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Last week, in response to the economic, ESG, and market consequences of Russia's invasion of Ukraine, we made the decision to exit our dedicated Emerging Markets exposure across our mutual fund and UMA model portfolios. Our direct exposure to Russia within our Emerging Markets strategies has always been limited due to Russia's minimal index weight and ESG concerns that predated the invasion. We believe the invasion requires a rethink of the merits of including Emerging Markets as a standalone asset class in portfolios. This is particularly true for ESG integrated portfolios that prioritize data on human rights, civil liberties, stability, and peace. As the situation in Ukraine develops, there are still wide-ranging risks and many unknown second and third order effects that have yet to ripple through markets.

ESG Considerations

ESG investment in countries with authoritarian governments and human rights issues has always been an area of much debate among investors, as it should be. ESG asset managers who do make allocations to these geographies have generally rationalized their investment with a strong company-specific ESG and investment thesis. And if they did not directly support the governments that these businesses operated in by avoiding state-owned-enterprises, then investors generally agreed with the allocations. The view on this approach to ESG investing is changing. Our ability to react to the rapidly evolving situation is an advantage to our active approach in managing our asset allocation. ESG data did not update quickly enough for us to follow its lead. For example, MSCI's decision to downgrade the Russian sovereign ESG rating to CCC- was not made until March 7th, a week after Russian exchanges closed and several days after we removed the Emerging Markets strategies.

We began reducing our Emerging Markets exposure from overweight to neutral in our UMA models at the end of 2021, driven in part by social and governance issues in China. The declared genocide of Uyghur Muslims, the Chinese Communist Party's interference in publicly traded companies and the tail risk of an invasion of Taiwan were driving factors. China has not joined the western world in its universal condemnation of Russia's actions and continues to push forward with a plan to construct a natural gas pipeline to Russia. There remains potential for their support of Russia's evasion of sanctions to increase. In conjunction with the existing ESG issues, we no longer think it is appropriate to mandate exposure to Emerging Markets given that China is the largest constituent of the MSCI Emerging Markets Index.

This decision was a difficult one because there is so much value in providing emerging economies with sustainable capital. "Asia alone accounts for about 60% of the world's population, 63% of the world's material use, half of the world's biodiversity hotspots and faces risk from water scarcity, floods, and other natural disasters." [1] Asia is expected to drive more than two-thirds of new global energy demand over the next 20 years and has made significant investments in green energy and renewables. China alone has lifted a billion people out of poverty in the last few decades. For these reasons, we are not completely divesting from Emerging Markets. Our international and thematic

[1] https://www.jhinvestments.com/viewpoints/esg/emerging-markets-and-the-case-for-sustainable-investing

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climate strategies will continue to have discretion to invest selectively in Emerging Markets companies where they find compelling climate or ESG opportunities. [2]

Economic Considerations

Since the end of the Cold War, globalization has been the foundational trend of the global economy. Russia and China adopted quasi-capitalistic economies and integrated into the global economic system, a rising tide that lifted the boats of smaller Emerging Market countries and reshaped global trade and financial markets. The hope was that the economic prosperity brought by free market capitalism would result in increased democratization in the two nations.

Over the last decade however, they have moved in a more authoritarian direction than had been expected. China's 2021 economic reforms tightened control over their citizens and have the potential to inflict pain on their financial and real estate sectors. Russian escalation in Crimea, Chechnya and Georgia were major red flags warning of the intensifying imperialist ambitions of President Putin. Combined with the impact of the Covid pandemic, the global economy may become more regionalized, with a focus on reducing reliance on foreign supply chains.

Significant sanctions have been imposed on the Russian economy, primarily targeting financial institutions and oligarchs. These sanctions have intensified with each passing day. Corporations including BP, Google, Starbucks, Apple and McDonalds have begun to divest from Russian assets and/or have ceased selling their products in Russian markets. The US has threatened to place sanctions on countries that provide support to Russia, including India, which receives military support from Russia. On March 8th, the US Commerce Secretary warned that Chinese companies that aid Russia could face sanctions or export controls.

One of the most significant economic impacts of sanctions thus far has been an increase in energy and other commodity prices. Emerging Markets can be broadly divided into two types of economies: commodity importers and commodity exporters. ESG strategies tend to overweight the former and underweight the latter. If commodity prices remain at today's elevated levels, it would worsen the risk/return prospects of investing in countries that rely on imports.

Market Considerations

The Russian stock exchange closed indefinitely on February 28th, leaving investors in onshore stocks unable to sell. Investors in Russian ADRs and GDRs have borne the brunt of the price declines with some stocks down 90%. *(Global Depository Receipts and American Depository Receipts are bank certificates that represent shares in foreign stock. They are commonly used by investors to hold shares of foreign companies without having to own them in the local market.)* Major clearing firms in Europe have stopped clearing trades in GDRs and many ADRs have been placed on "position close only" status. Foreigners own about a third of the onshore market cap of Russian stocks as well as a significant amount of both hard and local currency bonds. As of March 2nd, Russia has banned payments to foreigners holding ruble denominated bonds and stocks. With euro payments due on hard currency debt next week, the risk of a Russian

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bond default looms large. As of March 9th, MSCI removed Russia from its equity indices and reclassified it as Standalone Markets status.

Russian stocks and bonds are not commonly held directly by retail investors but are held by Emerging Market equity and debt mutual funds and ETFs, including the finishing vehicle that was used by our Emerging Markets manager in the UMA models. We can't look to the past to determine how this will play out since there have been no comparable events, but outflows may squeeze liquidity in certain funds which will benefit investors who sell early. Of larger concern is the risk that other countries, particularly China, could in the future restrict foreign investor access to their markets in a similar way.

Conclusion

While Emerging Markets have been touted as an essential part of an asset allocation portfolio, they are still a relatively new asset class. The MSCI Emerging Markets Index was introduced 34 years ago, initially representing only 10 countries compared to the current opportunity set of 24 markets. Emerging Markets generally experience high amplitude boom and bust cycles, but the historic rapid growth of the modernizing Chinese economy provided returns that made such volatility worthwhile. China's growth is now slowing and may decline if their property bubble bursts. Foreign investors are reevaluating ESG, macro and access risks of putting their money in authoritative regimes. Whether the Emerging Markets investment story will survive this moment is still in question and we think the best risk management approach is to wait and see until we have more clarity.