William Blair

2Q 2018

Fund Manager Commentary
William Blair SICAV Emerging Markets Leaders Fund

Fund Performance & Positioning

The William Blair SICAV Emerging Markets Leaders Fund outperformed its benchmark, the MSCI Emerging Markets Index (net), during the second quarter.

Outperformance versus the Index was driven by a combination of allocation and stock selection effects. Consumer Discretionary, Healthcare and Financials were the most significant contributors to relative performance. Consumer Discretionary performance was bolstered by the portfolio overweighting and strong stock selection. In particular, shares of Chinese hotel chain Huazhu Group (previously China Lodging) rallied after the company posted better-than-expected first quarter results and raised its full year guidance. Shenzhou International, the Chinese leading textile manufacturer, also added to the sector-relative results as the company continued to benefit from strong orders and improved production efficiency (aided by automation) as well as increased capacity in Vietnam. Healthcare outperformance was driven by strong results by CSPC, the Chinese branded generic pharmaceutical company. Within Financials, Indian holdings drove strong relative performance, especially consumer finance company Bajaj Financials.

Partially offsetting these effects was negative stock selection within the Energy and Industrials sectors. Within Energy, Petroleo Brasileiro (Petrobras) hampered relative performance. Shares of Petrobras, the Brazilian state-owned energy company, declined sharply amid investor concerns about government interference after the company reduced diesel prices in the wake of the truckers' strike. Industrials performance was dragged down by Industrial Conglomerates holdings Bidvest Group of South Africa and Koc Holdings of Turkey; both affected by weakening macroeconomic backdrops and depreciation in the respective rand and lira currencies.

Top 10 Holdings as of 30.06.2018

Company Name	***% of Fund***
Tencent Holdings Limited	6.6%
Alibaba Group Holding Limited	6.4%
Taiwan Semiconductor Manufacturing Company, Ltd.	5.2%
Samsung Electronics Co., Ltd.	4.1%
Naspers Limited	3.2%
Housing Development Finance Corporation Limited	2.4%
Infosys Limited	2.3%
Ping An Insurance (Group) Company of China, Ltd.	2.2%
Grupo Financiero Banorte, S.A.B. de C.V.	2.1%
Credicorp Ltd.	1.9%
Total of Top 10	36.4%

During the period Consumer Staples exposure was increased through several new purchases including Uni-President Enterprises and Hindustan Unilever. Uni-President Enterprises is the largest consumer conglomerate in Taiwan with a strong presence in China. We believe the company's solid earnings growth outlook is underpinned by improving trends in its China food and beverage business, Taiwan convenience stores, and profitability driven by innovation and premiumization. Hindustan Unilever, the leading household goods and food products company in India, was purchased as we believe its operating performance will be fueled by recovering India consumer demand, market share gains and improved pricing mix. Healthcare exposure was also increased to an overweight position during the period. These increases were offset primarily by reductions to Financials via positions trims and the sale of Korean bank Shinhan Financials Group due to decelerating operating momentum. From a geographic perspective, notable adjustments were an increase to China, offset by decreases to Brazil and South Africa.

Market Review & Outlook

Global equity markets posted mixed results for the first half of 2018, buffeted by escalating trade tensions, the U.S. Federal Reserve's continued tightening bias and dollar strength. In contrast to the global synchronized expansion environment of 2017, equity performance in the first six months of 2018 reflected a growing divergence, with the U.S. economy, earnings and share prices maintaining positive momentum while the rest of the world rolled over.

The benign 2017 environment of low volatility and uninterrupted monthly gains abruptly reversed course in late January 2018, as worries about the extended bull market and narrowing leadership culminated in heavy selling pressure following reports that a handful of niche equity volatility-linked ETF products had suffered significant losses, stoking fears of broader risk contagion.

As the first half progressed, investors became increasingly concerned that the Trump administration's pursuit of protectionist measures would ignite a trade war with China and potentially derail the U.S. expansion. The slowing pace of economic activity in Europe combined with increased turbulence in emerging markets also weighed on investor sentiment.

U.S. equities extended their gains during the first half of 2018 and significantly outpaced non-U.S. markets, bolstered by strong corporate earnings and tax reform. From a market cap perspective, U.S. small caps outperformed their large cap counterparts by approximately 3.5% during the period, as measured by the MSCI U.S. Standard and Small Cap indices. In addition to being less exposed to trade disputes given lower overseas revenues, U.S. small caps were expected to benefit more from tax reform: according to Bloomberg, for the three years ended December 2017, S&P SmallCap 600 Index companies had an average effective tax rate 4.3% higher than that of S&P 500 Index companies.
Non-U.S. developed market equity performance was hampered by negative returns in Europe amid softening economic data and renewed political turmoil in Italy. The euro depreciated approximately 3% versus the dollar in 1H18, reflecting these concerns in addition to expectations for prolonged monetary stimulus from the European Central Bank, which announced that interest rates would remain at record lows through the summer of 2019.

Harkening back to the 2013 taper tantrum episode, emerging markets equities and currencies were hit by a significant rise in investor outflows during the first half of the year. The stronger dollar and prospect of higher U.S. interest rates had a particularly detrimental effect on countries with larger current account deficits and dollar-denominated debt, including Argentina and Turkey.

Political uncertainty and a deteriorating economic growth outlook also weighed on emerging markets returns in the first half. Brazil's nationwide truckers' strike was projected to shave a full percentage point off 2018 GDP growth, threatening the country's nascent economic recovery and further clouding the reform outlook ahead of the presidential election this fall.

Although Chinese equities held up better than most emerging market countries for the six-month period, investors became increasingly wary of escalating trade tensions as the first wave of U.S. tariffs on $34 billion of Chinese exports was scheduled to take effect on July 6.

Technology and energy were the top performing sectors on a global basis during 1H18, while telecom, financials and consumer staples underperformed. Within emerging markets, energy was the only sector in positive territory for the six-month period, benefiting from the rebound in oil prices.

There is now a great deal of uncertainty about how the recently announced trade tariffs will impact intermediate term economic activity. Despite some market skepticism, global growth remains broad based and robust as we head into the second half of 2018. While global manufacturing PMIs declined from unsustainably elevated levels in February and March, the latest readings suggest that we are nearing the end of the in-cycle deceleration to levels in line with ongoing growth. Near-term economic fundamentals indicate that the current economic expansion has further to run. In times of economic expansion such as the current one, we expect companies to continue to post robust earnings growth. However, earnings growth cannot continue to accelerate at the same pace we experienced over the past several quarters, especially in the U.S., where acceleration has been quite pronounced. European corporates have also enjoyed relatively strong earnings growth, which is also likely to continue but at moderately slower rates in the near term.

While the underlying economy remains robust and economic indicators continue to signal positive momentum, escalating trade war rhetoric will likely have substantial consequences on market volatility, inflation, and growth dynamics over the coming quarters. As examples, tariffs on Canadian lumber are adding to higher costs for wood, which are fueling price increases of up to $9,000 for a new single-family home, according to the National Association of Homebuilders. Elsewhere, prices of washing machines sold in the U.S. surged by nearly 8.5% this year – the first increase since 2012 – after the U.S. administration restricted imports earlier this year.

More broadly, some U.S. companies are reportedly using the threat of new tariffs as a reason to raise prices. In short, tariffs amount to either a tax on consumption or corporate margin deterioration if firms choose to absorb some portion of cost increases. In aggregate, it worsens the tradeoff between growth and inflation, and will likely lead to tighter monetary policy. Much of this has not played out yet, because the U.S. administration has moved only recently. However, these effects will begin to manifest themselves over the coming quarters, and it is quite possible that this will bring us closer to the end of the current economic expansion cycle.

Longer term, we fear the U.S. administration's unilateral view of trade policy is suggesting an end to the decades-long building of integrated global markets and supply chains. If the U.S. chooses to limit or regulate trade however it sees fit, regardless of what agreements it may have signed in the past, trade and investment will become more volatile and more politicized. Multinationals from around the world will be more inclined to disentangle their operations from the U.S. The impact of this will only be revealed gradually over the next several years but could imply meaningful changes to competition, quality, and innovation.

From a portfolio strategy perspective, we believe emerging markets (EMs) are susceptible to further downside volatility in the second half of 2018 amid persistent dollar strength as interest rates and growth differentials continue to favor the U.S., and the Federal Reserve maintains its tightening bias. Positioning within our ACWI-oriented strategies has generally reflected our more cautious outlook, with reduced EM weightings in favor of increased developed market exposure, primarily in Europe. Within our dedicated EM strategies, we have maintained overweighted positions in China and India, and moderated exposures to Brazil and South Africa. Within China, our positioning continues to emphasize domestically-oriented consumer, healthcare and technology companies that we believe are well positioned to benefit from the economy's ongoing transition to a consumption and services-driven growth model.

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