



US Large Cap Growth Equity Portfolio

Portfolio Review

In the fourth quarter of 2008, the SGA Large Cap Growth portfolio composite returned -25.92%, trailing both the -22.79% return of the Russell 1000 Growth Index and the -21.94% return of the Standard & Poor's 500 and giving back a portion of the very strong relative gains of the third quarter. The average return of the Lipper Large Growth category was -23.75%.

As eventful years go, 2008 was one for the history books. It is not surprising then that the battle cry from many investors in the 4th quarter and particularly in December was simply "get me out!" One of the major themes was a massive amount of forced selling in the equity market in pursuit of liquidity triggered by significant mutual fund and hedge fund redemptions. In extremely volatile market conditions, the easiest securities to sell are often the most liquid, high-quality, large-cap stocks—the kind of companies we emphasize in the portfolio, resulting in the portfolio's overall underperformance for the quarter.

Although we gave up some of the third quarter gains in the fourth quarter, we outperformed the broad market, benchmark, and peer group for all of 2008 and we are encouraged by the strong relative performance thus far in 2009. We continue to believe that we are in the early stages of an extended period of outperformance for the sustainable growth companies in which we invest and that the primary driver behind this trend which began mid-2007 remains the continued scarcity of growth. Because growth is now scarce, those companies able to deliver it should do well. We recognize that this outperformance will not occur in a straight line—there will be intermittent periods of underperformance, such as in the 4th quarter—but we are optimistic that over the next few years, the portfolio should generate significantly superior returns.

Our confidence stems in part from current economic and credit conditions, which favor our investment strategy. There is a well-worn investment phrase used in evaluating businesses—"cash is king"—that refers to the importance of free cash flow. With the current scarcity of credit, companies that can generate the cash flows necessary to sustain and grow their businesses will have an enormous competitive advantage over those that need to fund their growth via the debt markets. Likewise, strong balance sheets are very important when credit is hard to come by. Furthermore, companies that are able to demonstrate pricing power and generate recurring revenues have greater earnings stability, which is an attractive trait in tough economic times. These characteristics are some of the hallmarks of every company in which we invest.

Corporate profits are another source of strength for the portfolio. As we have suggested in the past few quarters, corporate profit growth estimates have been overly optimistic, and now they are being revised downward at an alarming rate. Although estimates vary widely, the companies in the S&P are generally expected to see their aggregate earnings fall by more than 20% in 2008, and they will likely decline further in 2009. In contrast, we expect portfolio companies in aggregate to post double-digit earnings growth in 2008 and high-single-digit growth in 2009, despite what is likely to be the worst recession in the last 25 years. We believe this earnings advantage will be a long-term catalyst for future portfolio outperformance.

Perhaps most importantly, in 2008 we were able to take advantage of a compelling long-term opportunity to add a number of extremely strong growth franchises to the portfolio as valuations collapsed across the market. These additions have improved the growth profile and increased the cash flow of the portfolio, and we believe that the portfolio is well positioned to both ride out the current downturn and participate in the eventual recovery.

Technology, Financials Under Pressure

Every stock in the portfolio declined on an absolute basis in the fourth quarter, but our technology and financial stocks had the biggest negative impact on relative performance.

The most significant detractor was video game maker **Electronic Arts**, which proved to be our biggest disappointment of 2008. The stock fell sharply as a long-awaited roll out of critically acclaimed new game titles did not translate into hoped for sales and earnings. The weakening economy focused consumer and retailer purchases on only a few best-selling titles preventing the company from gaining traction in the marketplace and leading to further losses in market share. In addition, the company was late anticipating the raging success of the Nintendo Wii and has less exposure to the growing trend of multi-player online gaming. Given these headwinds, we decided to eliminate Electronic Arts from the portfolio during the quarter and redeploy the proceeds to other holdings.

In the financial sector, our weakest performer was credit card purveyor **American Express**. As the credit crisis worsened, American Express saw an increase in delinquencies and defaults in its credit card business, which had a detrimental impact on earnings.

We believe that American Express will emerge from this environment in a strong position and we remain confident in the long-term profitability of the company's business model. We believe it remains a worthy holding in our portfolio, albeit at an underweight position for now, given the near-term higher risk profile.

Another notable decliner was energy services and equipment company **National Oilwell Varco (NOV)**, which was negatively impacted by a 60% plunge in the price of oil during the quarter. Demand for oil has been temporarily reduced by the severe global economic downturn, but we expect an eventual rebound when the global economy recovers. There are secular forces which favor the growing need for drilling equipment and aftermarket services. There is a supply constraint for hydrocarbons over the long-term as existing reserves are being depleted. The development of newly discovered reserves in places like Brazil, the west coast of Africa and the Arctic, along with several other secular trends—the nationalization of the energy industry in many emerging economies, the increasing complexity of energy extraction, and the need to replace aging infrastructure—paint a compelling picture of robust long-term future demand for NOV's equipment and services.

Defensive Sectors Fared the Best

The portfolio's holdings in defensive sectors such as consumer staples and health care held up the best during the quarter. Household products maker **Procter & Gamble** was one of the top contributors for the second straight quarter. The maker of toothpaste, laundry soap, and other basic household products continued to deliver consistent growth that is less affected by the economic environment. In addition, the company has a notable presence in faster growing emerging markets.

The best contributor in the health care sector was generic drug maker **Teva Pharmaceuticals**. The availability of generic medications continues to grow as branded products lose patent protection. Many pharmacies and pharmacy benefits management companies encourage generic substitution because profit margins are greater. We believe that, because of its cost effectiveness, generic substitution is an effective way to lower overall health care costs, making it a likely focus of any proposed health care reform. Teva is well-positioned to continue to benefit from these trends.

The portfolio's top performer for the quarter was payroll processor **Automated Data Processing**. Despite the bleak employment picture, ADP has maintained a solid growth rate—we expect to see 16.5% earnings growth for 2008—as effective cost controls led to higher profit margins.

The company is also gaining market share as the employment downturn takes a greater toll on its competitors. ADP remains one of our largest holdings.

Portfolio Changes

In addition to Electronic Arts, we eliminated two other holdings from the portfolio in the 4th quarter. We sold our remaining stake in online auctioneer **eBay**—after unloading

most of our position in the 3rd quarter—because of a fundamental slowdown in its core auction business.

We also removed the remaining small position we had in shipping company **FedEx** from the portfolio. Although we still like FedEx as a way to participate in the growth of global commerce, the company's vulnerability to a downturn in the economy as well as other potential challenges to its business model—such as a looming political battle regarding its current non-union status led us to sell the stock and pursue better opportunities elsewhere.

One of those opportunities was agricultural products maker **Monsanto**, which was added to the portfolio. As the world's largest seed company, Monsanto is poised to benefit from a major global development—the need to increase agricultural productivity to meet the growing worldwide demand for food and biofuels given the limited supply of arable land. They are the dominant player, with proprietary genetic technology that provides pricing power and a formidable barrier to entry. We also used the proceeds from our sales to increase our positions in several key holdings during the quarter, including credit card processor **Visa** and online retailer **Amazon.com**.

Outlook & Strategy

The past 18 months have been tumultuous for the stock market but favorable for the portfolio. Not only have we outperformed over that period, ranking in the top 10% of our peer group, but the decline in the broader stock market presented us with an unprecedented opportunity to add higher growth quality franchises to the portfolio at significant discounts. We have taken advantage of these opportunities and believe those decisions will enhance our performance. In addition, the characteristics endemic to the companies in the portfolio—strong balance sheets, healthy cash flows, sustainable earnings growth—are more valuable in today's environment than they have been at any time in the last six years. These businesses are growing market share and strengthening their competitive positions, yet trading at very compelling multiples. Despite shrill headlines and the gloomy reports, all is not negative. The massive global response by fiscal and monetary authorities will ultimately succeed in stemming the decline. Mortgage rates have now fallen to the lowest level in history, providing one element in the foundation of the recovery. The recent collapse in oil prices is equivalent to a \$200 billion tax cut at the pump. The economy will recover, although the timing is clearly uncertain. It should be remembered that while economic conditions are likely to remain difficult for some time longer, the portfolio is on track for solid earnings growth in the coming year. The portfolio's enterprise yield (a measure of the aggregate free cash flow yield of our holdings) is at an all-time high of 6%—nearly three times the 2.2% yield on the 10-year Treasury bond. What's more, based on our discounted cash flow model, the portfolio would have to gain in excess of 150% to reach our estimate of fair value. In other words, the portfolio is growing its way through the worst economic downturn in nearly three decades while trading at valuations that are lower than we have ever seen before. That is why we are increasingly optimistic about the portfolio's prospects going forward.