SEAFARER

SEAFARER OVERSEAS GROWTH AND INCOME FUND

Portfolio Review

Third Quarter 2017

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During the third quarter of 2017, the Seafarer Overseas Growth and Income Fund returned 1.96%.[1] The Fund's benchmark, the MSCI Emerging Markets Total Return Index, rose 8.04%. By way of broader comparison, the S&P 500 Index gained 4.48%.

The Fund began the quarter with a net asset value of $12.76 per share. It paid no distributions during the quarter, and finished the period with a value $13.01 per share.[2]

Performance

As is evident from the performance of the Fund's benchmark, the emerging markets rose again during the third quarter. The benchmark's positive performance constitutes the third consecutive calendar quarter in which the index rose in excess of 5%.

A number of sectors contributed to the index's movement, but as was the case with the preceding quarter, technology shares were dominant. Within this sector, Chinese internet stocks again led the way (see the second quarter 2017 portfolio review[3] for an in-depth discussion of the Chinese internet industry). In addition to internet stocks, cyclicals – particularly commodity and energy shares – also made a notable contribution to the benchmark's performance.

From a geographical perspective, China was the prime mover within the index, accounting for over half of the index's 8% return. Within the Chinese market, and apart from the previously mentioned outperformance of internet stocks, banking and real estate stocks also performed strongly. The latter two sectors in China are notorious for the questionable condition of their balance sheets. Nevertheless, investors ignored such concerns and flocked to both sectors, pushing up stock prices sharply, apparently on the premise that the availability of credit within the country is improving.

Brazilian shares also produced notable performance during the quarter, lifted in part by considerable strength in the local currency, the real. Investors seemed enthusiastic that, despite ongoing charges of corruption within the government, the current administration has curtailed the country's worst fiscal excesses, and economic growth is poised to recover.

Against this strong backdrop, the Fund performed well in absolute terms, but lagged considerably in relative terms. The two most acute sources of relative underperformance stemmed from the Fund's lack of Chinese internet stocks and cyclical shares (energy and commodities). In the Outlook section below, I discuss some of the reasons why I am reluctant for the Fund to own such shares; yet in the short run, their absence from the Fund hindered its relative performance.

The Fund's sole holding in the Chinese real estate market also weighed on the Fund's relative performance during the quarter. The Fund owns the common stock of a company called Hang Lung Properties (HLP). HLP is a Hong Kong-based developer; it enjoys a balance sheet in excellent health, and a superior portfolio of commercial mall properties scattered throughout China. Strangely, and for no obvious reason, the stock declined moderately during the quarter, even as a number of highly speculative China-based developers saw their shares surge sharply higher. HLP's shares currently trade well below book value, and it has executed on its development portfolio quite well, despite difficult conditions within China. I remain convinced of HLP's merits, even as speculative stocks ruled the quarter.

Lastly, the Fund's holdings in the automotive industry also weighed on the Fund's performance. The Fund has three key holdings in the industry: Mobis of Korea, Astra of Indonesia, and Fuyao of China. Unfortunately, all three declined during the quarter, even as the index surged. The outlook for the industry is not terribly strong at present. In my view, this has given the Fund the opportunity to acquire shares for three companies at attractive prices – yet it also appears to have been the reason for their synchronized decline. Even as their performance went against the grain of the index, I remain confident in each company's prospects, and I believe the valuations associated with each compensate for any risks arising from the industry's lackluster growth.

In summary, it was a good quarter for the Fund, but a much better one for the index. Over half of the Fund's relative gap in performance stemmed from its absence in higher risk sectors within China (internet, banks and residential real estate). I question whether these three industries offer sustainable growth prospects (see the Outlook section below), and as such I do not believe most of the stocks are applicable to the Fund's strategy. I am therefore comfortable with their omission for the foreseeable future, even as their absence represented a forgone opportunity in the last quarter.

Allocation

During the quarter, the Fund quit three holdings and added four new ones.

The Fund quit two small capitalization positions in South America: Valid of Brazil and Herdez of Mexico. The former company provides a wide range of printing, document production and mailing services to commercial companies and governments. The latter company owns a number of food-related brands in sauce and canned good categories. The two companies share little in common, apart from their weak financial performance for several consecutive years, stemming from lackluster customer demand. When the Fund acquired these two companies several years ago, I understood that both might face difficult operating conditions; I thought their valuations compensated sufficiently for this risk. Still, I failed to anticipate those lackluster conditions would persist as they did. The Fund quit the holdings not because I have lost all hope of recovery, but rather because we have found replacements that I believe represent "upgrades." In my view, an "upgrade" is a new holding that offers a similar (or better) valuation than the outgoing holding, but which simultaneously affords improved growth prospects, improved financial condition (e.g., a better balance sheet), or both.

The Fund also quit PGE, an electric utility company in Poland. The Fund has held PGE for some time, and it was a difficult decision to quit the stock, as I believe it offers considerable value. However, the company has undergone a change in its "control party," with negative consequences.

When the Fund first invested in PGE over four years ago, the Polish government was the company's largest shareholder, and acted as PGE's "control party." It remains so today. Yet in the interim, a different political party came to power within the Polish government, and that party's new policies placed unwelcome strains on PGE. Prior to the change in political leadership, PGE had undertaken a number of impressive operational and financial reforms that suggested a strong commercial orientation and focus on long-term profitability. The new party's policies reversed much of that progress, notably forcing PGE to undertake acquisitions of dubious merit, and cutting dividends to fuel excessive investment plans. Though PGE's assets appear "cheap," the company's financial health and outlook have been set back considerably. The Fund has better uses for its capital, and thus it quit the position.

The Fund added three new holdings during the quarter: Venture Corporation of Singapore, a contract manufacturer of high-end consumer and commercial technological devices; Hengan International, a Chinese maker of branded diapers, tissues and sanitary napkins; and China Telecom, the nation's dominant fixed telecommunications network provider – and a rising contender in China's mobile telecommunications market. The three positions have little in common, save for the fact that all three enjoy strong balance sheets, good cash flow manifest in substantial dividend policies, and improving prospects for growth.

The latter two holdings obviously share one other characteristic: both are based in China. You will note in the Outlook section below that I express some serious reservations about the present state of the Chinese stock market. Still, I have not abandoned China outright; indeed, I intend for the Fund to invest in high quality companies with shares that have been overlooked during the recent (and seemingly speculative) surge in Chinese stock prices. I believe Hengan and China Telecom are two such holdings.

The Fund added one overlapping position during the quarter as well: the India-traded common stock of Infosys. For reference, the Fund already held a large stake in the company's American Depository Receipt (ADR). Infosys' common stock offers similar economic characteristics to that of the ADR, so in a basic sense, its addition does not change the Fund's construct much. Still, the common stock affords the Fund two subtle benefits: the Fund can take advantage of arbitrage conditions associated with the company's upcoming buyback program; and the new position diversifies the Fund's liquidity risk, at least when compared with the prospect of further concentration within the original ADR position.

Outlook

I believe there are two issues that will influence investment outcomes for the emerging markets over the next few years. The first is whether the recent surge in earnings growth within the emerging markets is sustainable. The second is whether the performance of the emerging market equity asset class might "decouple" from that of developed markets.

Is the Recent Surge in Growth Sustainable?

First, I would caution investors against extrapolating the recent surge in profit growth. Evidence from the past two years suggest that a legitimate recovery in profits is underway across much of the emerging markets. However, I suspect that the current recovery has been accelerated – and possibly over-stimulated – by events surrounding China's current political cycle. That cycle is at its near-term apex; when it subsides next year, I am concerned the sudden surge in growth will recede.

In my portfolio review for the first quarter of 2017,[4] I noted that analysts' forecasts for profit growth had shifted suddenly, from reasonable expectations to wild optimism. At the time, I could not see the basis for such enthusiasm. However, the results from the second quarter suggest the analysts were correct, at least in the short run: earnings growth has accelerated sharply. However, nearly all of the marginal improvement has been narrowly focused on a small number of industries within China (technology, banks and property) and industries that export products directly to China (i.e., commodities). Most other companies and countries across the developing world are not seeing an acceleration of the same magnitude, at least not yet.

I think the narrow concentration of good fortune is worrisome, and it should give investors pause. China's government is undergoing a political cycle at the present, and I suspect the cycle is as contentious as any witnessed in modern China. Most public reports suggest that all is calm within China's politburo, but much may be churning below the surface. At the same time, I note that the industries that have enjoyed sudden improvements in fortune are those most favored by China's leadership.

I am left to wonder whether China's leadership has orchestrated expenditure and investment programs to favor certain industries, perhaps as a means to distract from political intrigues. As such, I am concerned the current surge in profit growth is not the product of ordinary market forces, but rather the result of politically-driven stimulus emanating from China. Whatever the case, I suggest investors proceed with caution, at least until the recovery broadens demonstrably beyond a narrow set of companies and industries within China.

Decoupling – Is It Real This Time?

Second, and as discussed in the third quarter Portfolio Briefing video,[5] I believe that certain structural changes have occurred within the developing world, and those changes might allow the emerging market ("EM") asset class to exhibit a meaningful degree of "decoupling" from the developed world in the future.

By "decoupling," I mean that EM assets might offer enhanced diversification within the context of a long-term investment portfolio. I suspect that any such benefit will be manifest only over medium-term horizons (i.e., three to five year periods), or longer. However, I do not expect that EM assets will offer vastly different short-term results amid a financial crisis or economic shock. At best, the EM asset class might offer greater diversification when measured through an investment cycle – but little at all when measured in the short run, during times of crisis. For those comfortable with statistics: I think that "decoupling" will lower the correlation of EM assets with U.S. assets in the future, though I doubt the correlation will ever turn negative.

If my assertion is correct, EM assets might play a very different role within investors' portfolios in the future. In the past, investors have tactically accumulated (or sold) EM assets as a means to amplify (or reduce) "beta" – basically jargon for extra cyclicality, heightening both prospective risk and reward. In theory, EM assets offered a means to enhance exposure to the global investment cycle. If the world was growing, if rich countries were consuming, then EM assets were expected to deliver even faster growth, and the potential for higher return. In the future, the asset class might be notable for its lower but differentiated growth prospects, offering meaningful diversification when combined with equities from the developed world.

To be clear: I do not expect that the level of risk and return associated with the EM asset class might change. EM assets will of course remain subject to elevated risk. Rather, I am suggesting that, in the future, the performance of EM assets might be less synchronized with the rest of the world. And why might investors expect more "decoupling" from EM assets in the future? There are three main reasons, all rooted in the EM's rising financial independence.

First: central banks in the developing world enjoy more freedom to set monetary policy (i.e., interest rates) independently of the U.S. Federal Reserve (the "Fed"). Over the past two years, the Fed has increased interest rates four times; during the same period, nearly all developing world central banks have cut rates – some dramatically. This stands in contrast to the past, when the Fed's rate cycle cast an enormous shadow over the developing world. If the Fed hiked rates, nearly every other bank in the developing world was obligated to follow (or even anticipate) the Fed's action. It appears that the Fed no longer holds such sway.

The reason for this change is complicated, but it boils down to the fact that the developing world is far less dependent on borrowing in U.S. dollars than it once was. Nearly all countries have seen their local bond markets explode in scale, offering much greater liquidity and depth. The presence of local bond markets has reduced reliance on the dollar; and anyway, most governments in the developing world sit on large dollar reserves that can finance dollar borrowings, such that net exposures to the dollar are low.

All this means that, for better or worse, central banks in the developing world are less beholden to U.S. interest rate policy. Certainly, the Fed remains prominent in global markets, but it is no longer dominant. Central banks in the developing world enjoy greater freedom to set monetary policy according to domestic objectives and needs, rather than respond to global cues from the Fed. Evidence from the past two years suggests that interest rate cycles have already diverged, and this may beget divergent economic and financial performance.

Second: with the important exception of China, nearly all currencies in the emerging markets are managed, to varying degrees, such that their exchange rates "float" relative to the U.S. dollar. A "floating" exchange rate is usually determined by market forces, and it is essentially the opposite of a "fixed" rate that is determined by non-market forces (e.g., government intervention). Given that most currencies in the developing world now float relative to the dollar, currency risk has become routine: its manifestation is common, because EM currencies are fluctuating versus the dollar, every minute of every day. However, the likelihood of severe currency crisis is most likely reduced, especially from the perspective of the domestic investor within the developing world. As currencies fluctuate more frequently, temporary economic imbalances are brought back into equilibrium more frequently.

There is now far less chance that big imbalances can build up to the point of inducing a currency collapse and widespread defaults. With that in mind, I suggest you peruse financial headlines from a few years ago. They were rife with dire warnings of looming defaults and bankruptcies within the emerging markets. Yet apart from somewhat elevated bankruptcies within China – and China is the exceptional case, as its currency does not "float" – the emerging markets have not experienced a wave of defaults. It might still happen, but floating currencies have reduced these pressures, even as every day fluctuations are routine. Meanwhile, only two years ago most currency strategists suggested EM currencies would collapse once the Fed began to hike rates. Since then, the Fed has increased rates four times (cumulatively 1%), and at the same time, EM currencies have risen considerably.[6] So to sum up, emerging markets not only enjoy monetary (interest rate) independence, but currency independence, as well.

Third: the developing world enjoys greater profit independence than ever before. There is a widespread but false narrative in financial markets that corporate profits in the emerging markets are highly dependent on macroeconomic growth, and in turn macro growth is highly dependent on trade with the developed world. In a nutshell, this narrative exists for a reason: until roughly 10 years ago, it was partially true. Corporate profits in the emerging markets were not particularly dependent on macroeconomic growth; but macro growth was quite dependent on trade with the developed world.

Seafarer's analysis suggests that emerging markets' dependency on trade with richer nations began to decline around 2005. Today, such trade still makes positive contributions to growth, but its aggregate contribution falls below the aggregate growth rate – in other words, domestic economic growth outpaces export growth. Furthermore, corporate profits are not terribly correlated with either domestic growth or trade growth – in other words, corporate profits are a "micro" phenomenon in the emerging markets. This is not really a surprise, as a preponderance of studies conclude that corporate profits are not particularly correlated with economic growth anywhere in the world. In my view, there is ample reason to expect emerging market profit cycles to be independent of global trade cycles.

So this is why I think the EM asset class might "decouple" in a meaningful manner in the future: the preconditions are now in place. The developing world already exercises monetary independence; apart from China, the developing world has pursued currency independence; and the corporate profit cycles have always been somewhat independent, and are increasingly so now. This new financial independence does not guarantee that decoupling will occur, but it makes it much more possible than ever before.

To be candid, I have not been a fan of the concept of "decoupling" in the past. When the term was in vogue a decade ago, I thought it was mostly a marketing gimmick, meant to promote emerging market products for all the wrong reasons.

I knew it was a gimmick because of one key fact: the emerging markets had grown precisely because they had coupled with the developed world. The developing countries were not expanding because of their independence, but rather because they had opened their economies to global trade and competition. They were prospering because they had opened their financial markets to capital from richer nations – and that capital financed productive investment that begat faster growth. Financial markets were deeply intertwined at the time, so any notion that the emerging markets might "decouple" was mostly a marketing fantasy. Yet ten years later, the evidence points in a different direction. I think investors should evaluate the possibility of change within the asset class – and consider structuring their portfolios accordingly.

Thank you for investing your hard-earned capital with us, thank you for your patience, and thank you for staying focused on the long-term. We are, as always, very honored to serve as your investment adviser in the emerging markets.

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October 14, 2017

[1] References to the "Fund" pertain to the Fund's Institutional share class (ticker: SIGIX). The Investor share class (ticker: SFGIX) gained 1.89% during the quarter.

[2] The Fund's Investor share class began the quarter with a net asset value of $12.73 per share; it finished the quarter with a value of $12.97 per share.

[3] www.seafarerfunds.com/funds/ogi/portfolio-review/2017/06/Q2/#portfolio-review-performance

[4] www.seafarerfunds.com/funds/ogi/portfolio-review/2017/03/Q1/#realistic-expectations

[5] www.seafarerfunds.com/video/2017/09/ogi-portfolio-briefing

[6] Based on the performance of the MSCI Emerging Markets Currency Index (index code: MXEF0CX0), EM currencies have, as a basket, risen 10.7% versus the U.S. dollar between December 1, 2015 and October 13, 2017. For reference, the Fed's first interest rate increase in nearly one decade took place on December 16, 2015; and the Fed has undertaken three additional increases since.

Glossary

American Depository Receipt (ADR) is a receipt for the shares of a foreign-based corporation held by a U.S. bank. The receipt usually entitles the shareholder to all dividends (excluding withholding) and capital gains. ADRs are denominated in U.S. dollars. Instead of buying shares of a foreign-based company in an overseas market, Americans can buy shares in the U.S. in the form of an ADR. ADRs help to reduce administration and duty costs that would otherwise be levied on each transaction.

Book Value is the value of an asset as represented in the accounts of a balance sheet. An asset's book value is typically determined by the original cost of the asset, less any depreciation, amortization or impairment costs applied against the asset. The book value of a firm is typically determined by the value of the firm's assets, less its liabilities. In theory, shareholders would be entitled to the firm's book value if the company's balance sheet was liquidated.

Brazilian Real (BRL) is the official currency of Brazil.

For More Information

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The performance data quoted represents past performance and does not guarantee future results. Future returns may be lower or higher. The investment return and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than the original cost. View the Fund's most recent month-end performance at www.seafarerfunds.com/funds/ogi/performance.

The MSCI Emerging Markets Total Return Index, Standard (Large+Mid Cap) Core, Gross (dividends reinvested), USD is a free float-adjusted market capitalization index designed to measure equity market performance of emerging markets. Index code: GDUEEGF.

The MSCI Emerging Markets Currency Index tracks the performance of emerging market currencies relative to the U.S. dollar. The index measures the total returns of the currencies of countries in the corresponding MSCI equity index (i.e. MSCI Emerging Markets Index). Index code: MXEF0CX0.

The S&P 500 Total Return Index is a stock market index based on the market capitalizations of 500 large companies with common stock listed on the NYSE or NASDAQ.

It is not possible to invest directly in an index.

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As of September 30, 2017, Hang Lung Properties, Ltd. comprised 3.7% of the Seafarer Overseas Growth and Income Fund, Hyundai Mobis Co., Ltd. comprised 5.4% of the Fund, Astra International Tbk PT comprised 3.7% of the Fund, Fuyao Glass Industry Group Co., Ltd. comprised 2.1% of the Fund, Venture Corp., Ltd. comprised 1.6% of the Fund, Hengan International Group Co., Ltd. comprised 2.5% of the Fund, China Telecom Corp., Ltd. comprised 0.7% of the Fund, Infosys, Ltd. ADR comprised 5.0% of the Fund, and Infosys, Ltd. comprised 0.5% of the Fund. The Fund had no economic interest in Valid Solucoes, Grupo Herdez SAB de CV, and PGE Polska Grupa Energetyczna SA. View the Fund's Top 10 Holdings at www.seafarerfunds.com/funds/ogi/composition. Holdings are subject to change.

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