



US Large Cap Growth Equity Portfolio

Portfolio Review

In the third quarter of 2008, the SGA high quality large cap growth equity composite returned -1.18%, net of all fees, well ahead of the -12.33% return of the Russell 1000 Growth Index, the -8.37% return of the S&P 500 Index & the average -13.81% of the Morningstar Large Growth.

Winds of Change

The third quarter of 2008 was one of the more remarkable and tumultuous periods in the history of the U.S. stock market. The credit environment—which began to deteriorate more than a year ago with the implosion of the subprime mortgage market—continued to worsen, creating far more consequences than anyone anticipated and undermining confidence in the entire financial system. The chaos reached a fever pitch in September, when a number of venerable financial firms filed for bankruptcy, were rescued by the federal government, or accepted a buyout offer at fire-sale prices to avoid insolvency.

In addition, the U.S. economy weakened further, exemplified by a rising unemployment rate. The latest upheaval in the financial sector has increased meaningfully the risk of a deeper recession. Corporate profit growth continues to decelerate. Year-over-year earnings growth for the S&P 500, excluding financials, declined from 12% in the fourth quarter of 2007 to 9% in the first quarter of 2008 to 3% in the 2nd quarter. Furthermore, year-over-year earnings in the 3rd quarter, again without financials, are expected to *decline* by 5% and this likely will not be the end. Simply stated, growth is becoming scarce.

This scarcity of growth has led to increased demand for the sustainable growth companies in which we invest—companies that can, in aggregate, consistently deliver double-digit earnings growth, even in a weaker economic environment. Sector trends contributed positively. Declining commodity prices led to a sharp decline in energy, materials, and utilities stocks—segments of the market we have historically avoided because few of these companies meet our investment criteria. In contrast, consumer staples and health care stocks, which represent overweight positions, were among the few sectors of the market to advance in the third quarter thanks to their limited sensitivity to economic conditions.

Consumer Staples and Health Care Outperformed

The main theme among our top performers is that they are relatively well insulated from the downturn in the economy. While no company in the portfolio is entirely immune from economic fluctuations, a number of our holdings have less economic sensitivity than the broader stock market.

The portfolio's best contributor was biotechnology firm **Genzyme**, which focuses on medications that treat rare chronic genetic disorders. The company enjoyed solid growth in both new and existing products and there is clear visibility for solid earnings growth for the next few years. Demand for Genzyme's products is driven by the long-term medical need to treat chronic, debilitating diseases and the company is therefore not very sensitive to economic fluctuations.

Other top contributors included two consumer staples stocks—**P&G** and **PepsiCo**. Both benefited from a general flight to quality, as well as their relatively modest economic sensitivity. Thanks to the strength of its brands, P&G successfully raised prices, helping offset higher raw materials costs.

PepsiCo delivered as its snack-food business and shift toward healthier alternatives produced solid growth.

Technology Stumbled

The few portfolio holdings to detract from relative results were largely from the information technology sector. The most notable of these was online advertising and search firm **Google**, which slid by nearly 40%. Google reported earnings below expectations, largely because the company's incremental market share gains—given its already dominant market position—was not enough to offset the deceleration in online advertising spending. Nonetheless, we remain confident in Google's ability to generate strong growth over the long term. The company, like other portfolio technology holdings has no debt, generates strong free cash flow and is not exposed to the vagaries of the world's credit markets.

Video game maker **Electronic Arts** also declined on expectations of slowing consumer spending. This presents a very attractive investment opportunity. ERTS management team is executing well, introducing a strong slate of highly rated new games, many with high-margin owned intellectual property and they expect to reverse the recent share losses. The industry remains healthy with strong sales in hardware and software. It remains a bright spot in a pressured retail environment.

One of the most disappointing stocks was online auction company **Ebay**. Increased competition from the likes of Amazon and Google, which are attracting merchants from Ebay's platform, led to a persistent slowdown in the company's auction business, more than offsetting the tremendous growth in its payment processing unit PayPal. As a result, we sold the vast majority of our holdings in the third quarter and eliminated the position entirely early in the fourth quarter.

Energizing the Portfolio

As we have discussed over the past several years, the portfolio has avoided the energy sector for some time because we were concerned about both the longevity of earnings streams that seemed highly dependent on the price of a commodity and the increasingly speculative nature of the stock price increases of the past few years. Nevertheless, continued careful research in the oil services industry revealed layers of predictability we have grown to appreciate, and several recent developments helped convince us that there are investment opportunities worth pursuing here. First, the recent rapid rise in oil prices over the past couple of years has solidified the profitability equation for some companies in the sector. In other words, at current oil prices and despite the recent sharp declines of the past few months, the profitability of some companies is considerably more stable and predictable because the price of oil is still substantially higher than the cost of extraction and production. Second, two recent trends have emerged that provide long-term opportunities for some companies in the oil services industry. One is the increased nationalization of the energy industry in many emerging economies as countries seek to maintain energy independence and exert tighter control over their own natural resources. As a result, the customers of many oil services companies are no longer just the traditional integrated oil companies but also state organizations in countries like Brazil, Saudi Arabia, India and many others. Those national oil companies control much of the world's untapped reserves, are much less concerned about fluctuations in oil prices, do not spend any meaningful amounts on research and development and are thus almost totally dependent on the capabilities of the oil services companies and are far more inclined to enter into long-term service contracts. Second, with existing reserves depleting at increasing rates, a lot of new exploration and drilling activity is occurring far offshore and in harsh environments that require more complex drilling and increasingly sophisticated technology. In addition, much of the existing drilling infrastructure is 25–30 years old and in need of upgrade or replacement. The combination of enormous demand for new infrastructure and a massive replacement cycle provides a high level of long-term visibility and sustainability of earnings growth in the oil services industry. Finally, we experienced a bursting of the speculative energy bubble in the third quarter as concerns about the global economic slowdown and a sharp decline in the price of oil from its all-time high in July led momentum investors to abandon the sector, either willingly or through forced redemptions, causing a significant drop in the price of many oil services stocks. This created a very attractive valuation opportunity for us. Consequently, we began building positions in two oil services companies **Schlumberger** and **National Oilwell Varco** to the portfolio during the third quarter. SLB is the gold standard in the oil services business, with a great management team and tremendous technological expertise in integrated exploration and production solutions. NOV is the leading global provider of drilling equipment and components, as well as repair and

maintenance on drilling rigs. About 60% of the company's sales come from aftermarket sales, replacement parts sales and new product sales that are consumed during the ongoing operation of drilling rigs, providing a solid stream of visible revenues. As a result of the recent price declines, both companies are now trading at very attractive valuation levels.

Other Portfolio Changes

After participating in its first-quarter IPO, we sold **Visa** in the second after the stock enjoyed a very strong run-up. Since then, concerns about a consumer slowdown along with financial sector tribulations, pushed Visa's stock price back down to an attractive level, so we re-established a position. What is very appealing is the absence of credit risk, a powerful global brand, the leading position in faster growing debit cards and a strong international presence.

Complementing our purchase of dental products distributor **Henry Schein** in the second quarter, we initiated a small position in **Dentsply**, the world's largest manufacturer of dental products. Dentsply derives more than half of its sales from outside the US, and the vast majority of its products are consumable or disposable, providing the recurring revenues. In addition to Ebay, we sold the remaining shares in drugstore chain **Walgreen** after reducing our position substantially in the second quarter. Disappointing execution, a lack of conviction on our part that the company would be able to reverse quickly the lackluster trend in pharmacy sales and more attractive opportunities elsewhere led us to sell the stock.

We also sold industrial conglomerate **GE** and warehouse retailer **Costco**. We had pared back our position in GE in the second quarter, and we sold the rest in mid-September, shortly before the company's most recent earnings warning. We continue to like the growth prospects in GE's infrastructure business, but its finance arm faces too many challenges, creating a significant drag on the company's overall growth. Our valuation discipline came into play with Costco; the stock had become fully valued. We will look for a valuation opportunity to re-enter, as we like the company and its management.

Outlook & Strategy

We remain positive about the portfolio's prospects going forward. Our current estimate for aggregate earnings growth in the portfolio is approximately 12% for 2008, compared with negative earnings growth for the broader market. Importantly, we also look for double-digit earnings growth for portfolio companies in 2009. In addition, valuations remain particularly attractive at current levels. The portfolio's enterprise yield - our measure of the true free cash flow yield of portfolio companies - is currently in excess of 5% and well ahead of the rate of the 10-year bond, both all time high levels. Additionally, based on our discounted cash flow model, the portfolio was undervalued by more than 60% at the end of the third quarter and the market decline in the first few days of October have only widened the valuation opportunity. This reinforces our belief that we are in the early innings of a long-term trend of outperformance for sustainable growth companies, and although we may see some ups and downs along the way, we expect the results over the long run to be very favorable for the portfolio on both a relative and an absolute basis.