Confluence INVESTMENT MANAGEMENT

THIRD QUARTER 2020

# Emerging Markets • International Equity Strategies

Confluence Emerging Markets invests in large cap, growth-oriented companies in the more mature emerging markets around the world. The strategy's management team employs both top-down and bottom-up fundamental analysis to identify attractive emerging market countries and economic sectors as well as high-quality companies worthy of a long-term investment allocation. The portfolio's primary objective is long-term capital appreciation.

## Market Commentary

Emerging market (EM) equities tallied their best six-month performance in nearly 11 years during the second and third quarters of 2020. In the third quarter, the MSCI Emerging Markets Index rose 9.6% in U.S. dollar terms, exceeding the returns of developed international markets (MSCI EAFE Index, up 4.8%) and the U.S. markets (S&P 500 Index, up 8.9%). The impressive EM returns were driven by a rollback of COVID-19-induced lockdowns, better than expected economic indicators, optimism around potential COVID-19 treatments/vaccines, and widespread economic stimulus. These factors outweighed fears of second-wave outbreaks and renewed geopolitical tensions. As of September 30, 2020, the MSCI Emerging Markets Index has achieved 96% of its pre-COVID-19 peak. As a result of a weaker U.S. dollar (USD), EM currencies broadly strengthened against the USD, helping to propel EM equity returns ahead of those in the developed international markets for the quarter. The weaker USD is especially important to the emerging market economies; this fact was reinforced by Federal Reserve Bank Chair Powell, who announced during the third quarter that interest rates will remain low, even if it means periods of higher inflation.

Emerging market equities continued to be driven by a global "risk-on" environment. The reopening of global economies combined with copious amounts of monetary and fiscal accommodation have created a sharp recovery from the global shutdown in many of these places. However, some pockets of renewed rising infection rates have started to emerge globally. As long as these pockets remain isolated, we are confident that these economies will reaccelerate and continue to drive global growth. It is important to note that while equity markets are climbing rapidly back to pre-COVID-19 highs, the returns are not evenly distributed. Since the March 23 market low, China alone is responsible for more than 35% of the EM index return, with Korea and Taiwan contributing another 30%. Northern Asia's leadership this quarter is due to their advanced technology industries. Technology and other higher growth sectors such as Communication Services and Consumer Discretionary continue to drive performance within the emerging markets.

As a region, Asia ex-Japan had the highest performance in the third quarter. The strongest returns were in Taiwan, where the Information Technology stocks underpinned the strong performance. India, Korea, and China all posted double-digit returns. The Chinese equity market has now broadly retraced the COVID-19 losses and has turned modestly positive on a year-to-date basis. Chinese consumer spending is accelerating, with domestic demand rekindling in infrastructure, real estate, and auto sectors. Exports are rising as supply chains are being reestablished and the rest of the world is returning to work.

China was among the best-performing emerging market economies despite tensions with the U.S. intensifying over the last quarter. Earnings expectations, especially in the e-commerce sector, were ahead of consensus and added to strong gains. The U.S. has cracked down on several Chinese tech companies. Tighter restrictions by the U.S. Commerce Department will limit their ability to obtain critical advanced semiconductors needed to expand 5G network infrastructure as it may pose a threat to national security. Most recently, U.S. regulators have turned their attention to restrict the use of Chinese software applications WeChat and TikTok. As a result of these actions, a growing number of Chinese companies are pursuing secondary listings in Hong Kong and mainland China to get around strict new audit rules in the U.S. These companies face delisting of their shares from U.S. exchanges if corporate audits fall short of U.S. expectations.

Thailand, Indonesia, and the Philippines underperformed the benchmark. In Thailand, cabinet resignations and anti-government protests fed political uncertainty. Indonesia introduced mobility restrictions in its capital to combat a resurgence in coronavirus infections. All these underperforming economies reported increased numbers of COVID-19 cases, requiring additional lockdowns and reduced tourism.

In India, better than expected corporate results cushioned the market against the sustained COVID-19 spread in the highly populated country. Given that the mortality rate has been contained, with daily deaths significantly below peak levels, the Indian economy continues to reopen despite the surge in cases.

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**Market Commentary continued...**

The return for Russian equities was negative for the third quarter, driven by lower oil prices, geopolitical worries, and depreciation of the ruble. These negative factors overshadowed the development of a COVID-19 vaccine and better than expected second quarter 2020 GDP data.

In Latin America, the global rebound continued as social distancing measures were eased. Returns were generally weaker across the continent than the Asian emerging markets. Despite record-low interest rates, the Brazilian economy is still concerned about the fiscal outlook and key government reform measures. Compounding this view is lower than expected GDP growth. Brazil continues to be impacted by COVID-19, and its death rate is exceeded only by the U.S. and India. In Mexico, positive returns were driven by a stronger peso. The Mexican central bank reduced interest rates by 75 bps, bringing borrowing costs in Mexico to the lowest level in four years. Supply chain disruptions still impact some economies as the global recovery intensifies.

Energy prices retraced some previous gains in September following four months of successive gains. Concerns about fuel demand amid rising infections dampened the energy markets. Higher energy supplies by OPEC also weighed on energy prices. In a similar vein, commodity prices, especially base metals, have softened in September on weaker demand profiles and a slightly stronger USD. Weaker commodity prices have put pressure on emerging economies, such as Russia, Brazil, and Chile, which are heavily dependent on commodity exports.

Year-to-date, the EM sell-off was quick and brutal. However, it has provided opportunities to add high-quality, growth-oriented emerging market equities at attractive valuations relative to where they were at the beginning of 2020. We have found opportunities in economies best suited to handle the pandemic and reduced exposure to countries less prepared. One advantage of this recent upheaval within EM equities is that high-quality growth stocks are trading at a sharp discount to their U.S. counterparts, demonstrated by the forward P/E ratio of the MSCI Emerging Markets Index of 14.4x versus 22.3x for the MSCI USA Index as of September 30, 2020.

We have written intently about the impact of a weak USD on foreign equity markets. Simply stated, the direction of the USD is an important factor in the total return of EM equities. For over a decade, the USD has strengthened significantly, resulting in the outperformance of domestic stocks over their international contemporaries. The U.S. Dollar Index, a measure of the relative strength of the dollar against a basket of major global currencies, has been in a strengthening phase since March 2008. During this time frame, the S&P 500 recorded an annualized return of 9.4% compared to 2.3% for the MSCI EM Index. This continued and meaningful relative outperformance has caused investors to raise questions regarding whether they need an allocation to companies domiciled outside the U.S. However, during the most recent extended period of USD weakness from January 2002 through March 2008, the MSCI EM Index, on an annualized basis, returned 24.7%, while the S&P 500 posted a gain of 3.8% (annualized). Thus, a prolonged weakening of the USD would very likely serve as a catalyst for non-U.S. stocks, especially emerging market equities. On a year-to-date basis, the U.S. Dollar Index has weakened by 2.3% but has fallen by nearly 9% since the 2020 peak recorded on March 20.

In our **podcast** dated 9/25/2020 (Asset Allocation Weekly, episode 12), Confluence Market Strategist Patrick Fearon-Hernandez broaches the subject of whether now might be a good time to increase the allocation to international equities. He states that weaker population growth within large developed countries, less economic diversity, lower exposure to fast-growing sectors such as Information Technology, and differing financial systems all weighed on foreign equity performance over the past decade. Still, the predominant factor contributing to U.S. outperformance has been USD strength. We invite you to give the podcast a listen.

A fair question for investors to ask is that if we are nearing the end of this extended USD bull market, which factors, beyond currency, are in place to support non-U.S. equity markets? Looking first at global growth, according to 2019 World Bank data, 19 of the 25 largest countries in the world (by population) are classified as emerging markets. Further, the average population growth rate of these 19 emerging market economies was 1.4% compared to 0.3% for the six developed markets (U.S., Japan, Germany, France, U.K., and Italy). Looking at the data differently, the World Bank showed that the U.S. registered population growth last year was 0.5%. Although this rate of growth is faster than much of Europe, Asia recorded a population increase of 0.9%, while the world average was 1.1%. This data suggests that an increasing percentage of forward growth opportunities will be in the world's emerging markets. Additionally, *Capital Economics* is currently forecasting that emerging economies will outgrow developed markets by a ratio of nearly 2:1 over the next two years. Therefore, in addition to a weakening USD, the prospects for growth within many emerging markets appear to be improving.

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### Quarterly Trading Summary

While we did not execute any trades during the third quarter in the Emerging Markets strategy, the investment committee continued to identify countries and regions that have better adapted to the pandemic and implemented effective fiscal and monetary policies, along with industries and companies that were able to adjust and thrive. These companies tended to provide e-commerce, remote learning, and fintech solutions for some level of normalcy during the lockdowns, while the industries were able to quickly adjust to the changing needs created by the pandemic. That being said, even when the world returns to "normal," these opportunities will remain and continue to grow. The world was already moving toward greater e-commerce, distance/digital learning, gaming, cloud applications, and digital payment platforms; the pandemic "pulled forward" the adoption of these trends.

The pandemic has demonstrated that many emerging market healthcare systems were woefully unprepared for these situations, and they need to be modernized to meet the increasing healthcare needs of large populations of people with rising incomes. Maslow's "hierarchy of needs" would suggest that once food and basic shelter needs are met, spending on healthcare would be the next logical choice. We are currently evaluating possible candidates within the Health Care sector.

### Performance Review

During the third quarter, Confluence Emerging Markets was up 8.7% (gross of fees) compared to 9.6% for the MSCI Emerging Markets Index. On a year-to-date basis, Confluence Emerging Markets recorded a return of 0.5% (gross of fees) versus -1.2% for the index. [*Net-of-fees returns for the same periods were +7.9% QTD and -1.8% YTD. See disclosures on p.4 for fee description; actual investment advisory fees may vary.*]

The two best-performing countries within the portfolio on an absolute basis were Taiwan (+43.7%) and South Africa (+22.8%), while the weakest returns were recorded by Columbia (-11.6) and Russia (-4.7%). Health Care (+32.9%) and Information Technology (+18.7%) were the strongest sectors during the quarter, whereas Energy (-8.2%) and Consumer Staples (-3.1%) were the worst-performing sectors.

The best-performing and worst-performing positions during the quarter were as follows:

| Security | Avg Weight | Contribution |
|---|---|---|
| **Top 5** | | |
| Alibaba Group Holding Ltd. | 4.74 | 1.51 |
| Taiwan Semiconductor Manufacturing Co. | 3.19 | 1.19 |
| Yandex N.V. | 4.13 | 1.18 |
| Gold Fields Limited | 2.84 | 0.89 |
| Huazhu Group Ltd. | 3.14 | 0.84 |
| **Bottom 5** | | |
| MMC Norilsk Nickel | 2.22 | (0.23) |
| Ecopetrol S.A. | 1.67 | (0.25) |
| CNOOC Ltd. | 2.15 | (0.27) |
| Vipshop Holdings Limited | 3.44 | (0.75) |
| ZTO Express (Cayman) Inc. | 4.66 | (0.79) |

*(Contribution data shown from a sample account)*

### What We Are Watching

Aside from the path of the USD, U.S./China relations will be the predominant factor in determining near-term EM performance. Regardless of who wins the U.S. presidential election, we don't expect a significant policy shift in the way China is treated. We expect the ongoing U.S. trade/technology conflict to place continued pressure on supply chains, which may result in reduced globalization and reshoring.

We are optimistic that the worst is over for the world's emerging markets. The COVID-19 pandemic has highlighted the strengths of emerging markets, including social systems, governance, and, in some cases, healthcare. We have seen solid progress in terms of reforms from both the fiscal and corporate point of view. The financial strength of emerging markets, corporate balance sheets, and profitability have been sources of resilience throughout this crisis, especially in the Asian markets. While COVID-19 concerns have somewhat receded, the pandemic is still ongoing. Most emerging market countries and governments have moved away from broad national lockdowns to isolated movement restrictions. Monetary and fiscal accommodations are being tapered as economies are reopened. We believe social and financial healing is underway and that the combination of herd immunity and a widely accepted and effective vaccine should restore growth dynamics of the emerging markets.

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(as of 9/30/20)

| 10 Largest Holdings | Weight |
|---|---|
| Alibaba Group Holding Ltd. | 6.0% |
| Yandex N.V. | 5.1% |
| Tencent Holdings Ltd. | 4.9% |
| Huazhu Group Ltd. | 3.9% |
| ZTO Express (Cayman) Inc. | 3.7% |
| Taiwan Semiconductor Manufacturing | 3.6% |
| MercadoLibre, Inc. | 3.5% |
| WuXi Biologics (Cayman) Inc. | 3.2% |
| Dr. Reddy's Laboratories Limited | 3.2% |
| Gold Fields Limited | 3.0% |

| Sector Allocation | Weight |
|---|---|
| Consumer Discretionary | 23.0% |
| Communication Services | 15.9% |
| Financials | 13.3% |
| Information Technology | 11.6% |
| Industrials | 8.5% |
| Health Care | 6.4% |
| Materials | 6.4% |
| Consumer Staples | 5.6% |
| Energy | 5.1% |
| Utilities | 2.5% |
| Cash | 1.9% |

| 10 Largest Countries | Weight |
|---|---|
| China | 44.6% |
| India | 10.0% |
| Brazil | 7.2% |
| Russia | 6.9% |
| Mexico | 5.7% |
| Hong Kong | 5.5% |
| South Africa | 4.0% |
| South Korea | 3.6% |
| Taiwan | 3.5% |
| Argentina | 3.5% |

The listing of "10 Largest Holdings" is not a complete list of all stocks in the portfolio or which Confluence may be currently recommending. Application of the investment strategy as of a later date will likely result in changes to the listing. Listings of countries and holdings do not represent all of the countries/stocks currently or previously owned in the portfolio or which Confluence may be currently recommending. Sector/country weightings and holdings of individual client portfolios in the program may differ, sometimes significantly, from these listings. Contact Confluence for a complete list of holdings.

All investments carry a certain degree of risk, including possible loss of principal. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager. Equity securities are subject to market risk and may decline in value due to adverse company, industry or general economic conditions.

## Performance Composite Returns For Periods Ending 9/30/20

| | Pure Gross-of-Fees[1] | Net-of-Fees[2] | MSCI EM |
|---|---|---|---|
| Since Inception** | 4.9% | 1.8% | 4.0% |
| 10-Year* | 4.0% | 0.9% | 2.5% |
| 5-Year* | 7.2% | 4.0% | 9.0% |
| 3-Year* | (0.4%) | (3.3%) | 2.4% |
| 1-Year | 9.7% | 6.4% | 10.5% |
| YTD | 0.5% | (1.8%) | (1.2%) |
| QTD | 8.7% | 7.9% | 9.6% |

| Calendar Year | Pure Gross-of-Fees[1] | Net-of-Fees[2] | MSCI EM | Difference (Gross-MSCI EM) | # of Portfolios | Composite Assets (000s) | Total Firm Assets (000s) | Composite 3yr Std Dev | MSCI EM 3yr Std Dev | Composite Dispersion |
|---|---|---|---|---|---|---|---|---|---|---|
| 2009** | 10.3% | 9.5% | 8.5% | 1.8% | 5 | $1,030 | - | N/A | N/A | N/A |
| 2010 | 13.1% | 9.8% | 18.9% | (5.7%) | 5 | $1,462 | - | N/A | N/A | 0.1% |
| 2011 | (15.7%) | (18.2%) | (18.4%) | 2.7% | 7 | $2,430 | - | N/A | N/A | 0.0% |
| 2012 | 11.4% | 8.1% | 18.2% | (6.8%) | 4 | $2,346 | - | 18.3% | 21.5% | 0.8% |
| 2013 | 13.5% | 10.2% | (2.6%) | 16.1% | 1 | $220 | - | 16.0% | 19.0% | N/A |
| 2014 | (3.6%) | (6.5%) | (2.2%) | (1.4%) | 4 | $1,636 | - | 13.9% | 15.0% | N/A |
| 2015 | (2.7%) | (5.6%) | (14.9%) | 12.2% | 6 | $3,218 | - | 14.7% | 14.1% | 0.5% |
| 2016 | 0.7% | (2.3%) | 11.2% | (10.5%) | 17 | $6,265 | - | 15.5% | 16.1% | 0.2% |
| 2017 | 42.7% | 38.5% | 37.3% | 5.4% | 16 | $9,288 | - | 15.0% | 15.4% | 0.8% |
| 2018 | (19.7%) | (22.1%) | (14.6%) | (5.1%) | 15 | $8,643 | $5,486,737 | 14.8% | 14.6% | 0.6% |
| 2019 | 17.3% | 13.9% | 18.4% | (1.1%) | 13 | $9,604 | $7,044,708 | 16.0% | 14.2% | 0.6% |

**Average annualized returns*

***Inception is 10/1/2009*

**Portfolio Benchmarks**

***MSCI Emerging Markets (Net) Index*** – Free float-adjusted market capitalization index designed to measure the equity market performance of emerging markets. Performance results are presented net of estimated foreign withholding taxes on dividends, interest and capital gains. *(Source: Bloomberg)*

*(Prior to March 31, 2020, the S&P/BNY Emerging Market ADR Index was shown as a secondary benchmark. This index was removed to simplify the presentation, being less widely recognized and relevant than the primary benchmark. An index is unmanaged and does not incur management fees, transaction costs or other expenses associated with separately managed accounts. It is not possible to invest directly in the index.)*

**Confluence claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Confluence has been independently verified for the periods of 8/1/2008 through 12/31/2019. A copy of the verification report is available upon request.** Verification assesses whether: 1. the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis, and 2. the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.

The Emerging Markets Strategy was incepted on October 1, 2009, and the current Emerging Markets Composite was created on May 1, 2018. Performance presented prior to May 1, 2018, occurred while the Portfolio Management Team was affiliated with a prior firm and was independently verified for the periods of 10/1/1999 through 12/31/2017. The Portfolio Management Team members were the primary individuals responsible for selecting securities to buy and sell. Composite performance is typically net of foreign withholding taxes on dividends, interest income and capital gains with some exceptions based on custodian treatment. Confluence Investment Management LLC is an independent registered investment adviser. Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Past performance is not indicative of future results. The U.S. Dollar is the currency used to express performance. Returns are presented gross and net of all fees and include the reinvestment of all income.

[1] Pure gross returns are shown as supplemental information to the disclosures required by the GIPS ® standards.

[2] Net-of-fee performance was calculated using the highest applicable annual bundled fee of 3.00% applied quarterly. This fee includes brokerage commissions, portfolio management, consulting services and custodial services. The Confluence fee schedule for this composite is as follows: 1.00% on the first $500,000; 0.90% on the next $500,000; and 0.75% over $1,000,000.There are no incentive fees. Clients pay an all-inclusive fee based on a percentage of assets under management. The collection of fees produces a compounding effect on the total rate of return net of fees. Subsequent to February 1, 2013, bundled fee accounts make up 100% of the composite for all periods. Actual investment advisory fees incurred by clients may vary. Wrap fee schedules are provided by independent wrap sponsors and are available upon request from the respective wrap sponsor.

Performance prior to February 1, 2013, is based on the Emerging Markets–Direct Composite which was initially created on October 1, 2009. The Emerging Markets–Direct Composite includes accounts that pursue the Emerging Markets strategy, but do not have bundled fees. Gross returns from the Emerging Markets–Direct Composite include transaction costs and net-of-fee performance was calculated using the highest applicable annual bundled fee of 3.00% applied quarterly. A complete list of composite descriptions is available upon request. Additional information regarding policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. Prior to year-end 2018, the annual composite dispersion was an asset-weighted standard deviation calculated for accounts in the composite for the entire year. Beginning with year-end 2018, an equal-weighted standard deviation calculated for accounts in the composite for the entire year. The Emerging Markets Composite contains fully discretionary Emerging Markets wrap accounts. The Emerging Markets portfolio invests in U.S.-listed shares of companies from emerging markets. **Results shown for the year 2009 represent partial period performance from October 1, 2009, through December 31, 2009. N/A-Composite Dispersion: Information is not statistically meaningful due to an insufficient number of portfolios in the composite for the entire year. N/A-3yr Std Dev: Composite does not have 3 years of monthly performance history.

***Individual holding performance and contribution methodology as well as a list of every holding's contribution to the strategy can be obtained by contacting Confluence.*** *Material is published solely for informational purposes and is not an offer to buy or sell or a solicitation of an offer to buy or sell any security or investment product. Holdings identified do not represent all of the securities purchased, sold or recommended. Sector and country allocations along with securities mentioned represent a portion currently or previously held in a representative (model) portfolio invested in accordance with the stated investment strategy. Information is presented as supplemental information to the disclosures required by GIPS® standards. Opinions and estimates are as of a certain date and subject to change without notice. Investment or investment services mentioned may not be suitable to an investor and the investor should seek advice from an investment professional, if applicable. Past performance is no guarantee of future results. Investing in securities involves the risk of loss of the amount invested that investors should be prepared to bear. There can be no assurance that any investment objective will be achieved or that any investment will be profitable or avoid incurring losses.* ***Indices:*** *The MSCI Emerging Markets Index is shown as additional information. This index is unmanaged. An investor cannot invest directly in an index. It is shown for illustrative purposes only & does not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance.*