SGA 3Q-2011 Commentary

In the third quarter of 2011, the SGA large cap growth equity composite's gross return was –12.6%, compared with the –13.1% return of the Russell 1000 Growth Index and the –13.9% return of the Standard & Poor's 500 Index. The average return of the Morningstar Large Growth category was –15.1%. The portfolio's 5.0% gross trailing 12 month return was ahead of the indices by 124 and 387 basis points respectively.

Growth is Scarce – Get Used to It

U.S. stocks fell sharply in the third quarter of 2011 as the broad equity indices suffered their largest quarterly declines since the depths of the credit crisis in late 2008. The broad downward trend in stock prices was accompanied by a substantial increase in day-to-day market volatility as investors reacted strongly to developments on two major fronts. The first was a worsening sovereign debt crisis in Europe, as investors focused on the growing threat of a default in Greece, the potential spread of the contagion to larger but fiscally troubled countries such as Italy and Spain and the negative impact of these events on the global banking system. The second was a slowdown in economic activity here and abroad. Stubbornly high unemployment and a marked decline in consumer confidence in the U.S. combined with slowing growth elsewhere in the world (even in faster-growing emerging markets such as China) increased the odds of a return to recession.

This turbulent environment reinforced several themes we have repeatedly articulated since the U.S. economy emerged from recession in mid-2009. Our view has long been that the post-recession environment would be characterized by an extended period of uneven but largely below-trend growth. This has been borne out by the multiple periods of accelerating and decelerating economic activity over the past two years, resulting in a subpar recovery. Secular drivers of growth are few and far between, and the economy continues to struggle with the headwinds of consumer deleveraging and structurally high deficits at the federal and state levels. Political gridlock as well as fiscal and monetary authorities that have exhausted most of their stimulus capabilities also point to a lackluster growth profile.

It has also been our view that aggregate corporate earnings growth estimates have been too high given the scarcity of growth. We are now seeing these estimates come down; three-year estimates of earnings growth for the companies in the S&P 500 have fallen to less than 8% as of September 30 and could decline further in the coming months. In contrast, portfolio companies are still expected to grow earnings in excess of 15% annually over the same period.

These two trends—subpar economic growth and weaker earnings expectations—lead to a third theme we have been extolling: the importance of selectivity. In an environment where growth is scarce, only those companies that can consistently grow revenues without relying on cost-cutting measures will be able to produce sustainable earnings growth, and the companies we have selected for the portfolio all share this characteristic. Portfolio companies also benefit from robust free cash flow—on average, 88 cents out of every dollar earned by portfolio companies is converted to free cash, compared with 60 cents for the companies in the S&P 500. Strong free cash flow generation gives companies the financial flexibility to pursue strategic opportunities that solidify their competitive positions, serves as a source of funding (as credit conditions remain tight by historical standards), and allows companies to return cash to shareholders in the form of higher dividends and/or share buybacks.

The ability of portfolio companies to produce sustainable revenue and profit growth, as well as strong free cash flow generation, contributed to the portfolio's outperformance in the third quarter, and we believe this will also be an advantage as we move forward.

Technology Outperformed

The portfolio's top three performance contributors came from three different sectors of the market, but they all had one thing in common—a technology-based business model. The best contributor was medical technology firm **Cerner**, which has also been the portfolio's top performer through the first nine months of 2011. Cerner sells software to help hospitals become more efficient by enabling the digitization of medical records, by facilitating the integration of financial and patient systems and by reducing costly duplication of medical testing. Many hospitals are embracing this technological change to meet more stringent regulatory guidelines, but also to lower health care costs and improve overall profitability. Cerner is the leading public company in this industry and should continue to benefit from this trend over the next several years. Although we trimmed our position in the stock late in the quarter, it remains the portfolio's largest holding.

Consumer electronics maker **Apple** was another top contributor. The company's aspirational brands—including the iPhone, Mac and iPad, along with the associated app business—continued to drive robust revenue and profit growth. Apple also benefits from pricing power derived from the vertical integration of its business model—the company designs its own chips and hardware, and it owns the software and distribution channel. Although Apple founder and visionary Steve Jobs resigned as CEO in August (and died shortly after the end of the quarter), we have confidence in new CEO Tim Cook's ability to continue to manage the development of the company's product lines. Valuation remains attractive despite the run-up in the stock price in 2011 and it remains a sizeable position in the portfolio.

Online retailer **Amazon.com** also fared well during the quarter. The company continued to benefit from strong revenue growth driven in part by the breadth and strength of its seller network and by the continued benefits from its Prime membership which provides customers free shipping in exchange for an annual fee. This program solidified customer relationships and increased purchase velocity by removing shipping costs from the equation. The company has also been successful with ancillary services such as Amazon Web Services and the recent launch of Kindle Fire, a tablet computer and potential competitor to the iPad. One concern is the negative profit margin impact from these new initiatives in the near term. We modestly reduced our position in the stock in part due to those concerns, but we continue to view the company positively.

Energy and Financials Lagged

The energy and financials sectors were among the biggest decliners in the market in the third quarter, and this was also true within the portfolio. The portfolio's two energy stocks, energy equipment and services providers **National Oilwell Varco** and **Schlumberger**, were the weakest performers in the portfolio for the quarter as growing recession fears sparked concerns about falling energy prices and a potential reduction in demand for the companies' services. However, we believe that these two companies are well positioned to benefit from a powerful secular trend toward energy exploration and production in hard-to-reach areas, such as deep in the ocean.

National Oilwell Varco recently received a sizable order for deepwater drilling rigs off the coast of Brazil, while Schlumberger was a direct beneficiary of increased oil production in Iraq and elsewhere in the world. As a result, we took advantage of the declines in both stocks during the quarter to add to our holdings.

The portfolio's lone financial stock, **State Street**, was also a significant detractor in the third quarter. The company's custodial business derives its revenues from a percentage of the assets under custody, and the sharp decline in the equity market led to a contraction in State Street's custodial assets. In addition, State Street's net interest margins narrowed somewhat as long-term interest rates came down significantly during the quarter. Despite these challenges, State Street has a dominant position in global custodial services and also provides outsourcing and related services that give it a competitive advantage. Given our confidence in the company's business model and its high level of capital reserves, we increased our holdings of State Street in the third quarter.

Portfolio Changes

In periods of extreme market volatility, we seek out opportunities to improve the growth profile of the portfolio at attractive valuations. The market environment in the third quarter provided a number of attractive opportunities and we added three new stocks to the portfolio. **Salesforce.com** is the largest software-as-a-service provider, featuring applications geared toward sales and business analysis. The company is well positioned to benefit from the tremendous growth in cloud computing. **Starwood Hotels & Resorts** is a global operator of luxury hotel and resort properties with a strong pipeline of hotels opening in China, India, and other rapidly growing emerging markets. Finally, household products maker **Colgate-Palmolive** returned to the portfolio after a three-year absence. The company has been able to improve margins, raise prices and benefit from the 75% of their sales that originate outside the U.S. (45% from emerging markets).

We also eliminated four existing holdings during the quarter. Our valuation discipline came into play when we sold industrial parts distributor **Fastenal** after the stock's strong run-up over the past year. Shipping company **FedEx** and home improvement retailer **Lowe's** both face the growing possibility of a near-term cyclical slowdown, so we sold the two stocks to pursue better opportunities. We also eliminated enterprise software maker **Oracle** because of growing concerns about its hardware business following the company's acquisition of Sun Microsystems.

Outlook & Strategy

We expect growth to remain scarce going forward as the global economic engine continues to downshift. It is this environment where portfolio companies truly stand out, with their ability to consistently deliver strong revenue and earnings growth, as well as superior cash flow generation, even when economic conditions are subpar.

In addition to its favorable growth prospects, the portfolio also has an attractive valuation. As of the end of the third quarter, the portfolio's enterprise yield (a measure of true free cash flow) stood at 5.3%—the highest it has been since the first quarter of 2009 and well above the 1.9% yield on the 10-year Treasury bond. Our discounted cash flow model also indicates that the portfolio is nearly as undervalued as it was in early 2009, at the bottom of the bear market. We believe this combination of valuation and growth augurs well for the portfolio's absolute and relative performance going forward.

Best Regards,

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