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COLUMBIA THREADNEEDLE INVESTMENTS

Q4 2022 Investor Note

Responsible Global Emerging Markets **Strategy**

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Key risks

The value of investments and any income derived from them can go down as well as up as a result of market or currency movements and investors may not get back the original amount invested and in a worst case scenario there is a risk of total loss.

This document does not constitute, and should not be construed as, investment advice or a recommendation to buy, sell or otherwise transact in the fund.

Investing in emerging markets is generally considered to involve more risk than developed markets.

Investments may not be suitable for all investors and independent professional advice, including tax advice should be sought, where appropriate.

Screening out sectors or companies may result in less diversification and hence more volatility in investment values.

On the road in India

It is hard not to admire the resilience of the Indian people. Full street markets, busy vendors, overflowing train stations and the infamous Mumbai traffic were in stark contrast to the images of full hospitals and oxygen shortages we had seen in the news during the pandemic. As one local colleague put it bluntly, 'this is India, we move on.'

This quarter we spent nine days on the road in India with our time split across the two major cities of Mumbai and Delhi. This was the first time we have been on the road in India since the pandemic.

Optimism is clear to see

The outlook for India's economy is encouraging and the optimism was clear to see everywhere, from the management teams we met with to the general public. Corporate and bank balance sheets are in decent shape and consumer sentiment is steadily improving back towards pre-pandemic levels (in complete contrast to many other major economies worldwide).

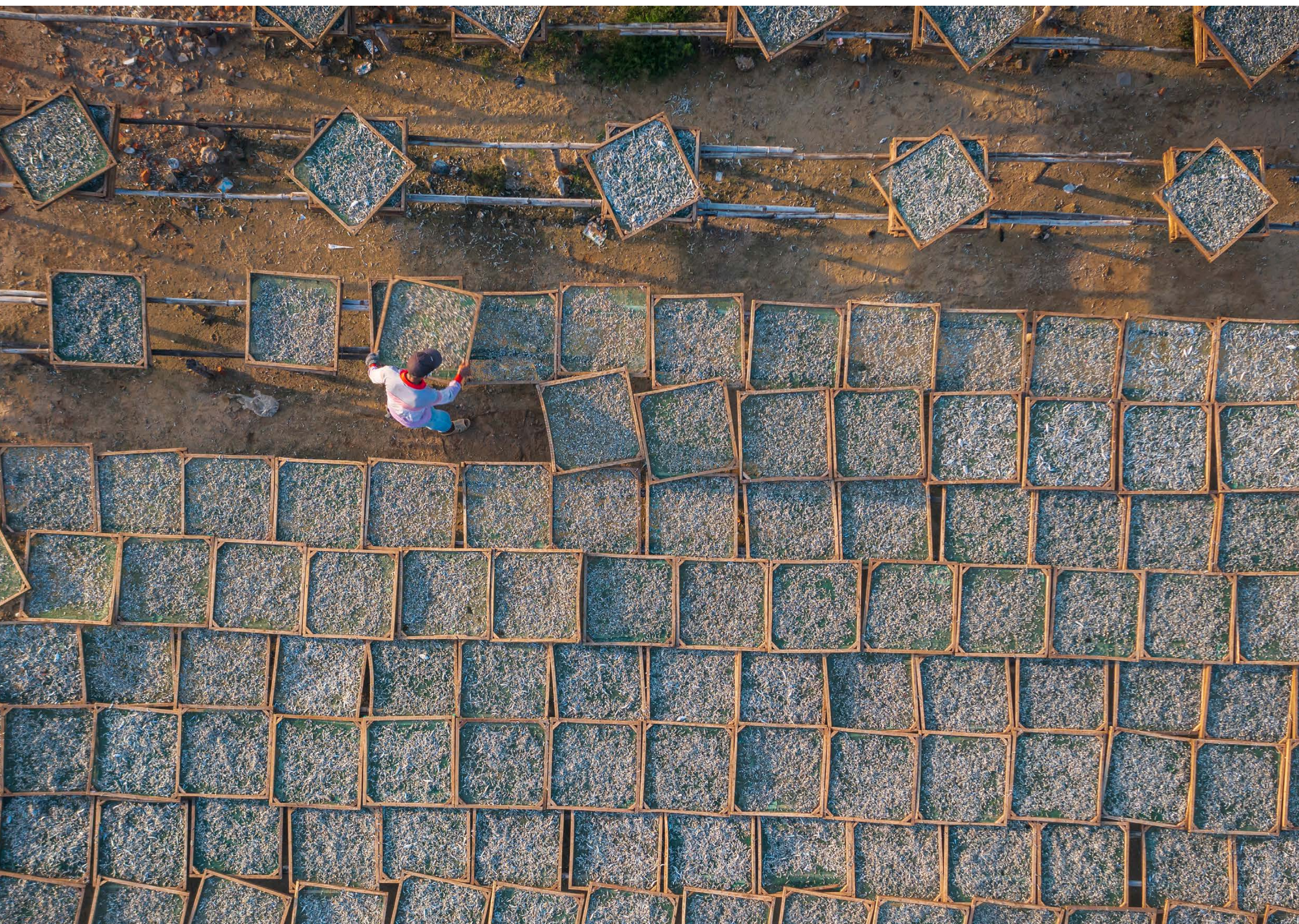
At the centre of a stable macro environment is a supportive policy environment. Stability is the mainstay accompanied by structural economic reforms (financial inclusion, Make-in-India, GST[1]) that are starting to yield results.

Distribution as a moat

Only when visiting India can the competitive advantage that few high-quality businesses enjoy, due to the scale and efficiency of their distribution, be understood. The country is 13 times the size and has 20 times the population of the UK. Such a scale requires distribution systems that are efficient, adaptable and digitalised.

The distribution advantage became fully apparent when we spent some time with an independent paints dealer at the CP Tank Market in Mumbai. Unlike the fast-moving consumer goods (FMCG) industry, the largest paint manufacturers in India do not employ distributors but utilise retailers (dealers) as their distribution network.

Asian Paints (the market leader) sends an account manager to the independent paint dealer every three days to listen to product feedback, take requests and resolve complaints. This reduces the gap between the end customer and Asian Paints



and is in divergence to competitors who visit their dealer outlets a maximum of once a week. Asian Paints has also digitalised the dealers' back-office systems which allows for full visibility of orders across their distribution network, plus it only takes five minutes for the dealer to get full access to monthly sales data.

The dealer can also digitally place orders at 9am and receive the product by 12pm. This is an important offering when many dealers have small stores with limited inventory. Further, Asian Paints has developed the systems, tools and internal behaviours to become the most responsive paints business in the industry. They focus on quality and are first to reimburse the dealers if any genuine issues are encountered. Supporting their ~70k retail dealers to this extent is a powerful moat that becomes very difficult to disrupt for competition.

Grasim, the largest cements company in India has embarked on an ambitious capex plan to build scale and disrupt the paints market. However, from our learnings, we believe it's going to be very difficult for them to challenge the moat that Asian Paints has built.

The move to online viewed as an opportunity

A question we had coming into this trip was whether certain online distribution channels were a genuine threat to incumbents' offline distribution networks in a post pandemic world. FMCG e-commerce sales to total sales, have increased to ~9% from 5% pre-pandemic[2]. From our discussions with many of India's largest consumer companies, it's clear that online distribution is here to stay.

Management teams cannot ignore the digital opportunity or the stronger competition from direct-to-consumer brands. Many consumer businesses are now launching products and brands specifically for the digitally native Indian consumer as well as continuing to invest in their offline distribution capabilities. India is home to 708 million Gen Z and millennials, the world's largest market for these age groups the majority of whom are connected to a smart phone. Our goal is to identify those businesses who see technology adaptation as an opportunity to strengthen their competitiveness instead of those who just see it as risk or fail to acknowledge its existence as a channel at all.

> "India is seeing an increase in digitalisation on the consumer facing side supported by government programmes. Digitalisation has also been extending to supply chains in recent years."

[1] Goods and Services Tax.
[2] The New India |Why This Is India's Decade | Morgan Stanley
[3] The instant real-time payment system developed by the National Payments Corporation of India.
[4] We witnessed a bank onboard/KYC a new customer via video-banking.

The emergence of direct-to-consumer has also increased competitive intensity, especially for premium brand consumers located in urban areas. However, we must acknowledge that the online channel is only a means of targeting a specific subset of the population in India.

Leader in digitalisation

India is also seeing an increase in digitalisation on the consumer facing side supported by government programmes like Aadhaar. Aadhaar is a voluntary, foundational digital ID ''formalising" the 1.3bn people carrying the digital ID. This system has allowed the state to effectively remit cash during the pandemic via UPI[3], banks to quickly identify an individual for banking[4] as well as providing access to health services, taxation and other public services. Aadhaar will accelerate development across India and more importantly support inclusion across all facets of society in India.

Digitalisation has also extended to supply chains in India in recent years. Let's take a building adhesives business that we have admired for some time as an example. We spent time with the CFO to understand the tech-stack that they have been building. Ten years ago, all orders and promotions were completed via email. Today, the business has defined stock norms for each distributor, auto-orders and all pricing and promotion is captured within a customer relationship management tool. This is all completed without the use of paper. The business now has full oversight over its supply chain. More impressively, the tech stack was created in-house and not bought off the shelf.

Achieving a Pan-India footprint is akin to achieving a global footprint

Travelling across India from state to state, the differences were stark and distinct. Culture, tastes and preferences seem to change from town to town. Take the spice market for example, the largest spice brand in India only captures 9% of the market. The market is dominated by smaller regional spice makers who cater for local cooking habits, tastes and preferences. An executive of a spice brand said in a CNBC-TV18 interview that 'in every local market, there are more than 100 brands that we have to compete with.'

It became apparent that achieving pan-India presence/scale to us is no different to achieving a global presence. A clear example of such is in healthcare (we met with a hospital provider plus several diagnostics players). These businesses have built strong brand equity in their home markets, however, achieving brand awareness outside of their core regions has been difficult. Organic growth is a slow burn, success can't be built overnight, and many have opted to go down the inorganic route to achieve national scale.

On-the-ground research

Getting back on the road underlined the importance of 'on the ground' research. Desk research can only go so far. Value add insights are often driven by 'soft impressions' of which are near on impossible to generate from behind the desk in London or from annual reports.

Lessons learnt – open-minded and purposeful investing

Looking back at what we've got right and wrong, so that we can implement lessons learned along the way, we have been reflecting on our experience since the inception of the Responsible Global Emerging Markets fund in 2010. Two key lessons stand out; we will delve into those and share how we are planning to use the insights as part of our continuous improvement initiatives:

1. Companies with strong sustainability tailwinds that are addressing genuine needs tend to do well.
2. Being open minded about our universe and not dismissive about sectors if underlying companies are of a high quality is beneficial.

When examining the **first lesson**, we see that the penetration argument applied by many emerging market managers remains valid but is not enough on its own. We have seen this play out in the dental care sector, in India, where penetration arguments are still being made. Whether it is reach to rural areas or frequency of brushing, dental care standards are still below what is deemed acceptable by the healthcare providers. Meanwhile, natural brands managed to create significant progress in market share over the past decade, slowing down what looked like an easy win for the most established brand, Colgate India. Today, the new natural brands are well recognised and thus unlikely to disappear, challenging existing incumbents

When we launched the EM investment strategy we sought to identify companies seeking to benefit from the six trends shown below. This is backed by the belief that firms positioned to address the needs of wider society, taking a long-term view, will flourish over time. Such businesses benefit from a long runway of tailwinds built by perfecting the product, market positioning and/or educating customers in their ability to improve livelihoods, operations and finances of the target customer.

The lesson we took away, after careful analysis of how the different companies we have invested in over the past 12 years behaved, has provided us with the conclusion that the best thing we can do for our clients is to remain focused on companies that have the right sustainability tailwinds, reflected within the six themes identified. These tailwinds are evidenced through a company's management's ability to allocate capital to areas that have specific societal and environmental benefits along with decisions that support long-term sustainable development trends in the respective markets. We remain more committed than ever to use the six themes as our North Star.

Our **second lesson** learned is to be open minded about our universe. Historically, we have focused more on the consumer and financial sectors as these emerged strongest following the global financial crisis and remained resilient thereafter. It was easier to explain the low penetration of products and services both internally and externally.

While the focus on consumers is easily understood, financials require more explanation. High-quality emerging market financials are essentially simple businesses engaged in deposit taking

The strategy will seek investment opportunities across areas impacted by key global shifts:

1. Health and Well-being
Supporting the provision of services to improve personal long-term wellbeing, e.g. education, health and sanitation.

2. Food and Nutrition
Helping advance sustainable production and consumption patterns.

3. Technological Innovation
Delivering technological and connectivity solutions to advance sustainable development.

4. Energy Transition
Fueling the economy with efficient and affordable energy from both conventional and alternative sources.

5. Sustainable Infrastructure
Helping build resilient infrastructure in transport, energy, water, communications and other sectors.

6. Responsible Finance
Providing financial services to advance financial inclusion, SME development, green finance and sustainable financial markets.

and lending to a range of mid-to-large scale clients. They are unlike the global financial giants doing anything and everything. Successful emerging market financials come with an historical track record of being tested – many EM countries have experienced crises of one sort or another over the years. Self-selection has meant that the quality ones genuinely stand out, and crises only enhances the moats they have created.

The recent history of stock market returns has played a key role in our decision-making regarding these sectors as other areas of the market have lagged. Three to four years ago our portfolio was close to 90% invested in consumer staples and financials. However, it was becoming obvious that other sectors also had a key role to play in the development of emerging countries. As a result, we broadened our scope to an expanded universe of stocks that upheld our quality criteria. The more we expanded our horizon, the greater the number of businesses we (re)identified for inclusion in our portfolio and invested in. On some occasions our timing could have been better. However, we take consolation from the knowledge that while we are not always able to eliminate or initiate on stocks at their peaks and troughs, our long-term focus means that we are nevertheless able to create value for our investors over an extended period of time.

Going forward, our clients should expect us to own the best companies listed in emerging markets, with strong competitive advantages, whether domestic, regional or global. We pledge to avoid solely judging a book by its cover and will keep seeking out the highest quality businesses that benefit from strong environmental and societal tailwinds and that take care not only of their shareholders but all stakeholders.

Engagement

We engage with companies to encourage them to develop business-relevant and impactful sustainability strategies, and to clearly assign oversight responsibilities for their implementation to management and the board. The purpose of our engagement is to mitigate risk and benefit from opportunities over the mid-to-long-term. We record every interaction and milestones that we achieve and are happy to share with our clients upon request.

During the year we have conducted 56 engagements with 22 of our investments and achieved 11 milestones. The vast majority of these engagements were in Asia, and specifically on Labour Standards, Corporate Governance and Climate Change. Climate Change and Corporate Governance are also the areas where we have achieved the most milestone success. From a Sustainable Development Goal language, we have predominantly engaged and achieved success on SDG 13 (take urgent action to combat climate change and its impacts).

Notable engagement during the quarter included our Portuguese, Polish and Colombian discount grocery retailer Jeronimo Martins,

IT firm Tencent and smart home company Haier Smart Home.

We have engaged with **Jeronimo Martins** on employee welfare on the back of rising costs and to understand the provision of ongoing support for employees and their supply chain during difficult periods. We were encouraged by the responses given in terms of providing support at the times when it is most required. We also followed up on the ongoing competition commission cases. We continue to monitor this situation and will follow up with the company to address actions they are taking to avoid a similar situation occurring in the future.

With **Haier Smart Home** we followed up, with investor relations, to encourage the remuneration committee to take a scorecard approach to executive remuneration and factor in ESG metrics. We asked for an update on whether it was on track to meet its circularity goals, whether it saw any impacts from the advent of right to repair legislation and the KPIs used to determine if pilot recycling programs should be scaled up. We also asked about the Company's human rights due diligence efforts and for disclosure of a human rights policy. We encouraged a disclosure of narrative on how human rights risks are mitigated, particularly for migrant workers in the extended supply chain and in response to allegations of sourcing from regions at high risk of forced labour concerns.

Last but not least, we engaged with **Tencent** six times this year and twice in the last quarter. As it is one of our largest holdings, we believe it is important to understand the different nuances of the company's position and what it can do to mitigate risk around ethical AI, human capital, diversity, emissions and the privacy of its user's data. In general, we have gained a good traction with the company and have seen improvements around diversity at the board level, as well as climate related disclosures and targets. On the privacy side, we are still in the process of understanding how Tencent is positioned relative to the globally accepted norms, alongside country specific rules and regulation. We hope to share further findings over the coming quarters.

During the quarter our logistics company, **SITC** achieved a targeted milestone of providing its first public disclosure to Carbon Disclosure Project. While SITC only scored a D, this is still an important step forward for the business in providing more transparency for investors and allows the company to clearly target areas which are undermining its climate performance. Ove the last three years we have been encouraging SITC to disclose to CDP and are pleased to see it beginning to regularly do so.

Voting

One of the core pillars of our investment process and philosophy is active ownership, i.e., engagement and voting. On the latter, we believe that we have a duty as shareholders to use our votes to send a clear message to the boards, of the companies that we own, about improvements they can make in their corporate governance practices. We, therefore, thoughtfully exercise our right to vote across all our holdings.

Starting with the high-level numbers, during the quarter we voted at shareholders' meetings for 6 of our companies. Out of the 33 resolutions we voted on, we voted 'For' management for 94% of these and 'Against' management for 3%. The final 3% was on Management Say on Pay. There were no abstentions this quarter.

Case study
Infosys Limited

The Indian IT services company is the only case this quarter where we have voted against management. We voted against the buyback of equity shares. Although, in principle, we agree with the decision by Infosys to repurchase shares with its excess cash, as we believe this demonstrates their commitment to enhance shareholder value, we felt the proposal to buy back shares at a 25-30% premium to the prevailing share price was excessive and not the best use of shareholder funds. Our policy is that when a company announces a share buy-back it should not be at more than a 10% premium or discount to the prevailing market price. We did reach out to management to inform them of our decision on this matter. While we have a very good relationship with the Infosys management, we exercise our right to vote against proposals if we believe there is scope for improvement. It's a good case study as it highlights that even with top quality companies, we may vote against management if we think they can improve on a certain aspect of their business.

Recapping on the year as a whole, we voted at 55 shareholders' meetings. Out of the 503 resolutions we voted on, in 2022, we voted 'For' management for 82% of these and 'Against' management for 11%. We abstained in just under 5% of these resolutions and voted the final 2% on Management Say on Pay. Among the instances where we voted against management in 2022, **Torrent Pharmaceuticals** stands out. We voted against the compensation for Aman Mehta. Mr Mehta is the Head of the India business and son of the promoter. Other key examples where we voted against management include **Tata Consultancy Services**, where a share buyback was being proposed at a 21% premium to the market price, and **Bank Central Asia** where we voted against proposals because information was lacking.

Responsible Global Emerging Markets Strategy

Portfolio discussion

During the quarter we identified and initiated a position in four new companies. We are excited about these businesses as they play an important role in Sustainable Infrastructure, Energy Transition, Responsible Finance and Health and Wellbeing.

One of the companies we initiated with is **Advantech**, the leading manufacturer of industrial computing hardware. More than 50% of its revenue comes from Asia, with over 38% market share in the Industrial PC market, competing with the likes of ABB and Siemens. They have consistently grown revenue over the years while keeping margins intact. 16% of Advantech's 2020 revenue came from products using sustainable applications: solar, wind, smart grids, EV, energy efficiency buildings, public safety, remote learning, public health, remote medical care, and smart agriculture to name some of them. Advantech's product department is rated on materials, energy consumption, packaging and recyclability. It aims for 80% of its products to meet its green standards by 2025 (from 10% in 2020). Advantech is re-engineering its products from the design/creation phase for them to comply with higher environmental (own/internal) standards. The business remains net cash with a very strong cash and free cash flow generation track record.

> “We initiated on four new companies this quarter that play an important role in Sustainable Infrastructure, Energy Transition, Responsible Finance and Health and Wellbeing.”

The business is led by its founder, KC Liu, who is also Chairman of Advantech. He directly and indirectly controls 30% of shares. Before founding Advantech, Mr. Liu worked as an R&D engineer and then later as a sales engineer for HP Taiwan. KC Liu is the key decision maker, strategic visionary and in charge of big capital deployment decisions. There is a strong professional management team in place with a track record of delivering excellent results in sales, marketing, and distribution, first in mainland China and then globally. The business unit heads have been with Advantech for several decades and have a very good track-record.

The second company we have introduced to the portfolio is **Max Healthcare**, a hospital operator in India with a strong focus on complex medical procedures. We were researching the investment for most of 2022 and had a number of calls with the management team and peers over the period. During our visit to India, we met with key decision makers and saw the operations firsthand. This confirmed for us that Max Healthcare had many of the characteristics we look for in a business. Max Healthcare is the second largest private hospital chain in India in terms of revenue. The management team have done a great job in improving profitability and maintaining patient care at the same time. Max

has a sharp focus on cost efficiency, and its EBITDA per occupied bed is 1.5x-2.0x higher than peers. Its operations are addressing the growing demand for high quality healthcare in India, where the existing infrastructure is struggling to keep up with the population's demand for improvements, particularly on the back of Covid-19. The company has an ambitious expansion plan that is expected to be funded internally, thanks to its strong operating and free cash flow generation. As part of its program to help those in need Max Healthcare treated over 235,000 underserved patients for free in 2021, that's 7% of its patient capacity. Being able to run a hospital chain with such impact while remaining profitable is a key attraction as investors.

The third name we have added to is **WEG** in Brazil. WEG is an industrial capital goods company which has been operating in Brazil, where it has around 70-75% market share, for over 60 years. It has always maintained a clean balance sheet and strong reputation. It is third in the world for producing electric motors behind Siemens and ABB and has the largest manufacturing plant in the world, based in Brazil, from where it exports goods around the world. Management have successfully taken the business outside of Brazil, from where WEG makes more than 50% of its revenues.

WEG's core products link to greater efficiency, a theme highly relevant in a world that is becoming more and more electrically powered and requiring more efficient consumption of energy. In addition, WEG has also been expanding product lines that address the shift towards renewables, energy storage, EV chargers and electric mobility. Renewables today account for 22% of its total revenue. Overseen by the family of the founders and run by a professional management team, we believe WEG will continue to benefit from various secular trends and be part of the renewable evolution.

The last position we added, in the fourth quarter of 2022, is a company we have held in our sister fund, Responsible Asia, for many years called **Bank Rakyat (BRI)**. It is one of the leading Banks in Indonesia with a very strong reach across micro, small, and medium-sized enterprises (MSMEs). BRI has taken some important steps over the past few years to incorporate ESG considerations in its corporate lending transactions, particularly to companies with high sustainability risks/impacts, e.g. palm oil. Since the launch of the Indonesian Sustainable Finance Initiative in 2018, of which BRI is one of eight founding banks, management has accelerated the implementation of a more comprehensive ESG risk management framework. As part of the Sustainable Action Plan the bank launched in early 2019, it will conduct an ESG risk mapping of its loan portfolio, roll out initiatives to further train credit analysts and relationship managers on ESG risk identification, assessment, and monitoring, and communicate expectations to clients. It is reasonably priced and backed by a strong professional management team. It remains reasonably valued with a strong capital position.

To fund the above purchases, we took advantage of the rally driven by China's reopening, bringing down the position weights of **Haier**, **Techtronic**, **AIA**, **Ping-An**, **Dian Diagnostic** and **SITC**. While we continue to see long-term benefits in owning these stocks, we remain cognizant of expectations vs reality. Other noteworthy reductions were among the handsomely priced Indian investments **TCS**, **Colgate**, **Infosys**.

> “Last year we saw huge rotation in the popularity of investment styles and themes. The key change though was the huge shift in sentiment towards China, to a more positive outlook, in December following the relaxation of its zero-Covid policy.”

Reflections

The future is always filled with uncertainty. To manage this, we go back to our processes and reflect on continuous learnings. Last year we saw huge rotation in the popularity of investment styles and themes, i.e. 'value' in and out of favour, 'growth' out of favour, 'energy' in fashion, etc. The key change though was the huge shift in sentiment towards China, to a more positive outlook, in December following the relaxation of its zero-Covid policy. This surprised some. Months before, the state of Texas was talking about creating an Ex-China EM portfolio, a sign of stocks bottoming out. We stuck to our strategy, focussing on the bottom-up credentials of the businesses we had invested in. We expect the continuation of fragility in global supply chains; war and lockdowns meant global supply chains were regularly interrupted. Consumers had purchasing ability (thanks to central banks), but companies had to work tirelessly to stock shelves in an environment where goods were in short supply. Reliable supply chains became a source of competitive advantage in a way that the markets hadn't appreciated.

Performance over the past year was not as strong as we would like. Most of the weakness occurred in the first half of the year, for reasons we have discussed in previous quarterly notes. We tweaked our holdings where we felt it was necessary and sold out of positions where we saw a deterioration of company fundamentals. We expect our long-term holdings to continue to deliver good growth in cash flows, albeit perhaps growing more slowly than in the recent past. Further integration with our new CTI colleagues has helped in the second half of the year by rapidly expanding the depth and breadth of our research coverage.

We remain confident in the underlying businesses we hold and believe that in the mid-to-long-term they will compound our clients' capital. As a testament to this, we invest side-by-side with our clients in the funds we manage. We believe nothing makes a stronger statement around our belief in our investment approach than choosing to invest our own capital in the funds we manage (as opposed to that being mandated).

Team updates

Our colleague Sam Mahtani has made the decision to leave after an exemplary career spanning almost 30 years with the firm. We would like to extend our gratitude to Sam for his many years of contribution and camaraderie. Sam will leave the company in April 2023 and will help with transition of the portfolio's management team in the interim.

As we publish this note, we are in the final stages of the process of joining forces with the Columbia Threadneedle Emerging Markets team – a move we are very excited about, as it is a great cultural and philosophical fit. Most importantly, we expect the new structure will bring stability and enhancements on top of our existing process that will have a positive long-term impact across the funds. We greatly appreciate your patience and understanding during this period.

We remain incredibly grateful for the trust you have placed in us in being stewards of your capital and wish you a successful and healthy 2023.

CT Responsible Global Emerging Markets Team

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