SGA
Sustainable Growth Advisers

Q3 2018 International Growth Commentary

Highlights

- *SGA's International Growth portfolio returned 0.9% (gross) and 0.6% (net) in Q3 2018 compared to 0.7% for its primary benchmark the MSCI ACWI ex-USA Index, and -0.3% for the ACWI ex-USA Growth Index*
- *Developed Markets outperformed Emerging Markets by a wide margin as investors steered clear of emerging markets over concerns tied to rising interest rates, reduced liquidity, currency issues, rising oil prices and trade tariffs*
- *Larger-cap companies performed best; the return to business quality was mixed*
- *Energy and Health Care, sectors performed best, while the Utilities, Consumer Discretionary and Technology sectors performed the worst*
- *Oil prices rose on supply concerns related to Iran and Libya while demand remained strong despite some slowing in global economic growth*
- *Positions in Nestle and Shandong Weigao were initiated and the portfolio's positions in Shoprite and Amorepacific were sold; several other positions were trimmed or added to during the course of the quarter*

Performance

SGA's International Growth Equity portfolio returned 0.9% (gross) and 0.6% (net) in the third quarter of 2018 while its benchmark, the MSCI ACWI ex-USA Index, returned 0.7%, and the MSCI ACWI Growth ex-USA Index returned -0.3%. On a year-to-date basis, the portfolio returned -1.5% (net) relative to -3.1% and -2.5% for the ACWI ex-USA and ACWI Growth ex-USA Indexes respectively.

Within the MSCI ACWI ex-USA Index, stocks in the Energy and Health Care sectors performed best in Q3. Energy led by a wide margin as oil prices rose significantly on the quarter. Stocks in the Utilities, Consumer Discretionary and Technology sectors provided the weakest returns. Value led growth, and larger cap companies outperformed smaller cap companies. Similar to Q2, the reward to business quality was mixed as investors rewarded companies with earnings (as opposed to no earnings), higher returns on equity, higher betas, and higher levels of debt.

Emerging Markets Trailed

Rising interest rates, ongoing trade tensions, the strong U.S. dollar, rising oil prices and weakening global economic growth combined to negatively impact emerging markets again in Q3. The MSCI Emerging Markets Index declined -1.1% for the quarter and -7.7% year-to-date as stocks most reliant upon a continuing global economic expansion underperformed. The Turkish and Greek markets declined double-digits (in USD terms) in the quarter while markets in China and South Africa also performed poorly. In contrast, the Mexican market rebounded following the country's presidential election in which left-wing favored candidate Andrés Manuel López Obrador (AMLO) and his party won, but not with the super-majority needed to alter key economic reforms put in place by the prior administration. More moderate rhetoric by the president-elect following the election also served to calm investors. Later in the quarter, an agreement between the U.S. and Mexico (and later with Canada) on a revised NAFTA accord benefited Mexican equities. The table below notes the best and worst performing markets in Q3 and year-to-date:

Quarter-to-date Best & Worst Country Returns

Top 10	Return	Bottom 10	Return
Thailand	13.6%	Turkey	-20.5%
Qatar	12.8%	Greece	-17.6%
Poland	10.6%	China	-7.5%
USA	7.4%	South Africa	-7.4%
Switzerland	7.3%	Egypt	-6.8%
Sweden	7.0%	Ireland	-5.4%
Mexico	6.9%	Belgium	-5.2%
Norway	6.6%	Pakistan	-4.9%
Taiwan	6.5%	Italy	-4.5%
Russia	6.2%	Colombia	-2.5%

Source: FactSet

Year-to-date Best & Worst Country Returns

Top 10	Return	Bottom 10	Return
Qatar	19.7%	Turkey	-44.1%
Finland	13.1%	Greece	-24.8%
Norway	11.6%	South Africa	-21.8%
Israel	10.4%	Philippines	-20.7%
USA	10.2%	Indonesia	-17.2%
Colombia	9.2%	Pakistan	-16.0%
Russia	9.1%	Brazil	-12.3%
Taiwan	5.5%	Chile	-12.0%
Thailand	5.2%	Hungary	-11.3%
Czech Republic	4.7%	Belgium	-10.4%

Source: FactSet

European Stocks Pressured by China Ties

Among the major global economies, the U.S. market performed best as Q2 GDP growth improved to 4.2% supported by high consumer and business confidence, lower taxes, a reduced regulatory burden and the repatriation of billions of dollars in funds previously held overseas. The U.S. market was rewarded by investors seeking perceived safety and stability given a significantly less certain global economic environment. The U.K. and Italian markets were weakest due to growing uncertainty over the British government's ability to negotiate a Brexit agreement before the pending deadline, and political uncertainty in Italy led investors to sell the markets. In fact, according to the Wall Street Journal, in 28 of the last 29 weeks, investors withdrew funds from European stocks. With approximately 19% of the revenues from companies listed in the Stoxx Europe 600 coming from Emerging Markets, as compared to about 14% for the S&P 500 Index, the region was also more sensitive to the weakening in developing markets. The region's close trading ties to China and the fact that European manufacturing export orders failed to grow for the first time in five years added to investor concerns as a protracted trade war between the U.S. and China appeared more likely creating more uncertainty for EU exporters.

Chinese Markets Among the Worst

China officially reported 6.7% Q2 GDP growth, slightly lower than Q1's 6.8%, but it is likely that trade related weakness tied to tariffs recently imposed will have a greater impact on growth over the remainder of the year and into 2019 unless some agreement with the U.S. is reached. Weakness in Chinese manufacturing worsened in Q3 with producers of cars, machinery and other products ceasing expansion in September and exports falling to their lowest levels in two years. Output from large state-owned manufacturers continued to weaken as well. While the manufacturing, or older, side of the Chinese economy faces increasing difficulty, the newer service side of its economy continues to generate more attractive growth. The indirect impact of tariffs on the services economy remains less clear. However, we continue to see selective areas where we expect domestically driven secular growth to remain steadier. The Chinese government's ability to reverse course on more restrictive monetary policies and add stimulus to the system through easier credit and increased government spending will likely support growth in the near term, however, while the long-term potential of the Chinese economy remains very compelling, already high debt levels are a concern worth monitoring.

Key Performance Drivers

The portfolio outperformed slightly in Q3 despite its overweight in Emerging Markets. The portfolio's stock selection in non-U.S. Developed Markets contributed positively to relative performance. Weakness in the Chinese and South African markets was broad and negatively impacted businesses across the quality spectrum. Our longer-term time horizon and deep fundamental research on companies led us to selectively take advantage of the higher level of volatility in emerging markets. This opportunistic approach has traditionally been a source of value added for our portfolios over time.

Stock selection in the Consumer Staples, Materials and Information Technology sectors contributed to relative performance most, while stock selection in Consumer Discretionary and Energy detracted from performance. The portfolio's sector weights detracted from relative returns due primarily to an overweight in the weakly performing Consumer Staples sector.

Top Contributors

Wal-Mart de Mexico (Wal-Mex) was the top contributor to performance in the quarter, benefitting from a rebound in the Mexican equity market following results of the presidential election in which left-wing favorite AMLO's victory fell short of the super-majority required to reverse the economic reforms of the prior administration, as well as the successful resolution of NAFTA trade negotiations with the US. During the quarter the company also posted solid Q2 results, albeit it slightly below consensus expectations but in line with ours, and continued to execute well in a difficult market environment in Mexico. Revenues and profits increased about 8% and 14% respectively. Comparable store sales growth easily outpaced the market,

marking the 14th consecutive quarter of outperformance versus peers. Top-line strength was driven by improving e-commerce sales and new store growth. Margin growth remained limited. Results were hurt by disappointing sales growth in Central America due to macro weakness in Costa Rica and increasing political unrest in Nicaragua which should prove temporary. Over the longer-term we continue to see Wal-Mex benefiting from a strong competitive moat in the regions it serves and a strong management team that has proven highly resilient in the more volatile markets they participate in. We maintained an average weight position in the stock.

Aon reported Q2 revenue growth in excess of consensus expectations and attractive margin improvement as they continue to work toward right sizing the expense structure of the organization. "AON United" is intended to create a single brand offering and eliminate unit brand identities such as Benfield, Hewitt and AON Risk Solutions. In the process, they are working toward developing new data and analytics offerings to enhance growth and margins. The company is one of the slower growers within the portfolio but its focus on cash flow growth and its industry leading position in risk management make it a good fit with our approach. However, we are cognizant of the need for Aon to continue to take steps to increase margins through cost cutting and efficiencies such as its current restructuring program which is expected to save over $1 billion in costs. We maintained an above-average weight position in the stock.

MercadoLibre posted mixed Q2 results but the stock rose following the report as the company guided toward renewed profitability in the second half of the year and investors looked beyond a trucker strike and increases in freight costs in Brazil. Solid and improving growth in Argentina, Mexico, Chile and Columbia helped offset weaker results in Brazil. We expect the company to continue to balance between improving profitability and growth over the next couple years, focusing on driving its scale and competitive advantages in logistics and payments as opposed to solely margin accretion. Over our 3-5 year investment horizon, we expect the company's focus on payments and more broadly FinTech, including merchant credit and creating a regional payment alternative to credit cards (akin to Ant or Wechat payments), to offer an even more lucrative opportunity than e-commerce. We see additional opportunity for margin improvement for the company when it decides to more seriously begin leveraging its advertising potential, similar to what Alibaba and Amazon have done, and continue to be impressed by management's execution across e-commerce and payments. Given the stock's valuation and the potential for increased competition, we maintained a below average weight position, adding to the position early in Q3 on weakness and later trimming on strength.

The fourth and fifth largest contributors to portfolio performance in Q3 were **Sinopharm** and **Fomento Economico Mexicano**.

Largest Detractors

A common denominator among the key detractors this quarter was their exposure to China. The Chinese stock market declined -7.5% amid rising trade tensions with the U.S. and fears over how far the impasse would go and its likely effect on the Chinese economy and businesses who derive a significant amount of their sales from it. Despite near-term uncertainty over trade issues, we continue to see select unique long-term growth opportunities in China which are being unfairly painted with a broad brush amid the current fears.

Ctrip.com reported a better than expected quarter amid fears over reduced outbound travel from China due to currency impacts and trade tensions, as well as increased competition from (Alibaba's) Fliggy unit and Meituan (which recently became public). Travel volumes remained healthy with attractive hotel, airline ticketing and packaged tour revenue growth. Customer-centric initiatives put in place by management (e.g., refunding travel expenses in cases where visa applications had been denied and an expanded hotel rewards loyalty program) are expected to differentiate the company from more purely transactional travel platforms and lead to stronger customer retention and loyalty. Management guidance was stronger than expected with margins expected to improve and easier comparable sales now that it has been a year since the government mandated changes to the bundling of insurance and other value-added services to air tickets. Given significant opportunity to further penetrate lower tier cities, continued improvement in domestic and outbound travel infrastructure (such as high-speed rail and more flights), growing numbers of travelers with higher disposable incomes and travel visas, we see Ctrip being able to build on its strong reputation and economics. However, we are incrementally more cautious on the business given trade issues and regional slowing, as well as due to increasing competition to Ctrip from Alibaba and others. As a result, we reduced the position to a below-average weight.

As in the case of Ctrip, **Tencent** shares were negatively impacted by the general weakness in the Chinese stock market in Q3. The stock also faced pressure following news that Chinese regulators delayed approval of new games due to a review of content, as well as concerns that the government is

growing increasingly concerned regarding the amount of time minors spend playing videogames. Online games account for approximately 47% of the company's revenues. We expect the approvals to be forthcoming in relatively short order, and see the risk of new regulations on games to be limited for Tencent given the longer lifecycle of their existing game franchises and the game time restrictions they already have in place. Our research for the company indicates an attractive long-term growth opportunity remains, driven by increased monetization from advertising which is still in its infancy, the company's ability to emulate Alibaba's Ant unit by offering financial services (such as money market funds, insurance and FinTech) to its extensive user base, and the attractive potential its cloud business offers. We expect robust top-line and incremental margin growth and see greater monetization and harvesting of recent company investments driving results in 2019. We purchased additional shares on weakness increasing the target to an above-average weight.

New Oriental Education (EDU) shares were negatively impacted by the general weakness of the Chinese stock market resulting from rising concerns over the likelihood of a trade war between the U.S. and China and the impact it could have on the growth of the Chinese economy and businesses. Further, 15% of EDU's business is catering toward students who take English language tests such as the GRE and GMAT for pursuing a degree in the U.S., therefore a further worsening of the relationship between the two countries could suppress such demand. In addition, concerns over new government regulations aimed at tightening licensing requirements for K-12 tutoring providers to discourage less qualified teachers and banning subject competitions negatively impacted private education stocks in China. News of stricter licensing requirements and a lowering of the burden on Chinese students is not new, and the change in focus appears to us to be a more strict enforcement of existing regulations as opposed to setting tougher requirements for tutorials. We consider concerns related to stricter regulation to be unwarranted and actually helpful to EDU as it accelerates industry consolidation and removes many smaller providers.

Likewise, EDU is not involved in subject competitions. One of its main competitors, TAL, is primarily focused on such things and weakness in its stock spread to EDU despite the very different nature of EDU's business. In fact, EDU is not likely to be impacted by a change in subject competition rules, but investors did not differentiate. We trimmed the position maintaining a below-average target.

The fourth and fifth largest detractors from portfolio performance were **HDFC Bank** and **Alibaba**.

Portfolio Changes

Turnover in the portfolio was slightly above normal as we took advantage of increased volatility in the markets, with the purchase of Swiss health and nutrition provider Nestle, Chinese medical supplier Shandong Weigao, and sale of South African retailer Shoprite. In addition, South Korean cosmetics company Amorepacific was added to the portfolio as the South Korean market finally opened for the portfolio in September, but was then sold later in the quarter. Several other positions were trimmed or added to during the quarter. Specifically, MercadoLibre was added to early in the quarter on weakness and then trimmed on strength later in the quarter. Other shares added to on weakness included Ambev, Core Labs, Diageo, HDFC Bank, Schlumberger and Tencent.

Purchases

We reinitiated a position in **Nestle** based on expectations for improving earnings and cash flow growth of the company over our 3-5 year investment horizon, combined with an attractive valuation. CEO Mark Schneider moved into his position in late 2016 and took steps to enhance the operating performance of Nestle, replacing leaders of underperforming businesses, cutting headcount where needed and consolidating cost centers. With improvements in operating profit margins already occurring and enhanced revenue growth expected by 2020, our research points to a gradual transformation taking place at Nestle which could allow the company to generate high-single-digit earnings growth and double-digit cash flow growth. While about 5% of the company's slower growing revenues have been replaced with more strategically consistent and faster growing businesses, much work remains as they take steps to optimize their business mix. Acquisitions such as the recent Starbucks packaged food purchase offer additional incremental growth. Global leadership positions in pet care, nutrition and bottled water, which comprise about 80% of profits, provide a strong mid-single-digit growth base as they cull slower growth, poorer fitting business units. With the stock underperforming by a wide margin in 2017 and early 2018, Nestle offered a cash yield of 5% plus a dividend yield of 3%. Accordingly, we took advantage of the underperformance and attractive valuation given the positive changes occurring at the company, and leveraged our longer time horizon to initiate an average weight position. We expect to build the position opportunistically moving forward.

Among the key risks we will be focused on are the ability of CEO Mark Schneider to continue to affect positive change in Nestle's established company culture. Continued steps toward rationalizing underperforming businesses and replacing them

with higher growth opportunities which build on Nestle's core operating strengths will be important. With a diverse multi-product, international business such as Nestle, currency and commodity cost fluctuations will affect short-term results and need to be evaluated in a longer-term context.

Shandong Weigao is a leading medical device company in China selling medical consumables and orthopedic implants. The population in China is aging rapidly as a result of the country's long policy of limiting one child per family. Healthcare in China has significant room to grow in order to meet the needs of the rapidly aging populace. Shandong Weigao is actively conducting research and development and launching new products to upgrade their portfolio, and continues to move from a more commodity-oriented portfolio to one incorporating more specialized products with higher barriers to entry and greater pricing power.

Consistent with China's strong preference for local businesses, we expect Shandong to be an important player in the expansion of the Chinese health care system. While in the past we have had some concern over management incentives at the company, with the listing of founding shareholders' shares on the Hong Kong exchange which were previously unlisted, we believe that the management incentives are now more properly aligned with that of public shareholders. Key members of management continue to own more than half the company. We expect to build the position opportunistically moving forward.

Among the key risks associated with the stock are the possibility of government policies that may curtail or restrict the use of medical devices or reduce pricing. Also, it will be important for the company to retain key talent in a highly competitive environment.

Sales

Amorepacific had been owned in the International portfolio since October, 2015. The stock was added to the International CIT on September 6th when the market was opened by the fund's custodian. We subsequently sold the stock later in the quarter. While we expect the business to continue its recovery as the THAAD missile defense related geopolitical headwinds with China abate, it appears the recovery is ramping slower than we had expected. Additionally, the company is investing heavily to launch into new markets such as North America, Middle East, and Southeast Asia, likely tempering the recovery in profits somewhat. While we expect that the company will succeed in its globalization efforts, considering some of the other opportunities arising in the portfolio, we redeployed the capital to positions in HDFC Bank, Diageo, L'Oréal and Schlumberger.

Shoprite was sold out of the portfolio during the quarter as the company continued to face short-term currency and macroeconomic (i.e. low inflation) headwinds likely to negatively impact Shoprite in its core South African market as well as key growth markets such as Angola and Kenya. While some of the challenges currently facing the business, including the lack of inflation in sales growth and currency headwinds, will eventually improve, given the portfolio's exposure to other South African equities, and our hard cap of 35 stocks, we used the proceeds to initiate a new position in Nestle as discussed in detail above.

Outlook

Much of the weakness in European and Emerging Markets this quarter was macro driven, with Europe struggling with myriad political headwinds and the emerging markets seen as the losers in a prolonged U.S. – China trade war. While broad geo-political and macro-economic forces dominated the headlines in Q3, our emphasis remains on deep, long-term focused bottom-up company research. If we identify high quality sustainable growth businesses with strong pricing power, truly recurring revenue streams and long-term growth runways, and buy them opportunistically, our portfolios should, if history is any precedent, provide the long-term capital appreciation our clients expect, regardless of the short-term swings in sentiment and macro fluctuations. Broad trends often paint swaths of companies the same regardless of their underlying fundamental characteristics or long-term growth opportunities. The downward price pressure seen across emerging markets this year provides us with the chance to leverage our deep research and longer time horizon to invest in attractive long-term secular growers at attractive prices. Historically, stocks we have been able to purchase under such circumstances have often ended up being amongst the better contributors to portfolio returns over time. We are confident that our opportunistic approach to managing concentrated portfolios of the highest quality long-term growth businesses we can find, is the best approach to ensuring less volatile growth streams and attractive absolute and relative returns over time.

Today, this portfolio is forecast to generate 14.6% earnings growth over the coming 3 years versus 9.4% for the ACWI ex-USA, with significantly higher cash flow generation, better profitability, less debt, and an attractive cash-flow-based valuation. While high momentum stocks have driven market performance over the last few years, our approach has

continued to take profits in these more expensive holdings and reallocate the capital to other more attractively priced high growth opportunities. The diversity and quality of our secular growth businesses and their attractive valuations makes us highly confident in the portfolio's outlook and we look forward to speaking with you in more detail about it.

Thank you for your continued confidence in our team and approach.

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SGA earnings growth forecasts are based upon portfolio companies' non-GAAP operating earnings. Results are presented gross and net of management fees and include the reinvestment of all income. The Net Returns are calculated based upon the highest published fees. The net performance has been reduced by the amount of the highest published fee that may be charged to SGA clients, 1.0%, employing the International Growth equity strategy during the period under consideration. Actual fees charged to clients may vary depending on, among other things, the applicable fees schedule and portfolio size. SGA's fees are available upon request and also may be found in Part 2A of its Form ADV. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. Upon request, free of charge, SGA can provide a list of all portfolio holdings held in SGA's International portfolio for the past twelve months. Past performance is not indicative of future results.