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THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Employing an Active Approach in Emerging-Market Investing

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KEVIN ROSS, CFA, is a Research Analyst on the International Value Equity team of Advisory Research, Inc. Prior to joining the firm, Mr. Ross was an international equity analyst at Driehaus Capital Management in Chicago. He also worked as a senior research associate at Raymond James with a focus on the real estate industry. Mr. Ross holds a BSBA in finance and international business from Washington University — St. Louis and an MBA from the University of Chicago — Booth School of Business with concentrations in finance, international business and economics.

SECTOR — GENERAL INVESTING

TWST: Could both of you please identify yourselves and list your titles?

Mr. Priani: Yes, my name is Marco Priani. I'm one of the portfolio managers of our emerging markets strategy. Our EM strategy is available through a U.S.-listed open-end mutual fund, the Advisory Research Emerging Markets Opportunities Fund (MUTF:ADVMX).

Mr. Ross: This is Kevin Ross. I'm one of the senior analysts on the emerging markets strategy.

TWST: Could we start by discussing the firm a little bit?

Mr. Priani: Advisory Research has been managing equities since the mid-1970s, but for most of its life was mainly a domestic-oriented firm. We launched in 2006 our International Small Cap Value strategy, which was our first international product. That product now has a track record of more than 10 years. Our team also manages a Japan-only strategy with a track record of more than five years. I personally have been with Advisory Research for more than 10 years.

Our investment philosophy is based on a long-term value approach. We believe that markets are not efficient in the short term due to behavioral biases, and those behavioral biases favor, over the long run, stocks with value characteristics. The historical evidence shows that the value effect is strongly more pronounced in emerging markets compared to developed markets by a factor of two to three times. In general, we look for companies that have solid balance sheets, understandable and sustainable business models, which can offer a clear path to improving profitability or cash flow generation, and whose valuation is temporarily depressed for reasons that we can ascertain. We tend to have relatively low turnover, with an average holding period of three years.

While our EM fund is an all-cap strategy, we tend to have a small-/mid-cap tilt that is linked to several issues in emerging markets. On the one side, there is a possibility of getting an informational advantage. The average stock in our emerging markets portfolio is followed by four sellside analysts compared to high teens for the average large-cap stock in emerging markets and similar to what you see in more developed markets.

On the other side, particularly in the emerging markets index, the large-cap stocks frequently have challenges in terms of corporate

governance, due to government interventions, and are also frequently driven by global markets, where we tend to favor the trends that support domestic emerging-market consumption growth over the long run rather than global drivers or commodity plays. For these reasons, we believe an active approach is better for emerging-market investments. The large-cap names could from time to time offer value, and we would buy them, but in this case, the inefficiencies are mainly related to different investment time horizons rather than informational advantages.

We have a team of seven investment professionals based in Chicago and Asia, and the makeup of our team is important for our investment process, which is fundamentally oriented, and gives particular importance to corporate governance and interaction with management. Cultural awareness is very important, and four members of our team have material experience in getting the cultural context in emerging markets and the language ability to interact locally. Kevin Ross, for instance, has been researching emerging markets for almost 10 years. Another of our analysts is a South Korean national and another is a Chinese national. I personally worked and lived in Argentina and Brazil, and have good cultural awareness in a Latin American context.

Although we screened and researched emerging-market equities since the launch of our international products more than 10 years ago, we noticed initially that the valuations were too high for our investment style. That started to change around five years ago, where we started to see valuations becoming much more attractive across the emerging markets universe. Our team started preparing for the launch of an emerging-market-dedicated strategy, which was formally launched in 2013.

TWST: What in the current economic environment make sense for why these funds will work?

Mr. Ross: If you look at the emerging markets valuation levels, currently they are trading at historically low and depressed absolute and relative valuation multiples. One example of this is the cyclically adjusted price to earnings (CAPE) multiple, which for emerging markets stands at 11 times compared to its historical median of 18 times and the absolute lows in the 1998 Asian financial crisis of 10 times. Previous instances where the CAPE ratio dipped to these levels led to strong returns over the subsequent 10 years. We also analyze price to book multiples, and currently, emerging markets are trading at close to global-financial-crisis lows and relative to developed markets are trading at where they traded back in the 1998 Asian financial crisis.

We believe the valuation opportunity for emerging markets looks very attractive, and then, when you consider an environment where the Federal Reserve is unlikely to raise interest rates for the rest of the year, that should also be supportive for emerging-market currencies. Our long-term currency models show many emerging-market currencies are trading at 20% to 30% discounts to their fair values against the U.S. dollar.

TWST: When the average investor takes a look at emerging markets, what are some of the issues they should consider?

Mr. Priani: I think one key decision is whether to go passive or active in emerging markets. As we have discussed, we think the inefficiencies call for an active approach for emerging-market investing because otherwise you end up having a high weighting of globally driven or companies with suboptimal corporate governance. Some examples are **Petrobras** (NYSE:PBR), the Russian oil companies and the Chinese banks, where you could say that they do not represent value when one considers a corporate-governance perspective. We think a more discriminating approach to emerging-market investing is important. At the same time, the fact that we analyze the political risk in each one of the regions allows us to orient the portfolio in areas that are more promising or in areas where the valuation incorporates the risks.

TWST: And do you find that people want to balance out their portfolio with emerging markets?

Mr. Ross: Yes. Emerging markets currently account for about 10% of the MSCI global indices. We think that most investors, particularly in a U.S. context, are underallocated relative to this because of a strong home bias. If you take the entire emerging markets equity universe, we estimate this represents 26% of total global equity market cap. Emerging markets now account for about 50% of global GDP, and we expect this to continue to increase as the fastest-growing economies remain in emerging markets, such as the Philippines, India and Indonesia. We think that investors should have a portion of their portfolio allocated toward emerging markets given the current valuation of the equity markets and currencies, as well as the fact that we expect emerging markets will demonstrate a higher contribution to global equity markets and global GDP going forward.

TWST: And how do you define emerging markets? Some people when they invest in business, they'll look at economies that are developing; others are looking at economies that are stronger. How would you define them?

Mr. Ross: We benchmark our fund to the MSCI Emerging Markets Index, which consists of 23 countries across the globe. About 69% of the MSCI Emerging Markets Index is allocated toward Asia, with the biggest countries being China, Taiwan and Korea. Within Latin America, the biggest country represented is Brazil, followed by Mexico. For EMEA, the largest countries are South Africa and Russia.

One of the unique attributes of our fund is that we can also purchase companies that are listed in developed markets but have the majority of their revenues coming from emerging markets. Our portfolio has several companies that are listed in developed markets, such as the

Highlights

Marco Priani and Kevin Ross discuss Advisory Research, Inc., and its emerging markets strategy. Mr. Priani and Mr. Ross use a long-term value approach to investing. It is also an active approach, which they feel is important in emerging markets because it allows them to be flexible and discriminating about their investments. In general, Mr. Priani and Mr. Ross favor companies with solid balance sheets, understandable and sustainable business models, and temporarily depressed valuations. The fund is benchmarked to the MSCI Emerging Markets Index; however, Mr. Priani and Mr. Ross can also invest in companies that are listed in developed markets but derive the majority of their revenues from emerging markets.

Companies discussed: Petroleo Brasileiro SA Petrobras (NYSE:PBR); Concentradora Hipotecaria SAPI de CV (BMV:FHIPO14); Haier Electronics Group Co., Ltd. (HKG:1169); Qingdao Haier Co., Ltd. (SHA:600690); FedEx Corporation (NYSE:FDX); United Parcel Service (NYSE:UPS); General Electric Company (NYSE:GE); Fila Korea Ltd. (KRX:081660); adidas AG (OTCMKTS:ADDYY); Nike (NYSE:NKE); Gran Tierra Energy (NYSEMKT:GTE); Ecopetrol SA (NYSE:EC) and Parex Resources (TSE:PXT).

U.S. or the U.K., but derive the majority of their revenues or assets from emerging markets. We also are willing to invest up to 10% of our portfolio in frontier markets, which tend to be countries with lower levels of economic development than the 23 countries represented by the MSCI Emerging Markets Index. Just following up on Marco's point, that's why we think an active strategy within emerging markets can add value because of the flexibility to find companies in these various areas.

Shanghai-listed companies through the Shanghai-HK Connect program, but we don't currently have any in the portfolio, and we see more attractive valuation opportunities within the Hong Kong opportunity set.

Haier Electronics is a $4 billion-market-cap company and is the subsidiary of the parent **Qingdao Haier Group** (SHA:600690), which is one of the largest white goods manufacturers globally. **Haier Electronics** specifically is the largest washing machine manufacturer in

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TWST: Did you want to highlight a stock that you find interesting?

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Mr. Priani: Yes, an interesting stock that we could highlight is a financial in Mexico. The name of the company is **Concentradora Hipotecaria** (BMV:FHIPO14). **FHIPO14** is a Mexican mortgage investment trust. The company has a market cap of around $650 million and is attractively valued trading around book value and less than 10 times earnings and dividend yield above 7%. The company was IPO-ed in November 2014 and is the first Mexican mortgage REIT-like company.

It buys part of the highest-quality portfolio of **Infonavit** — the Mexican entity that we could say is roughly comparable to **Fannie Mae** — and more recently also from other sources. Thus, its asset quality is outstanding. The company generates a strong dividend in spite of being lowly leveraged at 20% net debt to equity. The dividend yield, once leveraged one to one, which is the company target, has the potential to be more than double the average of the Mexican REIT market.

TWST: And what is it about this company that you think would be most interesting to investors?

Mr. Priani: I think it's a combination of having extremely high-quality mortgages, of which only 29 mortgages have some kind of credit event out of several thousand. This is a company that is a play on increasing consumption of the middle class in Mexico. The mortgage market in Mexico is extremely underpenetrated compared to developed markets, and as more people move into the formal economy, there will be many more opportunities to source mortgages. Finally, from an investor perspective, the fact that this company pays 95% of their profits and generates a strong dividend yield is extremely attractive in the context of low interest rates globally we see today.

TWST: How does an investor avoid risk with something like that?

Mr. Priani: I think the key for this particular business is the selection of mortgages, and the companies have the choice in terms of the mortgages it can buy from **Infonavit**, and it buys only the high-quality mortgages in terms of the percentage of the income that is devoted to pay the mortgage, the length of the employees remaining at the same employer, and also, something that clearly mitigates the risk is that, in Mexico, these mortgage payments are directly deducted from the payment of the salary by the employer. It really mitigates the risk as a consequence of the procedures they have in place.

TWST: Did you want to mention a second company?

Mr. Ross: The second company we would like to mention is **Haier Electronics** (HKG:1169), which is a company that's listed in Hong Kong. One of the things I'll point out is that most of our Chinese companies are listed in Hong Kong. We do have the option to purchase

1-Year Daily Chart of Haier Electronics Group Co., Ltd.

Chart provided by www.BigCharts.com

China with 28% market share and the number-one water heater manufacturer in China with about 20% market share. They have two businesses. One is the manufacturing business of their white goods, which accounts for 60% of their operating profits. That's really the cash cow of the operations.

Where we see longer-term opportunity and potentially more interesting growth opportunities is their integrated channel services — ICS — business, which accounts for the other 40% of operating profits, and consists of distribution and logistics services throughout China, both within urban and rural communities. **Haier** provides last-mile delivery and is becoming a leader in online logistics, which we think is a very fast-growing market. They are targeting to provide these services for large items — for example, white goods, furniture, sanitary ware and fitness equipment — which we think is different from the traditional parcel courier services or companies like **FedEx** (NYSE:FDX) and **UPS** (NYSE:UPS) that most people are familiar with.

Longer term, we see an opportunity for the group to split this integrated channel services business from the manufacturing business, once the ICS business has reached scale and becomes larger than the manufacturing. Currently, we think the market is applying very little value to the ICS business. **Haier Electronics** is trading at a 30% discount to our estimate of its net asset value and at 9 times stated earnings. The company has a net cash balance sheet, which makes the multiple lower when you take out the net cash.

One other interesting point that I'll highlight is that the parent group **Qingdao Haier** just recently acquired **General Electric's** (NYSE:GE) appliance business for $5.4 billion and is looking at rolling out some of the products throughout China. We think that **Haier**

Electronics, the company that we are involved with, will be able to provide the distribution and logistics for the **General Electric** brand throughout China, which should lead to upside revenue opportunities for the company.

TWST: Did you want to mention a third company?

Mr. Ross: The third company we will mention is a Korean company by the name of **Fila Korea** (KRX:081660) — $909 million market cap. The Fila brand itself dates back over 100 years. It was started by two brothers in Italy, became globally recognized in the 1970s and, over its history, was owned by several private equity groups, including **Cerberus Capital**, who ran into some operational problems in the mid-2000s. The management team from **Fila Korea** purchased the brand in 2007 for approximately $400 million.

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1-Year Daily Chart of Fila Korea Ltd.

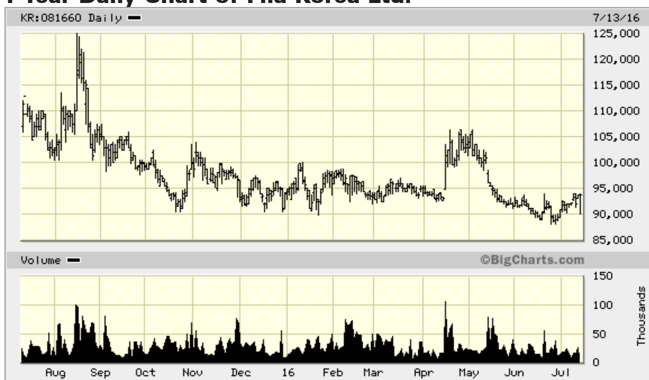

Chart provided by www.BigCharts.com

The other part of the **Fila Korea** story is that, in 2011, the management team along with a consortium of Korean-domiciled investors purchased **Acushnet** from **Fortune Brands**. **Acushnet** represents several global golf brands including Titleist, FootJoy and Pinnacle, covering all countries, including the U.S. and China, which are two of its key markets. Currently, **Fila Korea** owns 33% of the **Acushnet** assets, and we think the market is not ascribing appropriate value to this because it is owned through a complex ownership structure where **Fila** is a minority investor.

For its traditional sportswear business, **Fila** operates in Korea as the third player behind **adidas** (OTCMKTS:ADDYY) and **Nike** (NYSE:NKE). It also has royalty arrangements throughout 31 countries globally where it charge royalties of 6% to 8% of all revenues generated. These royalties require limited costs and capex from **Fila Korea's** standpoint and generate a lot of free cash flow back to the group. They can use the cash from the royalty streams to reinvest into their businesses in the U.S. and Korea, where they operate their own brands. In the U.S. for example, the brand has seen a significant resurgence and is looking to expand from the mass market into higher-end department stores. The Korean business is undergoing a restructuring by closing its unprofitable stores, and we anticipate improved results in the medium term.

I think the more interesting short-term element of the story that we've been focusing on is the **Acushnet** ownership, where we are seeing strong growth in terms of golf demand in emerging markets. **Acushnet** is currently in the process of being IPO-ed here in the U.S., which we expect to happen during 2016. This should crystallize the value of the **Acushnet** investment, which we see as a significant catalyst for unlocking the value in the company.

TWST: Did you guys want to mention a fourth company?

Mr. Ross: Yes. The fourth company we would like to mention is an upstream energy and production company called **Gran Tierra Energy** (NYSEMKT:GTE) — $1 billion market cap. About six months ago, when oil was trading below $40 a barrel, we started to analyze our energy holdings and added several new positions into the portfolio because we saw limited downside potential given where oil prices were trading relative to the marginal costs of producing a new barrel of oil. **Gran Tierra Energy** is listed in Canada and the U.S., but all of its assets are in Latin America, the majority being in Colombia, and then they also have a smaller portion of their assets in Peru and Brazil.

About a year and a half ago, a new management team was brought in following a push from an activist shareholder to refocus the company on developing their assets in Colombia and pursuing new growth opportunities throughout Colombia, leveraging the company's financial strength as they are one of the few energy companies globally with a net cash balance sheet. We thought that **Gran Tierra** would be able to acquire assets at the bottom of the cycle and be able to create value through adding them to their existing portfolio. Since the time of our investment, the company has done two bolt-on deals, and we also see opportunity for them to acquire fields from state-owned **Ecopetrol** (NYSE:EC), which is looking to divest some of their energy fields throughout Colombia. **Gran Tierra** and one other company called **Parex Resources** (TSE:PXT) are the leading potential buyers of these assets.

Gran Tierra has a very low operating cost per barrel of $16 to $17. The company trades at a discount to its Latin American energy and producer peer group, and to the two Colombian pure plays in particular. We also see opportunity following resolution with the FARC guerrillas in Colombia for the company to reduce their transportation costs by up to $4 to $5 per barrel, as they will not see pipeline disruptions once the guerrilla settlement takes place. Finally, on a more longer-term basis, as oil prices gradually recover, we believe that the company will sell their Brazil and Peru assets, which we don't think the market is currently ascribing any value to.

TWST: And we've mentioned Brazil in passing. Did one of you want to discuss what's going on with the Brazilian economy now and how investors might be able to take advantage of that?

Mr. Priani: Yes. To put a framework around Brazilian situations, we see that within a context of economic difficulties. Populism is retrenching in Latin America. That is visible in the decline of the PT in Brazil — the party of Lula and Dilma — also in the Macri election in Argentina, the agony of Chavez in Venezuela, with the presidential election in Peru and with the referendum that denied to Evo Morales in Bolivia an indefinite re-election. In this context, the Brazilian situation I think had probably an excess of optimism as Dilma was suspended. I think we have ahead of us one year and a half of difficult economic news in Brazil.

For many years, the answer to all of the problems was to increase consumption, and that is something that once it proves unsustainable, generates political difficulties to dial it back. At the same time, the Brazilian market is a very big market for Latin American standards. There is significant value there, even if you have to wait for one year, one year and a half to have a clear positive GDP reading, but there are some macro green shoots. For instance, there are indications that the industrial activity may have bottomed out and may have started to grow from this depressed level.

So I think Brazil is a source of opportunity, not very dissimilar to the situation that we saw in Brazil in 2002 previous to the first election of Lula as President when the market thought that the bottom was unhinged and there will be no further opportunity in Brazil, and that led to one of the best investment periods in the Brazilian equity market. So the Brazilian situation is something that we follow with extreme closeness and attention, and are optimistic with a long-term view.

TWST: Thank you. (ES)

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Investing involves risk including the possible loss of principal. Foreign investments present additional risks due to currency fluctuations, economic and political factors, lower liquidity, government regulations, differences in securities regulations and accounting standards, possible changes in taxation, limited public information and other factors. The risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economies. Small Cap stocks are more susceptible to market volatility because smaller companies may not have the management experience, financial resources, product diversification and competitive strengths of larger companies. Smaller company stocks tend to be sold less often and in smaller amounts than larger company stocks. Risk may increase due to potential for concentration in the Financial Sector.

Current and future portfolio holdings of the mutual funds are subject to change and risk. As of June 30, 2016, the securities mentioned in the article are represented in the Advisory Research mutual funds as follows:

Advisory Research Emerging Markets Opportunities Fund; 1.89% Concentradora Hipotecaria, 1.56% Haier Electronics, 1.17% Fila Korea, 1.49% Gran Tierra Energy

Advisory Research International All Cap Value Fund; 0.00% Concentradora Hipotecaria, 1.97% Haier Electronics, 0.00% Fila Korea, and 0.00% Gran Tierra Energy.

Advisory Research Global Value Fund; 0.00% Concentradora Hipotecaria, 1.00% Haier Electronics, 0.00% Fila Korea, and 0.00% Gran Tierra Energy.

Advisory Research mutual funds were not invested in Petrobras, Infonavit, Qingdao Haier Group, FedEx, UPS, General Electric, Cerberus Capital, Acushnet, Fortune Brands, Nike, Ecopetrol, or Parex Resources.

Cyclically Adjusted Price to Earnings Multiple (CAPE Ratio): a valuation ratio defined as a company's current market price divided by the average of ten years of earnings (moving average), adjusted for inflation.

Price-to-Book: a financial ratio used to compare a company's book value to its current market price. Book value is an accounting term denoting the portion of the company held by the shareholders; in other words, the company's total tangible assets less its total liabilities.

References to characteristics and yields refer to the underlying securities and do not represent or predict the performance of any fund. Past performance is no guarantee of future results.

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