ALTRINSIC

October 2018

Altrinsic Emerging Markets Equity Commentary – Third Quarter 2018

Dear Investor,

The MSCI Emerging Markets Index declined 1.1% as tightening monetary conditions in the U.S., the strong U.S. dollar, political uncertainty, escalating trade tensions, rising inflationary worries, and fund outflows weighed on performance. The Perterra Emerging Markets Fund, L.P. declined 2.8% during the quarter with relative performance impacted by our holdings in Brazil and not owning Russian energy stocks, which were significant outperformers.[1] Our Brazilian holdings have solid long-term fundamentals, attractive valuations, and generous dividend yields, but their share prices lagged during this period of pre-election political uncertainty. Macro fears and trade uncertainty continue to present the greatest risks to emerging markets, but our assessment of company fundamentals remains constructive. With moderating growth expectations and elevated risk in the markets, we have been adding to stocks with attractive upside while possessing strong underlying balance sheet strength, strong free cash flow generation, and valuation support.

We are disappointed that the portfolio did not perform better during the quarter, given that three of the four key themes embedded in it have played out as we expected.

- *Significant underweight in China* due to high multiples, regulatory hurdles, and trade headwinds. Our relative underweight in this declining market and stock picking added value.
- *Significant overweight in Mexico* where stocks were depressed due to fears of a trade war and political uncertainty. Our relative overweight in this rallying market and stock picking added value.
- *Significant underweight in technology*, particularly the Chinese internet services and Taiwanese hardware sectors where margins were unsustainably high and demand was weakening. This positioning added value, but weakness in Cielo (Brazil) offset gains; and
- *Overweight exposure to Brazil* in industry-leading franchises at attractive valuations with improving margins geared to an ongoing recovery in the domestic economy. However, a disruptive trucker strike led to weakening economic fundamentals. Our holdings have executed well operationally, but share prices disappointed, as investors worried about weakening consumer sentiment.

After the quarter ended, Jair Bolsonaro, Brazil's pro-business presidential candidate, won the first round of elections by a wider-than-expected margin, and markets reacted positively. While many commentators have pointed out that the reforms that lie ahead will be difficult, our view is that Brazil's economy is steadily recovering from the depths reached during the Dilma crisis. Its politicians understand what needs to be done to avoid the economic collapses in Venezuela and Argentina. While there will continue to be volatility leading up to the second round of elections in late October, we believe a new congress and president will make progress on the reform path. We retain a high level of confidence in the fundamental underpinnings of our Brazilian holdings. Below is a synopsis of our three largest positions:

- Ambev, the dominant beer producer, has protected its return on capital for 20 years, but weakness in both consumer sentiment and currency are impacting near-term financials. The company has no debt, generates steady free cash, and retains significant pricing power to pass through inflationary pressure and currency weakness.
- Telefonica Brazil, the leading mobile telecom carrier, has improved margins by 200 basis points per year since 2015, and we see further upside through 2020. The stock offers a 10% dividend yield.
- Cielo, the leading payment processor in Brazil, was the greatest source of negative attribution. This share price decline is disconnected from underlying fundamentals. The company has been navigating challenges both on the cyclical front, as Brazil's deep recession has been followed by a steady but sluggish recovery, and from a competitive perspective with new entrants moving nimbly into the high-growth micro-merchant segment. Regarding the latter point, we are encouraged by Cielo's steady execution in its core "high-touch" merchant segment and its disciplined strategy to compete in the micro-merchant space, offering entry level point-of-sale machines and attractively priced service bundles. With the shares trading at an all-time low 9x earnings and offering a 15% free cash flow yield, we believe we are being compensated for the uncertain cyclical and regulatory dynamics.

Trade Wars, Inflation, and Investment Opportunities

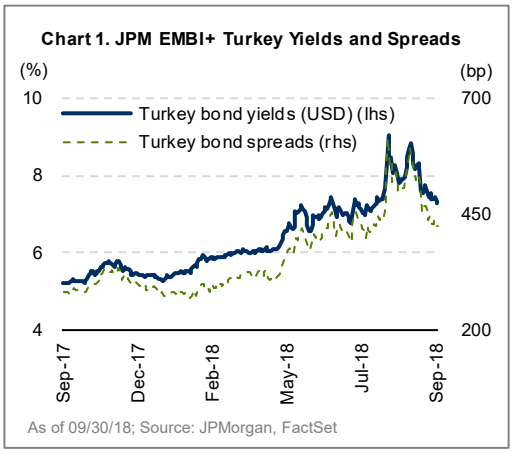
Elsewhere in Latin America, Mexico has been rallying as NAFTA negotiations reached a conclusion, but the U.S.-China trade war, which can have far-reaching repercussions, seems to be just getting started. Market consensus for a quick resolution to this issue has shifted to expectations of a drawn-out conflict after President Trump surprised the markets with tough import tariffs. These initial rounds of trade tariffs, the tripling of oil prices since 2016, and a strong U.S. dollar are leading to inflation worries in both emerging and developed markets.

The successful renegotiation of NAFTA was always the most likely outcome, as it was between geopolitically aligned parties and allies. However, this new U.S., Mexico, and Canada (USMCA) agreement does come with higher minimum wage requirements on the automobiles sold in the United States. This requirement comes against a backdrop of overall U.S. wage inflation that is already at an eight-year high, and it will only add to wage pressures. While all three sides gave ground on various points, the outcome does not meaningfully change trade flows in North America.

The escalating U.S.-China trade tensions, on the other hand, have the potential to realign global supply chains. In fact, manufacturers are already looking to switch production away from China to neighboring countries where they have excess capacity. The latest 10% tariffs on Chinese imports are quickly being passed on to customers and companies are taking actions to prepare for the possibility of the 25% tariffs, which could start in January.

As an example of the rapid tariff pass-through mechanism, we noted that the U.S. government's actions on aluminum and steel imports have already resulted in price increases for domestic consumers. Global beverage giants PepsiCo and Coca-Cola recently raised prices by mid-single digits, citing input cost increases and wage pressures. In addition, the recent weakness in the Chinese economy is forcing Beijing to open the credit taps to stimulate domestic demand and investment (cutting reserve requirements, opening additional funding channels for local governments, and mulling tax cuts on new car purchases), potentially leading to higher prices across the commodity space. The path to more and faster rate increases in the U.S. is clear, and the pressure on vulnerable emerging countries will likely intensify.

Given these fundamentals and the macro risks that lie ahead, some stocks and currencies have declined precipitously this year. We are finding value in the rubble and adding to new positions cautiously with a healthy respect for the unpredictable political and macro news flow. A recent example is Turkey, where the lira fell 24% during the quarter. Turkey's heavy reliance on foreign capital to fund its persistent current account deficits was amplified by the government's pre-election spending spree and the need for and rising cost of imported energy. The installation of President Erdogan's son-in-law as Finance Minister and the central bank's subsequent failure to raise interest rates, as inflation surged above 20%, led to a brief spike in credit spreads as seen in Chart 1 (which later abated as the central bank finally raised its key policy rate to 24%). During this period of fear, we added a new position in Garanti Bank, one of the leading private sector banks in Turkey. Although we do expect a rise in its stressed assets, we are comfortable that Garanti can absorb the worst of the storm due to its conservative level of general provisions and high capital buffers. Garanti has a long history of managing its risk exposure through periods of high inflation and currency depreciation in Turkey, and with the shares trading at a 30% discount to tangible book value, we believe we are being compensated for the risk.



Portfolio activity on the sell side largely consisted of trimming a number of stocks that neared our estimate of intrinsic value and the sale of three stocks, as we found better ideas. Among the new purchases were:

- Netease, China's second-largest gaming company, has a consistent history of developing games based on proprietary intellectual property. The stock is down significantly due to regulatory uncertainty. Also, Netease's margins are under pressure due to investments in e-commerce. We acknowledge the lack of near-term visibility but believe regulatory pressure will ease as China looks for easy wins to reinvigorate the domestic economy. Regarding the company's e-commerce investment, while it is margin dilutive, this segment is growing rapidly with the potential for an eventual IPO. We find the stock attractive at 14x normalized core profits with a strong balance sheet, solid cash flow visibility, hidden assets, and an ongoing share buyback program.
- Airtac International is a Taiwanese manufacturer of pneumatic equipment with products that are used by a wide range of industrial and manufacturing companies. Airtac generates 90% of its revenue from China and has steadily gained share against its key rival SMC, the Japanese market leader. Airtac's stock has de-rated from a P/E of 25x to 13x on slowing demand and market worries about the impact of the trade war. We find the stock compelling and expect it to gain further market share as it broadens the product portfolio and expands internationally, while still retaining a cost advantage over its Japanese competitors.
- Shinhan Financial Group, which operates one of Korea's largest banks, has de-rated to near all-time low valuations due to concerns that the slowing Korean economy will inhibit growth and profitability. While the economic risks are very real, Shinhan should be able to weather any storm given its strong capital levels and risk-focused management team. In addition, after years of rising costs, management has undertaken an efficiency program that is already streamlining the cost base and should eventually return bank margins to their long-term average. We expect the shares to re-

rate in the medium term as the bank executes on this cost-cutting strategy and manages the current slowdown without significant capital pressure.

A welcome result of this volatility is the fact that we are identifying a growing number of investment opportunities, as much of the recent market selloff has been fairly indiscriminate. As regulatory, political, and cyclical risks get priced into stocks, our preference remains well-capitalized companies with sustainable long-term earnings power. Below is a succinct summary or our positioning:

- Financials weighting has increased from 25% at the beginning of the year to 30%, driven by new holdings (Siam Commercial Bank, Garanti, and Shinhan) as well as additions to existing positions in CITIC Securities (China) and ICICI (India). We have consistently been drawn to opportunities in the financial sector this year, as macro and economic concerns have pushed down stock prices to reflect far worse credit loss outcomes than our analysis suggests. Common traits amongst our bank and insurance holdings include generous capital buffers, prudent loss provisioning, and cost discipline.
- Technology (23% of portfolio) is an area of increasing opportunity as both the semiconductor and internet cycles have hit snags. During the quarter we added three new positions in technology (NetEase, YY, and Naver) and continued to evaluate others, including some we had previously sold.
- Geographically, our exposure to Mexico has been reduced from 10% to 7%, as we sold stocks that approached our intrinsic value estimates. Our direct exposure to China increased slightly, as did the indirect leverage to the Chinese economy through purchases in Taiwan and South Korea.

In this volatile market, several of our large holdings have not performed well despite compelling theses, attractive valuations, and reliable cash generation. As the market looks past near-term macro and political overhangs, we believe the value in these companies will be realized. Nevertheless, we are acutely aware of the risks inherent in this new world and expect market volatility to remain elevated. We believe that our investment process in which company-specific and macro risks are constantly evaluated in each step from new idea generation through portfolio construction is well-suited for this environment.

Thank you for your interest.

Sincerely,

Srini Polaki
Chip Powell

[1]*Index Source: MSCI. Performance is presented gross of management fees and includes the reinvestment of all income. Gross returns will be reduced by investment advisory fees and other expenses that may be incurred in the management of the account. Past performance is not indicative of future results. Please see Important Considerations and Assumptions at the end of this letter for additional disclosures.*

ALTRINSIC EMERGING MARKETS EQUITY COMPOSITE
FULL DISCLOSURE PRESENTATION

	Total Firm	Composite Assets			Annual Performance Results				Ex-Post Standard Deviation (3 Yr Annualized)	
Year to Date	Assets (millions)	USD (millions)	% of Firm Assets	Number of Accounts	Composite Gross	Composite Net	MSCI EM (Net)	Composite Dispersion	Composite	MSCI EM (Net)
Q3 2018	6,656	86	1%	Five or fewer	-10.55%	-11.19%	-7.68%	N.A.	13.77%	14.09%
2017	7,259	97	1%	Five or fewer	30.24%	29.03%	37.28%	N.A.[1]	14.81%	15.35%
2016	7,107	78	1%	Five or fewer	13.75%	12.69%	11.19%	N.A.[1]	15.98%	16.07%
2015	8,927	34	0%	Five or fewer	-14.82%	-15.64%	-14.92%	N.A.[1]	N.A.	N.A.
2014	11,656	48	0%	Five or fewer	-2.72%	-3.64%	-2.19%	N.A.[1]	N.A.	N.A.
2013	14,261	50	0%	Five or fewer	-1.13%	-1.83%	-1.00%	N.A.[1]	N.A.	N.A.

N.A. - Information is not statistically meaningful due to an insufficient period of time.

N.A.[1] - Information is not statistically meaningful due to an insufficient number of portfolios in the composite for the entire year.

*Results shown for the year 2013 represent partial period performance from April 1, 2013 through December 31, 2013.

The Altrinsic Emerging Market Equity Composite is a diversified (typically between 50 - 80 holdings), bottom-up, fundamental, value oriented, Emerging Market focused portfolio, benchmarked to the MSCI Emerging Markets (Net) Index. The MSCI Emerging Markets (Net) Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of emerging markets. Portfolios in the composite may invest in countries that are not in the MSCI Emerging Markets (Net) Index. Additional information is available upon request. The minimum account size for this composite is $5 million. Returns include the effect of foreign currency exchange rates.

Altrinsic Global Advisors, LLC claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS Standards. Altrinsic Global Advisors, LLC has been independently verified for the periods from December 8, 2000 through March 31, 2018.

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. The Altrinsic Emerging Markets Equity Composite has been examined for the periods beginning April 1, 2013 through March 31, 2018. The verification and performance examination reports are available upon request.

Altrinsic Global Advisors, LLC is a registered investment adviser. The firm maintains a complete list and description of composites, which is available upon request.

Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Composite performance is presented net of foreign withholding taxes on dividends, interest income, and capital gains. Withholding taxes may vary according to the investor's domicile. Composite returns represent investors domiciled primarily in Australia, United States, and Canada. The MSCI Emerging Markets (Net) Index deducts withholding tax by applying the maximum rate of the company's country of incorporation applicable to non-resident institutional investors. 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 management fees and include the reinvestment of all income. Gross returns will be reduced by investment advisory fees and other expenses that may be incurred in the management of the account. Net of fee performance was calculated using the highest applicable annual management fee of 0.95% applied monthly. The annual composite dispersion is an asset-weighted standard deviation calculated for the accounts in the composite the entire year. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

The investment management fee schedule is 0.95% on the first $25 million, 0.85% on the next $50 million, and 0.75% on the remainder. Some accounts may pay incentive fees. Actual investment advisory fees incurred by clients may vary.

The Altrinsic Emerging Markets Equity Composite was created April 1, 2013

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