SGA
Sustainable Growth Advisers

Q1 2019 U.S. Large Cap Growth Commentary

Highlights

- *The portfolio generated attractive absolute and relative returns in the Q1 market rebound after providing strong downside protection in the Q4 market sell-off*
- *Despite the strength of small-cap and higher beta companies, stock selection was strong across most sectors and the main driver of the portfolio's outperformance; sector allocations detracted from results*
- *Selection in Consumer Staples, Technology and Real Estate contributed the most to performance while selection in the Communication Services sector was the only meaningful detractor*
- *The portfolio's position in Alliance Data Systems was liquidated and a new position in PayPal was initiated*
- *Positions in Lowe's, Visa, Amazon, Autodesk, Salesforce and FleetCor were trimmed on strength and we added to our position in Abbott on weakness and increased our target weight in Intuit*

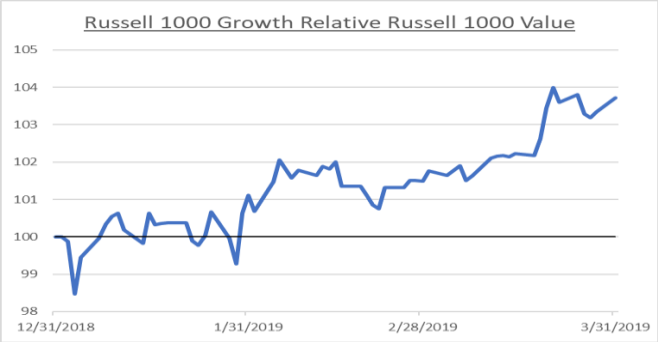
Performance

After outperforming its benchmark by a wide margin in the fourth quarter of 2018, and protecting capital as our approach traditionally has in times of market weakness given our focuses on high business quality characteristics and attractive valuations, SGA's U.S. Large Cap Growth portfolio participated strongly in the market rebound this quarter. The portfolio returned 17.1% (gross) and 16.9% (net) in the first quarter of 2019, while its benchmark, the Russell 1000 Growth Index, returned 16.1%, and the S&P 500 Index returned 13.6%.

Emotions and Leadership Reversals

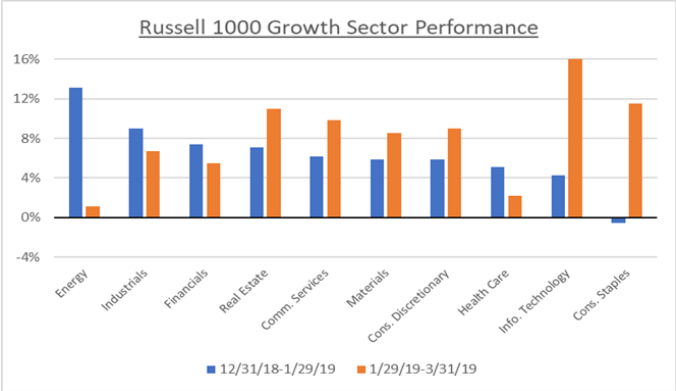
Concerns over rising U.S. interest rates and slowing global economic growth took a back seat during the first half of Q1 as cyclical stocks rebounded strongly leading stock markets across the globe sharply higher in one of the best starts to a new year since the rebound of 2009. Industrials and Energy, areas which were hardest hit in the Q4 market decline, performed best early in the quarter as investors reacted to more dovish comments by the U.S. Federal Reserve regarding future interest rate hikes and renewed hopes for a positive ending to the U.S. – China trade war. The cyclical rebound gradually ran out of steam, however, as worries over slowing global growth re-emerged, leading growth stocks particularly in the Technology, Consumer Staples and Real Estate sectors and those with higher quality characteristics to regain their leadership. While we continue to believe that we are in the early stages of a secular increase in market volatility due to peaking corporate profit margins, rising labor costs, and slowing global economic growth, volatility as measured by the VIX declined 9 straight weeks following its peak in December, marking the first time in history that this had occurred.

While the U.S. economy remains better positioned than most, growing signs of slowing are likely to be of concern to investors at a time when corporate profit margins are at (or very near) peak levels, the pace of employment growth appears to be slowing, manufacturing activity moderates and global growth weakens. With Global PMI's down significantly from year earlier levels, Chinese growth in secular decline despite meaningful stimulus, Europe highly influenced by Chinese weakening and Brexit uncertainty, and Germany with its 10-year Bund flirting with a negative yield, we believe there are ample reasons to expect higher secular levels of global market volatility moving forward despite the recent decline. As we have noted previously, this portfolio has traditionally benefited from rising market volatility since its inception, and we see no reason why that should be different looking forward as the key drivers of business quality, long-term sustainable growth, and our focus on taking advantage of short-term market variations pay off.



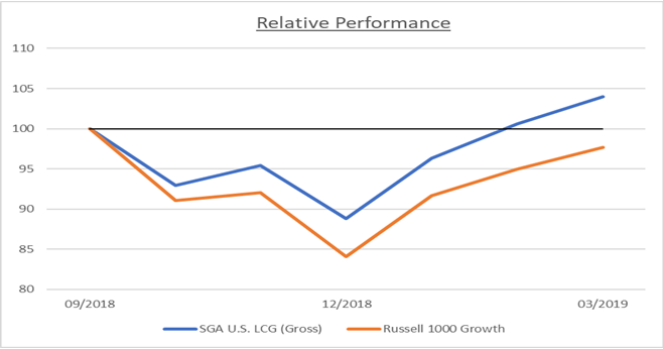
Source: FactSet, Russell Investments.

Reflecting the reversal in the leadership of the Russell 1000 Index which took place during the quarter, Energy and Industrials led the cyclical rebound in stock prices which occurred in January.



Source: FactSet, Russell Investments.

However, as risk appetites moderated beginning in February and running through March, as shown above, more traditional growth sectors regained their leadership. For the quarter, Information Technology generated the best return followed by Real Estate (which comprises less than 3% of the index), Communication Services and Industrials. All other sectors trailed the Index for the overall period, with more defensive Health Care and Consumer Staples underperforming by the widest margins. Smaller cap, value companies with lower quality metrics outperformed during the cyclical rebound early in the quarter which was driven by expectations for lower or at least stable interest rates, and expectations that global trade would get a boost from an end to the U.S. – Chinese trade tensions. As signs emerged that slowing in global growth had reached a level which may be difficult for central banks to reverse in the near-term, risk appetites declined leading to a renewed interest in more sustainable growth businesses that would be able to grow despite global weakening. For the quarter, small caps outperformed despite a significant rebound by large caps in March. Higher beta, growth stocks and companies with better returns on equity, and less debt outperformed, although companies with no earnings also outperformed.



Source: FactSet, Russell Investments, SGA Calculations.

Portfolio Attribution

The portfolio's outperformance was due to strong stock selection across most sectors, with selection in Consumer Staples, Technology and Real Estate contributing the most and selection in the Communication Services sector being the only meaningful detractor. Sector allocations detracted from results due primarily to the portfolio's overweight in Health Care, which was the weakest performing sector in the Index. The outperformance of smaller cap companies through January and February posed a headwind for our large-cap oriented strategy, but the trend reversed in March as concerns over global economic growth rose.

Largest Contributors

FleetCor reported solid Q4 growth with each of its four primary product categories (fuel cards, lodging cards, tolls and corporate payments) contributing to results. Fuel card organic growth was 9%, while its other businesses are expected to grow in the mid-teens for 2019. While organic growth continues to be attractive and in line with our expectations, FleetCor's mergers and acquisitions have traditionally been a meaningful contributor to corporate growth, and given higher prices in the market today, its pipeline of potential future acquisitions is likely lighter. In order to help mitigate the impact of lower M&A, the company bought back approximately 4-5% of the company's shares last year. They have the potential to buy back additional stock in 2019 should they wish. We continue to see FleetCor's long-term growth opportunity as attractive but reduced our target for the stock and trimmed our position given its strong performance and the potential for reduced M&A to impact future growth.

Equinix posted a good report for Q4, with demand for its services remaining strong, particularly in the Asia Pacific region where it signed a new very large deal toward the end of the quarter. Interconnection growth across geographies was strong while the churn in its client base remained in line to lower than expectations. Management guidance for 2019 was marginally below our expectations due to some accounting changes. The company announced a secondary public offering to allow it to lower its net debt ratio by paying off debt, and achieve investment grade status, even though its leverage remains quite low relative to other REIT's. We see the net benefit to the company from the reduction in interest expense more than offsetting the resulting short-term dilution from the additional shares. With the stock continuing to trade at an attractive valuation based on its 2019 AFFO (Adjusted Funds from Operations) multiple, we maintained our position in the stock.

Intuit posted a strong quarter that beat management guidance and our estimates, with revenues up 12% and operating profit growth of 15% driven by strength in QuickBooks and especially accelerating growth in add-on Online Services such as Payroll, Payments, and Timesheets among others. Building on its widely trusted TurboTax offering, the company continues to have early lifecycle growth opportunities with TurboTax Live and other newer offerings. With conservative guidance looking forward, our research continues to point to attractive growth over our 3-5 year time horizon. We maintained our position in the stock during the quarter.

Ecolab and **Autodesk** were the fourth and fifth largest contributors to portfolio returns.

Largest Detractors

While there were no companies that detracted from the portfolio's absolute returns for the period, the following companies were the smallest contributors to performance.

UnitedHealth was the smallest contributor to portfolio returns for the quarter despite the company reporting Q4 adjusted earnings that exceeded analyst estimates and ours. The company's United Healthcare side of the business, which includes its health insurance and health benefits business, performed in line with expectations (except for the segment which serves the Medicaid market where costs related to certain State Medicaid programs came in above plan). The company's Optum business, which is comprised of its physician network, pharmacy benefits manager and healthcare IT services platform, performed strongly across each of its businesses, with margins improving beyond management guidance in OptumCare, backlog growing to $17 million or 13% at OptumInsight, and OptumRx seeing 12% profit growth for the quarter, as management reaffirmed its 2019 guidance. We continue to see attractive future growth for UnitedHealth's integrated healthcare model but acknowledge that the stock will likely be subject to increasing volatility as the 2020 presidential election and health care debate intensifies. While there will continue to be rhetoric during the campaign season over lowering health care costs and improving coverage which may affect the perception of the company's insurance business, we see the actual underlying trend being toward more outsourcing of government health care programs and see UnitedHealth being in a strong position to be a part of the ultimate solution.

Booking's shares declined following the company's Q4 report. The report itself was quite good with 21% constant currency revenue growth and 33% Non-GAAP EPS growth. Booking's decision to pull back on its external search channel spending over the last year, and focus on its own brand development led to an acceleration in direct bookings. The company also released its metrics for alternative accommodations for the first time, showcasing 5.7 million accommodations relative to 6 million for AIRBNB. Additionally, the company noted that 40% of its active customers had booked alternative accommodations over the last 12 months, pointing to improving awareness and demand for such properties. Mitigating the company's strong operational metrics was management's conservative forward looking guidance. With greater unease around the potential impact of slowing global economic growth, and short-term disruptions from political events in Europe, combined with conservative guidance, Booking's shares didn't receive the credit they should have given the company's strong positioning in both traditional and alternative accommodations globally and the attractive profit growth we continue to expect over our 3-5 year time horizon. Given the somewhat more economically sensitive nature of the position relative to other stocks held in the portfolio, we maintained an average weight position in the stock.

Walt Disney reported strong domestic theme park growth and improved margins which were offset by international results dragged down by weakness at Shanghai Disney and Euro Disney where adverse macroeconomic conditions negatively affected both. Consumer products results were also temporarily weak due to fewer movie releases during the quarter, but are expected to improve in the second half of the year. Disney's $71.3 billion purchase of 21st Century Fox's movie, TV studio and other assets including a 30% stake in Hulu officially closed in Q1 of the calendar year, creating one of the largest libraries of high value content globally. With such valuable content including traditional Disney, Fox, Pixar, Marvel, Star Wars, National Geographic as well as its multiple touchpoints with consumers both domestic and internationally across segments, the company stands ready to launch an impressive proprietary subscription streaming service later in 2019. Combine this with its strong sports offerings via ESPN, and our research points to an attractive potential as the company begins to execute its plan to switch its distribution channels and capitalize more directly on its tremendous content advantage. We maintained an above average weight position in the stock during the quarter.

Alliance Data Systems and **Linde** were the fourth and fifth smallest contributors to portfolio returns.

Portfolio Activity

Turnover in the portfolio was somewhat below its long-term average, with the sale of private label credit card issuer and loyalty solution provider Alliance Data Systems and the purchase of leading online payment processor PayPal. We also took advantage of the significant strength in stock prices during the quarter to trim positions in Lowe's, Visa, Amazon, Autodesk, Salesforce and FleetCor while adding to our position in Abbott on weakness and increasing our target weight in Intuit.

Sales

We liquidated our position in **Alliance Data Systems** (ADS) given a deterioration in our investment thesis primarily due to the continued weakness in its digital marketing unit Epsilon. Our thesis for ADS was based on the company's strong private label credit card business, which we thought was a unique opportunity in digital marketing via Epsilon given the unit's rich store of consumer data, and improving results at its Loyalty One unit. While the company's credit card business continues to do well, continued difficulties in its Epsilon unit due to weakness in the consumer-packaged-goods companies it serves weighed on its shares recently. We expect ADS to sell its Epsilon unit and redeploy the proceeds advantageously, however given the deterioration in our investment thesis and more attractive growth opportunities present in the portfolio we decided to exit the position.

Purchases

Leading online payment processor **PayPal** was added to the portfolio in January 2019. PayPal is the leading accepted payment form for online merchants given its strong brand name and customer trust. PayPal's two-sided platform, whereby it serves both customers and merchants, drives both user engagement and trust as well as merchant conversion rates. PayPal is able to earn above-average take rates due to the breadth of services it provides to merchants and better than industry average checkout conversation rates, and has the highest digital wallet acceptance by merchants. Payments are recurring in nature and PayPal's ability to expand both its consumer and merchant base leads to increased stickiness and greater repeatability in its revenues. PayPal has a significant growth opportunity as the company is a beneficiary of the secular trend towards greater e-commerce consumption, the company continues to gain market share driven by network effects from its two-sided platform, and has additional monetization opportunities in some of its earlier lifecycle businesses such as leading peer-to-peer payment platform Venmo.

Outlook

Following the pronounced weakness in equity markets in Q4 2018, U.S. and global markets rebounded sharply in Q1 reflecting a reduction in investor concerns over future monetary policy in the U.S., and signs that an agreement of some sort may be coming in the U.S. trade impasse with China. While the quarter began with cyclicals outperforming in January by a wide margin, over the course of the quarter new data pointed to continued slowing outside the U.S., with Europe remaining weak due to uncertainty over Brexit and the residual effects of the region's close trading relationship with China. While the portfolio outperformed by a wide margin in Q4's weakness, the portfolio's outperformance in a very different environment in Q1 was particularly heartening, given that it was strongly driven by stock selection and a diverse set of businesses ranging across sectors from FleetCor, a leading provider of expense specific payment products, to Equinix, a datacenter REIT, and Intuit, a leader in tax preparation software.

We continue to believe that we are in the early stages of a fundamental transition in the markets where increased volatility and greater differentiation between businesses will be more widely apparent. There will obviously be variations in market sentiments influenced by macro-related issues, but given peak profit margins, rising labor costs, slowing PMI's, and a sluggish global economic back drop, we continue to believe the outlook for high quality businesses that can grow their revenues and earnings sustainably, regardless of the macroeconomic backdrop, is particularly attractive at this late stage of the business cycle.

We thank you for your continued confidence in our team and our approach and look forward to answering any questions you may have.

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before to the inception of SGA and represents the portable performance record established by two of SGA's founders (and investment committee members) Gordon Marchand and George Fraise while affiliated with a prior firm. 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 U.S. Large Cap Growth portfolio for the past year. SGA's earnings growth forecast data is based upon portfolio companies' non-GAAP operating earnings.