

US Large Cap Growth Equity Portfolio

Portfolio Review

In the third quarter of 2009, the Sustainable Growth Adviser's large cap growth equity composite returned 14.15%, compared with the 13.97% return of the Russell 1000 Growth Index and the 15.61% return of the S&P 500.

An All-Weather Portfolio

U.S. stocks enjoyed their second consecutive quarter of double-digit gains. The equity market's sharp advance reflected a continuation of the sea-change in investor sentiment that began to take hold in the second quarter of 2009 as expectations of a potential depression in the U.S. economy gave way to discussions about the shape of the recovery. Evidence of improving economic conditions in the third quarter included an increase in manufacturing activity, signs of stabilization in the housing market, and a slow decline in the pace of job losses.

In this environment, SGA's large cap growth portfolio essentially matched the performance of its growth-oriented benchmark index, though it modestly lagged the broad stock market indexes as growth stocks in general underperformed in the third quarter. We were pleased to see our portfolio of high-quality, sustainable-growth companies hold its ground versus the benchmark despite some significant headwinds. In particular, lower-quality stocks with less-than-pristine balance sheets continued to lead the market's rally, and cyclical sectors of the market—including materials and industrials, where we have very limited exposure—also outperformed during the quarter.

The portfolio's outperformance of its benchmark index and the broad S&P 500 over the last two years—a period featuring both a sharp market decline and a substantial rally—illustrates the “all-weather” nature of the current portfolio. During this period, the portfolio exhibited two important attributes, the ability to preserve capital in a downturn and then participate fully in a market recovery. The key factors behind the portfolio's outperformance are twofold. First, our commitment to investing in companies with predictable, sustainable earnings growth was a significant advantage in an environment where growth was—and is likely to remain for some time—a scarce commodity. The recession was very deep and led to a significant decline in corporate earnings for the broader market; in contrast, the aggregate earnings growth of the companies in the portfolio remained positive throughout the economic downturn. This core tenet of our investment philosophy helped the portfolio outperform as the market fell. The other key factor was our ability and willingness to capitalize on investment opportunities during the worst of the market's swoon. Throughout 2008, we were able to improve the growth prospects of the portfolio by investing in a number of companies meeting our criteria and trading

at extremely attractive valuations. A number of these new companies have been the portfolio's best performers so far in 2009, helping the portfolio keep pace with the overall market during the sizable recovery over the last six months.

Taken together, these two factors—our strategy of focusing on sustainable growth companies and the discipline to execute this strategy during a volatile but unprecedented period of opportunity—enhanced the growth profile of the portfolio. This helped it outperform over the past two years and, we believe, sets the stage for an extended period of outperformance going forward.

Recent Additions Take Center Stage

Four of the five top-performing SGA stocks during the third quarter were added to the portfolio during 2008, reflecting the wealth of investment opportunities we were able to pursue at that time. The two most noteworthy examples in the third quarter were credit card issuer **American Express** and energy services and equipment provider **National Oilwell Varco**. American Express continued to recover from the negative impact of the credit crunch in late 2008 and early 2009 as delinquency rates began to ease in the third quarter. American Express generates a large part of its profits from the discount rate it charges its merchants, not from the lending that it does. The company also benefits from controlling both the customers they decide to issue credit to and the merchants they allow on their network, allowing the company to reap higher profits and exert greater control over the degree of credit risk involved. American Express also generates considerable free cash flow as many of its customers pay off their balances every month. Toward the end of the quarter, we trimmed our holdings of this stock, taking profits after its strong run-up over the last six months.

NOV is benefiting from resilient demand for deepwater offshore drilling rigs as energy producers continue to spend capital to develop newly discovered reserves in such places as the coasts of Brazil and West Africa. The company is also expected to see higher sales of spare parts beginning in 2010 as rising energy prices lead rig operators to bring inactive drilling platforms back into operation. The promising outlook for both aspects of NOV's business bodes well for the stock. The only stock among the top five contributors that was not a recent addition to the portfolio was coffee retailer **Starbucks**, a longtime portfolio holding and the best performance contributor in the third quarter. After essentially over-expanding in the U.S., Starbucks

cut back on its domestic store base over the past year and focused instead on better cost management and making existing stores more profitable. This approach began to pay off in mid-2009 as comparable store sales stabilized, and we expect to see better results as we move into 2010. Additionally, the company has continued its growth overseas, where there's significant expansion room.

Only Three Decliners

Just three stocks in the portfolio declined in the third quarter. The most significant was hotel operator **Marriott Int'l**, which we added to the portfolio at the beginning of this year when it was trading at a very attractive valuation level. The stock rebounded very strongly in the first half of the year, causing the valuation to get ahead of the fundamentals, so we made the decision to sell the stock in the third quarter, lock in some profits and deploy the capital elsewhere. We owned Marriott for less than a year, which is an unusually short holding period for us, but an important component of our sell discipline is to respect our valuation metrics. Marriott simply no longer looked attractive relative to other alternatives for client capital.

The other two decliners in the portfolio were information technology stocks—enterprise software maker **Oracle** and wireless technology company **Qualcomm**, both of which fell modestly. Oracle performed very well in the first half of the year as it continued to make beneficial acquisitions and successfully raised maintenance fees despite the economic downturn. The third quarter was a quiet one for the stock, but we expect Oracle to remain on a robust growth path. Qualcomm faced questions about the velocity of demand for cell phone handsets given the continued economic weakness and concerns about the strength of the company's chip business, but the company remains well positioned to benefit from the industry's migration to 3G technology.

Portfolio Changes

In addition to Marriott, we eliminated two other stocks from the portfolio in the third quarter—consumer products company **Procter & Gamble** and food distributor **Sysco**. P&G's overly aggressive price increases in the midst of an economic downturn weighed on the company's market share and fueled demand for cheaper private-label brands. In addition, the tailwind for growth from emerging markets has diminished for P&G. With growth likely to be harder to come by we decided to sell the stock. For Sysco, the main driver of its growth for years was a secular increase in consumer spending at restaurants. Given the economic downturn and our expectations of a muted recovery, we think that has ceased to be a tailwind for the company. Furthermore, the company's recent decision to cancel the development of an additional distribution center leads us to believe that Sysco may have maximized the near-term potential for cost cutting. Consequently, we believe that there are better growth opportunities elsewhere.

We added three new stocks to the portfolio during the quarter, though two of them were held in the portfolio in the not-too-distant past. One example is diversified health care firm **Johnson & Johnson**, which we welcomed back to the portfolio after a one-year absence. We sold the stock in mid-2008 amid concerns about decelerating growth in the company's pharmaceutical and medical products businesses.

In the past year, however, J&J improved its drug development pipeline and lowered its cost structure, making it more attractive from a growth perspective, so we re-initiated a position.

Shipping company **FedEx** is another former holding that we added back to the portfolio. The stock's sharp decline since we sold it a year ago provided an attractive re-entry point for us. We expect shipping volumes to pick up as inventories rebuild and trends toward globalization and e-commerce continue to expand. In addition, FedEx has lowered costs dramatically and gained market share in domestic ground shipping.

The final new addition was networking products maker **Juniper Networks**. As consumers demand richer media applications on a wide variety of electronic devices, the mission-critical routers and switches that provide the backbone of the Internet Protocol networks will be in high demand, and Juniper is one of the few companies that has both the technological and service capabilities to deliver these products. The company earns recurring revenues from subscription maintenance contracts, and the rapid growth in this area leads to frequent capacity and technological upgrades.

Outlook & Strategy

In the near term, the U.S. economy should benefit from the substantial amount of fiscal stimulus from the federal government and a reversal in the massive inventory reductions of the last several quarters. However, we see few sources of secular, long-term economic growth, and as a result, we expect a muted economic recovery for the next several years. Several of the factors that drove economic growth earlier in this decade—such as relatively easy credit or the ability to use your house as an ATM—are gone, and the enormous U.S. budget deficit will also serve as a headwind to economic activity as the U.S. government seeks ways to fund the massive debt that will be coming due. Corporate profits have begun to bounce back recently thanks to rapid cost reductions during the economic downturn, but revenues are stagnant and likely to remain in the doldrums for some time to come.

Given this backdrop, it is clear to us that sustainable growth is, and will remain in short supply, causing investors to gravitate toward companies that deliver consistent, predictable growth. We believe that, over the next few years, it will be imperative to own companies with sustainable growth, robust cash flow generation, and strong balance sheets—characteristics endemic to each of our portfolio holdings.

We are also confident that the stocks we have added to the portfolio over the last 18 months by taking advantage of price dislocations in the broader equity market will continue to provide a significant boost to performance going forward, as they have so far in 2009. Despite our subdued expectations for overall economic growth, we expect portfolio companies to generate aggregate earnings growth rates of close to 20% in each of the next two years. Furthermore, the overall valuation of the portfolio remains extremely attractive. Based on our discounted cash flow, the portfolio is at least 50% undervalued. We continue to believe that the portfolio's outperformance will occur in fits and starts rather than a straight line. Over a longer time horizon, however, we believe that the paucity of growth in the broader economy will lift those companies that can consistently deliver superior growth, and our portfolio will continue to be a beneficiary of this trend.

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Sustainable Growth Advisers, LP