SGA
Sustainable Growth Advisers

# Q4 2016 International Growth Commentary

## Highlights

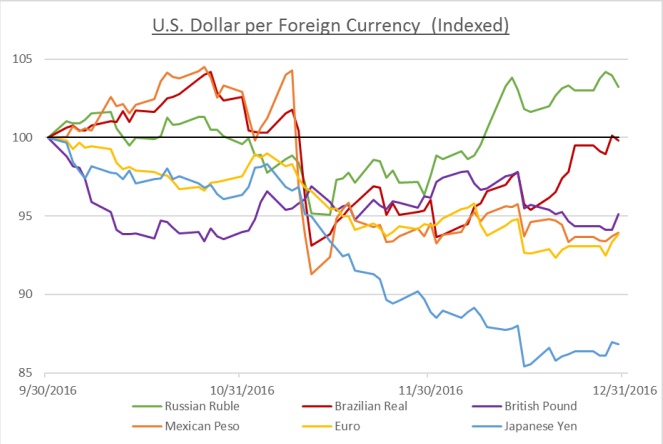
- *SGA's International Portfolio returned -9.9% (gross) and -10.1% (net) in Q4 2016 compared to -1.3% for the MSCI ACWI ex-USA Index and -5.7% for the MSCI ACWI ex-USA Growth Index.*
- *Higher interest rates and a rising U.S. Dollar after the November U.S. election led to a shift from emerging markets leadership to developed markets, with U.S. markets performing best.*
- *Economically-sensitive market segments outperformed; value outperformed growth by wide margin; Energy, Financials and Materials stocks outperformed, while Staples, Health Care and Utilities stocks performed worst.*
- *SGA International Growth companies are forecasted to generate double-digit earnings and revenue growth over the next three years, far exceeding the expectations for the MSCI ACWI ex-USA Index.*
- *Turnover was below-average for the quarter with a position in Raia Drogasil being added and a position in Ambev being liquidated and then repurchased.*

## Performance

SGA's International portfolio returned -9.9% (gross) and -10.1% (net) in the fourth quarter of 2016, while the MSCI ACWI ex-USA Index returned -1.3% and the MSCI ACWI ex-USA Growth Index returned -5.7%. For the year, the International portfolio returned 0.6% (gross) and -0.4% (net) compared to 4.5% for the MSCI ACWI ex-USA Index and 0.1% for the MSCI ACWI ex-USA Growth Index.

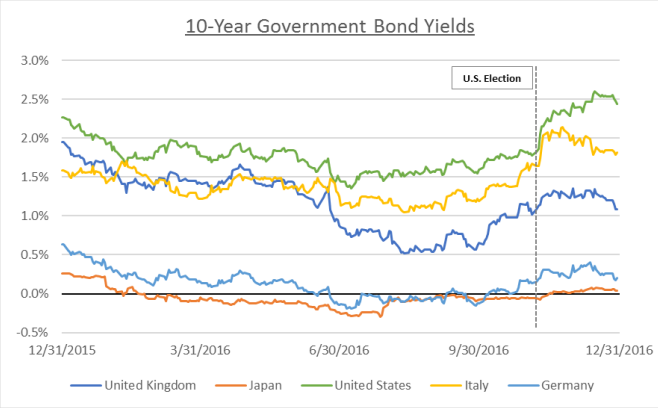
## Cyclical Leadership a Stiff Headwind

SGA's long-term focus on higher quality, more predictable growth businesses was squarely at odds with the advance of industrial cyclicals, money center banks and energy stocks which occurred in the market rally following the November 8th U.S. presidential election. Donald Trump's surprise win, and the ability of the Republican party to hold its majorities in both houses of Congress, unleashed hope for a major pro-growth shift in U.S. fiscal, tax and regulatory policy. This hope and expectation for more reflationary U.S. fiscal policies caused a spike in interest rates and the U.S. dollar rose to its highest level in 14 years relative to other major currencies.




*Source: FactSet*

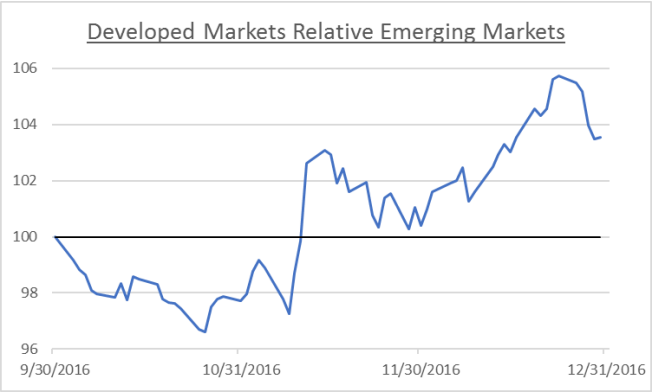
Bond yields had already been rising in the second half of 2016 and the results of the U.S. election accelerated the trend, exemplified by the 20 basis point jump in the 10-year U.S. Treasury yield the day after the election, the largest one-day move since the Taper Tantrum in 2013. Yields in major developed economies such as Italy, Germany, and the United Kingdom spiked as well, with the average Euro-area 10-year yield rising by an average of roughly 50 basis points. In addition, increased skepticism regarding the effectiveness of further monetary easing and the potentially negative implications of rates near or below zero, combined with political uncertainty helped drive rates higher in major developed economies.




*Source: FactSet*

While we concur that more pro-growth policies should enhance U.S. GDP growth in the coming years, we also believe there is danger in extrapolating a commensurate rise in GDP growth outside the U.S., where problems of overcapacity, high debt, and nationalist pressures are likely to continue to temper growth. With China tapering its large economic stimulus, the European Union showing few signs of strength despite quantitative easing, a fragile Eurozone banking system, and a greater likelihood of trade protectionism, there are clearly impediments to growth. Higher interest rates and a stronger U.S. dollar pose significant headwinds to global growth as well, especially with highly levered emerging economies and corporations burdened by large dollar-denominated debts. According to BIS, roughly 10% of emerging market corporate dollar-denominated debt matures in 2017, and as such will either need to refinanced or paid off at a time when currencies have weakened and rates have gone up, potentially causing further distress. Higher borrowing costs and political uncertainty add to the list of headwinds to any significant improvement in global growth.

### Developed Markets Outperform in the Second Half



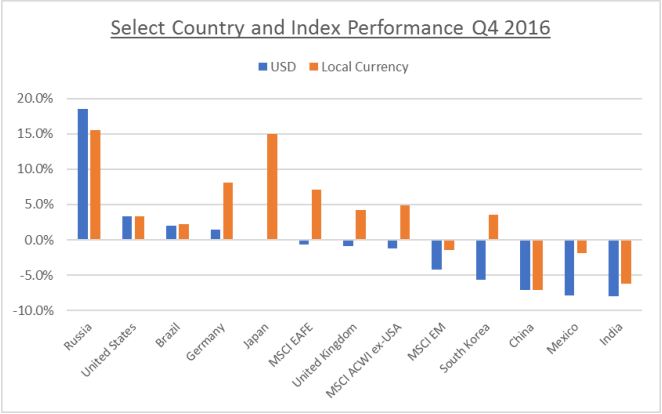

*Source: FactSet. Developed Markets represented is MSCI EAFE Index and Emerging Markets is MSCI Emerging Markets Index. Performance in USD.*

The unexpected U.S. election outcome combined with tighter monetary policies in the U.S. led to a swift change in market leadership as emerging markets swooned in November and December. In developed markets, Italy performed especially well despite political uncertainty relating to a constitutional referendum and a fragile banking sector which is among Europe's most unprofitable since its banks have failed to clean up their loan portfolios and have over 360 billion Euros worth of bad loans currently still on the books. Despite the structural issues, better-than-expected economic data in the region and an ECB bailout of Italy's biggest, and the world's oldest bank, Monte dei Paschi di Siena, led to a relief rally in Italian equities late in the quarter. German, French and Spanish markets also performed relatively well in the quarter buoyed by a pickup in economic activity. Eurozone manufacturing activity accelerated from low levels as indicated by a 68-month high in the manufacturing PMI in December. Inflation ticked up as well in December with average input prices rising at the fastest pace in five and half years. Eurozone firms have largely passed higher input costs on to customers as selling prices for goods and services have risen at the fastest pace in five and a half years. These factors contributed to the outperformance of more cyclically-sensitive areas of the markets during the quarter as expectations for higher growth among some investors increased.

Japanese equities performed well in the quarter in local currency, returning nearly 15%, as a weakening currency and continued monetary support were welcomed by investors who expected it to boost profits for export-driven Japanese companies. The weakening Yen however, led to flat dollar-based returns for the quarter.

In emerging markets, Russian stocks performed best, finishing up about 17% on the strength of higher oil prices and hopes that the new administration in the U.S. may lead to a softening of economic sanctions and better relations between the two countries. In contrast, Chinese stocks finished the quarter down about 8.2% as the country posted GDP growth of 6.7% for the 3rd consecutive quarter, and massive stimulus applied by the Chinese government earlier in the year was removed. The expectation for decline in government spending, after it had accelerated from 8% growth to 22% growth in 2016, put downward pressure on shares of companies around Southeast Asia which are heavily dependent upon exports to the country. Even countries as far away as Brazil were negatively affected as an estimated 20% of that country's exports go to China and Hong Kong.

South Korean equities were negatively impacted by the increased geopolitical tensions in South Asia, driven by North Korean missile tests, Chinese actions in the South China Sea, and South Korea's planned installation of the THAAD anti-missile defense despite Chinese opposition. In India, stocks faced pressure in the quarter as investors became impatient for more economic reform by the Modi government and the country undertook a demonetization program, aimed at taking counterfeit currency out of circulation and curbing the country's "black economy". The notes removed are used in an estimated 86% of all transactions in India, making the transition very disruptive to the economy in the short-term.




*Source: FactSet. Individual country performances represented by MSCI country indices.*

## Portfolio Summary

SGA's International portfolio underperformed its benchmark, the MSCI ACWI ex-USA, in the fourth quarter as market trends were generally unfavorable to our high-quality growth focused approach. Stock selection effects had the largest negative impact on relative returns with selection in Financials, Consumer Discretionary, and Information Technology detracting most from relative performance. From an allocation perspective, the portfolio's large overweight to Consumer Staples detracted most as the sector was the worst performer in the quarter. The portfolio's underweight to the strongly performing Financials sector also posed a headwind to relative returns, while the lack of exposure to the Telecom and Utilities sectors benefited relative returns. The portfolio's relatively large exposure to emerging market companies was another headwind in the quarter, as indiscriminate selling in emerging markets led to short-term pressures on many of our high-quality portfolio companies which are domiciled in emerging economies.

## Top Detractors

Hong Kong based insurer AIA Group, Indian financial services company HDFC Bank, and Tencent, the Chinese internet, media and mobile application leader, were the largest detractors from portfolio performance during the quarter. South Korean cosmetics company Amorepacific and China's ecommerce leader Alibaba were the fourth and fifth largest detractors respectively.

**AIA Group** provided an attractive third quarter sales update showing 25% growth in the value of new business and 17% growth in total premiums. However, the stock was weak in Q4 as concerns over further Chinese efforts to stem capital flight increased, which could negatively impact AIA's Hong Kong business which comprises about 30% of its revenues. In late October, China banned mainland Chinese visitors to Hong Kong from using their UnionPay cards to pay the premiums for dollar-denominated, savings-type insurance policies, further clarifying a $5,000 limit it had set in February on the purchase of life insurance policies in Hong Kong by mainland Chinese.

Approximately 40% of the value of AIA's new business comes from Hong Kong, and the company has benefitted from mainland Chinese purchases of life insurance policies in Hong Kong over the last 12 months, as mainlanders seek to diversify their wealth through purchases of U.S. dollar denominated life insurance policies which are available in Hong Kong. However, given AIA's focus on protection oriented products (versus savings) as well as its emphasis on smaller recurring life insurance policies (versus large one-time payment insurance policies), we expect the impact of the new rule to be manageable and that the company will continue to grow its new business at a double-digit rate. Moreover, AIA's mainland China business, which comprises about 20% of their overall business, has not been impacted by the policy and is growing strongly (50% in 1H16). While we acknowledge some limited impact on AIA's Hong Kong business and the potential for further capital controls, in light of the company's ability to continue to grow at an attractive rate despite this new policy regarding mainlanders' purchase of Hong Kong insurance products, we maintained an above-average weight in the stock.

**HDFC Bank** was the second largest detractor from portfolio performance for the quarter. The surprise currency exchange (de-monetization) in India created turmoil in the local markets and created a short-term headwind for HDFC Bank, caused by uncertainty around the level of lending that would occur in the near future, and how long it would take HDFC to realize potential benefits from the exchange program. This uncertainty surrounding the next few quarters resulted in the stock declining further. With our long-term investment horizon in mind, HDFC Bank will benefit from the currency exchange which will ultimately clean the system and increase economic lending, as well as increase HDFC's pool of low cost funds, resulting in higher net interest margins, and further improving HDFC's pricing power. Despite short-term uncertainties, the long-term thesis is still strong, if not slightly improved, and we therefore maintained our position in HDFC Bank and will look to add to it on any significant weakness caused by the currency exchange early in 2017.

Leading Chinese internet, media and mobile application company **Tencent** reported results highlighted by 52% revenue growth, 38% operating profit growth and 30% user growth as the company continued to capitalize on its key video game

business, growing music and video content subscriptions, attractive payment and cloud computing businesses and a significant advertising monetization opportunity through its different products. Weakness in the stock during the quarter was mainly the result of somewhat softer margins due to the company investing heavily in video content in Q3, and an increase in sales and marketing expenses as the company invested aggressively in its payments and cloud computing offerings. These issues as well as concerns over the likelihood that user growth slows and revenue growth moderates from its hyper-growth levels, as well as macro concerns over the pace of China's economic growth in 2017, lead to weakness in the stock. We remain positive on this very well managed company's long-term growth opportunities in gaming, value added services such as music and video, cloud computing and payments, and believe its advertising monetization opportunity remains highly attractive. We reduced our holding to an average weight position in the stock during the quarter, and will look to add to the position at points when better valuation opportunities present themselves.

**Top Contributors**

Russia's largest food retailer Magnit, oilfield technology supplier Schlumberger, and Dutch energy services provider Core Laboratories were the largest contributors to portfolio performance during the quarter. Ambev, the world's fourth largest brewer, and Aon, the leading global provider of insurance and reinsurance brokerage, were the fourth and fifth largest contributors to portfolio performance.

**Magnit** was the largest contributor to portfolio performance during the quarter, benefiting from a rally in Russian equities driven by a rebound in oil prices, a pickup in global growth, and hopes that the incoming Trump administration would ease economic sanctions. Magnit and other Russian food retailers also benefited in the fourth quarter from a rise in food prices which dipped in the third quarter, easing concerns of price competition among retailers. The company's third quarter results in October highlighted the issue as Magnit missed consensus expectations with weaker sales in part due to lower food prices and fewer store openings. Store traffic was generally up in the quarter, however, the average purchase per customer was down and lower margin items accounted for a higher percentage of sales. The economic environment in Russia continues to be challenging as the current recession and high inflation have hurt consumers, leading to near-term pressures on Magnit's sales and margins and that trend could continue in the near-term. Despite these headwinds our research continues to indicate that the company's structural advantage over its competitors, above-average industry margins and a strong management team focused on profitability makes the company an attractive, high quality, growth company with strong long-term prospects.

**Schlumberger** reported in-line EPS growth and margins to go along with revenues that were consistent with expectations. However, its outlook brightened as oil prices rose due to stronger oil market fundamentals and OPEC's decision to reduce production from member states. Schlumberger's stock price benefited particularly in November following the U.S. election as investors expected energy-related companies to benefit from less stringent government regulation in the U.S. and more capex spending by producers looking to take advantage of higher oil prices. Schlumberger is in a stronger position exiting the weakness in the oil sector over the past year due to its ongoing acquisition activity, a rationalization of its expense structure, enhanced scale and long-term relationships with key producers around the world, and has publicly stated it can return to peak EPS levels on roughly half of the prior peak revenue levels.

While **Core Labs** reported weaker than expected revenue and earnings growth for Q3, and remained cautious in their outlook given corporate reticence toward increasing capex spending plans, the company continued to participate in many significant projects, benefit from increased automation within their business, and see improved uptake of their products and services by clients. As was the case with Schlumberger, the U.S. election and OPEC's decision in November were both beneficial to the stock due to more stable oil prices, the likelihood of less regulation, and the expected increase in output from North American shale producers. We maintained our average weight position during the quarter.

**Portfolio Changes**

Portfolio turnover was below-average during the quarter with Raia Drogasil being added to the portfolio, and Ambev being liquidated in October and re-established in December. Consistent with our valuation discipline, we utilized volatility in the quarter to add to positions in FEMSA, LG Household & Health Care, and Novo Nordisk on weakness, while trimming positions in Aon, MercadoLibre, SAP and Tencent.

**Purchases**

In October, **Raia Drogasil** was added to the portfolio. The company is the largest drug store chain in Brazil with 1370 stores and approximately 12% market share. Raia Drogasil is expected to benefit from growth in the Brazilian pharmaceutical market, as well as market share gains from

continued square footage growth and scale driven economics. The retail drug store market in Brazil is still highly fragmented and economics favor large chains over independent stores, allowing for consolidation of the market in Raia Drogasil's favor. The company's scale provides pricing power over small independent competitors when dealing with pharmaceutical companies. Raia Drogasil sells personal care and over-the-counter products in addition to drugs, and all of these sales are recurring in nature and result in a large volume of return traffic to their stores. The company should also benefit from a significant tailwind from the expected growth of the pharmaceutical market in Brazil, driven by changes in demographics and income levels.

After strong performance in 2016, 2017 is expected to present a more difficult environment for Raia Drogasil due to the potential for governmental drug price increases to lag inflation, and for wage increases to lead inflation. Our research shows that despite these challenges, Raia Drogasil will remain the leader in the growing Brazilian drug store market given its scale advantage and pricing power, and we expect it to benefit from a secular, macroeconomic tailwind as Brazil's economy gradually emerges from recession. We initiated the position in Raia Drogasil at a below-average weight.

Brazilian brewer **Ambev** was sold from the portfolio early in the fourth quarter, but repurchased towards the end of the quarter. This type of trading activity is unusual for SGA's strategy and was the result of specific developments in the quarter in terms of the company's competitive environment and valuation. The decision to sell Ambev followed our reduction in the position at the end of the third quarter which was driven by deteriorating operating results due to a weakening consumer environment and adverse developments in the company's competitive environment. In terms of the consumer environment, rising unemployment combined with continued high rates of inflation resulted in increasing pressure on disposable income which forced management to reduce its expectations for the business for the year. On the competitive front, pressures intensified as a result of improved momentum from competitor Kirin, driven by recent rebranding and repricing initiatives, and Heineken, which is in the midst of a significant expansion of its production capacity and rumored to be interested in buying Kirin. Should the latter occur, it would result in a much stronger competitive threat to Ambev. As a result of these negative developments, we sold the position early in the quarter. Subsequent to our sale, new developments led us to repurchase the stock. First, Kirin agreed to sell one of its major Brazilian plants to Ambev, signaling that its aspirations for further market share gains were limited, while simultaneously enabling Ambev to expand capacity instead of rival Heineken. Second, a key Brazilian state announced more modest than expected beer tax increases for 2017 which could signal a more moderate tax environment overall. Third, the stock price declined by 20% after our sale, creating an attractive reentry point, and we now hold a below-average weight position in the company.

**Sales**

As noted above, we sold our position in **Ambev** early in the quarter before repurchasing a position in December.

**Summary**

While we expect some improvement in growth in the U.S. due to lower tax rates, reduced regulation of business and new infrastructure spending, we are skeptical that global growth will feel an equivalent benefit, and we remain concerned that decisions pertaining to trade policy may in fact have a negative impact on international growth moving forward. With that in mind, we believe it is paramount to focus on the key fundamentals of businesses which provide them the potential to maintain growth, despite difficult economic backdrops. The International portfolio is made up of these businesses which have recurring revenues, pricing power, and long runways of growth.

Today, our International portfolio offers forecast annual revenue and earnings growth over the next three years of 12.5% and 19.7% respectively versus the 3.5% and 9.6% expected for the MSCI ACWI ex-USA and the portfolio is trading at an improved free cash flow based enterprise yield of 3.3%.

We thank you for your interest in SGA, our International Growth portfolio, and our team, and look forward to answering any questions you may have.

---

*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.*