

# Latin American Strategy

## QUARTERLY LETTER | SECOND QUARTER 2018

*The Latin American equity strategy aims to achieve capital growth by investing in a concentrated portfolio of high-quality Latin American growth companies. The strategy seeks high absolute returns over the long term and minimises the level of long-term risk by choosing well-capitalised, high-quality investments at reasonable valuations.*

### INTRODUCTION

The Fund declined by 17.3% in the second quarter of 2018, by 17.5% in the first half of 2018 (including the dividend), and by 10.8% over the last twelve months (source: BBH). We see 2Q18 as a correction in an up-trend and remain very positive about the fund's potential returns over the next five years.

The Fund is currently well balanced and is positioned very differently to a typical Latin American index such as the MSCI Latin America. We have 41% invested in the Andean Bloc (Colombia, Chile and Peru) which we believe currently offers the best risk-adjusted returns in the region, 33% invested in Brazil, 13% invested in Mexico, and 11% invested in Argentina. Cash is 3%.

Chile, Colombia and Peru all have notably pro-market governments. They are also passing through clear cyclical accelerations and have attractively valued currencies. We like all three markets but we currently find the best bottom-up opportunities in Colombia and Peru.

We hedged the Mexican currency on April 11<sup>th</sup> at 18.22, when it was up 8% year-to-date because we were becoming more concerned about the presidential election. We also felt that sentiment around the NAFTA negotiations had become too optimistic in the short term. We remained hedged until after the election which saved the fund's NAV from a significant sell off in the peso. We also reduced Mexico's weight from 22% at the start of 2018 to 13%. We believe that the Mexican economy will continue to grow under its new president and expect him to respect the central bank and contracts associated with the reforms over the last six years. However, we don't want to risk being complacent and will limit our position until we have more visibility. We currently own five outstanding growth companies in Mexico all of which should thrive in the new political scenario and are valued at attractive levels.

We took profit in Argentina in 2H17 and 1Q18 due to concerns about multiples and currency valuations after a very strong run. We took advantage of the violent sell off in 2Q18 to double our weight back to 11%.

We continue to expect Brazil's cyclical recovery to be a key regional economic theme over the medium term regardless of who wins the presidential election in October 2018. We currently have a third of our NAV in outstanding Brazilian private sector growth companies which are notably attractively valued with plenty of single digit PEs amongst the non-financials.

**Our average investment has compounded its earnings per share at 14% per annum since inception<sup>1</sup>**, a period which has included the global credit crunch, the Brazilian and Argentine recessions and the commodity bust. We believe that Latin America is in the early days of a multi-year economic acceleration and expect our investments' EPS growth rate to accelerate with overall GDP in the region over the next five years. **The Fund's weighted average multiple is attractive at approximately 13x forecast 2019 earnings** (source: Brown Advisory).

We look at currencies on an inflation-adjusted basis against the U.S. dollar and we believe that our currencies should trade slightly above their 20-year averages given the improved policy structure and economic outlook in the region today. Today all our currencies



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<sup>1</sup>Source: Bloomberg. The CAGR figure is the weighted average of local currency compound annual growth rates from fund inception (2006) to 2017 for the portfolio as of July 2018, excluding stocks with negative earnings in 2017. For stocks where Bloomberg does not have 2006 data the CAGR has been calculated using the earliest data available.

look attractive so we hope to see currency appreciation against the U.S. dollar over the medium term. **Another popular way of looking at the value of a currency is the Economist's Big Mac index<sup>2</sup>. The July 2018 Big Mac index shows that the Brazilian real is undervalued by 20.1%, the Colombian peso by 24.9%, the Chilean peso by 26.5%, the Peruvian sol by 41.8%, the Argentine peso by 50.9% and the Mexican peso by 53.3%.**

**We hope that our NAV will compound in line with its future EPS growth, and we think it is possible that FX and multiple appreciation might add to dollar returns over the medium term.** However, we expect Latin American stock prices and currencies to remain volatile from time to time.

## FUND WEIGHTS

Chart 1: Geographical split of the Fund

Country Breakdown			
COUNTRY	% WEIGHT (06.30.18)	QTD 2018 % CHANGE	YTD 2018 % CHANGE
Argentina	11.1	4.3	2.7
Brazil	32.6	-3.1	-5.5
Chile	5.8	0.7	0.8
Colombia	18.7	7.3	8.3
Mexico	13.0	-12.0	-8.7
Peru	16.2	4.0	4.7
Cash	2.6	-1.3	-2.3

Source: Factset. Figures may not add to 100% due to rounding. Data as of 30<sup>th</sup> June 2018.

## PERFORMANCE

Our NAV declined by 17.3% during 1H18 with all of the decline occurring during the emerging market sell off in 2Q18. **FX comprised approximately 7% of our decline and stocks comprised the other 10%.** The biggest decline was from the Argentine peso and the Brazilian real which together generated almost all our currency loss in the period. All the currencies we invest in are now looking attractively valued against the U.S. dollar on a twenty-year inflation-adjusted basis and **we believe that as the region's economy accelerates, there is plenty of scope for many of these currencies to appreciate.**

There are several themes behind our year-to-date stock performance which we want to emphasise. **The first is that commodity stocks were the best performers in Latin American equities in 1H18 and as we structurally don't invest into these sectors, our NAV didn't benefit from these returns.** In Brazil, 1H18 was a particularly narrow market with returns dominated by natural resource companies which together make up about a quarter of the local index. The IBOVESPA index declined by 3% in local currency over the period and by 16% U.S. dollars. However, if we exclude Vale and Petrobras the index declined by 8% in local currency and 20% U.S. dollars (source: Credit Suisse). In Colombia, the COLCAP rose by 4% in local currency but if we exclude the state-owned oil & gas company Ecopetrol, the index declined by 1% in local currency (source: Credicorp). **We continue to believe that investing in high quality domestic growth stocks is the best way to capture the opportunity available in Latin America over the long term.**

**The second theme was that after a notably strong performance in 2017 from our Brazilian and Argentine portfolios, our investments in these countries held back our performance in 1H18.**

We did well in Brazil last year with a 41% U.S. dollar return compared to the MSCI Brazil's 25% appreciation (source: Findlay Park

<sup>2</sup> Source: The Economist, Burgernomics, The Big Mac index, 11<sup>th</sup> July 2018.

Latin American Fund 1Q18 Quarterly Update). This meant that some of our positions entered 2018 with room to pause and we saw some profit taking in many of these names in 1H18. For example, our holdings in Brazilian education stocks de-rated after a very strong 2 years - Kroton returned 144% in U.S. dollars and SER returned 405% in U.S. dollars in 2016-2017 (source: Findlay Park Latin American Fund 1Q18 Quarterly Update). During the quarter **SER's PE fell to 8x 2019 and Kroton's fell to 8.5x 2019<sup>3</sup>, coupled with a 4.6% dividend yield**. This occurred due to a cyclically soft intake cycle in 2018, the continued run off of FIES students, and in SER's case some growing pains. In addition our exposure to Brazilian growth cyclicals detracted from our 1H18 performance due to the truckers strike. **We believe, with high conviction, that all these holdings remain highly attractive and will perform very well again.** We continue to believe that Brazil is close to the start of a long cyclical recovery after its deep recession and believe that there is significant potential alpha from our positions here.

**Argentina was another strong market for us last year - our positions more than doubled in U.S. dollars which was approximately 2x the local market return** (source: Findlay Park Latin American Fund 1Q18 Quarterly Update). While we took profit in 4Q17 and 1Q18 we still had a 6% position going into the very sharp sell off in 2Q18, which moved the peso to below its twenty-year inflation-adjusted average against the U.S. dollar and resulted in more attractive stock multiples. **Supervielle** and **Pampa** are two of our core Argentine holdings and both stocks de-rated significantly in 2Q18 and were amongst our biggest detractors in 1H18. We added to some appealing structural growth companies at remarkably low multiples in this sell off which we believe is the right thing to do on a 12-18 month view.

Our NAV benefited from our positions in the Andean Bloc during the first half of the year and from our actions in Mexico. **Grupo Financiero Banorte** was our top performer in the year-to-date period. **El Puerto de Liverpool** and **Alsea** were also in our top five. These three stocks are all amongst our core long-term Mexican holdings. We benefited from a combination of reducing these position sizes well before the election at good price levels and hedging out the MXN currency risk in them. Our Peruvian holdings including top contributors **InRetail Peru Corp.** and **Credicorp Ltd.** also performed notably well in the first half of the year. They are generally benefiting from rising confidence surrounding the economic acceleration in Peru and specific company actions.

## PERFORMANCE CONTRIBUTION

Chart 2: Largest Stock Contributors

Largest Contributors Q2 2018		
STOCK NAME	COUNTRY	CONTRIBUTION TO RETURN (%)
InRetail Peru Corp.	Peru	0.3
Grupo Aeroportuario del Centro Norte SAB de CV	Mexico	0.1
Bancolombia S.A. Sp. ADR Pfd	Colombia	0.1
Grupo Financiero Banorte SAB de CV	Mexico	0.1
Bancolombia S.A.	Colombia	0.1

Chart 3: Largest Stock Detractors

Largest Detractors Q2 2018		
STOCK NAME	COUNTRY	CONTRIBUTION TO RETURN (%)
Ambev SA Sp. ADR	Brazil	-1.7
Grupo Supervielle SA Sp. ADR	Argentina	-1.6
Kroton Educacional S.A.	Brazil	-1.5
Iguatemi Empresa de Shopping Centers	Brazil	-1.2
CVC Brasil Operadora e Agencia de Viagens SA	Brazil	-1.2

Source: Factset. Data as of 30<sup>th</sup> June 2018.

<sup>3</sup> Source: Factset, Bloomberg and Broker Estimates. P/E ratio is based on the most recent stock price available (06/30/2018).

Chart 4: FX Contribution to Return

	Q2 2018	YTD 2018
<b>TOTAL</b>	<b>-8.8</b>	<b>-7.1</b>
Argentinian Peso	-3.0	-3.5
Brazilian Real	-4.3	-4.2
Chilean Peso	-0.4	-0.3
Colombian Peso	-0.8	-0.2
Mexican Peso	-1.2	0.2
Peruvian Sol	-0.1	-0.2
Cash	1.1	1.1

Source: Factset. Figures may not add to 100% due to rounding. Data as of 30<sup>th</sup> June 2018.

## THE ANDEAN REGION - CHILE, PERU, AND COLOMBIA

We have 41% invested in the three Andean countries – a very unusual position for a Latin American fund. We visited all three countries in 2Q18 and came away very happy with what we learned. All three countries are accelerating as we had hoped and the prospects for our companies look strong.

**Colombia** is now 19% of the Fund and has a good combination of high quality stocks, low multiples, and a nascent economic recovery which is starting to show up in the data. In addition, in June, Colombia elected a very pro-business President, Ivan Duque. One of the takeaways from our trip was that businesses were waiting for the election result before investing. This held back the recovery but now that the election is out of the way we expect rising investment to fuel the recovery. Colombia grew 1.8% in 2017 (source: Credicorp) and we expect 3-3.5% in 2019.

As an aside, much of the reporting around the Colombian election has focused on Duque's desire to amend the recent peace deal with the FARC (Revolutionary Armed Forces of Colombia). We expect this to generate political noise, but the FARC was militarily defeated long before the deal and even if they tear up the deal they don't have the power to be a real problem economically. That said, we hope the deal stands because peace is an opportunity for Colombia to extend the benefits of economic success to more of its people.

Roughly half of our Colombian weighting is in **Nutresa**, the dominant branded foods company. Nutresa is operating at 65% capacity utilisation (source: Nutresa company meetings) so it can grow volumes without adding much to operating costs, and it is trading at a bottom-of-the-cycle P/E ratio of approximately 14.6x<sup>4</sup>. We think it is a compelling opportunity with very little downside. It is the biggest position in the fund.

Another 3.8% of the fund is invested in Colombian banks, which should see rapid profits growth on the back of rising loan growth and falling loan loss provisions, and which trade on low multiples.

After our trip we added a small holding in **Grupo Argos**, a diversified infrastructure company with assets in cement, toll roads, airport concessions, generation, and land development. The company has transformed itself over the last 10 years from a confusing mess into a focused and growing holding company. We think it will be a clear beneficiary of Colombia's resurgent economy, and we think there are further strategic moves ahead that will unlock value.

**Chile** elected Sebastian Pinera to the presidency in late 2017. Pinera is very pro-business, but as President in 2010-2014 he was perceived as arrogant and didn't build cross-party support very well. This time appears to be different. His main goals are to simplify,

<sup>4</sup>Source: Factset, Bloomberg and Broker Estimates. P/E ratio is based on the most recent stock price available (06/30/2018).

but not undo, some of the reforms of the previous government. He also wants to digitise the state, reinvigorate infrastructure investment using PPPs, and reduce the time to get permits for projects without loosening standards. So far, he seems to have done a good job of building bipartisan support and we think he might be exactly the President Chile needs. Business confidence is high but unfortunately, so are valuations, so we have to be particularly careful with our stock picks in Chile. That's especially true given that Peru and to a large extent Colombia are on the same economic pathway as Chile, but 15 years behind. By focusing on those countries we think we get Chilean growth, but earlier and cheaper. Nonetheless we'd like to have more in Chile and will add when we find opportunities.

Our biggest holding in Chile today is **Falabella**, a diversified retail conglomerate with a great record of growth and capital allocation since it was founded as a tailor's shop in Santiago in the 1880s. We think it is a quintessential Latin American compounder and hope to hold it for a very long time.

**Peru** gets the Oscar for Andean political drama over the last couple of years but things have now calmed down. After a bitter Presidential race between two pro-business candidates in 2016 the relationship between the winner (Pedro Pablo Kuczynski) and the loser (Keiko Fujimori, who controlled Congress) descended into political warfare. This ended when Kuczynski was impeached and removed in March. Vice President Martin Vizcarra has taken the Presidency and quietly seems to be doing a good job. Political noise has died down and businesses can get on with the process of investing in the country's future. That has coincided with a natural cyclical recovery in the economy and we came back from our trip confident that Peru has some good years ahead.

We have three core holdings in Peru: the largest bank, the largest consumer staples company, and the largest retailer (which we review below). These three companies make up 14% of the fund and we believe all three have exceptional market positions in structurally high-growth and profitable industries. All three are also set to benefit significantly from the rebounding economy.

**InRetail** has three divisions, each producing about a third of operating profits. It has a 37% market share in supermarkets in Peru, ~90% in pharmacies, and 23% in shopping malls (source: InRetail Peru Corp, 2018). These shares refer to the formal market. The majority of retail in Peru is informal. Informal refers to mom and pop type stores that sell small quantities to regular customers – for example, if you get paid cash daily you might buy a scoop of rice each day for supper. Informal retailers suit a poor society, but as wealth rises they can't compete with formal players on economies of scale, quality and breadth of offer, or own brand products. Rising wealth therefore drives the formalisation of retail. In addition, many of the products InRetail sells are underpenetrated, and people will buy more of them as they get richer. For example, although Chilean GDP/capita is only 2x Peru's levels, Chilean pharmacy spending is 4x Peru's levels (source: InRetail Peru Corp, 2018). **InRetail therefore has three key growth drivers with very long runways: GDP growth, catch-up in underpenetrated categories and market share gains through formalisation.**

Each of InRetail's divisions also has a short-term driver. In supermarkets, InRetail is accelerating the rollout of discount proximity stores which cost far less than a hypermarket and have far higher returns on capital. They're also better able to compete with informal players than hypermarkets, so we think they will speed up the formalisation process. In pharmacy, InRetail recently bought the only other big formal player and will now look at extracting significant synergies and possibly expanding into Ecuador and/or Bolivia. In malls, InRetail is building a huge mall in the Lima suburbs which they believe will be their best mall yet in terms of returns on capital and which will open in 2019.

We also think InRetail will be a significant beneficiary of an accelerating economy after several tough years for the consumer. We are therefore very confident in the short and long term prospects for the company and we are very happy to have it as a 5.0% holding in the fund on 19.8x 2019 earnings<sup>5</sup>.

## MEXICO

We reduced Mexico from just under a third of our NAV in summer 2017 to 22% at year-end. At that point sentiment in Mexico was still very positive and Mexican shares had performed well. Although we remained bullish, we felt uncertainty would rise ahead of the July 2018 presidential election.

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<sup>5</sup> Source: Factset, Bloomberg and Broker Estimates. P/E ratio is based on the most recent stock price available (06/30/2018).

In April we started to believe that Andres Manuel Lopez Obrador's (AMLO) chances of winning the Presidential election in July were rising. We also felt that the negotiations over the North American Free Trade Agreement (NAFTA) could be a source of volatility. As a result we hedged our MXN exposure on April 11 at 18.22 when the currency was up 8% year to date versus the U.S. dollar. We also reduced our Mexican exposure to 13% of NAV. This worked well as it became clearer that AMLO would win. We removed the hedge after the election.

We plan to keep our allocation in Mexico at around 13% for now. We are invested in five notably high-quality mid-caps which have outstanding growth outlooks and are clearly valued at attractive levels. We expect all of these businesses to continue growing rapidly under AMLO and have been careful not to be exposed to any sectors which might be more controversial under him.

The Mexican economy is poised to benefit from the reforms of the last six years, a vibrant manufacturing sector, and an extremely cheap currency (which is two standard deviations below its inflation-adjusted twenty-year average against the U.S. dollar). We expect the economy to continue to grow under AMLO and believe that he will respect the central bank's anti-inflationary policies. We think AMLO will follow the same type of policies that he did when he was mayor of Mexico City, when he was fiscally responsible and worked successfully with the private sector. He designed PPP's with the private sector to build 2<sup>nd</sup> stories on many of Mexico City's most congested roads, he helped Carlos Slim revitalise the old town, and he improved planning laws which sparked a high-end residential boom. If AMLO behaves like this as President, then we expect a bull market in Mexican equities and an appreciating currency.

However, AMLO used to have more radical left-wing views. We don't know whether his recent shift to the centre was a genuine change of ideology or just a ploy to get elected. AMLO has effectively won an absolute majority in both houses of congress. This gives him more power than we are comfortable with and creates the risk that he might try to undo the energy reform.

Another source of uncertainty is NAFTA. We believe that it is clearly in the U.S.'s best interest to renew NAFTA. The majority of Mexico's top ten exporters are U.S. multinationals which are using lower wages in Mexico to keep themselves globally competitive. If the U.S. does choose to cancel NAFTA then the US-Mexico trade relationship would automatically revert to WTO rules. In Mexico's case, this would involve a maximum additional tariff on industrial goods of 3-5% which wouldn't make a big difference to Mexico's competition against U.S. based production given how cheap the peso is. However, a failure to renew NAFTA would no doubt be bad for sentiment.

Our base case remains bullish but given these uncertainties and the opportunities elsewhere in the region, we don't want to risk being too heavily invested in Mexico until we know more.

## ARGENTINA

We've successfully invested in Argentina over the last twenty years and feel that we have a good understanding of local fundamentals. After a strong run in 2017 we took profit in 4Q17 and 1Q18 due to valuations and concerns over the level of the currency. We took our weight down from approximately 9% to 6% over the first quarter, reducing positions such as Grupo Galicia ADRs at US\$65 and Grupo Supervielle ADRs at approximately US\$31 (source: Findlay Park Latin American Fund 1Q18 Quarterly Update).

President Macri inherited an economy that had been very poorly managed for fifteen or so years and is introducing pro-market reforms to deregulate the economy, reduce the state sector, and free up the private sector. However, he has avoided using risky shock therapy and has instead elected to gradually reduce subsidies, improve the fiscal deficit, and reduce inflation. We think this is smart and that he is poised to either increase or maintain his power base in the 2019 elections despite recent events. If this happens, it should give us a good six year runway of political visibility in Argentina.

**The country is changing in a very positive manner from a very low base which is creating huge opportunities for our companies to grow rapidly. We can't emphasise enough that there are some truly outstanding growth opportunities available in some parts of the Argentine stock market which we believe are highly attractive long-term investments.**

The Argentine economy grew 2.9% in 2017 and 3.6% in 1Q18. Sentiment was very positive with reforms being passed every month and Argentina's currency became expensively valued. This kept us from increasing our weighting despite our positive bottom-up views.



Our caution was warranted as the problem that triggered the recent mini crisis of confidence was the worst drought in fifty years which caused Argentina's harvest to fail. Argentina is an agricultural superpower and the harvest is one of Argentina's main sources of U.S. dollars. Soy bean exports alone reach c. US\$20bn in a good year (source: AR Partners S.A. referencing soy grain exports in 2011). The failure of the harvest pulled the rug from underneath an expensively valued currency. The central bank then cut rates which was a mistake as inflation wasn't behaving well enough. This all happened when sentiment toward emerging markets was souring due to the rise in U.S. longer term bond yields and the rally in the U.S. dollar. This perfect storm caused a violent sell off in the currency and stock prices. The central bank then increased interest rates from 25% to 40% to stabilise the currency and Macri arranged for a US\$50b facility from the IMF. Markets have started to stabilise and the head of the central bank has also been replaced by someone who is more market savvy.

This crisis will have a short-term knock on effect in the economy. 2Q18 GDP will almost certainly contract sharply sequentially due to the failed harvest. 3Q18 GDP is also likely to contract sequentially as the increase in interest rate volatility temporarily winds domestic demand. We expect the economy to bottom during the fourth quarter and return to growth in either late 2018 or early 2019. Inflation is also likely to accelerate due to the recent currency weakness before falling sharply in 2019.

We view this correction as a passing storm. The good news is that the currency has rebased to a much better level and stocks are back to being notably cheap. We doubled our weighting in 2Q18, buying back some of the positions we reduced earlier in the year at much better prices and buying some new positions including **Bolsas y Mercados Argentinos (BYMA)**. We continue to believe that Argentina has a tremendous medium- and long-term outlook on the back of Macri's reforms unleashing very substantial pent up growth, and it is now approximately 11% of our NAV.

**BYMA** is the central depository and stock exchange of Argentina. We added a 3.2% position in BYMA during the Argentine storm in 2Q18. The central depository and associated businesses account for the majority of BYMA's current revenue and close to 80% of its cash flow (source: *A Market Rising From the Ashes: BYMA, Itaú BBA, February 25, 2018*). This is a legal monopoly which holds all financial instruments in Argentina including government debt, corporate bonds and equities. This is a great business which is conceptually like a car park for financial assets and a custody fee is charged on all assets. It's hugely cash generative and benefits from the stock of financial instruments naturally growing as Argentina normalises. Argentina's assets under custody equate to approximately 26% of GDP which is less than half of the penetration of Colombia and Peru, 1/6th of the penetration of Chile and less than 1/10th of the penetration of South Africa (source: *A Market Rising From the Ashes: BYMA, Itaú BBA, February 25, 2018*). This business is a key beneficiary of the likely increase in government debt.

The stock exchange side of BYMA includes a monopoly in share trading and clearing, and a growing business in derivative and fixed income trading. The exchange side of BYMA only equates to approximately 20-25% of its current revenue. That's because Argentina's stock market is very underdeveloped with total market cap only 12% of GDP (source: *A Market Rising From the Ashes: BYMA, Itaú BBA, February 25, 2018*). We see an extremely clear opportunity for structural growth here: Argentina's promotion from frontier to emerging market status (effective from June 2019) should be a good long-term catalyst for this business, as should the recently passed tax and capital markets reforms which make local listings much more attractive to both issuers and local/foreign investors. In addition the tax amnesty saw c.US\$90bn of offshore assets declared by Argentines and some of this has been repatriated to Argentina (source: *A Market Rising From the Ashes: BYMA, Itaú BBA, February 25, 2018*). We believe some of these savings will end up being invested in Argentina's local capital markets.

BYMA was demutualised a year ago and there is plenty of low hanging fruit on the cost side. The company's EBIT margin should go from 33% in 2017 to 50% in the medium term (source: *1Q18 Earnings Presentation, Pro-forma statements, BYMA, May 4th 2018*). We have been meeting this company for several years in the run up to their demutualisation and feel we have an edge - we don't believe that many other foreign investors have met this company or understand the opportunity yet. BYMA has net cash and we acquired our position at approximately 11x 2018 forecast earnings (source: Brown Advisory). We believe that it should be trading at a much higher multiple and that it should be able to compound its earnings at between 30-50% p.a. over next 5 years.

## BRAZIL

Our ideal asset allocation is a third in Brazil, a third in Mexico, and a third in the Andean bloc and Argentina. We reduced Brazil's position from 38% at year-end 2017 to about 33% at quarter-end because we don't want to be overexposed before an uncertain presidential election in October.

The big picture in Brazil hasn't changed: we believe we are in the early days of a long-cyclical recovery after a tough two-year recession. GDP has grown sequentially in all of the last five quarters. Inflation fell from a high of 11% at year-end 2015 to 4.4% in June 2018, and interest rates fell from a high of 14.25% to a new all-time low of 6.5% (source: Findlay Park Latin American Fund 1Q18 Quarterly Update and Bloomberg). We think Brazil has entered its first multi-year period of single digit interest rates and believe that this will underwrite the recovery. Jobs are being created again and salaries are rising above inflation. Combined with pent-up demand this should drive solid demand growth. However, unemployment remains high and GDP growth remains slow so there hasn't been a 'feel good' factor yet. We believe that this will start to appear in 2019. Brazil's external sector is in good shape with its highest ever trade surplus last year and a current account deficit that is expected to be less than 1% in 2018, well below the typical 3-4%. We expect the cyclical recovery to continue regardless of who wins the presidential election in October 2018.

There was a disruptive trucker's strike in 2Q18 which probably caused the economy to contract sequentially in the quarter. We think this is a one-off, but GDP growth estimates for 2018 have been lowered to 1-2% (from 2-3%). This combined with poor global sentiment to drive a sharp sell off in Brazil's currency and stock market. We added 5-6% of our NAV in some high quality growth cyclicals several years ago. After generally performing well in 2016 and 2017 these stocks corrected sharply during the strike, partly because earnings estimates were reduced due to the economic impact, and partly because the government removed several corporate tax breaks which these companies benefited from in order to pay for fuel subsidies to placate the truckers. We continue to believe that these stocks have strong performance ahead of them as the recovery unfolds.

It's still early days in Brazil's upcoming presidential election. The first round is on October 7<sup>th</sup> and the second is on October 28<sup>th</sup>. The race is wide open at this point. Lula is in jail for corruption and is not expected to be able to stand. Excluding Lula, there are five leading candidates. Jair Bolsonaro currently tops the polls. A former army captain, he is on the far right with a law and order platform. He has a very pro-market economic adviser who believes that all state owned companies should be privatised. Marina Silva is second in the polls. She combines environmental policies with pro-business policies in a very coherent way. She has a well-respected economic advisor and is funded by families that own two big companies, Banco Itau and Natura. These two candidates appear to us to offer real change to Brazilians. Brazilians, like Mexicans, are fed up with corruption. We think they really want to see change and we wouldn't be surprised to see one of these two candidates winning. We think a victory by either of these two candidates would be a market neutral event until they built a coalition in congress to allow them to govern, but assuming they could govern we think both candidates would pass positive economic reforms. The other three candidates in the running that have a realistic chance of winning are Ciro Gomez, Fernando Haddad and Geraldo Alckmin. Gomez is an ex-governor of a small North Eastern state. He is standing for a small centre-left party and has a well-respected economic advisor. Haddad is the ex-mayor of Sao Paulo. He is the likely replacement for Lula as the workers party (PT) candidate. Whilst Haddad is currently only polling 2-3%, we wouldn't write him off as we believe that Lula is likely to support him later on and there are currently plenty of undecided voters (the majority of which are loyal Lula supporters). Alckmin is an ex-governor of Sao Paulo state. He is extremely pro-market and did a great job in Sao Paulo.

Once we get past the August deadline for forming coalitions and selecting candidates the real campaigning will start and it's likely that the polls will start to change. Alckmin has a big party infrastructure and we wouldn't be surprised to see him in the second round. One of the factors to watch will be whether one of the smaller party candidates can ally with a larger party. If they can't then they will have very little TV advertising time which is likely to benefit Alckmin and Haddad.

An Alckmin victory is our preferred outcome and a Haddad victory is our least preferred one. Four of the five leading candidates say that they intend to reform Brazil's bloated pension system as a priority. The fifth candidate (Haddad) hasn't clarified his position on this issue yet but we suspect that it might be a lower priority for him. The pension reform is important because Brazil has a slow burning fiscal problem which, with net debt/GDP at 52%, needs fixing (source: Bloomberg). A good pension reform might return Brazil to investment grade.

Our Brazilian holdings are generally producing solid results and their PE multiples have really de-rated in this sell off. We now have plenty of single digit PEs in our non-financial growth companies. We added to **Smiles**, one of the two leaders in the airline/credit cards rewards industry, in the quarter at approximately 8-9x forward earnings (source: Brown Advisory). Smiles is gaining share in a structurally growing industry, has net cash and a very high ROIC, and should provide a mid to high single digit dividend yield in most years. We feel that there is a lot of upside in our Brazilian portfolio and we are inclined to add but it is hard to find anything that we want to sell elsewhere.



## CONCLUSION

**We feel that Latin American equities are in a much more favourable part of their cycle than global equities as a whole. Latin America is entering into what we think will be a multi-year economic acceleration just as multiples and currencies are cheap.** Longer term, we believe that this region will gain relevance in global equities - the combined GDP of the countries we invest into is just under US\$5 trillion, the same size as Japan (source: World Economic Outlook Database, April 2018, International Monetary Fund).

**We believe that our fund, which only invests in high quality growth companies in the domestic part of these economies, is where you want to be positioned.** Commodity stocks have performed well recently but we believe that as the domestic economies accelerate the market will migrate toward our types of stocks. **Our fund is clearly trading at an attractive multiple of 13x 2019 forecast earnings and despite the recent volatility we feel very confident about its outlook** (source: Brown Advisory).

Rupert Brandt and Peter Cawston have a combined stake in the Fund equating to approximately 1.8% of its NAV.

### *The Latin American Team*

**RUPERT BRANDT, CFA**  
Portfolio Manager

**PETER CAWSTON**  
Portfolio Manager

Annual Performance	Latin American Fund
Inception to Year end 2006	17.90%
2007	19.08%
2008	-55.34%
2009	140.99%
2010	34.30%
2011	-23.44%
2012	34.92%
2013	-7.53%
2014	-7.84%
2015	-35.25%
2016	24.13%
2017	25.49%
YTD	-17.47%
Cumulative performance since inception	49.12%

Source: BBH. The performance shown above includes the performance of the Findlay Park Latin American Fund between 10 October 2006 and 28 March 2018 which merged into the Brown Advisory Latin American Fund on 30 April 2018. Past performance is calculated using the U.S. Dollar class of share, inclusive of any distributions, on a NAV to NAV basis, net of fees. The Brown Advisory Latin American Fund was launched under Brown Advisory's Irish UCITS umbrella on 30 April 2018. Data as at 30<sup>th</sup> June 2018.

Sector Breakdown			
SECTOR	FUND WEIGHT %	QTD % CHANGE	YTD % CHANGE
Consumer Discretionary	21.1	-4.5	-2.0
Consumer Staples	20.2	4.3	3.7
Banks	17.1	1.5	1.1
Other Financials	10.1	-0.4	0.6
Financial Exchanges	5.4	3.1	3.0
Transportation	4.7	-0.2	0.1
Building Materials & Cement	4.0	2.8	2.8
Private Education	4.0	-0.5	-1.8
Shopping Malls	3.8	-0.2	0.1
Industrials	3.4	-0.7	-0.2
Technology Services & Software	1.8	-0.0	-0.7
Real Estate Brokers	1.0	-0.3	-0.6
Utilities	0.8	-3.6	-3.8
Cash	2.6	-1.3	-2.3

Top 10 Positions Q2 2018		
SECURITY	COUNTRY	FUND WEIGHT (%)
Grupo Nutresa S.A.	Colombia	8.3
Credicorp Ltd.	Peru	5.1
InRetail Peru Corp.	Peru	5.0
Alicorp SA	Peru	4.5
El Puerto de Liverpool SAB de CV	Mexico	4.1
Ambev SA Sponsored ADR	Brazil	3.9
Wilson Sons Ltd	Brazil	3.7
Iguatemi Empresa de Shopping Centers S.A.	Brazil	3.5
Bolsas y Mercados Argentinos SA	Argentina	3.0
Grupo de Inversiones Suramericana S.A.	Colombia	2.8

Largest Purchases Q2 2018	
STOCK NAME	COUNTRY
Bolsas y Mercados Argentinos SA	Argentina
Grupo Financiero Galicia SA Sponsored ADR CI B	Argentina
Grupo Supervielle SA Sponsored ADR Class B	Argentina
Loma Negra Compania Industrial Argentina SA Sponsored ADR	Argentina
Grupo Argos S.A.	Colombia

Source: Factset. Data as at 30<sup>th</sup> June 2018.

Largest Purchases YTD 2018	
STOCK NAME	COUNTRY
Bolsas y Mercados Argentinos SA	Argentina
Grupo Financiero Galicia SA Sponsored ADR CI B	Argentina
Smiles Fidelidade SA	Brazil
Grupo Supervielle SA Sponsored ADR Class B	Argentina
Loma Negra Compania Industrial Argentina SA Sponsored ADR	Argentina

Largest Sales Q2 2018	
STOCK NAME	COUNTRY
Grupo Financiero Banorte SAB de CV Class O	Mexico
Pampa Energia SA Sponsored ADR	Argentina
Grupo Financiero Inbursa SAB de CV Class O	Mexico
Alsea, S.A.B. de C.V.	Mexico
El Puerto de Liverpool SAB de CV	Mexico

Largest Sales YTD 2018	
STOCK NAME	COUNTRY
Grupo Financiero Banorte SAB de CV Class O	Mexico
Pampa Energia SA Sp. ADR	Argentina
Grupo Financiero Inbursa SAB de CV Class O	Mexico
Alsea, S.A.B. de C.V.	Mexico
El Puerto de Liverpool SAB de CV	Mexico

Source: Factset. Data as at 30<sup>th</sup> June 2018.

Past performance is not a guarantee of future performance and you may not get back the amount invested.

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