

GLOBAL IMPRESSIONS

EMERGING MARKETS - UNCOVERED

BRAZIL « JUNE 2016

“IN THE MIDST OF CHAOS, THERE IS ALSO OPPORTUNITY”

Bovespa soars notwithstanding Brazilian political challenges

South Africa may have its fair share of problems but these pale in comparison with Brazil's current state of affairs. The country's sovereign credit rating has been downgraded 12 times in all; its growth came in at -3.8% last year and is expected to come in at -3.5% this year and its president, currently suspended, is on the brink of being impeached amid much political turmoil and public protests. Politicians are embroiled in the now infamous Petrobras (state oil company) scandal, where there are accusations that over \$2bn of bribes were paid.

It doesn't end there: its inflation rate sits above 9%, interest rates at a lofty 14.25% and the currency has blown out alongside all other emerging market currencies. Brazil's largest food retailer CBD recorded a loss in its food business in the first quarter of 2016 (January to March). When companies in sectors perceived as defensive record losses, it illustrates just how tough and unforgiving the Brazilian economy is.

SO WHY ARE WE STILL OPTIMISTIC ABOUT INVESTMENT OPPORTUNITIES?

In mid-March we visited Sao Paulo and Brasilia, the capital of Brazil, to assess both political and economic conditions first hand, as well as the companies owned in our portfolio that we believe have considerable upside potential. Apart from company management, we also met with the Minister of Finance, officials

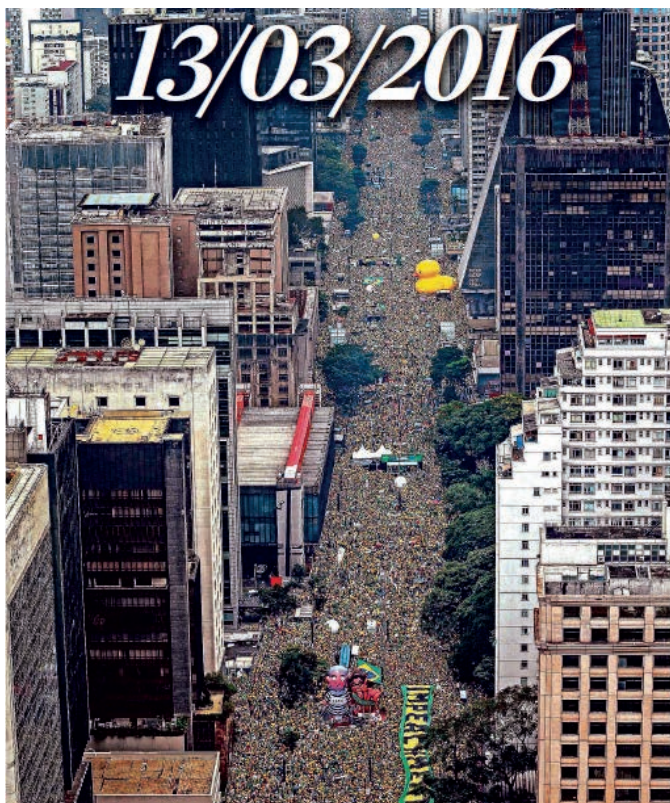
in the Treasury Department, opposition parties and economic and political advisors.



As interesting as the meetings with politicians are, they serve very limited usefulness in our investment decisions. We invest in businesses, so the meetings that really excite us involve seeing the operations of actual businesses. To touch and feel the companies we invest client's capital in. To see the factories, the stores, to meet competitors, suppliers and more importantly the customers. To gain their insights as to the quality of the business we invest in.

During our visit there was a massive protest in Sao Paulo. As South Africans we were quite dismissive of the hotel's concierge when he warned us about the protests. However, what was

expected to be 250 000 protesters turned into over 2 million, all in favour of the President being impeached. In South Africa protests are a very familiar thing but even we were extremely shocked by the scale of this protest. Being in the midst of a city where over 2 million people are protesting is quite something to see.



STOCK EXCHANGE SHRUGS OFF POLITICAL UNCERTAINTY

Notwithstanding the tenuous political and dire economic situation, Brazil's stock exchange index, the Bovespa, has been the best performing emerging market index this year so far.

Brazil is the seventh largest economy in the world and has a population of over 200 million so investors need to take into account that if the economy does stabilise the potential growth is significant. There are many different ways the current political power struggle could play out but with the President well on her way to being impeached, current conditions are probably as bad as it will get.

Against this admittedly uncertain backdrop, we pay particularly careful attention to the type of companies we invest in. Ultimately our clients work extremely hard to earn the funds they entrust us with and we take this responsibility very seriously; using our rigorous investment process to identify and buy companies that will thrive irrespective of the economic environment in which they operate.

Our philosophy is to invest in quality businesses with sound corporate governance trading at attractive valuations. Over time strong businesses models tend to become stronger in tough times. This is certainly what we saw in Brazil. The stronger companies are gaining market share, cutting costs, innovating and ultimately still managing to grow earnings. If a company can show positive growth when GDP has declined for 2 years by over 7% then what would happen when positive GDP growth resumes? The quality of a company, its management and its business model are often tested and proven in tough times. Therefore we pay careful attention to how management conduct their affairs and how the company fares against competitors in tough times.

On our recent trip to Brazil, we spent time with three companies that have been great contributors to our client funds.



Itau Unibanco is the largest private bank in Brazil. With over 30 000 service points, Itau is a significant operation. Banks are incredibly sensitive to economies due to their highly leveraged balance sheets, yet this is a bank that is generating fantastic returns in an economy that is in its deepest recession. It's a highly profitable bank in a country with a mere 10% mortgage to GDP penetration (South Africa is at 31% while the US is at 78%) and thus there is plenty of room for growth. Brazil's total credit to GDP penetration is about 54%, while most of the developed economies are north of 100% (South Africa being 85%), again highlighting the credit growth potential in the Brazilian economy.

Brazil has some very large state banks that had a 40% loan market share in 2011 but now have a 56% market share. As the economy became tougher the government attempted to stimulate the economy through aggressive lending by these state banks, which prompted the market share gains. Despite this intense market disruption, Itau continued to generate return on equity (ROE) north of 20%.

The government is now fiscally stretched and thus no longer has the finances to support aggressive state-owned bank lending. This, and the fact that their growth came at the cost of profitability, significantly curtails the ability of the state banks to grow and expand their market share further. Therefore going forward, the private banks (Itau being the largest) have the ability to gain market share from these now much weaker state banks, while still generating fantastic returns. What's really impressed us with Itau is how management have focused on expenses. In 2011 Itau employed 109 000 staff and electronic channels attributed for 42% of all transactions. In 2016 they have 89 000 employees and electronic channels account for 71% of all transactions. When management can operate a bank and generate such returns, while demonstrating exceptional cost management in an economy this tough, our clients are well placed to benefit from the same management when there is a recovery.

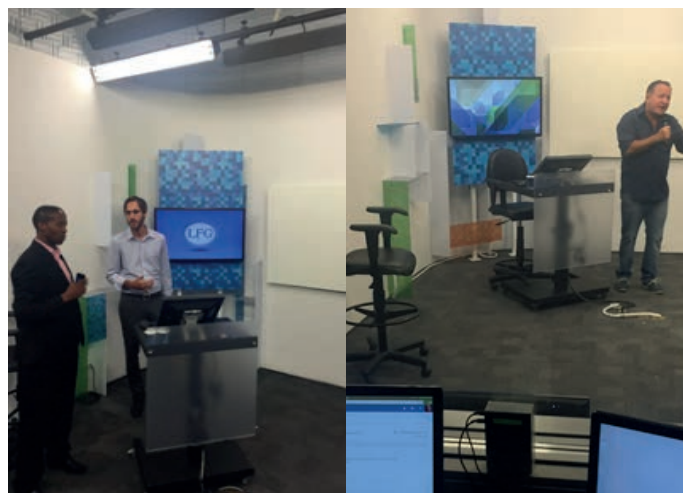
Kroton is the largest private education business in Brazil – and, in fact, the largest listed one in the world - and we visited several of its campuses on our visit. It educates some 1.4 million students in one of the most unequal societies in the world, where education makes a significant difference to earnings potential. Kroton's own surveys reveal a 181% salary increase post attaining a diploma from their programmes. This pay jump provides great incentives for students to flock to institutions like Kroton.

The company has grown its revenue at a compound annual growth rate of over 50% for the last 10 years. Its earnings before interest, tax, depreciation and amortisation (EBITDA) have also grown at a compound annual growth rate of just over 71% over the last 10 years. This level of growth demonstrates the high levels of demand for education in Brazil. It also demonstrates the strength of this company. Kroton is also an innovative company, with world class correspondence/online teaching systems, which we got to see first-hand.

Whether the economy is in recession or times are tough, people remain willing to do whatever it takes to educate and upskill themselves. Our investment in this business, which is best at educating Brazilians, has yielded, and we believe will continue to yield, fruitful results for our investors.

We like investing in the companies that run stock exchanges. They tend to make for fantastic long-term returns due to the following characteristics: they are often monopolies, have pricing power and

are extremely cash generative, with very strong balance sheets. They also tend to be rather defensive – they generate revenue irrespective of whether the market is rising or falling. Volatile times tend to lead to higher revenues for exchanges as investors tend to increase their frequency of trading.



What attracted us to **BM&F Bovespa** was the high level of interest rates in Brazil. The Selic rate (comparable to the prime interest rate in SA) is 14.25%, while inflation is over 9%. What this means is that investors don't need to accept the higher risk of investing in equities since they get a very good return by just investing in the fixed income market. This has meant investment funds in Brazil have only invested 11% of their funds in equities, with pension funds investing a measly 22% in equities. For the 7th largest economy in the world, Brazil's stock market capitalisation to GDP of 38% is extremely small relative to other more developed exchanges. The US's ratio is 151%, Japan 141% and India 76%.

Over the long term, as the Brazilian economy becomes stronger and inflation becomes less of an issue, the interest rates should decline, meaning fixed income should become less attractive in generating long-term investment returns. This will inevitably put pressure on investors to increase their allocation to equities, which will benefit a company like BM&F Bovespa and enable it to grow earnings at a rapid rate for a very long time.

BOTTOM LINE

Howard Marks reminds us that *“There are two concepts we can hold to with confidence: Rule No. 1: Most things will prove to be cyclical. Rule No. 2: Some of the greatest opportunities for gain and loss come when other people forget Rule No. 1.”*

For us Brazil presents, and has already presented, some great investment opportunities at extremely low valuations as the market seems to have priced in what is cyclically a tough period as a permanent state of affairs. This gives us the opportunity to buy some really great businesses at very attractive valuations. Our clients have already benefited from our Brazilian investments and we firmly believe they will continue to benefit in the years to come.

GLOBAL EMERGING MARKETS FUND

PERIOD ENDING APRIL 2016

PERIODS	FUND RETURNS*	MSCI EM NR INDEX	EXCESS RETURN
6 months	12 .17%	2 .90%	9 .26%
1 Year	4 .00%	-2 .03%	6 .02%
3 Years	17 .22%	11 .29%	5 .93%
Since September 2011	15 .88%	14 .07%	1 .81%

* Performance is gross of fees.

Sources: Old Mutual Investment Group, Bloomberg.



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