SOMERSET CAPITAL MANAGEMENT LLP

31 July 2021

MI Somerset Emerging Markets Small Cap Fund OEIC

Investment Adviser's Monthly Report

Mark Asquith
Partner & Co-Manager

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Partner & Co-Manager

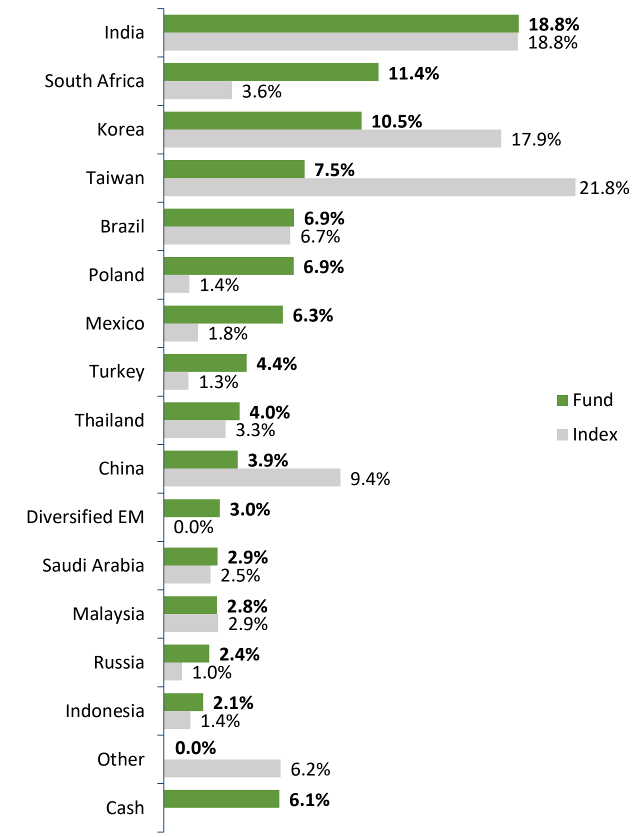
Fund Objectives

The Somerset EM Small Cap Fund seeks to achieve capital appreciation by investing in a concentrated portfolio of <50 emerging market stocks with a market cap of up to $2.5bn at purchase. Co-managers Mark Asquith and Henrietta Seligman follow a bottom-up, research intensive process where long-term profitability and value are paramount. In addition, company risk profiles are assessed using Somerset's independent criteria around environmental, social and governance risk and we actively engage with companies on material issues. Mark and Henrietta are supported by Somerset's team of fund managers and analysts based in London and Singapore.

Assets Under Management	
Somerset Capital Management LLP	$7,175 m
Somerset EM Small Cap Strategy	$284 m
Somerset EM Small Cap Fund OEIC	£9 m

Model Portfolio Data	
P/E (Historical)	34.3x
Dividend Yield (%)	1.6%
Wgt Ave Mkt Cap ($m)	1,198
No. of Stocks	42
Price (Acc)	172.96

Country Breakdown

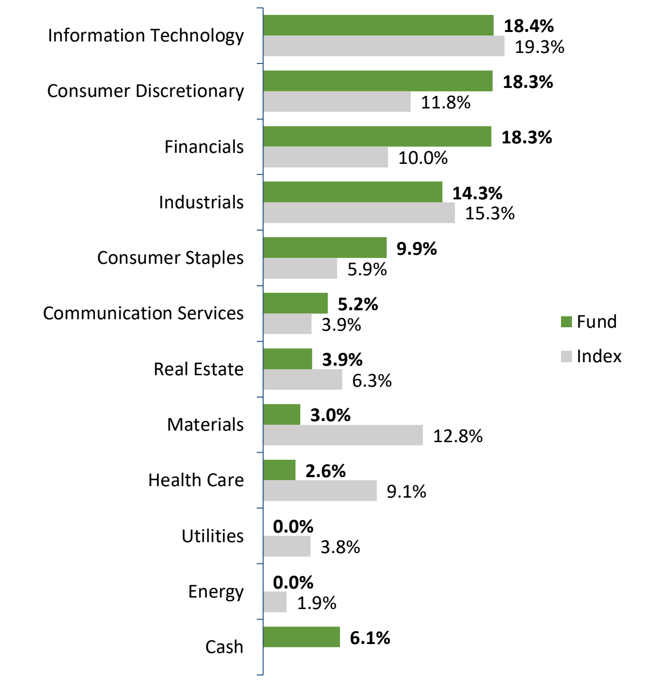


Acc GBP Performance (%) Net	Fund	MSCI EM SC	+/-
1 Month	-1.58%	-1.95%	**+0.37%**
3 Months	0.65%	3.11%	**-2.46%**
YTD	13.88%	16.22%	**-2.34%**
Since Inception*	72.96%	76.54%	**-3.58%**
2020	-3.53%	15.60%	**-19.14%**
2019	11.38%	7.20%	**+4.18%**
2018	-11.78%	-13.54%	**+1.76%**
2017	20.70%	22.25%	**-1.55%**
2016	35.35%	22.00%	**+13.35%**
2015	-10.96%	-1.45%	**-9.51%**
2014	11.17%	7.29%	**+3.88%**
2013	-0.18%	-0.83%	**+0.65%**
2012	19.36%	16.85%	**+2.51%**
2011	-17.92%	-26.64%	**+8.72%**

Top 10 Holdings	Country	NAV %
LEENO Industrial Inc	Korea	4.3%
Tata Elxsi Ltd	India	4.2%
China Overseas Property Holdings	China	3.9%
Sunny Friend Environmental Technology Co	Taiwan	3.2%
Logo Yazilim Sanayi Ve Ticaret	Turkey	3.1%
KEI Industries Ltd	India	3.1%
RHI Magnesita	Diversified EM	3.0%
Abdullah Al Othaim Markets	Saudi Arabia	2.9%
My EG Services Bhd	Malaysia	2.8%
Stock Spirits Group PLC	Poland	2.8%

Model Portfolio Market Cap Breakdown	Fund
< $500m	24.1%
$500m-$1bn	14.5%
$1-$2bn	17.1%
> $2bn	25.7%

Sector Breakdown



* Source: Maitland Institutional Services Limited & MSCI. Inception date is 1st November 2010. + The index is the MSCI EM Small Cap Index with Net Dividends Reinvested. Index data is sourced directly from MSCI.

The latter part of the month was overshadowed by China's regulatory crackdown on the education, technology and property sectors. The measures curb profitability for companies in these sectors and are at the expense of minority shareholders. They are particularly severe for the education sector where tutoring companies have been rendered non-profit entities. The magnitude of this round of regulations surprised many investors despite signalling from Beijing since the end of last year (a casualty was Ant Financial's IPO). While the measures touch on sectors covering about 30% of MSCI China, sentiment soured across the market, evident in the widespread, indiscriminate sell off in China from 26th July.

The regulations in the property sector are most relevant to the Fund owing to our investment in property manager, China Overseas Property. Most regulations were directed at property developers and particularly targeted the most leveraged ones. Importantly, China Overseas Property's parent, China Overseas Land & Investment, which provides the majority of its area under management, is one of the least leveraged. However, the main regulation that will impact property managers stipulates that revenue generated from public spaces commonly owned by property owners belongs to the property owners, not the property manager, after deducting reasonable costs. This will mainly impact revenue generated from public spaces such as advertising income, fees on car parking for visitors, venue rental fees, of which property managers will only be able to take 30%. This does not affect revenue from other value added services such as home decoration. This creates more transparent pricing and is aimed at weeding out smaller unregulated players. Revenue from public spaces is estimated at 3.7% of China Overseas Property's total revenues and only part of this may be impacted.

China Overseas Property de-rated by nearly 20% in the two days to 27th July along with the property sector asymmetrically to the smaller risk to its revenue and profitability. The de-rating gave us an opportunity to increase the stock's weight. This addition is underpinned by an investment thesis that remains intact: we expect earnings to grow at 20% CAGR over the next three years, return on capital to be maintained at circa 40% and an attractive 5% free cash flow yield.

These regulations reinforce our caution in China but do not make it un-investable. We continue to look for good stocks that fit our criteria such as China Overseas Property.

There are multiple interpretations of the rationale behind recent government actions ranging from the following:

- addressing social inequality and the standard of living;
- addressing corporate inequality;
- hurting US investors as part of the ongoing disputes between China and the US;
- a war against capitalism; and
- in the case of technology, wanting to divert human capital away from digital media companies to real economy industries such as semiconductors.

The most compelling explanation to us is that these regulations are driven by the Chinese government's social and political policies.

The new round of regulations can be viewed through a similar lens to the environmental crackdown in 2017 (as well as a more recent round of this), whereby policies are informed by the need to prevent popular unrest. The environmental crackdown was a response to increasing discontent over high pollution levels in certain cities, which led to the relocation of targeted industries and forcibly closing non-compliant factories, as opposed to being a product of the government pursuing an environmentally friendly agenda. It is incidental that social policy marries with the latter in this instance. There is anecdotal evidence that the environmental agenda is not driven by concerns about climate change given plans to increase coal-fired power generation capacity. That said, the contribution of renewable and low carbon technologies to the energy mix will be greater than from fossil fuels by 2030 and comprise the majority by 2040. Similarly, the regulations in the property and education sectors aim to address social inequality and the risk of unrest by lowering the cost of living.

We have been cautious about investing in China for many years. This is partly owing to governance and transparency challenges, partly owing to concerns about how China's meteoric growth over several decades has been fuelled by credit expansion that we believe is ultimately unsustainable and partly owing to our view that small cap stocks are structurally disadvantaged in China. A screen of 3,000 of our 3,400 strong China small cap universe underpins why we remain underweight in China. The median return on capital and free cash flow margin of 5.7% and 1.6% respectively illustrates how the vast majority of the universe is comprised of mediocre quality stocks with poor profitability. This universe is also not cheap trading at a median 0.4% free cash flow yield and 29.9x P/E.

The underwhelming characteristics of this small cap universe are the result of a market structure that favours state champions and allows advantages to accrue to the largest in the industry. This means that small cap companies are often disadvantaged against larger competitors or squeezed by them in the supply chain. This is illustrated by the smaller circa 300 stock China large cap universe (defined by stocks with a market capitalisation greater than USD 10 billion and average daily traded liquidity greater than USD 3 million) where the median return on capital and free cash flow margin is higher at 9.5% and 8.9% respectively.

The small cap universe is tilted toward a less attractive opportunity set. 26% of the China small cap universe is comprised of industrial companies with poor profitability: the median return on capital and free cash flow margin are 6.4% and 0.8% respectively. This contrasts to 14% of the China large cap universe in industrials with more attractive profitability metrics: 9.1% return on capital and 3.7% free cash flow margin. A further 16% of the small cap universe is comprised of stocks in the materials sector where, despite a strong rebound in commodity prices in the past year, return on capital is 7.0% and the free cash flow margin only 1.5%. This contrasts to 10% in the large cap universe where again the profitability metrics are stronger: 10.2% return on capital and 8.2% free cash flow margin.

In addition to the unfavourable conditions for small caps, we have also been wary of investing in companies in industries restricted (but not prohibited) to foreign investors such as voluntary education (compulsory education is prohibited) and online. Foreign investors are only able to invest in these companies through variable interest entities (VIEs). VIEs do not own the underlying assets of a company but are tied through a complex series of contracts to an onshore company that does. The onshore company is owned by Chinese nationals and often the company's founder, who are contractually bound to honour shareholders' certain rights to their profits (this ought to be equivalent to direct ownership). Some VIE structures are better than others but the main point is that these tend to exist for sectors restricted from foreign investment. The restrictions on foreign ownership are inevitably in more sensitive sectors (i.e. Internet platforms, financial services, telecommunications, energy, agriculture, transportation and education). This is risky because it makes VIEs reliant on the Chinese government's goodwill in already restricted sectors. Secondly, they rely on the integrity of the onshore entity and owner of the underlying assets honouring its contracts. The risk is greater for small cap stocks, which tend not to be state champions and less publicly prominent. The new regulations do not appear to be a direct attack on VIE structures but reinforce the riskiness of investing in sensitive sectors that are already restricted to foreign ownership.

The MSCI Emerging Markets Small Cap Index has a lower exposure to China (9.3%) than the MSCI Emerging Markets Index (34.6%). We currently have 3.9% of the Fund invested in China and have maintained our underweight for some time. Our underweight has been the largest positive contributor to the Fund's performance this year and month.

The underweight to China was the main tailwind behind the positive performance this month but some headwinds came from our large weights in India and IT, which averaged 18.8% and 18.4% respectively, taking a breather following strong performance year-to-date. There were no specific stock issues and we remain comfortable with our exposure

Mark Asquith and Henrietta Seligman

Fees
1.25% AMC
No Dilution Levy Applicable
5% Absolute Performance Fee

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Share Class Information (Acc)	
EUR SEDOLs	B5W4Q51
EUR ISINs	GB00B5W4Q517
GBP SEDOLs	B3M2G51
GBP ISINs	GB00B3M2G516
USD SEDOLs	B3PZH10
USD ISINs	GB00B3PZH106

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