BOSTON COMMON
ASSET MANAGEMENT

BOSTON
200 State Street, 7th Floor
Boston, MA 02109
CONTACT: Brian Chiappinelli
tel (617) 934-0932
bchiappinelli@bostoncommonasset.com

SAN FRANCISCO
111 Pine Street, Suite 1420
San Francisco, CA 94111
CONTACT: Ashley Lyon
tel (415) 813-1500
alyon@bostoncommonasset.com

# Emerging Markets Strategy Update

*Fourth Quarter, 2017*

## EMERGING MARKETS REVIEW

The MSCI Emerging Markets Index (“Index”) returned +7.4% in the fourth quarter, extending the full-year gain to more than +37%. Emerging Markets outperformed the developed markets again this quarter and also for the year. Continued confidence in global growth, higher commodity prices, and strong corporate earnings have supported both absolute and relative performance. EM currencies appreciated 1.7% against the US Dollar, led by the South African Rand (+9.1%) while the Mexican Peso (-7.2%) lagged. EMEA (+11.7%) and Asia (+8.4%) were the best performing regions, while Latin America (-2.3%) lagged.

South Africa (+21.4%) was the best performing country this quarter as investors were encouraged by the results of the elections within the ruling ANC party. Russia (+4.3%) lagged despite stronger commodity prices. India (+11.8%) led performance in Asia, following the incumbent Bharatiya Janata Party’s success in key state elections, which assured investors that structural reforms would continue. Korea (+11.4%) and the Korean Won (+7.0%) appreciated as concerns about North Korea dissipated. In Southeast Asia, Thailand (+9.5%) rallied on stronger than expected GDP growth, while Indonesia (+8.2%) benefited from an upgrade by ratings agency Fitch, confirming improvement in the country’s longer-term outlook. In Latin America, Chile was the best performing country (+7.2%) and the market rebounded strongly after Sebastián Piñera won the Presidential election. Brazil (-2.0%) and Mexico (-8.1%) were the laggards, as political uncertainties weighed on investor sentiment.

All sectors registered gains in the quarter, with consumption-related sectors such as Healthcare (+16.6%), Consumer Discretionary (+9.0%), and Consumer Staples (+8.2%) leading the pack. Energy (+7.9%) and Materials (+8.7%) also outperformed as the Crude oil price rebounded by 16%. Information Technology (+7.1%) lagged this quarter. Uncertainty around smart phone shipment growth and potential for excess inventory in the supply chain dragged down several component makers. For the full year, however, Technology was the best performing sector, rising more than 60%. Defensive sectors, such as Telecommunications (+3.0%) and Utilities (+1.5%) were the worst performing sectors.

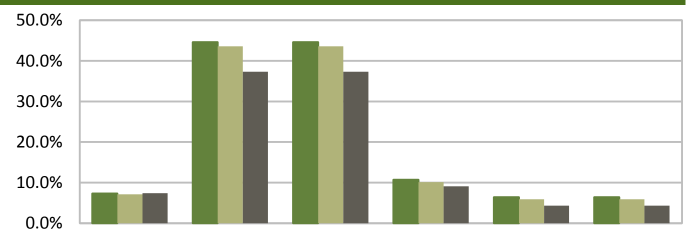
## PORTFOLIO REVIEW

The Boston Common Sustainable Emerging Markets Equity strategy returned +7.3% for the quarter, before fees, in line with the Index. For 2017, the strategy delivered strong absolute and relative performance, with a total return of +44.6%, before fees, compared to the Index’s return of +37.3%.

Stock selection in the Consumer Staples sector was the largest contributor to relative results in the quarter. Korean personal care company LG Household & Health Care (+34.0%) and Chinese hygiene producer Hengan International (+19.6%) rallied on strong earnings. We also benefited from strong stock selection in Financials, in which Chinese insurance company Ping An (+34.1%) and Indonesian holding Bank Rakyat (+16.0%) delivered steady growth. Financial services and products continue to gain popularity among the expanding middle class within emerging economies. Strong stock selection in South Africa was a key country contributor, including financial holding Standard Bank (+34.2%), Real Estate company Growthpoint Properties (+23.3%), and ecommerce company Naspers (+28.1%). Other notable contributors to the strategy’s relative performance include technology companies Naver (+23.5%) and GCL-Poly Energy Holdings (+29.7%).

Stock selection in Energy was the largest detractor from relative returns. Polish Oil & Gas (-3.0%) and Brazilian energy company Ultrapar (-5.0%) lagged their upstream peers given the strength of oil prices. The Healthcare sector was a small drag, as our portfolio did not have exposure to South Korean biotech companies that registered strong gains. Information Technology was another area of weakness. Sunny Optical (-14.4%) declined as investors were concerned about weaker smartphone demand. Delta Electronics (-7.2%), an

## PERFORMANCE




| | QTD | YTD | 1Yr | 3Yr | 5Yr | Since Inception* |
|---|---|---|---|---|---|---|
| Gross | 7.3% | 44.6% | 44.6% | 10.7% | 6.4% | 6.4% |
| Net | 7.1% | 43.6% | 43.6% | 10.1% | 5.9% | 5.9% |
| MSCI EM | 7.4% | 37.3% | 37.3% | 9.1% | 4.3% | 4.3% |

## CONTRIBUTORS & DETRACTORS

| TOP 10 | % OF CAPITAL | RETURN | RELATIVE CONTRIB. | SECTOR |
|---|---|---|---|---|
| NASPERS | 5.4% | 28.1% | 0.95% | Consumer Discretionary |
| PING AN INSURANCE GROUP CO | 4.2% | 34.1% | 0.91% | Financials |
| LG HOUSEHOLD & HEALTH CARE | 2.3% | 34.0% | 0.49% | Consumer Staples |
| STANDARD BK GR LTD | 1.4% | 34.2% | 0.38% | Financials |
| GROWTHPOINT PROPERTIES LTD | 1.6% | 23.3% | 0.32% | Real Estate |
| NAVER CORP | 1.7% | 23.5% | 0.25% | Technology |
| BANK RAKYAT | 2.8% | 15.9% | 0.24% | Financials |
| TENCENT HOLDINGS LTD | 2.0% | 20.1% | 0.22% | Technology |
| GCL-POLY ENERGY HOLDINGS LTD | 1.1% | 29.7% | 0.20% | Technology |
| VIPSHOP HLDGS LTD | 0.8% | 30.1% | 0.19% | Consumer Discretionary |
| | | | **4.15%** | |

| BOTTOM 10 | % OF CAPITAL | RETURN | RELATIVE CONTRIB. | SECTOR |
|---|---|---|---|---|
| CTRIP COM INTL LTD | 1.8% | -16.4% | -0.46% | Consumer Discretionary |
| GRUPO FINANCIERO BANORTE | 1.3% | -20.1% | -0.41% | Financials |
| ALIBABA GROUP HOLDINGS | 5.6% | 0.3% | -0.41% | Technology |
| ITAU UNIBANCO HLDG SA | 2.8% | -6.0% | -0.37% | Financials |
| SUNNY OPTICAL TCHNLGY | 0.9% | -14.4% | -0.27% | Technology |
| DELTA ELECTRONICS INC | 1.6% | -7.2% | -0.25% | Technology |
| BYD CO LTD | 1.5% | -6.0% | -0.21% | Consumer Discretionary |
| BEIJING ENTERPRISES WATER GR | 1.6% | -4.2% | -0.19% | Utilities |
| KIMBERLY-CLARK DE MEXICO | 0.9% | -11.6% | -0.19% | Consumer Staples |
| BANK OF COMMUNICATIONS CO | 2.8% | 1.4% | -0.19% | Financials |
| | | | **-2.95%** | |

*Since Inception: December 31, 2012

electronic control system manufacturer based in Taiwan, was hurt by slower growth in the traditional PC market while its industrial automation segment remains strong. Chinese online travel company Ctrip (-16.4%), Mexican Bank Grupo Banorte (-20.1%), and personal care company Kimberly-Clark De Mexico (-11.6%) were also significant detractors. On a country basis, our stock selection in India detracted modestly.

## PORTFOLIO ACTIVITY

Among our portfolio actions this quarter, we purchased Sunny Optical, a leading optical products manufacturer in China. Its key products include handset camera module and lenses, as well as vehicle lenses. In our view, Sunny Optical is well positioned to benefit from the significant expansion in optical components in smartphones, such as dual camera and 3D sensing, and is quickly closing the technology gap. In addition, Sunny Optical has achieved more than 30% global market share in vehicle lenses, which should continue to enjoy secular growth as autonomous driving-related technology advances. We expect rapid margin improvement as the product mix changes with technological advances. After the stock corrected on near-term concerns of slower smartphone demand, we saw an attractive buying opportunity given the strong future earnings growth outlook.

During the quarter, we sold Bancolombia. Fundamentals deteriorated more than expected and credit quality and profitability looked likely to decline further. Despite its attractive valuation, we do not view the potential upside as sufficient compensation for its ongoing challenges. We also exited Indonesian gas distributor Pgas due to less favorable fundamentals and a relatively unattractive valuation. We used the proceeds to add to our cyclical exposure in Thai companies, where we see a better growth outlook.

## ECONOMIC & MARKET OUTLOOK

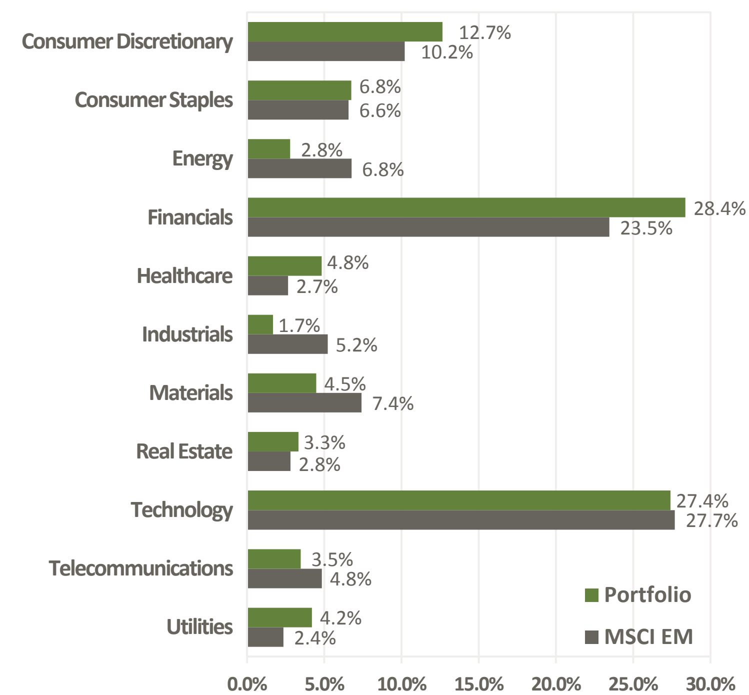
The favorable macro-economic conditions that supported Emerging Markets in 2017, namely, a synchronized global recovery and muted inflationary pressures, are likely to stay in place for 2018. Inflation remains subdued even as global growth picks up. Indeed, the majority of EM economies are experiencing inflation levels lower than policy targets, and we see no reason for aggressive tightening in most EM countries. However, higher interest rates in the US may contribute to tighter overall financial conditions. We remain cautious about the secular outlook for commodities, including energy, given the disruptive nature of US shale production on crude supplies, technological advancement in electric vehicles (EV), and China's diversification away from an investment-led growth model. While we see reasons to expect a tighter supply-demand balance in the near term, we remain underweight.

Looking ahead, 2018 earnings growth is likely to moderate in the wake of last year's strong 24% increase, but should remain healthy, with steadily improving Returns on Equity (ROE) supported by lower financial leverage and improving margins. The political outlook has improved in selected countries, with favorable election results in South Africa and Chile. With a heavy election calendar ahead in 2018, geopolitical risks remain significant. Despite this, we believe the outlook for EM investments remains positive because of the solid growth outlook and attractive valuation discount to developed markets. Our portfolio remains more exposed to domestic cyclical sectors such as Financials and Consumer Discretionary. In the defensive sectors, we have a preference for Healthcare and Consumer Staples stocks.

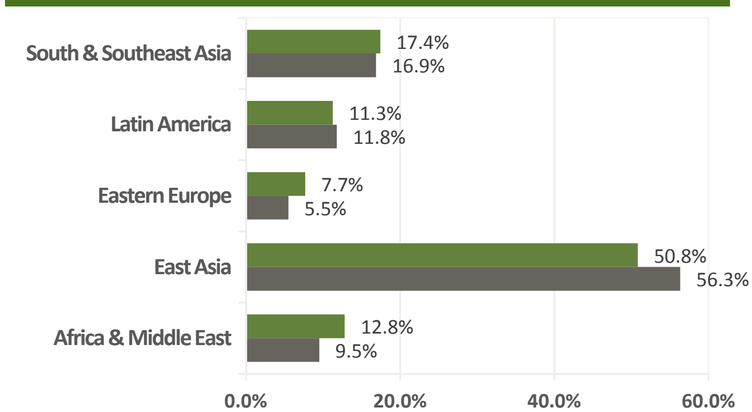
### *Asia*

Asia continues to be a major driver of the global economy. Indeed, emerging Asian economies, collectively almost the size of the US economy, grew almost 7% in 2017. Looking forward to 2018, there are grounds for optimism. We expect steady, albeit slower growth in China, which is consistent with the road map set by the recent 19th Congress Party. Policy emphasis will clearly be geared towards the quality of growth rather than the speed of growth. The Caixin China Services PMI in December 2017 pointed to the strongest pace of

## SECTOR ALLOCATION




## SUB-REGIONAL ALLOCATION




## PORTFOLIO CHARACTERISTICS

| | BOSTON COMMON | MSCI EM |
|---|---|---|
| # HOLDINGS | 50 | 846 |
| ***Valuation*** | | |
| Next 12m Price to Earnings | 16.2 | 12.4 |
| Price to Book Value | 2.6 | 1.8 |
| Price to Sales | 2.1 | 1.4 |
| Dividend Yield | 2.0% | 2.2% |
| ***Growth*** | | |
| 5yr Sales Growth | 6.0% | 2.8% |
| 5yr EPS Growth | 11.4% | 5.5% |
| ***Risk*** | | |
| Wtd Avg Mkt Cap | 93,075 | 98,890 |
| LT Debt/Cap | 25.7% | 22.1% |
| Beta | 1.05 | 1.00 |

expansion in the service sector since August 2014. President Xi has consolidated his political power, and we are monitoring the implications for future economic policy. Meanwhile, improvements are underway and progress is being made in supply-side reforms, financial-sector deleveraging, and environmental cleanup. China has shown renewed commitment to the Paris Climate Accord and is investing heavily in environmental technology, becoming the largest solar panel and EV producer globally.

While pundits debate China's high debt levels and tight political control, China's rapidly growing innovation ecosystems receive less attention. Over the past decade, China's spending on R&D has grown substantially, almost doubling its share of GDP. In a recent global study on which geographical clusters are generating the most patents, Shenzhen-Hong Kong came in at second place, after Tokyo-Yokohama but ahead of San Jose-San Francisco. Our holdings in China are mostly geared towards companies that can provide environmental solutions, address consumption upgrade demands, or benefit as Chinese manufacturers move up the value chain.

Southeast Asian countries lagged behind China in 2017, but we see a more favorable investment outlook in 2018 thanks to encouraging structural reforms and more attractive valuations. In the latest World Economic Forum's Global Competitive Rankings (which captures determinants of long-term growth for 137 countries), Indonesia leaped five places to 36th overall, one of the biggest improvements on the list. The country's performance has strengthened across all pillars, such as financial market development, health, and infrastructure. Indonesia has also been cited as 'one of the top innovators among the emerging economies.' After subdued growth in 2017, the country's GDP growth is expected to accelerate to 5.3%, driven by pent-up investment demand and healthy household consumption. We are overweight Indonesia. It is now trading at 15.6 times forward earnings, in line with its 10-year average relative to EM, but with one of the highest ROEs among Emerging Markets.

The Thai economy is also accelerating, with exports growing at a 9% annualized rate versus no growth in 2016. Growth has been broad based in both products and destinations. Exports to China, India, and CLMV (Cambodia, Laos, Myanmar, and Vietnam), almost 25% of total exports, are on track to grow more than 20% in 2017. Meanwhile, demand from the US and Europe (20% of total) is also strong. As exports gain momentum, we expect manufacturing capacity utilization to improve, potentially leading to renewed private investment. At the same time, the political landscape is stabilizing and the government has launched aggressive public spending initiatives after a decade of under-investment due to ongoing political tensions. We are mindful of potential political risks, but expect a more favorable economic outlook in Thailand to benefit cyclical sectors such as banks and materials. We have increased our exposure to cyclical names where valuations still remain attractive.

**Europe, the Middle East and Africa ("EMEA")**

Regional growth should hold up, supported by tailwinds from Europe and resilient domestic consumption. The political landscape has also improved in certain parts of the region. In South Africa, Cyril Ramaphosa, an antiapartheid activist, trade union leader, and prominent businessman was elected President of the ruling party (ANC) and is likely to become the country's next President. Ramaphosa is the first ANC chief with private-sector experience. While he still faces an uphill battle with existing Zuma loyalists in order to tackle many of the country's economic challenges, fundamentals in South Africa could improve from here. In Turkey, there are early signs of improvement as the US reinstated visa services after a diplomatic standoff between the two countries over the detention of two US embassy staff. This should alleviate investor concerns about Turkey's external financing needs. Given the improved fundamental outlook, we

## NEW & CLOSED POSITIONS

| CLOSED | SECTOR | % OF PORT. |
|---|---|---|
| BANCOLOMBIA S A SPON ADR PREF | Financials | 1.2% |
| PERUSAHAAN GAS NEW ORD | Utilities | 0.4% |
| TOTAL CLOSED | | **1.6%** |

| NEW | SECTOR | % OF PORT. |
|---|---|---|
| SUNNY OPTICAL TECH | Technology | 1.2% |
| TOTAL NEW | | **1.2%** |

## COMPANY SPOTLIGHT

***ESG Integrated Investment Thesis***

Growthpoint Properties Ltd. is the largest listed Real Estate Investment Trust (REIT) in Africa. GRT's management team has assembled a high-quality portfolio focused on sustainability, integrating environmental criteria when designing new constructions and retro-fitting existing buildings. An industry leader in green leases (80% of total), GRT plays a leadership role in promoting wider adoption of green leasing frameworks across South Africa. The company has created a competitive advantage by investing in green infrastructure, including waste management, energy efficiency, and water saving features. Since 2013, GRT has partnered with tenants by sharing financial savings obtained from decreased energy and water usage.

South Africa's economy is experiencing mediocre growth, yet GRT has been able to increase its distributable earnings by focusing on tenant retention and attraction. The diamond in its portfolio is the Victoria & Alfred (V&A) Waterfront, Cape Town, an historical location jointly owned with the South African Public Investment Corporation. As the most valuable and most visited location on the African continent (24 million visitors annually), V&A provides a mix of tenants including retail, hotel, industrial, and residential. Additionally, the company is exploring new revenue streams by building a funds management business, which should provide stable management fees and dividends without large capital investments. With 98% of earnings received on a recurring basis, a 14-year track record of uninterrupted dividend growth, a solid dividend yield, and potential to grow net distributable income at mid-single digit rate, the stock presents an attractive return profile.

***Company Profile***

Growthpoint Properties Ltd. was established in 1987 and is South Africa's largest property & development company. The company operates in five property segments: retail, office, industrial, V&A Waterfront, and Australia. Growthpoint's consolidated property assets are valued at USD $8.8 billion, producing revenues of USD $0.87 billion. The company audits its carbon footprint annually and analyzes the financial impact from environmental events and changing weather conditions including earthquakes, rain, hail, wind and heat. Under COP21, GRT committed by 2020 to obtaining a rating of four stars for its entire office portfolio under Green Star SA, a South African rubric similar to LEED in the US. The company is the largest generator of rooftop solar power in South Africa.

***ESG Engagement Opportunities***

While GRT has received among the highest marks on its corporate governance structure relative to global peers, the composition of its board is entrenched, with two-thirds of the directors having served for at least a decade. We are encouraged by 15% representation of women on the board and hope to see this increase with time.

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selectively added to companies in the region as valuations had become more attractive in the face of near-term political uncertainty.

**Latin America**

The region is continuing along a path of slow economic recovery, but the outlook is still dependent on political outcomes, particularly in Brazil and Mexico. Brazil's economy is finally growing, supported by lower interest rates, healthy external demands, and an improving labor market. However, political uncertainty continues to escalate as President Temer lost the necessary support to pass fiscal reform, key to a sustainable recovery and the reversal of the untenable public deficit. The window for economic reforms appears to be quickly closing ahead of the October 2018 election. In Mexico, uncertainty about the ongoing NAFTA negotiations and fiercely contested upcoming presidential elections in July cloud the outlook for economic growth. We remain on the sideline and view current valuations as not fully compensating for the uncertainties.

## Shareholder Engagement Highlights

| | |
|---|---|
| *Milestones* | **Climate Change:** In October, **EOG Resources** committed to publish its **first sustainability report in 2018**, following three years of sustained dialogue led by Boston Common and supported by a large investor group (20 investors). In that time, we have engaged EOG on issues such as the governance of sustainability, hydraulic fracking operations, climate change, methane, human rights, water stewardship, and board diversity. |
| *Work in Progress* | **Conflict Minerals:** The fight to keep **Conflict Minerals Reporting** continues as 2017 ends with **a proposed US House Appropriations Amendment cutting funding for Section 1502 of the Dodd-Frank Act** relating to conflict minerals. Boston Common is a lead investor supporting a new statement that went to the Congressional leadership on December 22nd supported by **80 investors with over $2 trillion in assets, to urge them to reject this appropriations amendment.** We led previous investor statements supporting Section 1502 in 2017, along with the Responsible Sourcing Network and others; the statements were signed by 127 investors with over $4.8 trillion in assets. |
| | **Chemical Safety**: In December, Boston Common co-convened an investor workshop with the **Chemical Footprint Project** and spoke on a panel at the BizNGO conference to raise the profile of this important **due diligence tool for investors and companies** and to address our precautionary approach to chemical safety. A new study released in the journal Environmental Health concludes that e**xposure to toxic chemicals, such as lead, mercury, and pesticides, may cost the world up to 10% of GDP**. Boston Common met with **CVS Health** about the implementation of its plan to **ban phthalates, parabens and prevalent formaldehyde donors in store brand beauty and personal care products,** to which they committed in 2017. We asked CVS to publicly report on benchmarks and a timeline for implementing its policy and raised the issue of **fragrance-ingredient labeling** following the efforts by peers Procter & Gamble, Target, Unilever and Walmart. |
| *New Initiatives* | **Racial Diversity**: We co-filed our first racial diversity shareholder resolution with **Alphabet** seeking to **link CEO compensation with the achievement of sustainability metrics including metrics on diversity** within the executive ranks. Though Alphabet, the parent company of Google, has publicly disclosed demographic data for its employees since 2014, progress has been slow. Google recognizes that the lack of inclusion of women and minorities in the tech space is a problem. Eileen Naughton, Vice-President, People Operations at Google has noted in a blog post, "Our employees, product and business depend on us getting this [more diverse and inclusive workforce] right." |
| | **Climate Change**: Boston Common is a founding signatory to the Climate Action 100+, a new **five-year initiative led by investors to engage the world's largest corporate greenhouse gas (GHG) emitters** to curb emissions, strengthen climate-related financial disclosures, and improve governance on climate change. The initiative aligns with the global investor initiative we have led for the past 3 years to engage 60 global banks to adopt the recommendations of the **Task Force on Climate-related Financial Disclosures (TCFD)** and to engage their own high-carbon sector clients on TCFD. We are engaging companies such as **Costco, Qualcomm, Kansas City Southern** and **Gilead Sciences** to establish science-based targets to reduce their own GHG emissions or adopt targets for energy efficiency and renewable energy. We have committed to further this work by engaging some of our highest carbon footprint portfolio companies including **Air Liquide, Origin Energy, Statoil** and **Veolia Environnement** in 2018. |