



US Large Cap Growth Equity Portfolio

Portfolio Review

In the second quarter of 2008, SGA's Large Cap Growth equity composite returned -5.73%, net of all fees, trailing the 1.25% return of the Russell 1000 Growth Index and the -2.73% return of the S&P 500 Index. The average return of the Morningstar Large Growth category was 1.47%.

Ebb and Flow

In the words of T.S. Eliot, "April is the cruellest month," and so it was for the SGA's Large Cap Growth portfolio. In April, the stock market enjoyed its best monthly return in 4 years, rising sharply as investors leapt to the conclusion that the credit crunch was abating, the economy was improving, and the worst of the financial sector downturn was behind us.

We revisited the speculative market conditions in place prior to the subprime meltdown in mid-2007, when investors disregarded risk and lifted lower-quality stocks to stratospheric heights. Furthermore, the parabolic surge in oil & commodities boosted energy & materials stocks while creating challenges—in the form of rising costs—for businesses in most other market segments.

Needless to say, this environment was not favorable for portfolio performance—most of the portfolio's quarterly underperformance versus the broader stock market, its growth-oriented benchmark index, and its Morningstar peer-group average occurred in April and early May.

Nonetheless, we viewed the second quarter as generally positive for portfolio companies overall. One cruel month was not enough to derail the trends which began last summer—namely, a marked deceleration in corporate profit growth, rising levels of risk aversion across multiple asset classes and a developing shift toward sustainable growth companies that can deliver consistent double-digit earnings growth.

As we discovered later in the second quarter and as of this writing, the April optimism regarding a recovery in the economy and credit markets proved to be false hope. The risk of recession remains as the job market contracts and the housing market deteriorates further; financial companies continue to report unexpectedly large credit-related losses and need to raise more capital to bolster their balance sheets; and corporate profits have declined for three consecutive quarters. While the aggregate decline

in corporate profits has so far been driven entirely by the financial sector—excluding financials, corporate profits grew by about 9% in the first quarter - the weakness is spreading.

Just as the above-average corporate profit growth cycle lasted far longer than we and others had anticipated, the deceleration may be deeper, more pervasive and last longer than many currently hope. As growth becomes more and more scarce in the broader market, selectivity will increasingly be key to investment success.

The good news is that growth remains plentiful in SGA's portfolio. The changing landscape represents a profound shift that we believe will be beneficial for portfolio companies for a considerable length of time. From a sector perspective, energy was by far the best-performing sector of the market in the second quarter, but materials and utilities stocks also fared well. This represented a substantial headwind for the portfolio, which has not historically invested in these sectors because few companies meet our investment criteria. The financial sector suffered the biggest losses during the quarter as the credit crunch continued to wreak havoc on banks and financial services companies. Industrials and consumer discretionary stocks also struggled in a weaker economic environment.

Consumer Staples, Industrials Lagged

Consumer staples and industrials stocks had the biggest negative impact on portfolio performance in the second quarter. The most significant individual detractor was industrial conglomerate **General Electric**. GE's first-quarter earnings report was a disappointment, leading to a sharp decline in the stock. Virtually all of the earnings shortfall occurred in the company's finance arm, GE Capital, where the challenging credit environment prevented the unit from completing several profitable real estate transactions. We still like the growth prospects of GE's global infrastructure business, but the difficulties in its finance unit led us to significantly reduce our position in the stock during the quarter. Consumer products maker **Procter & Gamble** was the weakest performer among the portfolio's consumer staples stocks. During the April market rally, P&G fell as investors shifted away from relatively "safe" consumer stocks and flocked to riskier names. Rising raw materials costs also weighed on the stock. The company delivered solid earnings growth in the quarter and we remain confident in P&G's ability to continue to grow earnings at consistent double-digit rates.

The portfolio was not spared from the drop in the financial sector, as trust and custodial bank **State Street** was among the portfolio's biggest decliners. State Street wisely opted to raise equity capital because of market value declines on several of its off balance sheet investment vehicles. In the event the company is required to consolidate these investments, its capital adequacy ratios will remain healthy. The difference with other financial companies is that beyond these issues, State Street is operating well and its growth trajectory is healthy—the company continues to gain market share, delivered better than expected earnings and raised guidance for the year. We added to our position in the stock during the quarter.

Winners in Technology and Health Care

The portfolio's best performers were largely concentrated in the information technology and health care sectors. The top contributor was online advertising and search firm **Google**, which we opportunistically added to the portfolio in the first quarter and which gained nearly 20% for the quarter. The company continued to execute its business strategy effectively, gaining market share in online search and reporting very strong earnings growth. The tumult surrounding the takeover talks between Microsoft and Yahoo! underscores the challenges both companies face in competing head-to-head with Google, both in online search and the burgeoning market for collaborative application software.

Wireless technology company **QUALCOMM** was another substantial contributor in the technology sector. QCOM, which earns royalties on its wireless technology patents, benefited from the continued rollout of 3G technology in cellular phones and other wireless devices. This transition to 3G technology on a global basis over the next several years will continue to be a robust source of growth for the company. Medical devices maker **Medtronic** was the best performer among the portfolio's health care holdings. Medtronic reported better-than-expected earnings despite continued lackluster performance in its implantable cardiac devices business, a testament to the company's well diversified product line-up. Other units within the company, most notably spinal products and stents, helped take up the slack.

Portfolio Changes

In the first quarter, we eliminated medical equipment maker Stryker from the portfolio because of its relatively high valuation. In the 2nd, we returned to this segment of the market by adding orthopedic products manufacturer **Zimmer Holdings** to the portfolio. Zimmer, like Stryker, is well positioned to benefit from the growing demand for hip and knee replacements from an aging but active population. In contrast to Stryker, however, Zimmer has a much more attractive valuation, the highest profit margins in its industry & a new management team that we believe will be a good fit. We also sold long-time health care holding **Johnson & Johnson**. Growth in many of the company's businesses are decelerating, most notably its pharmaceutical and medical

device units, and we simply believe that there are better alternatives for growth elsewhere in the health care sector. One example, which we added to the portfolio during the quarter, is **Henry Schein**, a dental products distributor. The company generates steady, predictable earnings growth, is relatively immune to the economic cycle, & is not vulnerable to medical reimbursement issues afflicting health care segments. In the consumer discretionary sector, we eliminated discount retailer **Target** and added online retailer **Amazon.com**. Target proved to be more economically sensitive than we anticipated. In contrast, online retailing remains a rapidly growing industry, and Amazon is the dominant segment player. Amazon generates a substantial amount of cash flow from an increasingly diverse product mix, with a business model considerably less capital-intensive than brick-&-mortar retailing. We eliminated one other consumer stock during the quarter—natural foods retailer **Whole Foods Market**. The integration of the recently acquired competitor Wild Oats is progressing slower than we anticipated & its same-store sales comparisons have been decelerating. This proved to be a good decision as the stock has fallen an additional 25–30% since. One final sale made in the second quarter was a stock we bought just a few months before—credit card company **Visa**. We participated in the company's March IPO, bought more when the stock began trading and saw the stock price appreciate very rapidly in subsequent weeks. At that point, we felt that the strength of the business was already fully reflected in its share price, so we eliminated the position. This was an unusual circumstance, since we typically buy and hold them.

Outlook & Strategy

We expect the underlying trends that have developed over the past 12 months—a weak economy and decelerating corporate profit growth—to remain in place for the foreseeable future. Consequently, we believe that our portfolio will continue to benefit substantially from the market's shift toward companies with consistent, sustainable, double-digit earnings growth and strong free cash flow generation.

We expect the companies in our portfolio to grow their aggregate earnings by approximately 16% in 2008. This compares to a current consensus expectation of roughly 8-9% earnings growth for the broader market—just half the portfolio's growth rate. In addition, SGA portfolio companies are currently generating cash flow after all capital expenditures and acquisitions of nearly 5% of their market capitalization, well ahead of the 10-year bond and an all-time high. In a world of tight credit and hampered financial flexibility, that cash flow generation is another powerful differentiator of these outstanding businesses.

The changes we made to the portfolio in the first half of 2008 have strengthened the quality of the portfolio's businesses and increased its growth potential. In addition, the valuations of portfolio companies remain very compelling. We are very confident about the portfolio's prospects for both relative and absolute outperformance going forward, and we are well positioned to reap the rewards of patience after facing extraordinary performance headwinds over the past several years.