SOPHUS EMERGING MARKETS STRATEGY QUARTERLY COMMENTARY

Sophus CAPITAL
A VICTORY CAPITAL® INVESTMENT FRANCHISE

As of March 31, 2024

EXECUTIVE SUMMARY

Sophus Capital employs a disciplined, bottom-up approach utilizing both quantitative and fundamental processes to invest in companies that we believe have the potential for strong and sustainable earnings growth at attractive valuations, with revisions as the catalyst. By investing in companies with these characteristics, coupled with our risk-managed approach, we seek to provide consistent excess returns over time.

- The Sophus Emerging Markets Strategy advanced by 5.0% (gross) and 4.8% (net) for the quarter, outperforming its benchmark by 240 basis points on a net basis.
- Global markets advanced in the first quarter as expectations of monetary loosening and the halo effect of the artificial intelligence (AI) thematic drove market dislocations to further extremes.
- Nevertheless, Emerging Markets' (EM) resilience carried over from 2023 into the first quarter of 2024. The US Federal Reserve (Fed) stayed on hold, contrary to market hopes for earlier rate cuts, keeping the US Dollar (USD) elevated and therefore a headwind for EM equity performance.
- Investor optimism remains high, as global investors find comfort in a better-than-Goldilocks outcome to 2024, ignoring both ongoing geopolitical conflicts and domestic political risks alike. With an onslaught of elections to come and inflation risks skewed to the upside, central banks' target rates could be forced to stay "higher for longer," at least until internal pressures demand some fudging.

PERFORMANCE RECAP

The Sophus Emerging Markets Strategy advanced by 5.0% (gross) and 4.8% (net) for the quarter, compared to the MSCI Emerging Markets Index benchmark, up 2.4%.

Stock selection in Industrials served as the largest contributor to performance in the quarter, thanks to holdings like Fortune Electric (Ticker: 1519 TT), a leading domestic transformer maker in Taiwan that provides customized manufacturing of electric equipment required for electricity transmission and distribution systems; HD Hyundai Electric (Ticker: 267260 KS), a global Korean manufacturer of electric systems and part of Hyundai Group; Korean aircraft parts manufacturer Hanwha Aerospace (Ticker: 012450 KS); and Santos Brasil Participações (Ticker: STBP3 BZ), a port operator providing logistics services. We remain selective on industries within this sector, targeting certain pockets seeing sustained growth due to imbalance of demand and supply at attractive valuations.

Financials was another major contributor to performance, due to positive stock selection, as evidenced by holdings across the EM banks landscape including PT Bank Mandiri (Ticker: BMRI IJ), ICICI Bank (Ticker: IBN US), National Bank of Greece (Ticker: ETE GA), and Yapi ve Kredi Bankasi (Ticker: YKBNK TI), which remained resilient, driven by strong underlying fundamentals amidst broader macroeconomic pressures weighing on the sector as we near the peak of the current interest rate cycle. Our underweight allocation in poor performers like HDFC Bank (Ticker: HDFCB IN) also proved beneficial. From a positioning standpoint this sector began the year as our largest underweight, which decreased over the course of the period in response to improved domestic dynamics and increased fundamental conviction in new buy ideas like PKO Bank Polski (Ticker: PKO PW), Quálitas Controladora (Ticker: Q* MM), and Saudi Awwal Bank (Ticker: SABB AB).

From a country perspective, China contributed the most to performance, driven by positive stock selection, given positions in copper player Western Mining (Ticker: 601168 C1); education tutoring turned educational experience provider New Oriental Education & Technology (Ticker: EDU US); and SOE oil and natural gas producer PetroChina (Ticker: 857 HK). In China, consumer and business confidence remained depressed, labor and housing markets weak, as deflationary pressures persist. Despite these challenging conditions, we have increased our positioning in the country during the quarter, driven by bottom-up stock selection. While we remain more cautious around government policy and growth overall, ultimately, we continue to see opportunities in this market. This is best demonstrated by the aforementioned companies, which resumed their advance in Q1 on strong underlying fundamentals leading to share price improvement.

Saudi Arabia moderately detracted from performance due to negative stock selection, driven mostly by our holdings SABIC Agri-Nutrients (Ticker: SAFCO AB) and Saudi Telecom (Ticker: STC AB), while our underweight position in this market also weighed negatively on performance, as it has rallied sharply since mid-October. The Energy sector also detracted from performance, on a combination of negative allocation effect given our underweight position (in a sector that outperformed), and the most materially strong performer we did not own, Reliance Industries (Ticker: RIL IN).

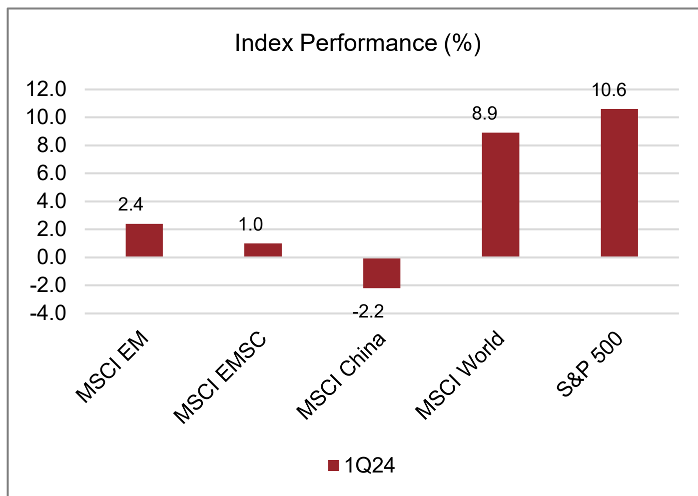
From an individual stock perspective, the two largest contributors to performance were Fortune Electric and HD Hyundai Electric (as previously mentioned). Fortune Electric reported all-time-high sales growth for 4Q (+110% YoY), bringing 2023 sales to +80% YoY on replacement demand from the US. The HD Hyundai Electric share price rally YTD has resulted from expectations to be included in the Kospi Large-cap Index in March and the MSCI Korea Index in May, as well as solid fundamentals reaffirmed by the company's latest earnings. We anticipate continued strong performance from both names.

The main detractors from performance were Hon Hai Precision Industry (Ticker: 2317 TT), which we did not own, and PDD Holdings (Ticker: PDD US), which we held. Hon Hai provided a positive guidance update for FY24 sales, to "significant growth" from a "neutral" forecast five months ago. This is mainly on the back of solid demand for AI servers from cloud service providers.

PDD posted another massive earnings beat in late March for 4Q. Revenue grew 123% YoY/29% QoQ, with both online marketing and transaction service revenue growth accelerating, which reflected increased monetization in China and the continued fast growth of Temu abroad. The muted share price reaction reflects two worries by investors: 1) rising noise around potential restrictions imposed on Temu's US business, and 2) lack of transparency and guidance from management (as usual) and hence the lack of perceived visibility into 2024. We note PDD's stronger-than-expected GMV (gross merchandise value) growth in China, and the continued take rate improvement with surprising cost cutting in Temu (which may continue into Q1). The current 2024 earnings consensus seems still too conservative and may be revised up further. However, we continue to evaluate these compelling fundamental drivers against the growing governance concerns as well as broader geopolitical uncertainty, which have constrained the share price so far this year.

MARKET OVERVIEW

Emerging Markets (EM) underperformed Developed Markets (DM) during the first quarter. The MSCI Emerging Markets Index advanced 2.4% vs. returns of +8.9% and +10.6% for the MSCI World Index and the S&P 500® Index, respectively.



Source: MSCI, Sophus Capital

Markets were resilient during the quarter, as US Tech earnings and strong macro data continued to support equity markets. Investor optimism was high and positioning elevated, as a Goldilocks outcome (or better) became consensus. However, inflation risks remained skewed to the upside given loose financial conditions, tight labor markets, and easy fiscal policy, which could keep monetary policy from the US Federal Reserve "higher for longer."

Asia was the best performing region in the period, up 3.4%, with Taiwan (+12.4%), the Philippines (+6.1%), and India (+6.1%) up the most. Taiwan extended on from a strong full year 2023, with an equally robust start to 2024, thanks to a combination of positive macroeconomics, growing AI demand, and geopolitics. Any election overhang quickly rolled off early in the period following presidential and parliamentary elections held on January 13. Lai Ching-Te from the pro-democratic Progressive Party (DPP), the ruling party since 2016, claimed victory with 40% of the votes. This narrow DPP victory, paired with the lack of a majority in Parliament, gives China less reason to be aggressive about the outcome, as it renders DPP's position in lawmaking much weaker than the prior administration and less able to push through sensitive policies.

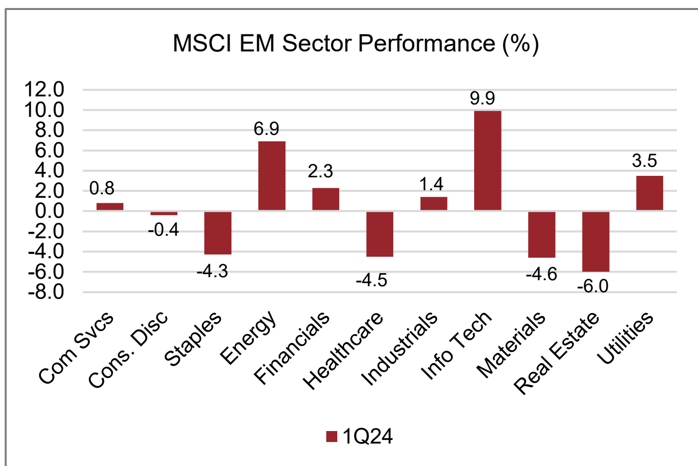
The Philippines benefited from growing diversification away from China, in addition to valuation, which remains cheap relative to the market's history in the context of healthy earnings growth. Furthermore, the Philippine economy has so far proven relatively resilient despite 450 bps of monetary tightening between May 2022 and October 2023. India remains a clear beneficiary of continued sentiment around shifting supply chains away from China amid geopolitical tensions thanks to its large domestic market, low trade dependency, relatively high monetary sovereignty, and domestic structural reforms. While the general election is set to begin on April 19 (spanning six weeks), Prime Minister Narendra Modi has become almost a foregone conclusion to secure a third term in office. Valuations in India remain expensive (and a well-known area of concern), whereas the growing gulf between credit growth, which is running at +17%, and nominal GDP, growing at a rate of less than 10%, is less often discussed though potentially no less of a problem.

Eastern Europe, Middle East, and Africa (EEMEA) was solid in the first quarter, up 0.9%. Turkey (+14.6%) was the top performer in the region, rebounding from profit-taking at the end of 2023. Investors continue to weigh a big structural shift (based on a credible mix of monetary and fiscal policies) against concerns around the execution of the policy mix. The Central Bank of Turkey (CBT) delivered another demonstration of its commitment to normalization with a surprise 500-bp interest rate hike in March amid renewed pressure on the currency and reserves, amplified in prior weeks by February inflation which came in higher than the CBT's projections. This came just days before Turkey's local election on March 31 which struck a blow against President Erdogan and the AKP, and should support market confidence in TRY assets moving forward. A decisively tight monetary stance will achieve disinflation in 2H24 through moderation in domestic demand, real lira appreciation, and improvement in inflation expectations.

Saudi Arabia (+4.7%) was another notable performer across EEMEA, trading on expectations for structural improvement given energy reforms and firm investment growth underpinning Vision 2030, supported in the quarter by a strong USD and stable commodity prices. For Saudi Arabia, the macro growth story is promising – the IMF forecasts >4% non-oil CAGR GDP growth extending to the end of the decade. Foreign ownership remains low at just 13% of the free float, and as of the end of January, 43% of GEM funds owned zero Saudi stocks, representing the biggest underweight of any major EM market. Improving demographics specifically via female participation in the labor force (up from 33% of the Saudi labor force in 2016 to 40% now), is a key component of the Vision 2030 reform plan.

Latin America was the weakest region in the period, down 4.0%, with Brazil (-7.4%) weighing the most on some profit-taking following a very strong 2023. While Brazil continues to benefit from well-behaved inflation trend (the direct result of the country's decision to begin hiking interest rates in 2021, ahead of global peers), the disclosure by Petrobras in March that it would not be paying any extraordinary dividends drove profit-taking for the stock as well as Brazilian equities overall given investors' sense of elevated risk, particularly around fiscal policy over the medium term. Though these macro concerns remain (especially on the fiscal side), Brazil will benefit from the easing monetary cycle, which should lead to increased consumer spending and positive corporate earnings growth.

Mexico, on the other hand, proved more resilient and continued to advance on nearshoring/onshoring of global supply chains happening in tandem on different sides of the US/Mexico border, with strong US economic data reinforcing such narratives and upcoming presidential elections merely escalating each trade respectively. Mexico continues to gain market share in US imports, surpassing China as the top US trading partner last year. At the same time, Mexican imports from China have also increased in USD terms, due mostly to a strong domestic economy. For context, every 1% gain in market share in US imported goods represents a US$31bn increase in gross Mexico exports. This is equivalent to around 2.4% of Mexico's GDP.



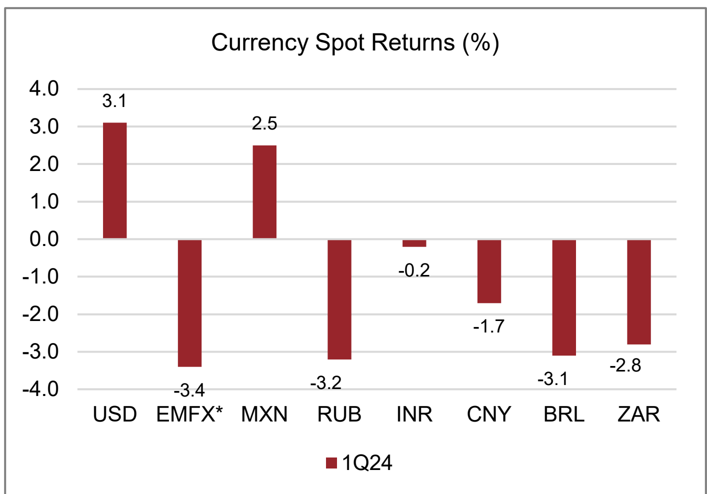
Source: MSCI, Sophus Capital

The S&P 500® Index ended the quarter up by more than 10%, marking its best start to a year since 2019. The AI craze, record corporate profits, and optimism around cooling inflation were all contributing factors to the boom.

The USD began the year in retreat, as expectations for Fed easing in the first quarter mounted. This quickly shifted in response to US growth outperformance and sticky service inflation keeping the Fed on hold. Elevated geopolitical tensions have also served to support the USD, which advanced 2% in the period. As of the March Federal Open Market Committee (FOMC) meeting, the Fed remains dovish, dismissing recent inflation surprises, upgrading growth forecasts, and embracing the supply-side narrative that the economy can grow faster and sustain low unemployment without generating overheating pressures. This opens a path for the Fed to cut interest rates despite strong growth and low unemployment as long as inflation declines.

In contrast, Japan hiked interest rates for the first time in 17 years, as the country's economy finally showed some signs of growth after years of low inflation and wage stagnation. This move ends the world's only remaining negative rates after several European central banks ended their policies in 2022. Bank of Japan Governor Kazuo Ueda said the negative interest rates and other measures the country took to boost its economy – like yield curve control and risk asset purchase programs – have "fulfilled their roles," marking the BOJ's long journey toward monetary policy normalization.

Asian policy rates are in the unusual position of being lower than the federal funds rate, which explains the discretion taken by Asian central banks (ex-Japan) to hold off on cutting rates even though inflation has fallen in most cases. Broadly speaking, EM central banks will have more room to cut rates in these countries due to earlier and faster rate hikes at the initial onset of the pandemic crisis. Over 10 central banks met around the world in the final weeks of the quarter, and their decisions vis-à-vis monetary policy suggest a new era lies ahead, one with less synchronization than prior periods.



Source: Bloomberg, Sophus Capital

*EMFX: J.P. Morgan Emerging Market Currency Index (EMCI) Live Spot

Commodities advanced in the first quarter of 2024, as illustrated by the Bloomberg Commodity Index rising by 2.2%. Brent oil finished the quarter up 13.6%, near a 4-month high, with markets focused on the continued escalation of geopolitical tensions in the Middle East along with hopes that stimulus measures coming from top importer China start to bear fruit, overshadowing concerns of oversupply. Other commodities proved more muted/mixed performance-wise, with industrial metals down 0.7%, precious metals up 6.6%, and agricultural commodities down 3.0%.

Focusing on raw factor returns within the global Axioma risk model, Medium-Term Momentum and Size were the best-performing risk style factors in the first quarter, while Volatility and Market Sensitivity lagged. Risk style factors overall were a marginally negative detractor to the MSCI EM Index, mainly due to negative returns for Country factors (China and India most notably), whereas Industry factors (Semiconductors, Tech Hardware, Oil & Gas most notably) had a positive impact.

OUTLOOK

In its January 2024 World Economic Outlook Update, the International Monetary Fund (IMF) revised up its global growth forecast for 2024 to 3.1%, up 0.2% relative to its previous projection in October. The exceptional strength of the US economy was the largest contributing factor of said upgrade. The improved world economic outlook was also boosted by economic stimulus in China, which has faced deflation and a real estate crisis, among other issues. Other economies, including India, Brazil, and Russia, also performed better than expected, helping to support the IMF's more optimistic forecasts for the year ahead.

Overall, Developed Market (DM) growth is expected to slow in 2024 to 1.5% GDP, but a boost to real incomes from further disinflation and monetary easing should offset much of the external drag for EM, which is projected to remain stable with GDP growth of 4% through 2024. EM continues to face restrictive interest rates, fiscal consolidation, tight global financial conditions, and slowing DM and China growth. Global trade flows remain relatively resilient in the face of ongoing shipping disruption spanning unexpected shocks from Baltimore to the Suez Canal. Rising trade distortions and geoeconomic fragmentation are expected to continue to shape global trade for better and worse.

Global headline inflation is expected to fall from an estimated 6.8% in 2023 to 5.8% in 2024 and 4.4% in 2025. Overall, about 80% of the world's economies are expected to see lower annual average headline and core inflation in 2024.

One of the largest outstanding risks to preserving global growth and trade while containing inflation would be any further escalation of tensions, particularly between the United States and China as alluded to by former President Donald Trump via tweets, would have a much bigger impact on the global economy than the most recent two conflicts (Ukraine, Middle East), potentially igniting a significant second wave of inflation and subsequent market sell-off.

EM easing cycles are likely to broaden beyond the early movers in 2024, although interest rate cuts are expected to remain measured and policy stances still restrictive. A more hawkish Fed pivot combined with USD strength could reduce the scope for EM easing in 2H24. In this scenario, a more pronounced reprising of US monetary policy, perhaps in which the Fed does not cut at all, could force more EM central banks to recalibrate their rate cycles. In other words, the global monetary policy outlook continues to dominate EM risk perceptions on either side.

What Is Weighing on EM…*Can This Subside?*

The primary deterrent to investment in EM, and indeed non-US assets overall, has been the exceptionally strong US equity market. The stunning rally in the US has been driven by an ideal combination of better economic growth, rising earnings (accelerated by the arrival of generative AI), and falling bond yields. IMF projections call for EM/DM GDP growth to accelerate into mid-year, supported by US monetary policy easing. The environment should favor EM equities as the growth differential has been an important driver of relative performance historically. However, many will wait for confirmation that the US economy is indeed slowing and that the inflation outlook will support lower federal funds rates, before increasing EM allocations.

The USD has been on a remarkable ascent, experiencing record relative valuation in 2023, reaching 91% against non-US currencies in terms of purchasing power parity (PPP), surpassing previous peaks observed in 1985 and 2002 and breaks with historical trends of roughly decade-long cycles of strength and weakness. We note three headwinds which could serve as catalysts of USD volatility ahead.

US Debt to GDP: The annual cost to America's government of borrowing for ten years has risen to 4.6%, the highest since 2007. But whereas then the federal government had a debt/GDP ratio of 62% of GDP, today that ratio is 120%. Setting aside bipartisan antics, most of the long-term pressure on America's budget comes from rising mandatory spending (i.e., public pensions and health care), which neither party has interest in confronting.

Current Account Balance: The US trade deficit remains large (a result of strong currency and less competitive goods/services exports), which is a byproduct of *deglobalization* trends with more emphasis on regionalization.

Political Climate: Polarization in the US has risen in the Social Media era, spreading into markets vis-à-vis global trade (tariffs), geopolitics (tension with China), and inflation pressures more recently following the pandemic. This volatility historically increases ahead of US presidential elections, the next coming this November.

Historically, the USD has benefited from its safe-haven appeal (and more recently, attractive high interest rate regime), but it is now seen as overvalued. Should the Fed prioritize the employment mandate over inflation, effectively fudging the 2% inflation target, expectations of rate cuts would subside, allowing for a weaker dollar.

While China still registers as the largest component of the MSCI EM benchmark (~25%), it remains on a downward trajectory from its ~40% peak weighting only a few years ago. This has been the result of both a cyclical component from pandemic scarring (insufficient and misdirected policy responses, etc.) and a structural component reflecting a sharp decline in productivity growth, driven by disruptive domestic regulatory changes/interventions (in education tutoring, platform internet, financial services, etc.) which eroded private business confidence. The deterioration in US-China relations has further impacted the growth outlook.

Global investors are focused on three areas of concern regarding the China investment story: 1) the prolonged property sector contraction, 2) local government debt constraining investment, and 3) headwinds to corporate profitability and consumer confidence from deflation. Until properly addressed, these obstacles will remain impediments to any meaningful return of foreign investment flows into China. In the meantime, the rise of EM ex-China mandates and mostly passive flows continue to illustrate the severity of this negative sentiment, demanding due consideration of investment into this market (or alternatively, the consideration of entirely different markets).

Alternatives exist, and investors seek replacement via a number of channels such as *growth beneficiaries* of the current geopolitical climate (India, Mexico, Saudi Arabia, etc.) or *indirect exposures* to what remains consistent ~5% GDP growth in China (i.e., South Korea and Taiwan for tech supply; Brazil and Chile for commodity supply; Thailand for tourism). EM is more than a China story today.

The End of Globalization?

When analyzing the current state of *globalization* against the backdrop of an evolving geopolitical landscape, we consider four key elements to evaluate this phenomenon: 1) trade, 2) population, 3) capital, and 4) ideas.

TRADE

Global trade accelerated during the decade preceding the global financial crisis (GFC), rising from 40% of global GDP in 1995 to 55% of GDP in 2005. The expansion of trade was supported by a broad set of factors, none as impactful as China's increased role as a global exporter following its accession to the WTO in December 2001. Chinese exports as a share of global exports surged from 4.3% in 2001 to 8.7% in 2007, around which time China's share of global trade flattened out at high levels, and the pace of significant new trade agreements slowed materially.

Following the GFC, global investment slowed with the share of investment to GDP flat/declining across major economies. Given that global trade tends to be capital-goods intensive, this proved a powerful headwind impeding trade growth. As a result of the pandemic, and the subsequent bottlenecks that arose throughout global supply chains, supply chain management shifted from focusing only on efficiency, productivity, and cost to prioritizing supply chain resilience (via near-shoring and "China Plus One" strategies).

China remains an enormous player in the global trade apparatus. While trade with the US directly may have declined in recent years (2023 most notably), overall exports have not, as evidenced by February export volume (+10.3% YoY) hitting a record high for the period and yielding a trade balance of 890.86bn yuan (USD125bn). Two points on the evolution of US-China trade specifically: Although the share of US imports of manufactured goods from China has declined between 2017 and 2023 from 24% to 15%, the share of imported value added goods in US final consumption actually increased slightly, from 24% to 25% between 2017 and 2020 (the most recent year for which data are available). Furthermore, there is almost a perfect correlation between Vietnam's increase in exports to the US and its increase in imports from China. The point here being that the US may just be rerouting imports through third countries that contribute a small amount to the final value (e.g., final assembly), leaving supply chains no less reliant on China and perhaps even more so.

Whether in response to elevated geopolitical tensions following Russia's invasion of Ukraine, or China's willingness to align itself with less savory peers (in addition to Russia, this list includes Iran and North Korea), trade appears to be reconfiguring toward geopolitically closer partners, illustrative of broader thematics like regionalization or even the formal transition to a more multi-polar world order of influence. Ultimately, these trends toward trade reconfiguration and fragmentation weigh negatively on global growth through a loss of export markets but also higher import costs as a result of switching away from (in most instances) cheaper Eastern group supplier economies to next-best suppliers.

POPULATION

India is the fastest-growing major economy in the world (GDP grew 8.4% in the final quarter of 2023) and currently the fifth largest economy in the world, with expectations for the country to pass Japan and Germany, taking the third spot behind the US and China. Much of this growth stems from attractive demographics. Last year, India surpassed China to become the largest nation by population. It is also alone in the top five economies in that it is young, with 40% of the population under the age of 25. India will stay relatively young because it is the only top five economy where births exceed the replacement rate. GDP growth equals productivity improvement plus population growth, and in India's case, the numbers are in their favor.

In contrast, China and South Korea are facing declining populations, which require advancements in productivity in the coming years to stay competitive. Indeed, last year half of all the industrial robots installed worldwide were fitted in China, making it the fifth most automated country in the world when measured by robots per worker. Longer-term, as much of the world grows older and birth rates continue to fall, Africa is projected to have the strongest population growth of any region by 2050 as well as the youngest region by median age (25 years).

One of the most important elements to consider when analyzing population as a component of globalization is legal immigration. While more recently politicized rhetoric has given rise to anti-immigration waves in the US, the Congressional Budget Office (a nonpartisan group) released a report in February saying that the surge in immigration could boost US GDP by $7tn over the next 10 years. If legal immigration continues at its current rate, the US labor force will increase by nearly 5.2mn people by 2033. That would mean more workers, more taxes paid by those workers, and more demand for goods and services. Some economists believe the jump in immigration in 2022 and 2023 helped stave off a recession in the US and allowed industries like hospitality to rebound from pandemic-era labor shortages.

While several notable emerging markets (like China and Korea as previously mentioned) struggle with aging populations, the US population of young people is growing thanks to legal immigrants – of which the largest group of immigrants entering the country are age 25-54. This represents another positive attribute of globalization, and contrary to popular belief population flow is not slowing, which remains to our own benefit in the US.

CAPITAL

Emerging markets proved resilient in the last five years in the face of numerous global shocks and 500 bps of rate hikes – given low debt, high savings and a rapid pivot into the hiking cycle ahead of developed markets, demonstrative of remarkable discipline especially in contrast to recent crises of the past 30 years, yielding stronger current accounts as well as currencies relative to history. As such, many developing economies are seeing strong investment inflows. Average annual cross-border greenfield investment inflows to Africa (+109%), India (+54%), Central Asia and the Middle East (+26%), Emerging Europe (+33%), and Mexico (+15%) have risen markedly relative to pre-pandemic averages.

Victory Capital®

20240415-3502663

It is important to note that these inflows are not at the expense of the US, which along with Canada has also experienced increases (+33% relative to pre-pandemic averages), driven by re-shoring initiatives and exceptionally strong currency.

One major trend with respect to capital flows developing over the last ~10 years has been the changeup of foreign ownership of US debt. For decades, China and Japan stood apart from the world, ready to buy any amount of US Treasuries as “non-economic” or “price insensitive” purchasers. But many dynamics, both foreign and domestic, economic and geopolitical, have changed. In its latest report, the Congressional Budget Office (CBO) projects that interest costs in 2024 will total $870bn – a jump of 32% from the previous year and following increases of 35% and 39% in each of the two years before that. This year’s high interest bill is not a one-off phenomenon, but rather part of a trend that stretches into the future, as debt continues to climb and relatively high interest rates push up the cost of borrowing.

IDEAS

The exchange of goods between countries and regions has dominated much of the globalization conversation over the last 50 years. The massive consolidation of tools and convergence of information over that time into a single device that fits in the palm of one’s hand has been nothing short of transformative (iPhone, Android). Looking ahead, artificial intelligence (AI) stands poised to revolutionize services in the years and decades to come, automating tasks in the near term across industries like banking, insurance, software & platforms, capital markets, energy, communication & media, retail, and health care with little human involvement.

For further evidence of the globalization of ideas flowing throughout the world today, consider the S&P 500’s “Magnificent Seven” CEOs, as more than half of them were born in an emerging market. Beyond the US, China, Taiwan, and India all fall within the top eight of 257 countries in terms of total revenue exposure of the S&P 500, of which 16.2% has come from emerging economies so far in 2024, up from 14.4% in 2023.

Globalization is far from disappearing. The concept of global interconnectedness is merely evolving to encompass current needs like supply chain diversification – as the world’s concentration risk to China was exposed by the pandemic and Europe’s vulnerability to Russia for energy was revealed following the invasion of Ukraine, given subsequent geopolitical tensions as well as the West’s united response in the form of sanctions. Ultimately, the strongest argument in favor of globalization’s survival is self-interest, because the benefits are ubiquitous rather than concentrated in any single country or region.

Two Roads

Underlying fundamentals are shifting in favor of EM, given the now very expensive US valuations, potentially waning US exceptionalism in terms of growth delivery, and the rising risk of momentum reversal given extreme market concentration. The YTD performance of only five stocks (NVDA, MSFT, GOOGL, AMZN, and META) has pushed market concentration to even more extreme levels, widening the spread between the largest 10 and next 40 stocks in the S&P 500® Index. This extreme concentration yields several predictable risks but also unforeseen complications, most notably the great difficulty for active managers to abstain from such outperformers when they lack alignment with a given mandate. To this extent, the rise of *style drift* has become more prevalent in asset classes like emerging markets, where in many cases names like NVDA represent the largest holding.

In the end, the most fundamental reasons to maintain dedicated exposure to emerging markets are the most obvious ones: stronger demographic trends, differentiated growth characteristics, and attractive valuations vs. their own historical average and DM at present. Higher population growth, rise of the middle class, increasing urbanization, young working age, etc. all contribute to stronger demographics in EM, which account for 86% of the world’s population and generated 62% of the world’s nominal GDP growth in purchasing power parity (PPP) terms over the past ten years. Free trade, capital flow and return, migration and services, the exchange of ideas/tech…*globalization* serves as the foundation for global participation, global *growth* in a way that serves all countries uniquely in accordance with their specializations or offerings. To its core, the performance of EM is meant to offer diversification for allocators, spreading risk across different regions/sectors, reducing vulnerability to downturns in any single region/market.

As always, we continue our search for sustainable, attractive earnings growth *purely within the emerging market universe*, while monitoring geopolitical risk. We continue to note the higher need to factor in sovereign risk to investment opportunities at the country and sector levels of our selection process.

We thank you for your continued support.

Sincerely,

The Sophus Emerging Markets Team

20240415-3502663

Region Allocation	% Portfolio
Asia	74.32
Latin America	12.56
EEMEA	11.49

Top Ten Holdings	% Portfolio
Taiwan Semiconductor Manufacturing Co., Ltd.	9.65
Samsung Electronics Co., Ltd.	5.50
Tencent Holdings Ltd.	4.37
ICICI Bank Limited Sponsored ADR	3.07
PDD Holdings Inc. Sponsored ADR Class A	1.77
Alibaba Group Holding Limited	1.72
PT Bank Mandiri (Persero) Tbk	1.69
Industrial and Commercial Bank of China	1.59
NetEase, Inc.	1.36
Western Mining Co., Ltd A Share	1.24

Top 5 Contributors (%)	Contribution to Relative Return %
Fortune Electric., Ltd.	0.50
HD Hyundai Electric Co., Ltd.	0.44
Taiwan Semiconductor Manufacturing Co., Ltd.	0.33
Western Mining Co., Ltd. A Share	0.30
PT Bank Mandiri (Persero) Tbk	0.26

Top 5 Detractors (%)	Contribution to Relative Return %
Hon Hai Precision Industry Co., Ltd.	-0.22
PDD Holdings, Inc.	-0.20
SK Hynix, Inc.	-0.19
WuXi AppTec Co., Ltd. A Share	-0.18
Reliance Industries Ltd.	-0.17

Investment Performance (%)
Average Annual Returns as of March 31, 2024

Sophus Emerging Markets Strategy	Quarter	YTD	1 - Year	3 - Year	5 - Year	7 - Year	10 - Year	Since Inception (3/31/13)
Gross of Fees	4.96%	4.96%	12.91%	-4.82%	3.58%	4.53%	4.42%	3.88%
Net of Fees	4.75%	4.75%	12.01%	-5.58%	2.76%	3.66%	3.56%	3.02%
MSCI Emerging Markets Index (Net)	2.37%	2.37%	8.15%	-5.05%	2.22%	3.71%	2.94%	2.54%

Past performance is no guarantee of future results. Returns for periods greater than one year are annualized. Returns are expressed in U.S. dollars. Composite and benchmark returns are net of transaction costs and gross of non-reclaimable withholding taxes, if any, and reflect the reinvestment of dividends and other earnings.

Gross-of-fees returns are presented before management and custodial fees but after all trading expenses. Net-of-fees returns are calculated by deducting 1/12 of the highest tier of the standard fee schedule in effect for the period noted (the model fee). The composite model fee for each period is either the highest tier of the current fee schedule or a higher value, whichever is required to ensure the model composite net-of-fee return is lower than or equal to the composite net-of-fee return calculated using actual fees. Actual fees may vary depending on, among other things, the applicable fee schedule and portfolio size. The firm's fees are available on request and may be found on Part 2A of its Form ADV.

Index returns are provided to represent the investment environment during the periods shown. Index performance does not reflect management fees, transaction costs or expenses that would be incurred with an investment. One cannot invest directly in an index.

All investments carry a certain degree of risk including the possible loss of principal, and an investment should be made with an understanding of the risks involved with owning a particular security or asset class.

20240415-3502663

Various account minimums or other eligibility qualifications apply depending on the investment strategy or vehicle.

Contributors and Detractors source: FactSet. The top contributors and detractors are presented to illustrate examples of the portfolio's investments and may not be representative of the portfolio's current or future investments. The percent displayed is contribution to return. Holdings are as of quarter end and may change at any time.

Characteristics, Top Ten Holdings and Sector Diversification source: FactSet Research Systems, Inc. The top ten holdings and sector diversification are presented to illustrate examples of the portfolio's investments and may not be representative of the portfolio's current or future investments.

The representative account serves as the model against which each Sophus Emerging Markets strategy account is managed. The representative account is an actual portfolio and the information provided, including performance, will vary for other accounts. The representative account is being used solely as a tool to help demonstrate how performance can be attributed to the investment policies applied in the management of the Sophus Emerging Markets strategy.

This information is based on data obtained from recognized services and sources and is believed to be reliable. Any opinions, projections or recommendations in this report are subject to change without notice and are not intended as individual investment advice. The securities highlighted, if any, were not intended as individual investment advice. A complete list of all holdings for the previous 12 months, each holding's contribution to the strategy's performance, and the calculation methodology used to determine the holdings' contribution to performance is available on request. Furthermore, Victory Capital Management Inc., and its affiliates, as agents for their clients, and any of its officers or employees, may have a beneficial interest or position in any of the securities mentioned in this report.

The opinions are those of the authors as of the date indicated and are subject to change at any time due to changes in market or economic conditions. The comments should not be construed as a recommendation of individual holdings or market sectors, but as an illustration of broader themes.

The Sophus Emerging Markets Composite includes all discretionary accounts invested in the Emerging Markets Strategy. The Strategy employs an integrated investment approach whereby powerful proprietary quantitative screens are melded with deep fundamental analysis to capture the growth of emerging markets companies across the market-cap spectrum. The composite creation month is May 2013.

The MSCI Emerging Markets Index is a free-float-adjusted, market-capitalization-weighted index designed to measure equity market performance in the global emerging markets.

Victory Capital Management Inc. (VCM) is a diversified global investment advisor registered under the Investment Advisers Act of 1940 and comprises multiple investment franchises: Integrity Asset Management, Munder Capital Management, New Energy Capital, NewBridge Asset Management, RS Investments, Sophus Capital, Sycamore Capital, THB Asset Management, Trivalent Investments, Victory Income Investors (formerly USAA Investments, a Victory Capital Investment Franchise); and the VictoryShares & Solutions Platform. Munder Capital Management and Integrity Asset Management became part of the Victory Capital GIPS firm effective November 1, 2014; RS Investments and Sophus Capital, effective January 1, 2017; Victory Income Investors, effective July 1, 2019; THB Asset Management, effective March 1, 2021, and New Energy Capital, effective November 1, 2021. Effective September 1, 2023, INCORE Capital Management is no longer part of the firm definition.

Request a GIPS® Report from your Institutional Relationship Manager or visit www.vcm.com. Victory Capital claims compliance with the Global Investment Performance Standards (GIPS®).

©2024 Victory Capital Management Inc.

V17.093 // 1Q 2024 SOP EM Strategy COM