

Please note that the commentary is for the retail class of the fund.

The fund had a poor quarter, returning -11.4% compared to the MSCI Emerging Markets Index's return of -7.5%. British American Tobacco and 58.com were the biggest detractors, with Housing Development and Finance (HDFC) being the biggest contributor. In trying to analyse the reasons for the fund's large underperformance in 2018, there is no one clear factor. This is in contrast, for example, to 2015 when the underperformance was almost entirely due to Brazil that went through an unprecedented recession between 2012 and 2016 during which GDP per capita contracted by 30% in USD.

In 2018, the fund somewhat unusually saw 5 disparate businesses among its top 15 positions decline by c. 50% in USD, for different reasons, with insufficient winners to offset the impact. The 5 largest detractors for the year were Kroton, British American Tobacco, Magnit, Tata Motors and JD.com. On the positive side, Adidas, Airbus, HDFC and Banorte contributed, but not sufficient to offset the impact of the negative contributors.

We have covered most of these 5 stocks in detail in various commentaries during the course of the past year but given the extent to which they detracted from performance in 2018, it is worth providing a summary of what went wrong as well as our current view on each share.

- Kroton (the top private education operator in Brazil). Disappointing earnings reported and concerns relating to its student base as government-funded students graduate drove the share price down. We would agree that for these reasons the short-term prospects are unattractive but we believe the long-term prospects remain very attractive. Kroton trades on less than 10x 2019 earnings, with a 3.5% dividend yield and c. 80% upside to fair value.

- British American Tobacco (2nd largest global tobacco company). The US Food and Drug Administration has proposed banning menthol cigarettes in the US. This, together with general concerns over the transition to alternative nicotine products, drove the move in the share price. We believe that the prospects for the global tobacco companies are better than they have been for many years – for the first time these companies have credible alternative (much lower risk) products to make them more sustainable over the long term. The proposed menthol ban will take many years to implement and may be blocked by the courts if (as is likely) challenged by the affected companies. The share price is now at a 7-year low (and rating near a 20-year low) and trades on less than 9x 2019 earnings, with a 8% dividend yield and c. 70% upside to our estimate of fair value.

- Magnit (2nd largest food retailer in Russia). Magnit was beset by poor operational performance and the resignation of its founder and CEO, Sergey Galitsky, who sold his remaining 30% stake in the business at the time of his resignation in February 2018. With a new board and new CEO, Olga Naumova, who was largely responsible for the turnaround of Magnit's main competitor, X5 Retail during her 5 years there, a number of positive changes have taken place. These include the accelerated refurbishing of stores, changes in product mix and the introduction of a management incentive scheme. Results have started to improve in response to these changes. Magnit and X5 Retail are the two leaders in the Russian food retail market and each has only 9% market share. We believe that they can roll-out stores and grow market share for many years to come. Magnit trades on c. 13x 2019 earnings, with a 3% dividend yield and over 100% upside to our estimate of fair value.

- JD.com (#2 e-commerce company in China after Alibaba). In our view, the share price decline was driven by 3 factors: an approximately 20% to 30% decline in all Chinese internet stocks, slightly poorer-than-expected operational performance from JD.com, and an allegation of rape against the CEO in the US (prosecutors have declined to press charges citing insufficient evidence to secure a conviction). In our view, JD.com has created a very strong e-commerce business over the past decade by building their own fulfilment infrastructure (replicating the Amazon model) and that is sufficiently differentiated from Alibaba to enable both companies to win in the fast-growing Chinese e-commerce market (Alibaba is also a fund holding, albeit a smaller position). We believe JD is worth more than double the current share price as there are large revenue and margin opportunities that are not reflected in current prices.

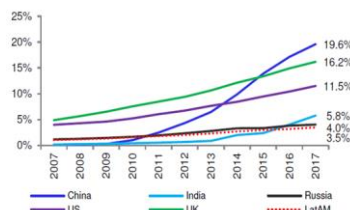
- Tata Motors (owner of JLR). This was a poor investment and a mistake in our view, and we sold out of the position during the 2018. A combination of internal factors (including poor cost control measures and mediocre new product launches) and external factors (such as Brexit, EU emissions legislation and US-China trade wars) led to a sharp decline in profits. Given the very thin current margins, combined with high debt levels and an uncertain future both in terms of alternative vehicles as well as Brexit (the UK represents 20% of sales, with a large part of the manufacturing base being in the UK) and other countries, we felt that the risk/reward became unattractive and sold the position.

With volatility at above-average levels in emerging markets, we were more active than usual with several new buys. Some have been owned in the past, while one was new not owned before (MercadoLibre). In terms of other buying activity, we continued to add to the fund's position in New Oriental Education, HDFC and Chinese Bajju producer Wuliangye.

Yandex was the largest new buy (2.0% of fund) during the quarter and a previous holding. Yandex has the number 1 search engine in Russia with 55% market share (Google has the balance). We are positive on the prospects for search and in our valuation this part of the business alone is worth more than the current share price. In addition, Yandex has net cash and a number of other smaller businesses that are currently growing revenue at a rapid rate but that are still loss-making. Some may never make money, but there are a few that we believe have the potential to do so, including the taxi ride business (which is dominant after merging with Uber Russia and in which Yandex owns a 59% stake) and the e-commerce joint venture with Sberbank. Yandex trades on c. 20x depressed 2019 earnings.

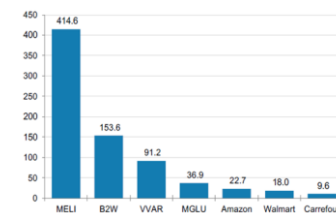
The other new technology (internet) buy was a 1.3% new position in MercadoLibre, the largest e-commerce platform (third-party marketplace) in Latin America. MercadoLibre has operations in 18 countries, of which it holds a number 1 position in 10 of them, including Brazil and Argentina - the 2 biggest contributors today. The company was founded 20 years ago and the CEO and founder, Marcos Galperin, still owns a meaningful stake (9%) in the business and is very involved. MercadoLibre's revenue has grown by 31% p.a. in USD over the past 7 years and continues to grow at a high rate. E-commerce penetration in Latin America is very low (see below graph) and MercadoLibre is the leader in Brazil (see below), which today contributes 70% of group earnings. Besides the e-commerce business, the long-term opportunity for the payments business (Pago) is also potentially significant, having only a 1% market share of card payments today. Profitability is well below normal in our view and we believe MercadoLibre can grow both its topline and profits at a high rate for many years to come.

E-Tail as a % of sales by country



Source: Euromonitor

Top e-commerce sites in Brazil by visits (millions)



Source Similarweb

Melco Resorts and Entertainment (Melco) is a casino operator in Macau and also a previous holding. The 45% decline in its share price in 2018 brought it back to attractive valuation levels. Macau holds its own set of regulatory and licensing risks, but the long-term prospects as a gambling destination and mass market holiday destination remain attractive given proximity mainland China (where gambling is banned) and rapidly improving transportation links. We prefer Melco over other operators as it is more mass-market focused (making it less cyclical), has better historical capital allocation and is more attractively valued at over 10% free cashflow yield (free cash flow per share divided by the current share price)

The Chinese consumer is significantly the largest buyer of luxury goods (c. 45% of all global luxury sales) between purchases in China and while traveling abroad. The fund has owned a number of global luxury goods companies over the past 10 years and the sector sold off significantly in 2018. This enabled us to buy Kering (1.6% position) at what we think is an attractive price. While owning a number of luxury brands, including Saint Laurent, Bottega Veneta and Balenciaga, the lion's share of profits (c. 80%) come from Gucci. Along with Hermes and Louis Vuitton, Gucci is one of 3 global true high-end soft luxury brands and has been reinvigorated over the past 3 years. Gucci was historically less profitable than Louis Vuitton and Hermes, but over the past 3 years this gap has narrowed, leading to an uplift in return on capital. Buying Kering at c. 15x 2019 is an attractive entry point given our positive view on the leading players in this sector and their attractive economics.

We have owned HDFC in the fund for the past 3 years and today it is a 4.2% position. By owning HDFC, the fund has indirectly owned HDFC Bank as HDFC owns a 22% stake in HDFC Bank, which represents about 35% of HDFC's value. The long-term fundamentals of the Indian financial services market are very attractive: in particular, the low financial services penetration and the fact that the poorly run and capital constrained state banks still have 70% national market share. This backdrop has formed a key part of our investment case for other Indian financials, which the fund has and continues to own, including HDFC, Yes Bank and Indiabulls. HDFC Bank obviously also benefits from these tailwinds and, in addition to this, is arguably the highest-quality bank in India, being the leader in digital, having the 2nd highest ROA, the highest provision coverage ratio, the lowest cost to income ratio and high retail exposure. This means that it is currently well placed to accelerate its market share gains given the current troubles faced by a number of Indian banks.

Members of the Global Emerging Markets team continue to travel extensively to enhance our understanding of the businesses we own in the fund, their competitors and the countries in which they operate, as well as to find potential new ideas. In this regard, over the past 2 years we have done detailed work (modelling, fair value and research report) on 57 new companies, 17 of which have made it into the portfolio over this period, representing 33% of the fund today. In the fourth quarter, there were 3 trips to China, 1 to India and 1 to Brazil. The coming months will see a further 2 China trips (including 1 trip specifically focusing on the baijiu industry) and 2 trips to India.

In December a new analyst joined the Coronation Global Emerging Market team, taking the team to 10 members. The analyst is a Mandarin-speaking Chartered Accountant and will mainly cover Chinese stocks (including a number of the A shares of which the annual reports, in most cases, are only available in Mandarin) and will also do ad-hoc investigative and corporate governance-related research as and when required. Over and above this, the Coronation Global Developed Markets' team of 8 individuals cover a number of emerging market stocks as well as developed market stocks that are eligible for the fund. The Coronation South African equity team of 15 analysts also covers a number of stocks in which the fund is invested.

The fund's weighted average upside to fair value at the time of writing was approaching 80%, well above its long-term average of c. 50% and close to the highest it has ever been. As such, and after a very disappointing year, today we are very positive on the prospects of the fund going forward.

Portfolio managers
Gavin Joubert and Suhail Suleman
as at 31 December 2018