SEAFARER OVERSEAS GROWTH AND INCOME FUND

Portfolio Review

Second Quarter 2022

Andrew Foster
Chief Investment Officer and Portfolio Manager

Paul Espinosa
Portfolio Manager

During the second quarter of 2022, the Seafarer Overseas Growth and Income Fund returned -9.23%.[1,2] The Fund's benchmark indices, the Morningstar Emerging Markets Net Return USD Index and the MSCI Emerging Markets Total Return USD Index, returned -11.72% and -11.34%, respectively. By way of broader comparison, the S&P 500 Index returned -16.10%.

The Fund began the quarter with a net asset value of $12.81 per share. During the quarter the Fund paid a semi-annual distribution of approximately $0.117 per share. This payment brought the cumulative distribution, as measured from the Fund's inception, to $4.616 per share.[3] The Fund finished the quarter with a value of $11.51 per share.[4]

Performance

As is obvious from the preceding statistics, both the Fund and the Morningstar Emerging Markets Index experienced sharp declines during the second quarter. What is not obvious from the preceding statistics is the extreme short-term volatility that coincided with that weakness. Between March 31st and May 12th, the Fund declined -9.5%; by May 31st, the Fund recouped the bulk of those losses, such that it had declined only -1.5% relative to the prior quarter's end; then in the month of June, the Fund and the broader markets slumped once more, such that the Fund and the benchmark index returned -9.2% and -11.7%, respectively, for the quarter.

I have rarely experienced such pronounced, bi-directional, short-term volatility during my career. Markets might fall in a pronounced fashion over a 3-month period; they might equally rise. Yet to witness them collapse nearly 10%, climb and erase most of those losses, only to slump nearly to the nadir once more – all in the span of three months – is uncommon.

To be honest, I am not certain what drove such wild, short-term swings in performance (indeed, I am never confident about short-term market movements – most of the time, I think it is noise). Yet I would be remiss not to note that during the quarter, investors' perception of inflation changed dramatically and quickly.

This portfolio review addresses the second quarter of 2022 (4/1/22 to 6/30/22). As of 6/30/22 the annualized performance of the Fund's Institutional class was: 1 year -20.50%, 3 year 4.49%, 5 year 2.94%, 7 year 3.37%, 10 year 5.30%, and since inception (2/15/12) 5.13%[1]; the gross expense ratio was 0.92%. 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/performance.

At the outset of the quarter, investors had recognized that inflationary pressures were gathering around the globe (especially in the U.S.), but judging by pundits' commentary in the popular press, many dismissed the idea that inflation would become either severe or persistent. By June, the data suggested that such dismissals were ill-considered: inflationary pressures were broad-based (especially in the U.S. economy) and running at levels not seen in decades.

Given this backdrop, I presume that stocks in the Fund (and in the emerging markets more broadly) swung on changing perceptions about the severity of inflation, along with the repercussions for near-term profit growth. Effectively, the markets were trying to figure out – or, in the parlance of the industry, "price in" – the impact of inflation on future earnings and financial performance. If my presumption is correct, then I suspect the Fund's holdings buckled for two main reasons: first, stocks were repriced based on concerns that inflation would push up input costs, thereby squeezing current profit margins; second, investors grew fearful that the U.S. Federal Reserve would be forced to undertake many and sustained interest rate increases in order to quell the inflation – and that such rate hikes would precipitate a recession, dampening future revenue growth.

Stocks in the Fund (and in the emerging markets more broadly) swung on changing perceptions about the severity of inflation.

This is admittedly guesswork on my part: I do not definitively know what drove markets to swing so far, so fast. However, if the first explanation weighed on markets (i.e., current profits will be squeezed due to higher input costs), there is yet scant fundamental evidence to substantiate such fears. As I write now, in the third week of July, very few companies held by the Fund have published financial results for the second quarter (the bulk of such reports will occur over the next six weeks). Those very few that have reported have produced acceptable (or, in some cases, quite good) results – refuting, however tenuously, the idea that costs are about to swamp profits. Nevertheless, Seafarer will be reviewing forthcoming results carefully for indications of material deterioration in profit margins due to inflationary pressures. We shall see what happens next; personally, I am concerned, but not overly so, about this potential problem.

If the second explanation weighed most on markets (i.e., future rate hikes in the U.S. and elsewhere will beget a global recession, and dampen revenue growth) – again, there is no tangible evidence in support of such fears. Of course, there won't be any present evidence: investors are reacting to a recession risk that is 6 to 18 months in the future, and we won't see a discernible impact for several quarters. Yet, given the stocks that fell most precipitously during the quarter, the "future recession risk" seems to be the dominant explanation.

The Fund holdings that declined most were a mixed bunch, but especially prevalent among them were financial services companies (**XP, Inc.**, a Brazilian asset management firm; **Sanlam**, a South African multi-line insurance carrier; **Credicorp**, a Peruvian bank; and **Itaú Unibanco**, a Brazilian bank) and companies with somewhat more cyclical revenue streams (**Greatview Aseptic**, a China-based packaging company; **Samsung Electronics**, a South Korean semiconductor maker; and **Pacific Basin**, a shipping company in Eastern China). This collection of stocks suggest that investors were pricing in higher rates (which can impede both profits and growth for financial firms) and unstable global growth (which would tend to impact globally-driven, cyclical industries such as packaging, semiconductors and shipping).

I am no expert on the market environment in the United States, but to my untrained eye, inflation seems elevated, widespread, and increasingly entrenched, possibly necessitating many rate increases. Outside the U.S., in the developing world, the same pressures are present, but are materially less problematic (except for India). I am not a macroeconomist, but I suspect inflationary conditions are relatively subdued in the developing world because most central banks there have proactively increased rates – well ahead of the U.S. Federal Reserve – before prices spiraled out of control. China is a special case, as its economy is stalling out – by no means "good" news, but at least inflation there has been tepid. Even so, more rate hikes may loom in the developing world, and consequently the market's apparent fear of a future recession may prove justified. Yet at present – and referring solely to the Fund's holdings, not all companies and certainly not all emerging stock markets – I am not terribly concerned about a sudden decline in revenue growth (I will expand on this topic in the Outlook section below).

Allocation

During the second quarter, the Fund entered three new positions: it re-established a position in a company previously exited (**Alibaba Group**); it introduced a new holding (**Anheuser-Busch InBev**); and it added a new position in another share class of a company long-owned by the Fund (**Samsung Electronics** – the common stock was purchased for the first time alongside the preferred share). One position was exited (**Jiangsu Hengrui**, a China-based pharmaceutical company).

In mid-May, the Fund exited its position in Jiangsu Hengrui and used the proceeds to re-establish a position in the Alibaba Group. The Fund exited Jiangsu Hengrui after several quarters of sub-par financial performance, during which Hengrui's sales were exceedingly weak (in part due to a severe regulatory environment for drug prices, but also due to an aging drug portfolio in China that is increasingly commodified). Even as sales were weak, Hengrui's management chose to spend profusely on certain administrative and research costs, depressing profits. The management's lack of cost control during a time of

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depressed sales undermined my belief that Hengrui had the discipline and capability to become a globally competitive pharmaceutical company, and prompted its exit from the Fund's portfolio.

The proceeds and additional capital were redeployed into Alibaba Group, just prior to the release of its financial results for the final quarter of the 2021-2022 fiscal year (i.e., the first calendar quarter of 2022). Alibaba was formerly one of the Fund's largest holdings, from the autumn of 2018 until the autumn of 2020; the position was exited then due to excessive valuation and the recognition that the stock market seemingly failed to appreciate certain risks associated with the Chinese government's intrusion into corporate governance among the country's leading technology firms. Since the peak market valuation achieved in the fall of 2020, Alibaba's share price has fallen by about 65%, largely because such risks are now manifest, and investors no longer blithely ignore their impact – such risks are now accounted for in the market valuation of the company.

At present, there is public discussion among some China investors and pundits that "regulatory risk" in the Chinese technology sector is waning. (I believe the term "regulatory risk" is a gross misnomer that obfuscates both the nature and the severity of the risk in question, but that is an argument for another day.) I understand the basis for such discussion, but I do not agree with it much. It is true that the manifestation of "regulatory risk" in China's technology sector has been both capricious and destructive. To some degree, the capriciousness was heightened because of the Chinese government's poor internal organization and communication about its intent to intervene in the domestic technology sector. I suspect that the haphazard approach will decline, alleviating some of the risks that investors now perceive. However, I believe that the frequency and severity of such intrusions will not change much, and consequently that the domestic technology sector is quite unlikely to recover its former size, growth potential and industrial momentum.

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The Fund has re-purchased Alibaba not because I perceive reduced "regulatory risk" in China, but rather because such risk is now amply reflected in the company's share price, just as it was not in the autumn of 2020. Consequently, the risk that the company is substantially overvalued has subsided, and it may yet prove undervalued. I believe that Alibaba's organizational structure will undergo substantial change in the next three to five years, during which portions of the Group will be spun out, sold, liquidated, or otherwise restructured in response to market forces, along with domestic and international regulation. I suspect that at such time, investors will award the separate units a higher collective value than is presently afforded the Group. In addition, I believe investors have not fully appreciated the value embedded in Alibaba's commerce and logistic businesses in Southeast Asia. Taken together – lower valuation risk with the possibility of enhanced returns from organizational conversion and underappreciated value in the company's international businesses – Alibaba presented a better risk-versus-reward trade-off for the Fund than did Hengrui, and thus the exchange was made. Alibaba presented the further advantage that, unlike many of its peers in China's technology sector, it produces substantial free cash flow which it directs into material buyback campaigns (ideally it would pay a dividend as well, but that has yet to occur).

In addition, Anheuser-Busch InBev was added to the portfolio in light of the substantial business that it conducts in the developing world – at the group level, the majority of its sales are derived in developing countries. Seafarer's Value team, led by Paul Espinosa, has scrutinized the group's distribution practices in such countries, especially in the practices of its subsidiary Ambev (itself already a holding of the Fund). Paul concluded that the group's operational know-how and technological deployment for product distribution has established a substantial advantage over its competition – an advantage that might afford incremental advantages for many years to come, manifest in an ability to expand its volumes and increase prices at a pace unmatched by peers.

Lastly, the Fund added a new position in the common stock of Samsung Electronics. The Fund has held a large position in the preferred shares of the company since 2014. The financial risks and rewards that result from the two share classes are subtly different, but quite similar overall. However, the preferred share class once traded at a pronounced discount to the common stock, seemingly without good reason: in March of 2014, when the Fund first accumulated a position in the preferred share, it was priced at a 21% discount to the common stock.[5] That discount was the primary reason for the preferred share's initial appeal. However, that discount has narrowed in the preceding eight years, such that it now is routinely under 10% (the exact discount varies by day, as it is determined by the relative market prices for each class). As the discount has narrowed, the incremental appeal of the common stock has grown in my view. The common stock regularly presents much greater liquidity than the preferred, and it affords the owner a voting right which the preferred share does not. The addition of the common stock alongside the preferred allows the Fund to maintain its overall exposure to the company (with only subtle differences between the two) with a substantial enhancement in overall liquidity (the Fund now has two different classes of stock it can sell if needed – and by spreading sales across two distinct markets, the Fund is less likely to depress either due to its own transaction activity).

Outlook

Looking forward, there are (as always) multiple events and conditions that might materially impact the performance of the emerging markets. The war that Russia has brought to

Ukraine continues to cloud prospects for Europe, including Hungary, Poland and the Czech Republic where the Fund invests. Brazil is amid a tumultuous, four-year presidential election cycle. India is attempting to balance its objectives for growth alongside persistently high rates of inflation, while simultaneously managing conflicts at its border with China. The global economy's vacillation between inflationary and recessionary conditions might hamper growth in many countries, particularly those with globally-driven, cyclical industries such as semiconductors (South Korea and Taiwan) or manufactured exports (China and much of Southeast Asia).

However, there are two conditions that I believe require particular attention for shareholders of the Fund. The first is the broader environment for corporate earnings growth relative to that of the Fund's holdings. At the outset of this year, the consensus forecast for earnings growth for 2022 within the emerging markets was +6%.[6] By mid-year, that same consensus forecast for 2022 was revised downward to -4.3% (i.e., over 10% lower). The reasons for this sharp downward revision – from expansion to contraction – are not entirely transparent, but it appears that the decline is mostly due to the impact of inflation (rising input costs are dragging down profit margins) and very slow growth in China (stemming especially from Covid-19 "lockdown" policies).

By contrast, the consensus forecast for earnings growth for 2022 from the Fund's holdings has fluctuated this year between +8% and +11%, and currently stands at +9% as of the end of June 2022.[7] This statistic is remarkable to me: even as growth has broadly declined across the emerging markets, and expansion has turned to contraction, the Fund's portfolio is expected to produce meaningful growth, effectively unscathed. Frankly, I think the persistence of this statistic is unlikely. I expect the consensus forecast for the Fund's constituents' earnings will decline before the year is out; such downward revisions may well occur in the coming weeks, as financial results for the second quarter are published. I suspect inflationary pressures will eat away at 4% to 6% of the Fund's forecast earnings growth – perhaps more – as profit margins are hampered by the higher cost of labor and materials. Still, if the Fund manages to produce growth of 3% to 5% in a year where the market is in overall decline, it would be a remarkable outcome. It would suggest that the Fund's strategy of investing in companies with durable earnings growth, manifest in stable and rising dividends, is finding purchase amid an otherwise difficult year.

On a less welcome note, the second condition that requires shareholders' attention is the acuteness of financial distress in China. After decades of extraordinary economic expansion, and after years of rapidly rising household incomes, growth in China has decelerated dramatically. The deceleration appears structural to me: foregone economic reforms and problematic actions undertaken by the Xi administration have stunted the country's potential for expansion. As a result, I think average growth over the next decade is at best 3% to 3.5%, and very likely slower. Should financial shock disrupt the economy for a time, the long term rate of growth will be lower still. Of course, China might experience brief periods of faster growth when spurred by stimulus, or as the formulaic result of comparison to a depressed base (e.g., when recovering from recession). Yet even a pace of 3% would constitute a remarkable achievement, given the economy's breadth and scale. A country of China's scale that can expand at such pace will likely produce many valuable companies over time, given that such growth equates to billions of dollars in new annual productivity.

The problem is that China has accrued a great deal of debt on the path to its current scale. The debt has been accumulated in the banking sector, especially among the opaque, state-held policy banks; the debt has been accumulated on corporate balance sheets, especially poorly-run and loss making state-backed enterprises; the debt has been accumulated in local government financing vehicles, off-the-books quasi-public entities that borrow on behalf of provinces and townships that can't otherwise legally borrow; and the debt has been accumulated on household balance sheets, as all generations – especially younger generations – have stretched for mortgages to purchase urban properties at elevated prices. Slower growth makes all this debt less easily serviced, and the system-wide strain is beginning to show.

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China might be nearing its first modern financial crisis, centered on the residential housing sector. Years of negligent lending to poorly run (and oftentimes corrupt) housing developers have led to cascading defaults and financial strain. The implications are severe, as by most estimates the housing sector drives at least one eighth of the country's output; some of the highest estimates claim it accounts for nearly one quarter. An even larger portion of the banking system's collateral is backed by properties. If values were to decline amid a housing crisis, eroding collateral values could undermine the system's solvency. Residential housing units also account for a large portion of households' collective wealth. If the sector was to decline, it would not likely bankrupt households in aggregate, in my view – they enjoy too much accumulated net wealth. However, it would undoubtedly dampen their proclivity to spend and consume as such wealth was diminished.

For three decades, the Chinese government has acted carefully – and sometimes boldly – to forestall past financial crises. As a result, China can rightfully state that it has avoided the sort of financial meltdowns that troubled Japan in the late 1980s, Southeast Asia in 1997, or the U.S. in 1999 and again in 2008. Given the present strain in the housing sector, the government has already begun to respond, but to date its efforts have lacked sufficient scale to address the problem. I suspect the government's ability to respond is hampered by the precarious nature of its own balance sheet, which has deteriorated after years of ill-conceived spending for national infrastructure projects and politically motivated projects overseas. The strain is really beginning to show.

Still, China has some financial tools that might help it forestall crisis, yet again. The balance sheet of the central government is not heavily indebted; a bold maneuver might have the central government explicitly assume some of the off-balance sheet debts of the provincial governments, thereby freeing up local resources to stimulate growth and possibly shore up the housing sector. For more information on the central government's balance sheet – and the likelihood of it being deployed to prevent crisis – please see my colleague Nicholas Borst's Prevailing Winds[8] commentary. The government also has a surfeit of regulatory tools and sovereign controls that can blunt the speed and uncertainty of an unmanaged crisis. In my view, it is unlikely China will experience a catastrophic, chaotic collapse akin to the "Lehman moment" that occurred in the U.S. in 2008; a slow-moving crisis is much more likely. Still, such tools and controls would only slow the transmission of crisis; they are unlikely to prevent one altogether, and China's prospective growth will deteriorate as a result.

Some might read the preceding paragraphs and question whether the Fund should remain invested in China, and if so, why. To remove doubt, I can verify that for the foreseeable future, the Fund will remain invested in China, albeit very selectively (as always). It will do so because while we can see the precursors of crisis, we do not know when or even whether it might manifest. The Fund will do so because the country is home to a broad, vibrant private corporate sector – companies whose value persists and may even be underappreciated regardless of a potential crisis, in my view. The Fund will do so because even if a crisis manifests, we suspect that it will not preclude China from recovering and resuming its growth – the country possesses too much collective talent, resources and enterprise to imagine otherwise. Nevertheless, investors should be aware of the challenges that lie ahead.

It has been a tough year for investors in the Fund. We are honored that you have remained invested in the Fund, and we thank you for entrusting us with your capital.

Andrew Foster
Chief Investment Officer and Portfolio Manager

with

Paul Espinosa
Portfolio Manager

July 22, 2022

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[1] References to the "Fund" pertain to the Fund's Institutional share class (ticker: SIGIX). The Investor share class (ticker: SFGIX) returned -9.30% during the quarter. All returns are measured inclusive of Fund distributions paid (in relation to Fund performance) or dividends paid (in relation to index performance), reinvested in full (exclusive of any U.S. taxation) on the pertinent ex-date.

[2] 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.

[3] The Fund's inception date is February 15, 2012.

[4] The Fund's Investor share class began the quarter with a net asset value of $12.74 per share; it paid a semi-annual distribution of approximately $0.115 per share during the quarter; and it finished the quarter with a value of $11.44 per share.

[5] Source: Bloomberg.

[6] The constituents of the MSCI Emerging Markets Index are used here a proxy for the overall market. Source: J.P. Morgan, "Emerging Markets Equity Strategy Steering Board," 6 January 2022 and 30 June 2022.

[7] Seafarer does not publish its own proprietary estimates of corporate earnings growth, but rather calculates a forecast based on public consensus estimates as available from Bloomberg. Sources: Bloomberg, Seafarer.

[8] www.seafarerfunds.com/prevailing-winds

Glossary

Free Cash Flow: operating cash flow minus capital expenditures.

Liquidity: the ability to buy or sell an asset readily and with reasonable volumes without affecting the asset's price.

Local Government Financing Vehicles (LGFVs): special purpose vehicles that borrow funds on behalf of local governments to finance projects ranging from infrastructure to real estate development.

Policy Banks: three banks in China (Agricultural Development Bank of China, China Development Bank, and Export-Import Bank of China) that were established in 1994 to finance state-invested projects, as well as economic and trade development priorities.

Solvency: the ability of a borrower to meet its long-term debt obligations.

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seafarerfunds.com

For More Information

Individual Investors
(855) 732-9220
seafarerfunds@alpsinc.com

Investment Professionals
(415) 578-5809
clientservices@seafarerfunds.com

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The Morningstar Emerging Markets Net Return USD Index measures the performance of emerging markets targeting the top 97% of stocks by market capitalization. The index does not incorporate Morningstar's environmental, social, or governance (ESG) criteria. Index code: MEMMN. The MSCI Emerging Markets Total Return USD 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 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 June 30, 2022, Anheuser-Busch InBev SA/NV comprised 2.1% of the Seafarer Overseas Growth and Income Fund, Alibaba Group Holding, Ltd. comprised 3.8% of the Fund, Samsung Electronics Co., Ltd., Pfd. comprised 4.2% of the Fund, and Samsung Electronics Co., Ltd. comprised 0.6% of the Fund. The Fund did not own shares in Jiangsu Hengrui Medicine Co., Ltd. View the Fund's Top 10 Holdings at www.seafarerfunds.com/funds/ogi/composition. Holdings are subject to change.

ALPS Distributors, Inc. is the distributor for the Seafarer Funds.

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