SGA
Sustainable Growth Advisers

Q2 2018 International Growth Commentary

Highlights

- *SGA's International Growth portfolio returned -2.3% (gross) and -2.5% (net) in Q2 2018 compared to -2.6% for its primary benchmark the MSCI All Country World ex-USA Index (ACWI ex-USA), and -1.4% for the ACWI ex-USA Growth Index*

- *Higher U.S. interest rates and significant repatriation of funds by corporations due to tax law changes pushed the U.S. dollar higher negatively impacting emerging market currencies influenced by the dollar*

- *Non-U.S. developed markets outperformed emerging markets which are more levered to currency fluctuations and restrictive trade policies; European economic growth showed signs of decelerating and markets particularly in Latin America and Europe faced selling pressure*

- *Smaller-cap growth companies performed best; higher levels of business quality were rewarded but the reward varied significantly over the course of the quarter*

- *The Energy sector performed best by a wide margin as global oil prices rose; traditionally defensive sectors including Health Care, Utilities and Consumer Staples performed next best as concerns over global economic growth amid rising interest rates and trade frictions grew; Financials, Telecommunications and Industrials performed the worst*

- *Positions in JD.com and Raia Drogasil were sold and a new position in Temenos was added*

Performance

SGA's International Growth portfolio returned -2.3% (gross) and -2.5% (net) in the second quarter of 2018 while its benchmark, the MSCI ACWI ex-USA, returned -2.6%, and the ACWI ex-USA Growth Index returned -1.4%.

	YTD	1-Year	3-Year	Inception
SGA International - Gross	**-1.6%**	**12.1%**	**8.9%**	**8.2%**
SGA International - Net	**-2.1%**	**11.0%**	**7.8%**	**7.2%**
MSCI ACWI ex-USA Net TR	*-3.8%*	*7.3%*	*5.1%*	*4.2%*
MSCI ACWI Growth ex-USA Net TR	*-2.3%*	*9.9%*	*6.6%*	*5.7%*

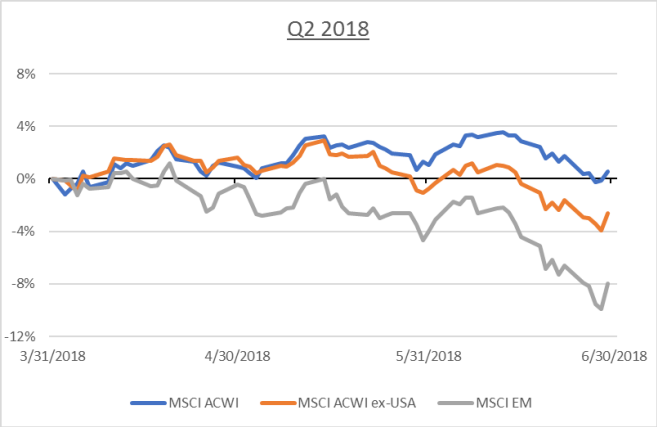
Source: SGA, MSCI.

The portfolio's Q2, 2018 relative performance was strongly influenced by two key factors:

1. Increased defensiveness given rising U.S. interest rates, increasing trade tensions between the U.S. and China and fears that further escalation could weaken global growth

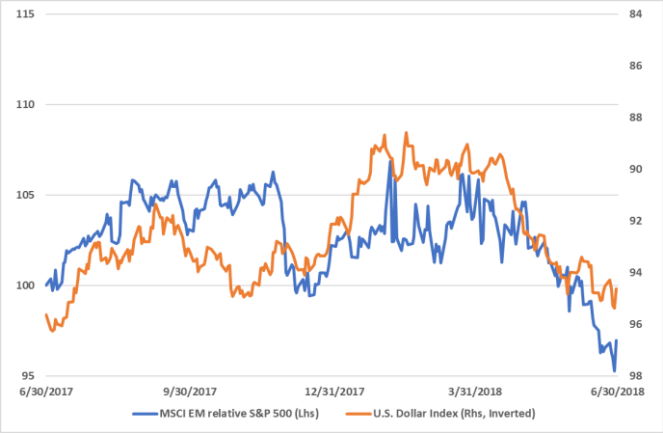
2. The rising U.S. dollar and its negative impact on emerging market currencies

Emerging markets underperformed developed markets by a wide margin in Q2 given their greater reliance on continued improvement in global economic growth and their sensitivity to higher interest rates in the U.S. and the appreciating U.S. dollar. The strong dollar, rising oil prices, global trade tensions, signs of weaker growth in Europe and liquidity issues compounded by currency weakness in emerging markets led investors to redirect funds toward the perceived safety of the U.S. market where they rewarded smaller cap businesses with less international sales and currency exposure.



Source: FactSet, MSCI.

The chart below illustrates the close relationship between movements in the dollar and emerging markets relative performance over the past year.



Source: FactSet, MSCI.

China's Shanghai Composite Index fell 14.7% during the quarter on rising concerns over the possibility of a trade war with the U.S., as Chinese authorities took steps to loosen monetary policy to stem losses. The Yuan was allowed to drift lower relative to the U.S. dollar in hopes of mitigating some of the impact from higher tariffs on Chinese products. Weakness in the Chinese equity markets, and concerns about the long-term impact of a trade war on China's economic growth, negatively impacted returns in other markets across Asia and the Pacific where any material weakening in China's growth would have a direct effect. Among the most affected were Thailand, Indonesia, Malaysia and Singapore, while markets in New Zealand and Australia were among the best performing for the quarter.

In the Eurozone, economic growth slipped in Q1 while growth in the UK weakened further. Poor weather, a historically severe flu season in Germany, and labor strikes in France tempered growth, but should largely reverse themselves in coming quarters. Europe's growth however is heavily influenced by growth in China given that China is currently the European Union's second largest trading partner and the EU is China's largest trading partner. The European Union imports industrial and consumer goods, clothing and footwear from China and exports motor vehicles, aircraft and chemicals. The threat of further trade tariffs being imposed on European goods, renewed political instability with the populist Five Star movement assuming power in Italy, Europe's third largest economy, Brexit negotiations faltering and signs that the European Central Bank will scale back its monetary stimulus in the coming months, pressured European markets. Among the worst performing markets in the region were Turkey (-25.9%), Hungary (-14.4%), and Poland (-11.6%). Turkey's market experienced weakness on further signs of stalling economic growth and increased political concerns as President Erdogan extended his 15-year reign in a highly controversial election.

Turning to emerging markets, Brazil (-26.4%) was the worst performing emerging market in Q2, driven by slowing economic growth and rising political concerns. An economic recovery that appeared to be occurring in Q4 lost traction as uncertainty over the country's upcoming presidential election in October rose, the economy was disrupted by a nationwide truckers' strike, industrial production plunged and GDP growth moderated. Meanwhile, South Africa's economy reported its worst quarterly GDP figures in nearly a decade as the economy shrank by 2.2% in the first quarter, amid broad-based weakness across its economy, which pressured South African equities.

Key Performance Drivers

Within the ACWI ex-USA Index, the Energy sector performed the best, and provided the only positive absolute return among the sectors in the Index. Defensively oriented sectors such as Health Care, Utilities and Consumer Staples held up best while more cyclically oriented sectors such as Financials, Telecom and Industrials were weakest. Portfolio sector allocations contributed positively to relative returns in Q2 while stock selection detracted due to weakness in the Consumer Staples and Health Care sectors where positions in Ambev, Sanlam and MercadoLibre detracted most. Stock selection in the other remaining sectors contributed positively with selection in the Consumer Discretionary, Materials and Financials sectors contributing most. Positions in New Oriental Education, Wal-Mart de Mexico, Chr. Hansen, HDFC Bank and AIA Group were most beneficial. The reward to high business quality factors varied during the quarter and become stronger later, given the more defensive perspective of investors. High return on equity companies with low levels of beta and debt that were generating earnings outperformed due to a surge in their performance in June, after having generally trailed earlier in the quarter.

Top Contributors

Temenos, which was added to the portfolio in Q2, was the largest contributor to performance. A full discussion of the company and how it fits our investment criteria is provided in the Purchases section below.

Core Labs reported strong Q1 results as their business benefited from improved operating leverage, rising margins and attractive gains in free cash flow generation. Strength at Core Lab's Production Enhancement business boosted results. North American well completions continued to grow quickly as

Core Labs helped customers get more from their existing wells. We continue to expect the company to capitalize on its growing strength in the North American market and international markets. We maintained an average size position in the portfolio during the quarter.

SAP reported solid operating results with revenues up 9% and operating profits up 14% on a 31% increase in Cloud subscriptions and guidance for 2018 revised slightly upward due to its accretive Callidus acquisition. Software licenses declined modestly as expected given the company's focus on transitioning clients to new maintenance and support relationships. Software support sales rose 5%. Recurring revenues rose to 71% of total revenues, and we expect this trend to continue as SAP transitions from a licensing business to a Cloud-based software maintenance and support relationship business. Free cash flow declined due to SAP's rapid Cloud infrastructure buildout, which we see as being highly beneficial in the long-term, while income tax expenses rose due to one- time items. The company continues to execute well as it transitions from a licensing to Cloud-based support business and enhances the quality of its revenue stream and long-term cash flow. We maintained an above-average sized position in the portfolio during the quarter.

The fourth and fifth largest contributors to portfolio performance were **L'Oreal** and **HDFC Bank**.

Largest Detractors

Ambev reported results which were slightly below expectations due to weak volumes in Brazil beer (down 8%) and disappointments in Canada which offset solid results in other parts of Central and South America where profits rose 22% and 26% respectively on strong revenue and volume gains. The early timing of Carnival, which traditionally marks the end of summer in Brazil, as well as cold and wet weather, and difficult year-over-year comparisons along with slow improvement in the consumer environment in Brazil combined to hurt volumes. Canadian results reflected difficult year-over-year comparisons. Based on our analysis, we view the issues above as shorter-term in nature and expect improvement in Brazil moving forward albeit it at a gradual pace in the near term in part because of ongoing political instability in the country. Ambev's premium beer business continued to do well posting double digit sales growth, and volumes for its overall business appear to have turned positive thus far in Q2. Also, despite its poor volume growth in Brazil in Q1, profits in the country grew 14% aided by significant margin expansion. Separately, the stock was also impacted by broader issues facing Brazilian equities including the impact of a truckers' strike on Q2 GDP as well as pressures from a strengthening U.S. dollar. With an improving local macroeconomic backdrop and significant margin recovery likely, we remain positive on Ambev's outlook, however given the stock's valuation, we maintained a below-average weight in the stock.

South African equities underperformed materially during the quarter, which detracted from portfolio performance due to holdings in financial services conglomerate Sanlam and retailer Shoprite. The South African Rand depreciated significantly, negatively impacting returns measured in US dollars. In addition, poor sentiment across the emerging markets resulted in weakness across the space. Leading up to this, South African equities had materially outperformed in reaction to the election of the new president in Q4 and hopes for stability and economic reforms. With the weakness in Q2, South African equities retrenched, giving back some of what they had gained earlier in the year. Given the election driven strength in Q1, we had trimmed our South African related positions prior to the weakness.

Sanlam was the second largest detractor from performance this quarter. Slow economic growth in South Africa and concern on the part of the market over the third and final phase of the company's acquisition of Saham Finances (a Morocco based insurer) negatively affected the stock. We view the acquisition favorably given that Saham provides Sanlam with an attractive footprint in the sub-Saharan Africa market which has attractive long-term growth potential and little penetration at the moment. The equity raise to fund the purchase dilutes the shareholders, but it does meet their hurdle rate requirements. They expect to build a life insurance presence in Saham's markets leveraging Sanlam's expertise in the area while also building Specialist and Reinsurance businesses. We expect gradual improvement in the South African macro-economic situation as reforms are instituted but our thesis is not dependent upon material improvement as Sanlam is well positioned to succeed despite ongoing volatility in the country and region's economic growth. We maintained a below-average weight in the stock.

MercadoLibre's stock declined during the quarter after its Q1 results missed optimistic analyst estimates due largely to a hike in its shipping costs in Brazil and the perceived headwind that presents to the company's margin structure as it offers free shipping across its markets. The rising U.S. dollar negatively impacted the Brazilian real and other emerging market currencies. Concerns about the weakening macro-economic environment in Brazil also contributed as MercadoLibre generates a majority of its sales from Brazil and is sensitive to fluctuations in its currency and market. We remain positive on

MercadoLibre's long-term growth opportunity and see the recent price drop as an opportunity given an acceleration in the company's strategy to reduce its dependence upon the Brazilian post service (Correios) and enhance its own delivery logistics. As the company faces increased competition from B2W and others, we expect a greater tradeoff between profitability and growth, but see the company as being attractively positioned to capitalize on the region's continued move toward greater e-commerce penetration given its pole positioning, improving fulfillment and logistics capabilities. In addition, opportunities for the company to build its Financial Technology offerings to better serve its MercadoPago user base through rapidly scalable, highly profitable but less costly merchant financing and payment processing offer another attractive growth avenue over our 3-5 year time horizon. We maintained an average weight position in the stock.

The fourth and fifth largest detractors from portfolio performance during the quarter were **Sinopharm** and **Shoprite**.

Portfolio Changes

Turnover in the portfolio was about average during the quarter, with the sale of Chinese retailer JD.com and Brazilian drug store chain Raia Drogasil, and the purchase of Swiss financial software provider Temenos.

Purchases

Temenos, a leading provider of packaged software solutions to financial institutions around the world, was added to the portfolio. Based in Switzerland, Temenos' software solutions cover mission critical areas such as core banking (retail deposit, mortgage and loan processing), payments, wealth management and other applications. It serves more than 2000 customers across 145 countries, including 41 of the top 50 banks in the world. With much of the software used in the banking industry outdated and internally developed/maintained, there is an accelerating trend toward the use of packaged software to lower costs and to meet the demands of the digital consumers. With packaged software penetration still early, our research shows attractive sustainable growth opportunities over the next 3-5 years for Temenos.

Approximately two-thirds of Temenos' revenues are recurring in nature, consisting of maintenance, SAAS and services revenues. While the license revenues can be more volatile, the company sources 60% of its license revenues from its existing client base, which increases the visibility to the company. Additionally, the company has dominated new sales in the Tier I Financial Institution space over the past five years outside the USA and given the highly risk averse nature of their clients, Temenos has built significant barriers to entry, becoming the "safe choice" for banks.

Among the key risks associated with Temenos, are the likely volatile license sales to new clients that can be difficult to predict. Also, the company has recently expanded to the U.S. market, and needs to successfully go live with its U.S. clients and establish key references. We see reasons to be optimistic on their potential but acknowledge that license sales can vary significantly from quarter to quarter. Cloud application may also present a risk in the long-term by lowering the barriers to entry in the market, although Temenos also has a cloud offering. Other miscellaneous risks include regulatory and execution risks.

Given the attractive long-term opportunity, we established a below-average position in the stock upon weakness on the announcement of a deal to buy Fidessa, which did not materialize due to a competitive bid, and plan to build the position opportunistically.

Sales

JD.com, China's largest retailer, was removed from the portfolio during the quarter in order to make room for the investment in Temenos. With increasing competitive pressures from Alibaba and a less attractive valuation, we determined the long-term growth opportunity at Tenemos was more attractive.

Raia Drogasil, Brazil's largest drug store chain, was sold due to concerns over increasing competition. We had trimmed the position earlier in the year on the same concern, and while Raia Drogasil continues to possess competitive advantages relative to peers given their logistical and CRM capabilities, as well as significant scale, we decided to liquidate the small position to make room for other opportunities.

Outlook

With myriad challenges facing the global economy after years of unprecedented monetary accommodation and strong investment returns for equity markets, we see a probability that markets and returns over the next five years will look very different from those investors have become accustomed to. We have high confidence in the businesses we have invested in, and despite strong absolute and relative returns over the past few years, the portfolio remains well-positioned to outperform as the market transitions from a low volatility, high correlation type environment where sub-par companies have benefited from cheap borrowing and many investors had become complacent in their benchmark hugging and passive strategies.

By its nature, this portfolio is built stock-by-stock based solely on the opportunities our investment process identifies. While our key focus is always on the business quality and growth opportunity a company possesses, the third consideration is always weighing the value of the quality and growth relative to other candidates on our Qualified Company List that we could own. As such, we continuously upgrade the portfolio taking advantage of opportunities in great high-quality growth businesses. While growth as a broad factor has led global markets over the past several years, given the restrained GDP growth most countries have faced over much of the post Great Financial Crisis period, returns have been concentrated in narrow pockets of high growth, particularly in recent years. Our ongoing focus on valuation and the resulting reallocation of capital from less attractive high momentum stocks to businesses with more attractively valued 3-5 year opportunities has maintained the attractive opportunity offered by the portfolio.

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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.