SGA
Sustainable Growth Advisers

Q4 2017 International Growth Commentary

Highlights

- *SGA's International Growth portfolio returned 6.9% (gross) and 6.6% (net) in Q4 2017 compared to 5.0% for its primary benchmark the MSCI ACWI ex-USA Index, and 5.8% for the MSCI ACWI ex-USA Growth Index*

- *Emerging markets continued to outperform developed markets; Asia was the strongest performing region while Latin America lagged*

- *Energy, Materials, and Information Technology sectors performed best while more defensive sectors such as Utilities, Telecommunications and Health Care were weakest*

- *Portfolio performance benefited from strong stock selection particularly in Technology and Financials, while selection in Consumer Discretionary detracted from returns*

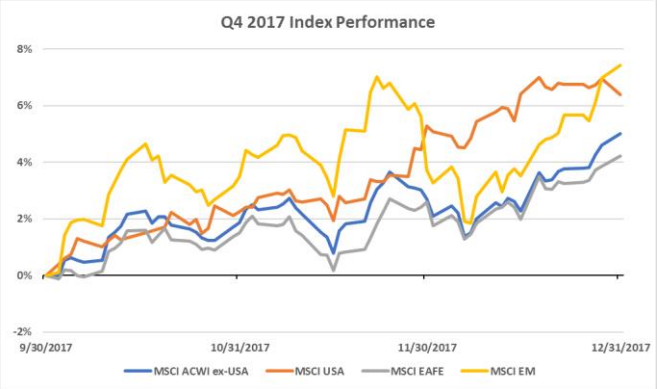
Performance

SGA's International portfolio returned 6.9% (gross) and 6.6% (net) in the fourth quarter of 2017, while the MSCI ACWI ex-USA Index returned 5.0% and the MSCI ACWI ex-USA Growth Index returned 5.8%. For the year, the International portfolio returned 37.8% (gross) and 36.5% (net) compared to 27.2% for the ACWI ex-USA and 32.0% for the ACWI ex-USA Growth.

Markets Rallied on Improving Global Economic Outlook

Q4, and 2017 as a whole, were strong periods for global markets as investors responded to improving global economic growth, rising corporate earnings, tax reform in the U.S., and continued monetary accommodation in Europe and Japan. A favorable global backdrop with better than expected economic growth in major economies such as the U.S., China and Japan encouraged investors to look beyond geopolitical challenges and rising interest rates in the U.S.

Emerging markets, which are most levered to improving global economic growth, performed best amid the optimism. Markets in South Africa (+21.4%), Greece (+13.3%), India (+11.8%) and Korea (+11.4%) were strongest, with Asia being the best performing region. In contrast, markets in Latin America posted the lowest returns for the quarter after leading the emerging markets rally in Q3. Mexico (-8.1%) was the weakest country followed by the United Arab Emirates (-4.6%) and Sweden (-3.8%). Unlike Q3, when commodity rich markets as a whole performed best, in Q4 leadership was more country specific. South Africa benefited from greater certainty following the election of Deputy President Cyril Ramaphosa to be the new leader of the ruling African National Congress (ANC) after a bruising race that had cast doubt over future stability in the country. In Greece, after regaining access to capital markets in 2017, speculation that the country may exit the international bailout program after years of austerity, sparked investor interest. In India, Prime Minister Narendra Modi's ruling party pulled out a win in his home state of Gujarat, increasing the likelihood that key reforms would continue.



Source: FactSet. Performance in USD.

In the Asia-Pacific region, South Korea's economy grew at its fastest rate in seven years in Q3 and its market was among the best performers in Q4 returning 11.4% and over 47% for the year. Continued positive economic data, excitement over the pending Olympic games, some reduction in concerns over North Korea's missile tests, and indications that China may ease travel restrictions which had hurt many Korean businesses benefited South Korea's stock market.

China's equity market returned 7.6% for the quarter, as its Q3 GDP grew at a better than expected rate of 6.8%. While monetary policy has tightened, interest rates have crept up, and lending standards have become more demanding, the deleveraging process has continued to be slow. Household debt remains low relative to many developed economies despite showing significant growth from approximately 30% of GDP in 2012 to 44% in 2017. With the completion of the Fall Communist Party Congress and the consolidation of President Xi's power base, investors became less concerned about the chances for meaningful economic deceleration in China.

Among the major economies, Japan performed best as it reported better than expected Q3 growth, up +1.4% annualized, its seventh straight quarter of expansion and its longest positive

streak since 2001. Four years of fiscal stimulus under Prime Minister Shinzo Abe and extraordinary monetary stimulus benefited growth while inflation remained low.

In Europe, the European Central Bank committed to maintaining low interest rates for the foreseeable future, and announced plans to continue buying government bonds until September 2018. Greece (+13.3%) was the best performing European market in the quarter while other larger developed markets such as the United Kingdom (+5.7%) Ireland (+3.5%), Germany (+2.8%), France (+1.5%) and Belgium (-1.5%) produced lower returns. European returns were largely driven by emerging markets, with several developed countries posting negative returns such as Sweden, Finland, and Spain, and holding the broader region's returns to a little more than 2%. With the reemergence of political uncertainty in England amid ongoing Brexit negotiations, the weak approval ratings of President Macron in France, the surprisingly poor electoral showing of Chancellor Merkel in Germany, the Catalonian separatist movement in Spain, and the specter of Italy's upcoming parliamentary election, exogenous events raised concerns among investors in the region that the economic improvement expected could be negatively impacted.

Portfolio Summary

Global markets performed much as they had for the year in Q4, with the ACWI ex-USA posting another 5%+ return. Markets were led by growth companies with the reward to business quality mixed. Companies with higher returns on equity and earnings outperformed, as did companies with higher debt levels and higher betas. The portfolio benefited from positive stock selection effects, with selection in Technology and Financials contributing most, while selection in Consumer Discretionary detracted most. Sector allocations contributed positively to relative performance due to a large overweight to Consumer Staples and a lack of exposure to the underperforming Utilities and Telecommunication sectors. From a regional perspective, the portfolio's stock selection in non-U.S. developed markets benefited performance as did a large overweight to emerging markets.

Top Contributors

Sanlam was the largest contributor to portfolio performance during the quarter after meeting first half expectations and benefitting from macroeconomic and currency tailwinds. Sanlam's first half earnings update was in line with expectations. While all segments were weak on an EPS basis, RoGEV (Return on Group Equity Value), which is more closely watched by the market, was good. Investment related business segments, such as Sanlam Investments, were weak in the first half, and Santam, the non-life insurance business, was affected by higher claims. Sanlam's emerging markets business was mixed depending on locale, and the South African insurance and corporate and employee benefit business were strong. The company also benefited from strength in the South African market and Rand as Cyril Ramaphosa won the nomination of the ANC, the country's current ruling party, easing some of the macroeconomic concerns that have negatively impacted South African equities. Considering Sanlam's track record of navigating the ebbs and flows of the African macroeconomic environment as well as the secular growth opportunity presented by underpenetrated markets, we maintained an average weight position in the company.

MercadoLibre was the second largest contributor to portfolio performance after a strong Q3 revenues report. The company's free shipping initiative is significantly accelerating user and transaction growth; however, the growth comes at the cost of shrinking margins. Items sold accelerated to 56% growth, Gross Merchandise Volume accelerated to 94% growth in local currencies, total payment volume accelerated to 86% growth and confirmed users grew 21% leading to 61% revenue growth in USD terms. However, gross margins and operating margins dropped due to the costs of free shipping and elevated marketing spending. MercadoLibre's management continues to execute well on their growth initiatives, and while there is some near-term lack of visibility and potential for competition from Amazon, our research indicates MercadoLibre is in a strong position to capitalize on longer-term network effects in e-commerce and payments in the underpenetrated markets of Latin America. Following strong performance to end the year, we trimmed the position in MercadoLibre back to its original above-average weight target.

Chinese video game and e-commerce firm **Tencent** was the third largest contributor to portfolio performance as the company reported strong results with user growth rising 16% to 980 million, revenue growth accelerating from 59% to 62%, and profit growth accelerating to 45%, the highest level in 12 quarters. Videogame revenues grew 48% with continued market leadership supported by a promising pipeline featuring two new games which have already generated over 20 million pre-registrants. We were pleased with the strong level of growth reported in this key segment but expect some moderation in the pace of growth as we model 2018-2019. Advertising revenues grew 48% led by increases in social advertising and we look for re-acceleration in the company's non-social ad growth in 2018 as Tencent completes the consolidation of its multiple ad-buying systems and enhances the ease with which customers can make purchases. Revenues

from the cloud and payments businesses grew quickly, rising 143% as the company continued to increase its market share in the electronic payments business. Our research indicates continued attractive secular growth for the company as it begins to advance its advertising capabilities more and benefits from continued growth in its gaming and social media businesses as well as its burgeoning cloud, payments and international opportunities outside China. Following Tencent's considerable stock price appreciation over the last year, we reduced our position size based on our valuation discipline, but maintained an above-average target weight.

Amorepacific and **AIA Group** were the fourth and fifth largest contributors to portfolio performance.

Largest Detractors

Magnit was the largest detractor from portfolio performance during the quarter. The company reported disappointing Q3 results with traffic down across all its formats, weak gross margins and continued strong competition. New store economics were disappointing as their new stores must now penetrate more areas where competitors such as X5 are already firmly entrenched. We envision increasing costs as the company makes major investments in new growth initiatives, remodeling and redesigning a number of its large stores to transition them to the new hypermarket format, focuses increasingly on acquisitions to augment its growth, and resorts to increased promotional activity in order to gain share. With the payback to such investments longer due to intensifying competition, increased M&A and rising capex and price investment costs, we determined that the thesis had become less tenable and redeployed the capital to other more attractive investment opportunities.

Chinese online travel agency **Ctrip.com** was the second largest detractor from performance in Q4 as it delivered a strong Q3 report but issued more conservative guidance for Q4 due to expectations for reduced cross-selling activity. Specifically, Chinese regulators asked Ctrip.com and other online travel agencies to cease automatically bundling travel insurance and other extras into ticket prices and travel packages. We expect this to be a temporary issue for Ctrip.com and see many ways in which they can exercise their profitability lever to compensate over the long-term. We continue to expect strong growth as the company benefits from the secular opportunity in Chinese travel, its ability to reach customers directly via mobile, expanding its services into lower tier cities and accelerating outbound travel by increasingly affluent Chinese consumers. We added to the position on weakness during the quarter, increasing it to an average weight.

Aon, the leading global provider of insurance and reinsurance brokerage, risk management services, human resources solutions and outsourcing services, was the third largest detractor from portfolio performance in Q4. The company's Q3 report disappointed, despite EPS mostly in line with estimates, due to slowing overall organic growth. Aon cited tough comparisons and a focus on processing claims during hurricane season as reasons for the weakness. Our research indicates a continued long-term growth opportunity due to the company's available capital, success in their current cost savings program and improving growth rate mix and cash flow growth.

Nielsen and **Sinopharm** were the fourth and fifth largest detractors from portfolio performance.

Portfolio Changes

Turnover for the period was in line with expectations. New positions in Air Liquide and New Oriental Education were established, while the portfolio's position in Magnit was liquidated. During the quarter we initiated a position in Nielsen, but subsequently exited the stock later in the period following several developments after our purchase, including the company's annual investor meeting where management expressed a more tempered sales outlook for the Buy business, as well as the announcement of a partnership with Wal-Mart that will pressure the company's margin progress. While such rapid turnover in a stock is very atypical for our strategy, we believed that client capital would be better served by investing in a relatively more attractive opportunity in Air Liquide. Positions in Schlumberger, Ambev and Ctrip.com were added to on weakness, while positions in HDFC Bank, Tencent, Novozymes, Chr. Hansen, and Alibaba were trimmed on strength. MercadoLibre and Amorepacific were both added to earlier in the quarter on weakness, and then trimmed at the end of the quarter on strength, maintaining above-average weight positions.

Purchases

Air Liquide is the largest industrial gas supplier in the world, competing with Praxair, Linde and Air Products and Chemicals. Air Liquide has also established a healthcare logistics business in Europe as well as a technology business in Asia producing specialty gases used in electronics manufacturing. The acquisition of Airgas, the leading merchant gas supplier in North America, gives Air Liquide dominant positions in major markets in both North America and Europe. The oligopolistic nature of the industry, particularly in markets where they have a dominant position such as Germany, France, Poland and Russia, strengthens the company's pricing power.

Approximately one quarter of the company revenues are from large industry clients which typically have 15-year take or pay contracts, and the industrial merchant business operates on contracts which recur. Revenues have been further diversified with the development of the Health Care and Technology businesses, and Air Liquide's acquisition of Airgas provides an opportunity for increased regional strength in North America, as well as continued growth in emerging markets including Asia, the Middle East and Africa which currently account for approximately 20% of sales.

While cyclical risks exist since a meaningful drop in economic activity would cause a drop in gas consumption, these risks are somewhat mitigated by the diversification of the company's revenues by industry and geography, and the long-term contracts present with large industry clients. Financial leverage remains higher than normal after the acquisition of Airgas; however, they are ahead of schedule in realizing synergies and paying off the debt.

The change in growth of the merchant business from flat or down to up mid-single digits may be an indicator of synchronized global industrial improvement, and our research indicates growth acceleration along with global GDP in the merchant business as well as healthcare and technology businesses. We established a below-average weight in the company initially before building it further to an average weight.

New Oriental Education is the largest private educational company in China based on the number of program offerings, total student enrollments and geographic presence. The company offers a range of programs including English test preparation courses for students taking language and entrance exams in the U.S., U.K. and other commonwealth countries, K-12 after-school tutoring for elementary through high school students and overseas school application consulting services, as well as general adult language training courses. Its revenue growth in recent years has been driven mainly by K-12 after school tutoring services, due to Chinese millennial parents' strong willingness to spend on education for their next generation. A strong brand reputation combined with its scale advantages and technology capabilities enhance the company's pricing power. The resulting attractive profit margins allow EDU to attract better teachers and pay them more which, in turn, attracts more students, enhances the brand further and leads to stronger pricing in a virtuous network effect. With competition to enter good schools rising within China, and parents increasingly aware of the benefit EDU's programs can offer, the company's revenue stream is more predictable and recurring. Further contributing to EDU's expected growth is the decision by Chinese authorities to replace individual state created exams with a national-standardized test that should benefit nationally oriented providers who have the ability to expand across more regions. With industry leaders EDU and TAL accounting for less than 5% of market share, the current educational provider market is quite fragmented allowing stronger providers ample opportunity to gain share from smaller, local providers.

Among the key risks we see for EDU are the consolidation taking place within the market and the potential for the company to pay too much or expand too quickly, negatively impacting their teaching quality and their brand, and the potential for advances in online technology. Other risks include policies which create obstacles to obtaining overseas study visas, and the ongoing risk of pandemic outbreaks in China which would likely severely damage the company's revenue stream and lead EDU to lose market share to online educational providers. Considering these risks and the secular growth potential that EDU offers, we established an average weight position in the company.

Sales

As noted above, with the thesis upon which we purchased **Magnit** changing, we determined that other more attractive investment opportunities existed on our Qualified Company List and redeployed the capital.

Summary

Global markets rallied steadily in 2017 as investors rewarded improving GDP and profit growth and anticipated further gains in each. A synchronized reacceleration across major economies and the emerging markets encouraged investors to look beyond debt levels, valuation and geopolitical concerns. Technology and e-commerce related businesses globally outperformed for the quarter and year by wide margins. The International portfolio benefited from strong stock selection in developed markets as well as a large exposure to surging emerging markets which benefited most from the improved global outlook.

We continue to expect improving global economic growth in 2018 but remain cautious about the potential for rising interest rates in developed countries and geopolitical threats to moderate the current level of enthusiasm. At year-end, the portfolio was forecast to generate 17.5% earnings growth over the next three years while the MSCI ACWI ex-USA was forecast to generate 9.2%. With higher equity market valuations, stock volatility at historic lows and investor complacency widespread, we strongly believe that the portfolio's combination of superior

business quality, attractive earnings growth and cash flow based valuation will be rewarded over the long-term.

We look forward to speaking with you in more detail about the portfolio's positioning and performance.

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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.