SEAFARER

SEAFARER OVERSEAS VALUE FUND

# Portfolio Review

## Third Quarter 2021

**Paul Espinosa**
Portfolio Manager

During the third quarter of 2021, the Seafarer Overseas Value Fund returned -3.91%.[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 -7.23% and -7.97%, respectively. By way of broader comparison, the S&P 500 Index returned 0.58%.

The Fund began the quarter with a net asset value (NAV) of $13.81 per share. It paid no distributions during the quarter and finished the period with a value of $13.27 per share.[3]

## Performance

During the third quarter of 2021, the Value Fund's NAV experienced an absolute decline of -3.91%, after appreciating 12.92% during the first half of the year.[2] The Fund continued its outperformance year-to-date relative to its benchmark, the Morningstar Emerging Markets Index.

It is difficult to ascribe the relative outperformance to any one factor. In an absolute sense, the negative contribution from stocks impacted by global dynamics, such as Covid-19's resurgence in the form of the Delta variant and Brazil country factors, detracted from the strong positive contribution by specific holdings driven by idiosyncratic factors.

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The Fund retains a meaningful exposure to travel-dependent companies in the form of **Shangri-La** (Breakup Value and Asset Productivity sources of value; see Figure 1 for definitions of the sources of value referenced in this review), a hotel owner and operator in Asia; **Melco International** (Breakup Value and Asset Productivity), a casino owner and operator in Macau; **Genting Singapore** (Balance Sheet Liquidity), a casino owner and operator in Singapore; and **Pico Far East** (Segregated Market), a designer and organizer of trade show exhibitions and conferences. Unsurprisingly, the stock prices of these companies suffered as the pandemic resurfaced.

*As of 9/30/21 the annualized performance of the Fund's Institutional class was: 1 year 29.51%, 3 year 7.75%, 5 year 7.78%, and since inception (5/31/16) 7.91%[1]; the net expense ratio was 1.05% and the gross expense ratio was 1.47%. 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.*

### Figure 1. A Working Definition of Value

Seafarer has identified seven distinct sources of value in emerging markets that may give rise to viable opportunities for long-term, value-oriented investments.

| Opportunity Set | Source of Value | |
|---|---|---|
| Balance Sheet | Balance Sheet Liquidity | Cash or highly liquid assets undervalued by the market |
| | Breakup Value | Assets whose liquidation value exceeds their market capitalization |
| | Management Change | Assets that would become substantially more productive under a new owner / operator |
| | Deleveraging | Shift of cash flow accrual from debt holders to equity holders |
| | Asset Productivity | Cyclical downturn following a period of asset expansion |
| | Structural Shift | Shift to a lower growth regime, but still highly cash generative |
| Income Statement / Cash Flow | Segregated Market | Productive, cash-generative assets trading in an illiquid public market |

*Source: Seafarer* Sources of value are highlighted in this document using This Style.

Additional information is available in the white paper *On Value in the Emerging Markets* at www.seafarerfunds.com/value-in-em.

Likewise, the Fund's Brazilian holdings – **Itaú Unibanco** (Asset Productivity and Breakup Value), the largest privately-owned bank in Brazil, and **Ambev** (Structural Shift and Asset Productivity), a Brazil-based brewer in the Americas – suffered as the entire Brazilian equity market declined due to the confluence of unease surrounding the country's 2022 presidential election, federal budget and tax reform uncertainty, and impressively rapid interest rate increases by the country's central bank.

This quarter was a reminder that while I attempt to minimize the impact of "macro" factors on Fund performance, in practice, it is impossible to realize the dream. However, I am pleased to see that on the other side of the ledger, I could not discern any pattern among the positive contributors to total return.

**HRnetGroup** (Balance Sheet Liquidity), a Singapore-based recruitment and staffing firm operating in Asia, stood out – despite its small market capitalization – with a strong stock price performance in the midst of the pandemic's resurgence, which, all else equal, one would have expected to delay corporate hiring plans. As usual, all else is rarely equal in the real world, and this company demonstrated incipient signs of a business recovery in the first half of the year.

Demonstrating the same principle that reality invariably confounds consensus, **Pacific Basin** (Asset Productivity), a dry bulk shipping company headquartered in Hong Kong, continued its long-running positive contribution to the Fund's NAV by reporting very strong first half 2021 results as the Baltic Handysize Index (BHSI), the spot rate at which small dry bulk sea vessels may be chartered, reached a thirteen year high. Indeed, the dry bulk shipping industry's recession since 2008 has finally relented, driving the decade-long negative consensus view on the stock into its own recession.

A more recent positive contributor, and off the beaten track, is **PetroVietnam Fertilizer and Chemical** (Management Change and Asset Productivity), a Vietnamese fertilizer manufacturer. Higher capacity utilization at its new plant, as well as higher urea prices, are driving a newfound earnings acceleration and the prospect of significantly higher dividends at this positive net cash company whose capital expenditure has peaked.

## Allocation

During the third quarter, the Fund established a new position in **Dairy Farm International Holdings** (Management Change and Asset Productivity), a multi-format retailer operating in Asia. The company is majority owned by Fund holding **Jardine Matheson** (Breakup Value and Management Change), a Southeast Asia-focused conglomerate operating in the real estate, auto, and food retail industries, among others.

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I expect Dairy Farm's new management team, which took the reins in 2017, to bring the company out of a long era focused on expansion – at the expense of productivity – by adopting twenty-first century operational best practices. The onset of the pandemic served to make this stock's valuation more than attractive by masking the fruits of management's labor over the past years.

During the quarter, the Fund exited **Crédito Real** (Asset Productivity), a Mexican finance company, due to newfound concern over the company's credit approval process, as well as incipient structural challenges for the industry.

## Outlook

As the performance of several Fund holdings during the third quarter highlighted, individual holdings – or a diversified portfolio – are never truly immune to the context they operate in. And that context changed significantly during the quarter at several levels: from the fundamentals of the risk-free rate of return (the Federal Reserve suddenly shifted, without explanation, from average inflation targeting to a forward guidance of imminent rate increases), to the fundamentals of investing in China (Beijing implemented curbs to specific industries), to the fundamentals of the post-pandemic recovery (the spread of the Delta variant and persistent supply chain bottlenecks.)

These developments share the trait of impinging negatively on equity valuations. However, I would propose a different interpretation of all three developments. My intent is to highlight a silver lining within third quarter developments, not to be a contrarian without a cause.

Within the confines of textbook finance, a rise in the risk-free rate equates to a theoretical lowering of equity values. Free of textbook constraints, the real-world record of financial history shows that discount rate fluctuation is a recurrent event and not a cause for alarm in itself. When these shifts may be of concern is when they take place in the context of historically extended equity valuation levels and unprecedented leverage in the economy, as is the case in the United States and many developed markets. What are the tax implications of doubling the cost of servicing the federal debt, especially when budget deficits are at war-time levels?

Before the reader accuses me of being another "value-guy doomsayer," my point is to highlight that the emerging markets (EM) are actually ahead of developed markets in this path. It is rare, if not unprecedented, for EM central banks – in the aggregate – to foretaste the Federal Reserve's forward guidance. Yes, in most instances EM monetary authorities, such as the Central Bank of Brazil which raised the target SELIC overnight rate from 1.90% to 6.15% year-to-date, are responding to inflation that is running ahead of that of the U.S. dollar.[4] That is not the point. What is worthy of appreciation is the anticipatory and resolute nature of said rate increases, in the face of a severe federal budget deficit. In other words, EM central banks – generally speaking, certainly not all of them – are proving their independence and demonstrating to developed market central banks the meaning of maintaining, or at least trying to maintain, the integrity of the national currency. This latter point is certainly a first.

I would add that EM equity valuations are generally acknowledged to be lower than those in the U.S. Thus, on the verge of a potential shift from average inflation targeting to imminent interest rate increases at the world's reserve currency, there is reason to dismiss textbook recipes on the implications for EM valuations (a question I am often asked), and instead opt for a more considered outlook, which in my opinion is reasonably healthy as it concerns emerging market equity fundamentals.

On the prevailing third quarter topic of whether Chinese equities are investable after Beijing's curbs on the private education and various internet-related industries, I would point out that these new regulations have been long in the making. In my view, contrary to the developed market investor view of Beijing's actions as surprising, I would argue that what was unreasonable was investors' dismissal of the potential ramifications of Xi Jinping Thought on industry regulation – a potential fault I am not free of myself, of course, even if I did not happen to suffer from it in this instance. So yes, China remains as investable as last year, more investable than a decade ago, and probably less investable than it will be a decade from today.

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Finally, with regard to life after the pandemic, well . . . the third quarter questioned whether one should use the preposition "after" or use "with" instead. Persistent supply chain disruptions supported the stock price of Fund holding Pacific Basin, while a resurgent incidence of Covid infections pressured the stock prices of Fund holdings such as Shangri-La and Melco International, whose revenue hinges on their customers' ability and willingness to travel.

In the context of an eventful third quarter, it is important to highlight that I do not "position" the Seafarer Overseas Value Fund to "capture" any of these "macro" developments. The intent is the exact opposite. The Fund held Shangri-La and Melco International prior to the pandemic. I could have, but did not, sell them as the pandemic gathered momentum, or as the Delta variant reared its head. Instead, the Fund continued to hold the names on the view that they could weather the storm (a view validated eighteen months into the pandemic) and purchased more shares as investors focused on earnings momentum accepted a significantly lower price for the stock.

In the case of Pacific Basin, the Fund invested in the shares prior to the pandemic and I have partially sold them as investors were willing to pay a meaningfully higher price to buy earnings momentum. The point is not to do the opposite of what the market – the aggregate of investors transacting in a security – is doing, but to invest in companies that can (mostly) weather whatever the unpredictable future brings such that one can afford to willingly transact at the desired price, and not be forced to accept the market price at any given point in time. This ideal (imperfectly attained in real life) is the goal that directs the Value Fund.

Thank you for entrusting us with your capital. We are honored to serve as your investment adviser in the emerging markets.

Paul Espinosa
*Portfolio Manager*

October 13, 2021

[1] References to the "Fund" pertain to the Fund's Institutional share class (ticker: SIVLX). The Investor share class (ticker: SFVLX) returned -3.92% during the quarter.

[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/ovl/performance.

[3] The Fund's Investor share class began the quarter with a net asset value of $13.78 per share; it finished the quarter with a value of $13.24 per share.

[4] Sources: Central Bank of Brazil, Bloomberg. 1.90% as of March 17, 2021; 6.15% as of September 30, 2021.

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**Correction: November 3, 2021** An earlier version of this portfolio review incorrectly stated that the Value Fund did not exit any holdings during the third quarter of 2021. During the quarter, the Fund exited Crédito Real, a Mexican finance company.

## Glossary

**Leverage**: the amount of debt capital used to finance a firm's assets, usually considered or measured in relation to the firm's equity capital.

**Market Capitalization:** the value of a corporation as determined by the market price of its issued and outstanding common stock. It is calculated by multiplying the number of outstanding shares by the current market price of a share.

**Net Cash:** a company's cash position, calculated by subtracting the company's total debt from its total cash.

**Risk-free Rate of Return:** the theoretical rate of return of an investment with zero risk. The risk-free rate represents the interest an investor would expect from an absolutely risk-free investment over a specified period of time. In theory, the risk-free rate is the minimum return an investor expects for any investment because he will not accept additional risk unless the potential rate of return is greater than the risk-free rate. In practice, however, the risk-free rate does not exist because even the safest investments carry a very small amount of risk. Thus, the interest rate on a three-month U.S. Treasury bill is often used as the risk-free rate for U.S.-based investors.

**SELIC Overnight Rate:** the Brazilian Central Bank's overnight rate; the interest rate at which a depository institution lends or borrows funds in the overnight market.

**Spot Rate:** the price quoted for immediate settlement on a commodity, security, or currency. The spot rate, also called the spot price, is the current market value of an asset at the moment of the quote. This rate is based on how much buyers are willing to pay and how much sellers are willing to accept.

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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/ovl/performance.*

*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. The Baltic Handysize Index is the spot rate at which small dry bulk sea vessels may be chartered. Index code: BHSI. It is not possible to invest directly in an index.*

*The views and information discussed in this commentary are as of the date of publication, are subject to change, and may not reflect Seafarer's current views. The views expressed represent an assessment of market conditions at a specific point in time, are opinions only and should not be relied upon as investment advice regarding a particular investment or markets in general. Such information does not constitute a recommendation to buy or sell specific securities or investment vehicles. It should not be assumed that any investment will be profitable or will equal the performance of the portfolios or any securities or any sectors mentioned herein. The subject matter contained herein has been derived from several sources believed to be reliable and accurate at the time of compilation. Seafarer does not accept any liability for losses either direct or consequential caused by the use of this information.*

*As of September 30, 2021, Shangri-La Asia, Ltd. comprised 3.7% of the Seafarer Overseas Value Fund, Melco International Development, Ltd. comprised 2.6% of the Fund, Genting Singapore, Ltd. comprised 1.9% of the Fund, Pico Far East Holdings, Ltd. comprised 2.4% of the Fund, Itaú Unibanco Holding SA comprised 3.8% of the Fund, Ambev SA comprised 3.4% of the Fund, HRnetgroup, Ltd. comprised 4.0% of the Fund, Pacific Basin Shipping, Ltd. comprised 4.4% of the Fund, Petrovietnam Fertilizer & Chemicals JSC comprised 2.7% of the Fund, Dairy Farm International Holdings Ltd. comprised 2.2% of the Fund, and Jardine Matheson Holdings, Ltd. comprised 3.3% of the Fund. The Fund did not own shares in Crédito Real SAB de CV SOFOM ER. View the Fund's Top 10 Holdings at www.seafarerfunds.com/funds/ovl/composition. Holdings are subject to change.*

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

***Investors should consider the investment objectives, risks, charges and expenses carefully before making an investment decision. This and other information about the Funds are contained in the Prospectus, which is available at www.seafarerfunds.com/prospectus or by calling (855) 732-9220. Please read the Prospectus carefully before you invest or send money.***

*Important Risks: An investment in the Funds involves risk, including possible loss of principal. International investing involves additional risks, including social and political instability, market and currency volatility, market illiquidity, and reduced regulation. Emerging markets are often more volatile than developed markets, and investing in emerging markets involves greater risks. Fixed income investments are subject to additional risks, including but not limited to interest rate, credit, and inflation risks. Value investments are subject to the risk that their intrinsic value may not be recognized by the broad market. An investment in the Funds should be considered a long-term investment.*

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