# US Large Cap Growth Equity Portfolio

2nd Quarter 2009 Commentary

## Portfolio Review

In the second quarter of 2009, the Sustainable Growth Advisers US Large Cap Growth Equity portfolio returned 15.45% after fees, compared with the 16.32% return of the Russell 1000 Growth Index and the 15.93% return of the Standard & Poor's 500 Index. The average return of the Morningstar Large Growth category was 15.74%.

**Riding the Growth Train**

The U.S. equity market enjoyed its best quarterly performance since the last three months of 1998. The market's strong gains were driven primarily by growing optimism that the deterioration in the U.S. economy is showing signs of abating. The positive news included three consecutive months of rising home sales, an uptick in consumer confidence, and a slower rate of job losses. In addition, investor confidence got a boost from indications that the financial sector was beginning to heal, highlighted by several major financial institutions paying back funds received from the federal government under the Troubled Asset Relief Program (TARP).

The portfolio generally tracked the market rally in the second quarter. It is worth noting that the portfolio exceeded the 40% returns of the market during the powerful rally from the low on March 9 through June 1.

The fact that the portfolio participated fully in the market's recent advance was notable because the stock market rally that began in early March was predominantly led by low-quality, highly leveraged stocks that had been severely beaten down during the market's sharp decline in late 2008 and early 2009. Despite this skewed market leadership, our portfolio of high-quality, sustainable-growth companies kept pace with the broader market. This was driven in our view by the ability of those businesses to deliver solid results in the midst of a lackluster growth environment. Solid growth, powerful cash flow generation and very healthy balance sheets are hallmarks of the businesses we invest in. These attributes are increasingly rare and those that have them are well positioned to benefit.

Despite the rampant optimism that the worst of the downturn may be over, there is little evidence to support the notion that a robust economic recovery is right around the corner. "Less bad" in other words is a far cry from "good". Growth remains scarce as evidenced by a sustained contraction in the manufacturing sector, continued deleveraging by both consumers and businesses, and the highest unemployment rate in 26 years.

Corporate earnings remain on a downward trajectory, though they are declining at a slower rate. The easy credit that fueled a multi-year period of robust economic activity in the middle of this decade is unlikely to return anytime soon. Thus, the positive earnings growth in aggregate generated by the companies in the portfolio remains a significant tailwind for performance, and should continue to be for quite some time to come.

The portfolio's outperformance so far in 2009 is also a testament to the unprecedented opportunities—and our readiness to capitalize on them—that emerged during the severe market downturn in 2008. Many of the portfolio's top performers during the first half of the year were companies that we added to the portfolio in the prior 12 months. We believe the portfolio's current holdings offer a winning combination of strong growth prospects, high quality, and attractive valuations that should provide the impetus for future outperformance.

**Winners in Financials and Technology**

The two best-performing sectors in the stock market during the second quarter were financials and information technology, and the portfolio's top contributors came from these two sectors. Consumer electronics maker **Apple** was the portfolio's leading contributor as the company continued to generate strong results despite the broad weakness in consumer spending. Apple remains a highly innovative company with powerful brands—most notably the iPhone (a new model was released during the quarter), iPod, and Mac—that consumers continue to buy even in challenging economic times. In addition, the growing portfolio of applications for its devices is a source of lasting competitive advantage and should enable Apple to maintain or widen its lead on its competitors.

Credit card issuer **American Express,** which we added to the portfolio last year, rebounded smartly in the second quarter after credit concerns weighed on the stock earlier in 2009. The company controls the entire channel for its credit cards, from merchants to consumers, which makes for a profitable business model. In fact, American Express generates 20x more revenue per transaction than credit card processors do. We expect to see the company's delinquency rates decline going forward, which should lead to significant improvement in profitability. American Express was also one of the companies that repaid its TARP funds during the quarter.

Custodial bank **State Street** was another financial holding that recovered nicely during the quarter and returned the TARP money it received ahead of schedule. This stock was adversely impacted by concerns that plagued all financial institutions in the last half of 2008. State Street's higher quality, fee-based custodial and outsourced financial services businesses provide a significant competitive advantage. We added to the position on weakness earlier this year following a series of conversations with the company's senior management which paid off handsomely.

**Materials and Industrials Lagged**

Among the few decliners in the portfolio during the quarter, agricultural products maker **Monsanto** was the weakest performer. A cheaper generic version of the company's Round-Up herbicide from Chinese manufacturers weighed on Monsanto's earnings during the quarter. However, we believe the most important source of long-term growth for Monsanto is its genetically modified seeds business, which helps increase the productivity of the world's food growers. Arable land is a finite resource and farmers all over the world are continuously seeking new ways to improve productivity. Insect and drought resistant seeds are examples of ways farmers can produce more crops from existing land, increasing their profitability and supplying more crops to mitigate against global shortages. As a result, we continue to own the stock, albeit with a small position.

Biotechnology firm **Genzyme** also struggled in the second quarter because the company was forced to suspend production of one of its major medications due to a viral contamination in its production facility. We believe that this is a temporary issue that will hurt Genzyme's profitability in the short run, but should not detract from the company's long-term growth prospects.

Another notable decliner was a new addition to the portfolio during the quarter—industrial and construction supplies distributor **Fastenal** (see below for more details). Weakness in the manufacturing sector led to a lower-than-expected earnings report during the quarter. We have taken advantage of the decline to build a starter position in the stock.

**Portfolio Changes**

We eliminated one holding from the portfolio in the second quarter—dental products maker **Dentsply**. The dental business was not as resilient as we anticipated during the economic downturn, and the company's growth prospects were not as dynamic as those we found elsewhere.

In that vein, we added three new companies to the portfolio during the quarter. As mentioned previously, we initiated a position in Fastenal. The company derives approximately half of its sales from maintenance and replacement parts that are consumed in the operations of its commercial and industrial customers, which provide the recurring revenues we seek. In addition, Fastenal's physical proximity to its customers gives the company a competitive advantage in delivery, which translates into pricing power.

We also added business software maker **Oracle** to the portfolio early in the quarter. Oracle is the undisputed leader in database management software and a leader -- with portfolio company SAP-- in the area of enterprise software. The company has expanded its product base via a series of judicious acquisitions and has done well integrating those additional capabilities while enhancing its growth prospects. Maintenance contracts with many of its customers help the company generate steady and reliable cash flows that are largely resistant to economic fluctuations. Indicative of the mission critical nature of the software these companies provide, both Oracle and SAP have been able to increase their maintenance fees despite the weak economic environment.

Finally, near the end of the quarter, we initiated a small position in **Cerner**, a leader in healthcare technology solutions that enables hospitals and physicians to become more efficient by getting access to clinical and administrative data in real time and by digitizing medical records. In addition to a growing focus on the part of hospitals to adopt information technology to improve productivity, the recent government stimulus package provided sizeable funding to enable them to accelerate the adoption and use of these technologies. Cerner will be a direct beneficiary of the Obama administration's health care initiatives.

**Outlook & Strategy**

Since corporate earnings began decelerating in earnest in mid-2007, the portfolio has outperformed the broader market by a substantial margin, and we believe there is significant additional upside potential going forward. While we believe an economic recovery will eventually take hold, it is likely to be muted and gradual, which means that growth will remain hard to come by in the equity market. Based on current estimates, the aggregate earnings of the companies in the S&P 500 will be down a cumulative 55% in 2008 and 2009. In contrast, the companies in the portfolio should deliver positive earnings growth of 15% over the same time frame.

Despite its outperformance over the past two years, the portfolio remains attractively valued. The portfolio's enterprise yield (a measure of the true free cash flow of a business) remains above 5%—high by historical standards and well ahead of the 3.5% rate of the 10-year Treasury bond yield. Historically, the enterprise yield has traded at about half the 10-year rate, implying that the upside to the portfolio on this measure is more than 100%. In addition, our discounted cash flow model indicates that portfolio companies are undervalued by roughly 80%. In other words, two separate cash flow methodologies are pointing to a significant undervaluation of the current portfolio. We clearly believe the potential for upside from here is sizeable.

While we are very optimistic about the portfolio's prospects going forward, we recognize that results will not occur in a straight line. But in a world where growth will remain scarce, cash flow generation, strong balance sheets and strong growth rates will likely be highly sought after. We believe that this portfolio of businesses is poised to deliver.