SGA
Sustainable Growth Advisers

Q1 2017 International Growth Commentary

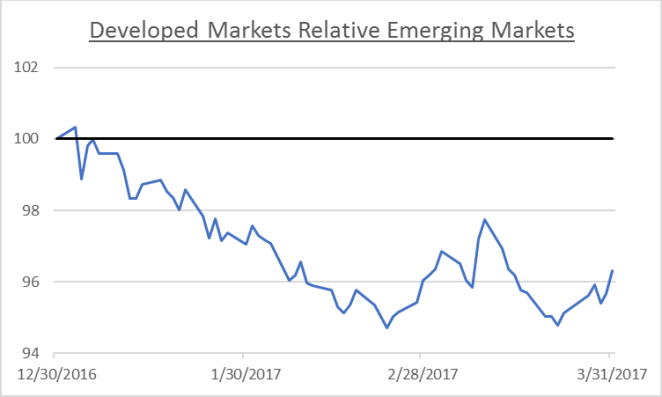
Highlights

- *Emerging markets outperformed developed markets, due in part to a weaker U.S. dollar, moderating expectations for U.S. Interest rates and skepticism over the strength of U.S. economic growth*
- *Emerging Asia markets performed best followed by Latin America*
- *Moderating growth expectations benefited growth stocks; quality factors were generally positive*
- *Technology, Industrials and Consumer Staples sectors performed best while Energy was weakest*
- *Many headwinds to rising global economic growth: U.S. interest rates, oil prices, China, upcoming European elections, trade policies*
- *Expect modest improvement in global economic growth; higher and more predictable growth opportunities likely more valuable, but selectivity to remain key*

Performance

SGA's International portfolio returned 10.3% (gross) and 10.1% (net) in the first quarter of 2017, while the MSCI ACWI ex-USA Index returned 7.9% and the MSCI ACWI ex-USA Growth Index returned 9.1%.

Emerging Markets Regain Leadership



Source: FactSet. Developed Markets represented is MSCI EAFE Index and Emerging Markets is MSCI Emerging Markets Index. Performance in USD.

Emerging Asia, Latin America and Asia Pacific were the strongest performing regions in Q1, followed by Europe. The list of the top five performing markets was led by Poland with a return of almost 18%, followed by India, South Korea, Mexico, and Chile. In contrast, developed nations including the U.S., Japan, Italy, the United Kingdom and Canada, among others, underperformed. Russia and Greece performed the worst during the quarter, with both economies under pressure.

The outperformance of emerging markets relative to developed markets reflected increased confidence by world markets in the ability of the global economy to accelerate its growth. Expectations for improved stability and growth in Europe, a continuation of growth in the U.S. and strong albeit slower growth in China, mitigated fears over impediments to improved emerging market growth. The U.S. dollar weakened as concerns over rising U.S. interest rates, weak European economies and political instability in Europe moderated. Markets became less certain of the Trump administration's ability to implement new tax and regulatory reforms, and enact significant new infrastructure spending. The weaker dollar and reduced apprehension about the pace of future interest rate hikes also benefited emerging market economies flush with dollar denominated debt.

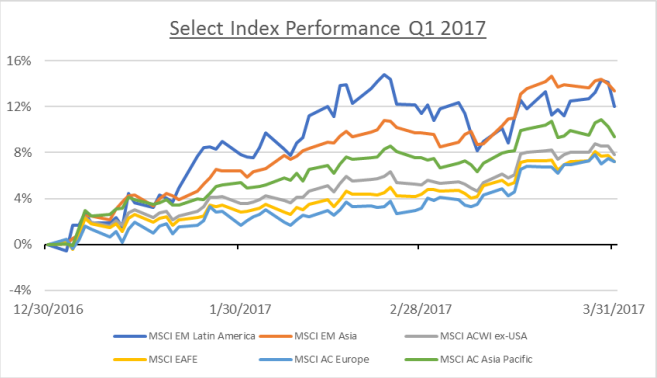
In China, weaker economic data and moves by the government to reign in the stimulus measures of 2015 and 2016 by raising short-term borrowing rates, tightening home mortgage and lending standards and increasing the auto sales tax, gave investors pause. Chinese retail sales growth in January and February slowed to 9.5% year-over-year, a healthy figure by most standards, but did mask a 3-month average which fell to its lowest level in 13 years. Chinese personal income growth slowed to half the 13% year-over-year growth experienced between 2004 and 2012. While stimulus is moderating and growth is gradually slowing, the Chinese economy continues to outpace most others globally and present selective opportunities in high quality businesses that continue to capitalize on that growth.

In South Korea, geopolitical concerns continued as consumers were shaken by a corruption scandal and ultimately the impeachment of President Park Geun-hye. The deployment of the THAAD missile defense system resulted in Chinese government intervention restraining Chinese tourist traffic to

Korea as well as imports from Korea, in turn slowing economic growth and negatively impacting stock market returns for Korean companies dependent on sales to China and Chinese tourists.

In Europe, Dutch Prime Minister Rutte's victory over nationalist candidate Geert Wilders, polls showing French populist candidate Marine Le Pen's declining chances of winning the upcoming French presidential election, and victory by Angela Merkel's conservative party in German regional elections, calmed investor concerns of a nationalist wave sweeping Europe and threatening the Eurozone. Great Britain's triggering of Article 50 of the Lisbon Treaty to initiate its separation from the European Union was met with little trepidation in the markets. A weak Euro and a steeper yield curve prompting an acceleration in bank loans within the region, as well as signs of improving economic activity in Europe, buoyed investors. The March IHS Markit Purchasing Managers Index (PMI) for the Eurozone showed the strongest economic conditions in six years, while the U.S. Composite PMI fell to a six-month low.

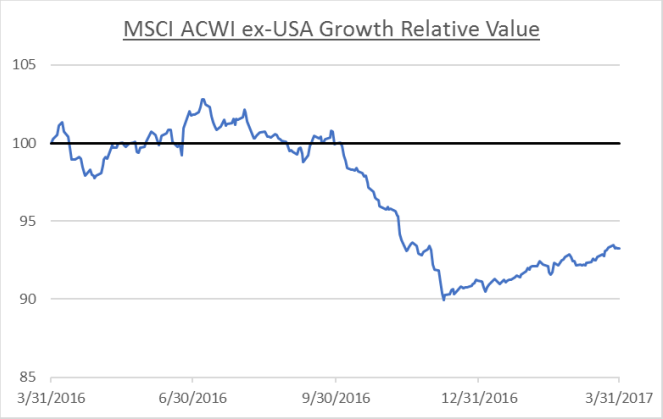
While there is disparity across Latin America in terms of current and prospective economic growth, overall the region was among the best performers during the quarter. Mexico saw consumer and business confidence declining further post the U.S. election on rising uncertainty over the country's trading relationship with its biggest export market. Despite this, Mexico returned 16% for the quarter rebounding significantly from Q4 2016, due in large part to currency swings (returned 6% in local currency). Brazil's economy contracted 3.6% in 2016 after contracting 3.8% in 2015. However, with the political landscape stabilizing after the turmoil surrounding the country's impeachment of its president in 2016, early signs of improvement in the economic outlook, such as moderating interest rates and inflation declining to 6% from 10% in 2016, produced hope that perhaps Brazil was turning the corner. While Brazil did trail the MSCI EM Latin America Index, it still outperformed the MSCI ACWI, returning 10.4%.



Source: FactSet

Portfolio Summary

As investors' expectations for global economic growth have increased over the last year, markets have responded positively leading to strong absolute returns. With an improving economic backdrop, companies more exposed to the business cycle outperformed. However, due to recent moderations in economic expectations, there was a shift towards traditional growth sectors, especially companies that had been out of favor late in 2016. These companies began to outperform in the first quarter of 2017. In contrast to the fourth quarter, the more favorable backdrop led the portfolio to outperform its benchmark helped by strong stock selection, especially in Consumer Discretionary and Financials. The portfolio also benefited from its overweight to the Information Technology sector, whereas stock selection in the Consumer Staples and Energy sectors detracted most from performance.



Source: FactSet

The portfolio's large exposure to both emerging market domiciled companies and companies which generate a large portion of their revenues from emerging markets was beneficial to performance. Stock selection within emerging market

companies also benefited performance, as did stock selection and an underweight to non-U.S. developed companies.

Top Contributors

Following weakness in the fourth quarter related to uncertainty about the impact of the Indian Central Bank's demonetization program, **HDFC Bank** recovered in the first quarter as the banks fiscal Q3 results indicated that while the demonetization program negatively impacted new loan growth and fee growth in the short-term, results were recovering and expected to be back to normal within the first quarter. Although the demonetization program increased short-term uncertainty, we continue to have conviction in the secular growth opportunity ahead for HDFC Bank and project the company to deliver high teens revenue and earnings growth over the next three years.

Wal-Mart de Mexico reported solid Q4 results with comparable store sales up 8% in Mexico and 5% in Central America, outpacing their competitors and consensus expectations. E-commerce sales increased 37% for the quarter, up from the 27% average for the year. Gross margins improved, benefiting profit growth. We expect 2017 to be another good year for WalMex as the company continues to leverage its scale and operational expertise by investing in price, logistics and other capabilities to further extend its competitive advantages. We also expect WalMex to continue to pass through higher food inflation to customers, which should help support its margins and comparable store sales. While moderating GDP growth in Mexico and potential hiccups in U.S-Mexico trade relations pose threats, the company's business is geographically balanced throughout Mexico with more reliance on the central region of the country, and less on the northern region which could be affected more should trade relations between the U.S. and Mexico deteriorate.

Chinese internet retailer **Alibaba** was the third largest contributor to performance during the quarter. The company continues to make investments in strengthening its ecosystem; in early January, the company announced its acquisition of Intime, a top-tier Chinese department store, for $2.5 billion. This is in line with Alibaba founder Jack Ma's statements that the future of e-commerce is in the hybridization of online and offline retail, creating a more valuable experience for consumers and merchants. While in the short-term Alibaba's stock dropped slightly following the announcement of the acquisition, the stock recovered and gained steadily through the quarter, benefiting from a more moderate tone from the White House regarding U.S.-Chinese relations.

Tencent and **MercadoLibre** were the fourth and fifth largest contributors to portfolio performance.

Top Detractors

Russian retailer **Magnit** was the largest detractor from portfolio performance in Q1 following its report of weak operating results amid increased competition and continued weakness in the Russian economy. Reinvigorated competitor X5 continued to open new stores aggressively across Russia's major cities putting pressure on Magnit's market position in certain regions. Higher inflation in Russia has outstripped gains in pension and wages, further squeezing retail customers. While the country's economy was negatively impacted by declining oil prices in 2016 as well as economic sanctions due to its decision to occupy Crimea, the increase in oil prices in recent months should benefit Russia's economy going forward. The company continues to be highly efficient due to its vertical integration, logistics and meaningful scale benefits which provide it with superior margin structures and more attractive pricing power relative to peers. Magnit plans to accelerate store openings and store refurbishments and make changes to mid-level managers and incentives, in order to regain market share momentum. Such changes at the company level, along with a gradually improving macroeconomic backdrop as oil prices stabilize at higher levels, should improve the company's sales and profitability in the coming year. We continue to evaluate the impact increasing competition is having on Magnit's business model and growth prospects looking forward, relative to other opportunities in the portfolio.

Schlumberger was the second largest detractor from performance in the quarter. The Energy sector came under pressure following a decline in oils prices, as doubts surfaced over the impact of OPEC's production cuts given continued high inventory levels in the U.S., and questions surrounding compliance by OPEC and non-OPEC members. The company however, reported a quarter that was broadly in line with expectations and provided a more positive outlook relative to prior quarters. Revenues increased modestly, marking a change from the declines experienced in previous quarters. We expect Q1 to show the first year-over-year increase in the last two years, and expect further improvements in free cash flow generation. Following the completion of its latest round of cost reductions, Schlumberger is more efficient and likely to benefit as oil prices stabilize and companies move ahead with increased capital spending across the globe. Our research indicates that U.S. oil inventory levels are high due primarily to seasonal factors (such as refinery maintenance), as well as excess oil production by OPEC members in the period following the announced cuts, but prior to the cuts being implemented at

the beginning of the year. As such, we remain of the view that the backdrop will improve for the companies we are invested in as we move further into 2017.

South Korean cosmetic company **Amorepacific** was the third largest detractor from returns in Q1. The company reported weaker than expected Q4 results with sales up about 7% amid political turmoil leading up to the recent impeachment of the country's President Park Geun-hye, as well as tension with China related to Korea's decision to allow the deployment of the THAAD anti-missile system, which resulted in China's decision to limit tourist travel to Korea. Domestic sales (32% of total sales) decreased 5% due to a sluggish South Korean economy and increased competition. Duty free sales, which account for 28% of total sales, grew a respectable 7%, and Asian exports (33% of total sales) grew 27%. While the Korean market is likely to stay weak in the near-term, the company has already begun its transition away from domestic markets given that 60% of sales are coming from duty free and exports. The company considers the U.S. market a large opportunity for growth as well and plans to enter it in 2017. While duty free sales to Chinese tourists will suffer in the short-term, we look for the incident to pass and the impact to dissipate as other similar situations have in the past. We increased the position to an average weight.

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

Portfolio Changes

There were several changes to the portfolio made during the quarter with a position in Heineken added and positions in Nestle, LG Household & Health Care, and Shandong Weigao liquidated. In addition to this turnover, positions in AIA Group and Tencent were trimmed on strength. Schlumberger was trimmed offsetting an increase in Core Laboratories and thus maintaining the portfolios total energy exposure. Raia Drogasil, Alibaba, MYOB Group and Amorepacific were added to on weakness.

Purchases

Heineken reported good second half 2016 results with 5% organic sales growth and 8% earnings growth. For the year, the company posted profit growth of about 10% on 5% organic revenue growth, exceeding consensus estimates. Results were boosted by strong sales in Asia-Pacific, the Americas and Europe, more than offsetting weaker than expected results in Africa and Russia. We continue to see the company benefiting from relatively stable recurring consumption patterns across the world, with its geographically diverse base, and its premium pricing power driven by #1 or #2 market shares in 5 of the top 10 premium markets across the world. Our research continues to indicate that Heineken is well positioned to benefit from two of the key secular growth drivers in the global beer market - the premium segment and the developing markets segment which generate higher than average margins. In the short-term, management provided limited guidance for 2017 citing a more uncertain backdrop in Mexico where economic growth is being impacted by concerns over potential trade relations with the U.S., tougher comparisons in Asia and currency pressures, but did express confidence in achieving its annual target of 40 bps of operating margin expansion. Given our 3-5 year time horizon when evaluating candidates for inclusion in our portfolio, this provided us with an opportunity to add the stock at an attractive valuation.

Sales

Nestle was sold from the portfolio due to low top-line growth and limited margin improvement prospects. The company's long standing growth target of 5-6% has been reduced to 4% and margins have significantly improved over the last few years leaving little room for further margin improvements. While Nestle brought in a new CEO from outside the company and unveiled a major new efficiency plan, the transition to this plan and new leadership is likely to be choppy and the benefits may be several years off. We sold the position in Nestle in order to fund more attractive, higher growth opportunities.

LG H&H was sold from the portfolio as we increased our position size in Amorepacific, another South Korean cosmetic company. Both companies have been negatively impacted by the increase in geopolitical tension between South Korea and China arising from the installation of the THAAD missile defense system in South Korea. While duty free sales will be negatively impacted for both companies as Chinese tourist traffic to South Korea slows temporarily, we view Amorepacific as better positioned for long term growth given its larger mainland China presence as well as its increasing sales in other countries. We took advantage of the weakness in Amorepacific and increased the position size in the portfolio to an average weight, and sold LG H&H as a result.

Shandong Weigao was sold from the portfolio in January. We originally purchased Shandong Weigao partially on the basis of their leading market position in medical devices in China. We held the position through a sales force restructuring process amidst increasing competition in their consumables business, which resulted in performance in the consumables unit stabilizing recently, albeit at a lower growth rate as the overall

market growth slowed. Our research indicates that the company's ability to launch new products that have higher value features should enable them to fend off the increased competition to this unit. However, the company's other higher growth business units, orthopedics and dialysis, are faltering due to increased competition as well. To motivate the management of the orthopedics and dialysis units, Weigao sold equity stakes in both units at a discount to internal management of those units. Although incentivizing management with equity issuance makes sense, the equity in the dialysis unit being sold to management brought the company's stake down to only 49%, which we were disappointed to see. While we wait for clarity on the impact of the equity issuance to the orthopedics and dialysis management teams, we exited the position in order to fund other, more attractive growth opportunities.

Summary

The market rally of Q4 continued through the first part of Q1 although the drivers of performance were very different. Emerging market stocks assumed leadership from developed markets as investors began to question the ability of the new U.S. administration to enact the reforms which had caused U.S. and other developed market stocks to rally so strongly beginning last November. Greater comfort with the likely measured pace of U.S. interest rate increases, and less concern over harsher, protectionist trade policies by the Trump administration benefited emerging market stocks, as U.S. interest rates and the U.S. dollar tapered some of their recent strength. Although political headlines in the U.S. have been a major driver of global markets of late, stabilization and signs of improvement in Europe, as well as continued, although slower, growth in China, have helped boost these markets further. We are of the view that the global economy will improve modestly in 2017, but also believe that the euphoria following the U.S. election will continue to be tempered by the reality of governance. As such, periods of renewed optimism will likely be followed by some disappointment amid harsh political rhetoric. As the post-U.S. election rally begins to slow and fluctuate, there will be a greater focus on growth in Europe and the continued saga of "Brexit", in China where there are questions surrounding the pace of future growth, in Latin America where large currency fluctuations and geopolitical events seem to be the norm, and in other emerging economies which are often vulnerable to slowdowns in the U.S. and weakness in oil and other commodities. Volatility, which has traditionally been positive for SGA portfolios, is likely to pick up, and we will continue to avail ourselves of opportunities to enhance the business quality, growth and valuation of the portfolio. With global economic growth likely to remain modest over the next few years, the superior predictability and sustainability of the growth of portfolio companies' earnings and cash flows should be rewarded. As of March 31st, the portfolio is forecasted to generate 13.1% and 21.5% revenue and earnings growth respectively over the next three years, while companies comprising the MSCI ACWI ex-USA Index are expected to generate 4.5% and 12.2% revenue and earnings growth respectively over the same period. Meanwhile, the portfolio remains attractively valued based on our enterprise and discounted cash flow valuation metrics.

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.
