compared to an index return of +39.4%.

The returns from the Fund will inevitably follow a different pattern from those of the Index, which contains more than thirty 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 2017 - depending on the annual progress of earnings at our companies and whatever happens to be in vogue at any point in time. In 2017, the fund finished ahead of the benchmark. This will not be the case in every calendar year. Over the course of many years, however, we expect the earnings of our companies to march higher, comfortably outgrowing the average and affording better investment returns than the Index.

2017 was notable for being the best year for the benchmark since 2009. Of the Fund's NAV at the end of the year, approximately 61% was invested in companies that are represented in the MSCI Emerging Markets Index, 37% 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 10% 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 Dali Foods, Megacable and Becle. Somewhat surprisingly, the index compilers at MSCI have decided that MercadoLibre - Latin America's largest e-commerce company and a ~5% position in the Fund - is ineligible for inclusion in the MSCI Emerging Markets index and have instead categorised it as a developed market company.

At the end of 2017, the Fund owned 28 equities compared to 846 in the MSCI Emerging Markets Index. We cast our net wide to identify those companies that have exposure to the emerging markets opportunity but we focus our portfolio on a small number of equities that offer a combination of growth and quality and are available to purchase at an attractive valuation. It is our view that, over the long-term, considered investment in a small number of companies will generate superior returns when compared to investing in a highly diversified index that includes many companies with poor economics and excludes a number of attractive investment opportunities in the region.

Examples of the Fund's investments

We thought that we would take this opportunity to share more details of some of the companies that the Fund invests in. We highlight three in the following section, all of which have featured in the ten largest holdings at some point during the year. We hope that anyone who invests with us will consider themselves – like we do – as part owners of these businesses.

Frutarom

Frutarom is the Fund's largest position. While our UCITS Fund started in December 2016, another of the emerging market funds managed by GuardCap began in 2003 ('Aurora') and has been invested in Frutarom for more than a decade. The investment makes for an interesting case study.

Frutarom is an Israeli-headquartered and listed flavours company. It started out in the 1930s, selling citrus products to local beverage manufacturers. Today it sells a huge range of products to more than 30,000 customers in 150+ countries and has revenues in excess of $1bn. Its market capitalisation exceeded US$5bn for the first time in 2017.

When the Aurora Fund first purchased shares in Frutarom, MSCI classified Israel as an emerging market country. In 2010, this changed when Israel was promoted from emerging to developed market status. FTSE had made a similar reclassification 2 years earlier. Evidently, the reclassification by the index compilers did not alter the underlying economics of Frutarom's business and it did not affect Aurora's willingness to invest in the company. If anything, we think that investor interest in Israeli companies declined as a result of these changes. Israel went from being a small percentage of the emerging markets index to being a tiny percentage of developed market indices. Emerging market investors who continued to own Israeli companies were seen to be venturing 'off-benchmark' while developed market investors had little reason to fear underperformance from a zero weighting in Israel.

Under the leadership of Chief Executive Ori Yehudai, who has been with the company since 1986 and CEO since 1996, Frutarom has delivered consistent growth in revenues, profits and cash flow. This has been through a combination of organic growth and acquisitions. Frutarom has specialised in providing ingredients and flavours to small-to-mid sized customers, who have different requirements from the large consumer products companies. SME customers typically require bespoke product in relatively small volumes and with short lead times. To meet these requirements, Frutarom has invested in R&D and client service at a local level. This is somewhat different to the approach of the larger flavours companies, serving multinational food and beverage companies that require large volumes of standardised product at regular intervals. The craft brands and private label customers that make up the majority of Frutarom's customer base are generally growing faster than the global consumer brands.

Frutarom has also had a strategic focus on natural products, recognising that consumer preferences for natural ingredients, natural colours and natural preservatives would continue to grow in popularity. Approximately 75% of Frutarom's revenues today come from natural products and these are growing faster than the industry average.

Another important part of the company's strategy has been to make acquisitions, which are typically small in size and 'bolt-on' in nature rather than transformational. Since 2011, the company has completed more than 40 partial or full acquisitions, usually with the purpose of expanding its market share, its manufacturing capacity and its product range or access to technology. Management are skilled at negotiating deals and integrating the acquired companies. A typical acquisition will bring opportunities for operational savings as well as the cross-sale of Frutarom's extensive product catalogue to its newly acquired customers. Partly as a result of cost savings and partly as a result of scale benefits, Frutarom has been gradually increasing its profitability as its revenues have grown. Valuation discipline has also been a consistent feature of its many deals and financial leverage is reasonable. In late 2017 the company agreed the acquisition of fellow Israeli company Enzymotec, its largest to date in terms of cash outlay. With completion finalised in early 2018, this acquisition is designed to broaden the product range that Frutarom offers to its customers and is expected to provide opportunities for cost savings.

The capital requirements of the flavours business are quite low, such that if the company should run out of acquisition opportunities, the potential to return cash to shareholders would be significant. However, we think that the opportunities for profitable growth – both organic and acquired - remain strong and we are pleased to see Frutarom continue with the strategy that it has been successfully pursuing for many years. The results have been excellent. Over the last decade, revenues and earnings per share have grown at a compound annual rate of 14% and 19% respectively and shareholders have been rewarded with a ten-fold increase in Frutarom's share price (in US dollar terms).

MercadoLibre

Another quirk of index composition means that Latin America's largest e-commerce retailer does not appear in the MSCI Emerging Markets Index.

MercadoLibre was founded in 1999 by Argentinian Marcos Galperin. The company is headquartered in Buenos Aires, incorporated in Delaware and has been listed on the Nasdaq since 2007. It operates across Latin America, with Brazil representing its biggest market by revenues and profits. At the end of 2017, it had a market capitalisation close to US$15bn. In 2015, MSCI decided to include certain Chinese companies with US listings - such as Alibaba and Baidu - in the MSCI Emerging Markets Index. It has not yet extended this privilege to MercadoLibre. MSCI is, however, currently reviewing whether to promote Argentina from frontier market status to emerging market status and Galperin has stated that the company is considering an Argentine listing, so it may yet find its way into the MSCI Emerging Markets Index.

Despite MercadoLibre's absence from the index it is for all intents and purposes, an emerging markets business and we believe that it has outstanding prospects for sustainable growth. The company has established itself as the leading e-commerce platform in Latin America and is taking a number of steps to consolidate this position. Alongside its marketplace for buyers and sellers ('MercadoLibre'), it is developing a range of payment and financing options for buyers and sellers ('MercadoPago' and 'MercadoCredito') as well as a logistics system that can offer expedited and free shipping ('MercadoEnvios'). Its business is growing fast both 'on-platform' (i.e. on the MercadoLibre marketplace) and 'off-platform' (e.g. merchants that use MercadoPago to process payments on their own websites or in-store). E-commerce as a percentage of retail sales is estimated to be less than 3% in Brazil and Mexico, compared with close to 10% in the US and above 20% in China.

In the last 12 months, the company has made a significant strategic move by introducing free shipping in most of the countries where it operates including Brazil and Mexico. This has led to rapid volume growth in its marketplace business, albeit with a cost in terms of profitability. CFO Pedro Arnt has spoken of management's desire to provide the best possible customer experience ("we think of our consumers, we build back from them, and we see how we can innovate on their behalf") while seeking to learn lessons from the experiences of peer companies ("we benchmark and we learn from others where applicable"). An essential reason for offering an enhanced marketplace – using payments, credit and fulfilment to improve the customer and merchant experience – is to seek to avoid the market share losses that other third party e-commerce platforms operating in other markets have suffered to first party e-commerce models.

The introduction of free delivery has reduced the company's return on invested capital in the medium term but we expect that profitability will improve as the fulfilment business gains scale. Moreover, the combination of product, payments, credit and shipping is helping MercadoLibre to establish a significant economic moat, which should support profitable growth for an extended period, especially in light of the relatively low penetration of e-commerce in Latin America.

Yum China

Like MercadoLibre, Yum China is incorporated in Delaware and listed in the US (albeit on the NYSE rather than Nasdaq). It is, however, included in the MSCI Emerging Markets Index because MSCI permits the inclusion of Chinese companies with foreign-listed shares. We certainly consider Yum China to be an emerging markets business, given that all of its revenues come from Greater China.

Yum China was separated from its parent company Yum! Brands in November 2016. Our emerging markets strategy owned Yum! Brands in anticipation of the separation and Yum China was a top 10 position for the UCITS fund at its inception in December 2016.

KFC was the first Western fast food chain to go to China, opening its first restaurant in Tiananmen Square in 1987. Today, KFC is the clear market leader with more than 5000 restaurants in 1100 cities across China. There are many reasons why it has thrived where other restaurants chains have not. At its simplest, chicken is suited to local tastes and the offering is tailored to the local market, with local management and a nationwide supply chain. Yum China has also had significant success in operating the franchise for Pizza Hut, which has more than 2000 restaurants in the country.

Having been an engine of growth for the parent company for more than a decade, the Chinese business became something of a problem child in recent years when growth in sales and profit fell short, mainly because of food safety concerns. Under pressure from activist shareholders Yum! Brands agreed to spin the China business out to shareholders, agreeing that Yum China pay a relatively modest 3% of revenues as a franchise fee to its erstwhile parent under the new arrangements. As dedicated emerging market investors, we were delighted to have the opportunity to own a share of this business, which has excellent economics and which we think has the potential to be a significantly bigger business over time. It also came out of the parent company with a pristine balance sheet and at a valuation that we considered to be very attractive.

Yum China has made good progress in its first year as an independent company. Sales at its KFC stores have been gradually improving following a period of significant decline from 2012-15. The company has seen an upturn in fortunes thanks to a recovery from food safety concerns, store remodelling, menu innovation and a growing emphasis on digital and delivery. Digital and delivery are a big focus for investment and we think that these new areas of growth will offer very significant scale economies over time. For example, it has attracted more than 100m members to its digital loyalty program in the space of two years.

Pizza Hut has continued to face sales challenges not least because it operates in the more competitive casual dining section of the market. However, management are taking steps to address this, using a similar approach to that which has worked for KFC.

Encouragingly, new store economics remain excellent for both brands. Management think that they have the room to treble the store base over the long-term. We think that Yum China offers the potential for an extended period of sustainable, profitable growth that we look for in our investments. We are reminded that when Yum! Brands separated from Pepsi in 1997, many considered it to be the ugly duckling. Over the coming years it blossomed into something more resplendent, growing almost 14-fold (including dividends reinvested) until the time of the separation of the Chinese business, a CAGR of 15% and comfortably outperforming the S&P 500 by more than 1000% over the period.

A small number of investments benefiting from the emerging markets opportunity

Frutarom, MercadoLibre and Yum China are 3 of the 28 investments that the Fund owned at the end of 2017. The three of them accounted for approximately 17.5% of NAV at year-end. There are other businesses with excellent prospects amongst the additional twenty-five investments and we will explain more about these in the future.

We hope that this letter gives our readers a flavour of what they are getting when they invest with us. It is our goal to build something that is worth building for the long-term, a Fund that creates wealth for its investors and goes about doing so in an intelligent way.

We do not know yet whether we will be successful but take heart that we operate in an environment that fosters long-term thinking. We believe that thoughtful long-term investing in a small number of excellent businesses is a sensible approach to the emerging markets opportunity. It is our expectation that good investment returns will follow.

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