SGA
Sustainable Growth Advisers

Q3 2017 International Growth Commentary

Highlights

- *SGA's International Growth portfolio returned 6.6% (gross) and 6.4% (net) in Q3 2017 compared to 6.2% for its primary benchmark the MSCI ACWI ex-USA Index, and 6.3% for the MSCI ACWI ex-USA Growth Index*
- *Emerging markets continued to outperform developed markets; Latin America and commodity rich economies such as Brazil, Norway, and Russia performed best*
- *Energy, Materials, and Information Technology sectors performed best while Health Care and Consumer Staples were weakest*
- *Portfolio performance benefited from strong stock selection particularly in Consumer Staples, Financials, and Health Care while selection in Energy, Consumer Discretionary, and Industrials detracted*

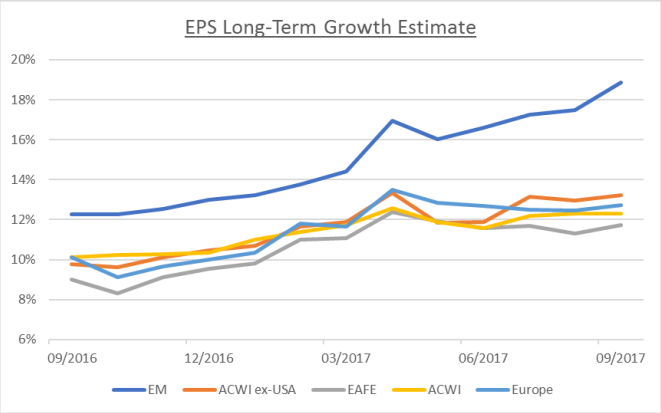
Performance

SGA's International portfolio returned 6.6% (gross) and 6.4% (net) in the third quarter of 2017, while the MSCI ACWI ex-USA Index returned 6.2% and the MSCI ACWI ex-USA Growth Index returned 6.3%.

Emerging Markets Outperform as Earnings Expectations Accelerate and Investor Risk Appetite Increase

Emerging markets outperformed developed markets for the period partially as a result of strength in Latin America where Brazil (+22.9%) and Chile (+16.9%) performed best. Year-to-date, emerging markets have outperformed developed markets by approximately 8% (27.8% versus 20.0% respectively). Given an improved outlook for global economic growth, commodity rich economies such as Brazil, Canada, Norway and Russia performed strongly, benefiting from rising expectations for growth in the U.S., Europe, China and Japan. This synchronized improvement in the outlook for growth across several of the world's key economies benefited "value" as a style and stocks with lower business quality later in the quarter, while growth had outperformed for the majority of the quarter.

As the outlook for economic growth around the world has improved, so have expectations for earnings growth. Investors are increasingly expecting growth to pick up, especially in emerging markets. Over the last year, the long-term growth estimate (3-5-year consensus estimates) for the MSCI EM Index has improved from 12.4% to 18.9%, an improvement of more than 50% in expected earnings growth for markets that still rely heavily on Chinese growth and imports, commodity prices, and favorable movements in the U.S. Dollar given high U.S. Dollar denominated debt loads.



Source: FactSet

Eurozone markets benefited as consumer confidence continued to move higher and unemployment declined to 9.1%, its lowest level since February of 2009. GDP growth for the second quarter showed further improvement as the region grew at an annualized rate of 2.2% from the first quarter, its fastest growth since the first quarter of 2011. While many pointed to the election of Emmanuel Macron as President of France as a rebuke of populism in the region, the narrow election victory of Chancellor Merkel in Germany and new separatist pressures in Catalonia highlighted that such potentially disruptive forces remain a threat to stability in Europe.

China's economy showed better-than-expected strength with second quarter GDP growth being reported at 6.9%, helped by heavy government spending as President Xi worked to further consolidate his position ahead of the country's Communist Party Congress. While positive sentiment boosted returns for Europe and China during the quarter, we believe it is important to point out the benefit the Eurozone economy had gained from a weaker Euro over the last three years. The recent strength in the Euro, however, may be a potential headwind for European exports and manufacturing moving forward. Likewise, the rise in demand from China over the last year as its economy has strengthened has significantly benefited European economies which export heavily to the country. Should Chinese growth begin to moderate following the Communist Party Congress, Europe is likely to eventually feel the effect. While excessive debt loads, manufacturing overcapacity, and negative long-term demographic trends are likely to moderate the pace

of China's economic growth in coming years we continue to identify unique businesses which our research indicates should generate highly attractive revenue and earnings growth over the next 3-5 years.

Japan's economy likewise showed signs of improvement as its exporters benefited from the Yen's decline relative to other major currencies, and continued fiscal and monetary stimulus. Japan has benefited from "Abenomics" as seen in the significant tax cuts over the past four years which have improved profitability, and in turn business spending and capex, while enhancing productivity and increasing employment. Second quarter GDP growth of 4% surprised to the upside as consumer spending grew at its fastest pace since the government's imposition of a sales tax increase in 2014. While growth has improved as a result of government policies, progress remains fragile, as Japan's inflation picture remains below expectations and longer-term headwinds including difficult demographic trends, high debt levels and new geopolitical threats make sustained improvement more difficult.

Portfolio Summary

Equity markets continued higher in Q3 on the back of better-than-expected economic data, continued low asset price volatility, and improving outlook for global growth. While "growth" as a style generally outperformed for most of the quarter, smaller cap companies with higher betas also outperformed. The portfolio benefited from positive stock selection effects, with selection in Consumer Staples and Financials contributing most, while selection in Energy and Consumer Discretionary detracted most. Sector allocation effects detracted from relative performance due in large part to the portfolio's overweight to Consumer Staples.

Top Contributors

Chinese e-commerce leader **Alibaba** posted strong quarterly results with overall revenues up 56% and earnings per share up 62% driven primarily by continued strength in its e-commerce business. Alibaba's mobile monthly active users (MAU) now exceed 529 million, and revenue per mobile MAU continues to inflect upward as the company continues to refine and enhance its mobile targeting capabilities for merchants. Meanwhile, Alibaba's other businesses continue to grow nicely, with its cloud computing business growing its user base by almost 75% and nearing profitability, and other businesses in its Media & Entertainment and Innovation segments gaining traction. Alibaba has also embarked on international expansion, most notably with its increased stake in Lazada, a leader in e-commerce in Southeast Asia. As the stock has appreciated substantially, we have trimmed our position, but maintained an above-average weight, as we continue to expect Alibaba to leverage its formidable advantages to gradually create a seamless shopping experience for Chinese consumers similar to what Amazon is doing in the U.S. and other countries.

Chinese video game and e-commerce company **Tencent** reported strong results with revenues increasing 59% and gross profits up 38%. Videogame revenues grew 39% due to strength in online and mobile games while advertising revenues grew 55% as ad loads continued to gradually increase. Revenues from the cloud and payments grew quickly, rising 177%, and combined WeChat/QQ users grew 19% up to 963 million users. With the company's popular game "Honor of Kings", Tencent's user base experienced gains in non-traditional demographic groups, and in the PC game segment, while its user base stayed relatively constant, a larger proportion of its players elected to spend more on in-game product offerings. As Tencent's stock has appreciated considerably over the last year, we have reduced our position size due to its higher valuation, but we continue to see the company as offering attractive secular growth as it begins to target its advertising capabilities more and benefit from continued growth in its successful game and social media businesses but also in its burgeoning cloud, payments and international opportunities.

Ping An Insurance Group (Ping An) benefited in the quarter from better-than-expected economic growth in China, and global earnings growth showing some signs of improvement. Ping An was originally added to the portfolio to benefit from its million plus professional agents selling Ping An's proprietary products, their enviable position in the quickly growing Chinese auto insurance market where they were a first mover, and growth in their bank which has taken significant steps over the past three years to establish substantial loan loss reserves to address any future weakening in credit quality associated with their legacy institutional loan portfolio. However, given the significant appreciation of its stock price this year, and with valuation becoming less attractive relative to other opportunities on our Qualified Company List, we sold the shares and reallocated the capital.

HDFC Bank and **Chr. Hansen** were the fourth and fifth largest contributors to portfolio performance.

Top Detractors

Amorepacific reported weak Q2 results with the company's sales declining 16% and operating profit down 60% as key travel trends from China continued to be disappointing due to ongoing tensions over South Korea's deployment of the THAAD

anti-missile defense system in response to the North Korean nuclear threat. Its business within mainland China decelerated during the quarter as well, but Amore reported improving trends there later in the period and expects better results by Q4. The company had halted all of its advertising and promotional activity in China to avoid being targeted by the government, but gradually restarted such activity later in Q3. Meanwhile, Amore's domestic business also experienced weakness due to poor tourist traffic in key commercial areas and increased pressure from local competitors. Expectations for the quarter were low given the geopolitical issues impacting its sales, and the fact that it continued to invest during the quarter in additional salespeople, improved digital capabilities, remodeled stores and innovation which contributed to lower margins. While additional weakness in the short-term is certainly possible given the high degree of uncertainty associated with the North Korean nuclear threat and geopolitical tensions, we expect the company to continue to manage through these issues with continued global expansion in China, Southeast Asia and the U.S. In domestic markets, the company continues to invest in digital capabilities to strengthen its e-commerce capabilities amidst changing customer shopping patterns. We maintained an average weight position in the stock.

The second-largest detractor during the period, South African financials conglomerate **Sanlam**, reported their first half of FY2017 results in September, shortly after we established the position. The results showed a strong adjusted return on group equity value (RoGEV) of 16.2%, well ahead of its target of 13.2%. Net results from financial services increased 1% and new business volume decreased 4%, negatively impacted by adverse currency movements, a difficult macro environment, and one-time events. While the results weighed on the stock following our purchase, we continue to view the long-term growth prospects of Sanlam favorably, given the underpenetrated African insurance market, and look to build our position opportunistically on fluctuations in its stock price.

Philippines-based consumer food and beverage company **Universal Robina** was the third-largest detractor during the quarter. Universal Robina was negatively impacted by weak second quarter results, which showed flat organic sales growth and operating profits declining 10%. The lackluster results were anticipated however, given that the company is still recovering from a recent recall of key drink brands in Vietnam, which comprise about 10% of sales, and faces increased competition in its home market, particularly for ready-to-drink coffee. Uncertainty about a potential sugar tax implementation in the Philippines also impacted its stock price in the quarter given that roughly 15% of Universal Robina's total sales are derived from sugary drinks in the country. While we have taken the risk of such an implementation into consideration in our thesis, we remain positive on the company's growth prospects given its strong market position, the growing middle class in the country, and the high quality and recurring nature of its revenue stream. We used weakness in the stock to add to our position, while maintaining a below-average weight position.

FEMSA and **Core Laboratories** were the fourth and fifth largest detractors from portfolio performance.

Portfolio Changes

Turnover for the period was below average. The portfolio's position in Alibaba was trimmed on strength, while positions in Universal Robina, Sinopharm, and MercadoLibre were added to on weakness. The portfolio's position in Ambev was increased based on a positive inflection point in year-over-year cost comparisons and an improving Brazilian macro environment. Sanlam was added to the portfolio during the quarter, while our position in Ping An Insurance was liquidated.

Purchases

South African financial services conglomerate **Sanlam** was added to the portfolio during the quarter. The company operates in 47 countries with approximately three-quarters of its income being generated by its life insurance business, and the balance spread across general insurance, investment management, credit & structuring and other businesses. Sanlam has a history of maintaining capital at sound levels while being able to extract attractive dividends from its life business, and its management team has remained stable with its CEO and CFO both having been with the company for several years. Sanlam generates a high level of repeat revenues due to the long-term nature of the life insurance they sell. 75-80% of their income is considered repeat business. The company also benefits from favorable demographics in most of the markets they serve, excluding South Africa. Insurance penetration is relatively low in most of their markets, allowing them to generate attractive growth given their dominant position. This strong position also provides them with better pricing power in many markets, and helps them attain improved economies of scale. South Africa's market is more mature, but the level of coverage is fairly low and insurance products have traditionally been used more as investment products. Accordingly, an attractive opportunity remains in terms of increasing coverage levels among those already insured, in addition to extending coverage to lower income segments of the population which may not currently have coverage. We also expect the company to benefit from regulatory changes which are expected to result

in lower commissions being charged which should enhance its cash flows, as well as further consolidation in its markets.
We initiated a smaller than average position in the stock and expect to build it opportunistically moving forward. Among the risks facing the company, we remain focused on the political uncertainty in the country, the possibility of lower interest rates in South Africa as inflation eases and the impact on the income generated on shareholder capital, as well as potential adverse regulatory changes which could impact Sanlam's business. On the latter, we believe they are in a position to work with regulators and influence the nature of changes rather than simply being on the receiving end of regulatory change.

Sales

We liquidated our position in **Ping An Insurance** during the quarter and reallocated the capital. With China's GDP growth surprising investors to the upside and global earnings growth showing some signs of improvement, the stock has appreciated significantly this year, and the company's valuation become less attractive relative to other opportunities on our Qualified Company List.

Summary

Emerging markets outperformed developed markets during the quarter, led by Latin America and commodity producing economies such as Brazil, Norway and Russia. These countries along with emerging markets overall, have benefited from increasing optimism over the outlook for global economic growth. As economic forecasts across the world have increased, earnings growth estimates have also increased across both developed and emerging markets. While this optimism and improvement in outlook has benefited markets in the short term, we believe that the higher growth expectations which are now being discounted may prove to be too rosy over the next 3-5 years. With continued geopolitical tensions in Southeast Asia, questions about stability in the Eurozone, uncertainty over the upcoming presidential election in Mexico, and the volatile political landscape in South Africa and other nations, there remain substantial headwinds to sustained, synchronized improvement in global growth. Countries that are still dependent on the Chinese growth engine, favorable U.S. dollar currency movements, and commodity prices, may be more vulnerable to shocks caused by these uncertainties. Given this environment, we expect selectivity based on the fundamental characteristics of companies, such as pricing power, recurring revenues, and long growth runways, to be key drivers of outperformance over our time horizon.

We are enthusiastic about the long-term growth opportunities present in our portfolio companies. While there will inevitably be periods where our strategy will be out of favor due to fluctuating macroeconomic growth expectations or spikes in fear over geopolitical issues, our approach will continue to identify what we see as superior quality businesses that are attractively valued, with above average sales and earnings growth that is repeatable over time.

Thank you for your interest in our team at SGA and our investment approach to international markets. We look forward to answering any questions you may have.
