Q4 2018 U.S. Large Cap Growth Commentary

SGA
Sustainable Growth Advisers

Highlights

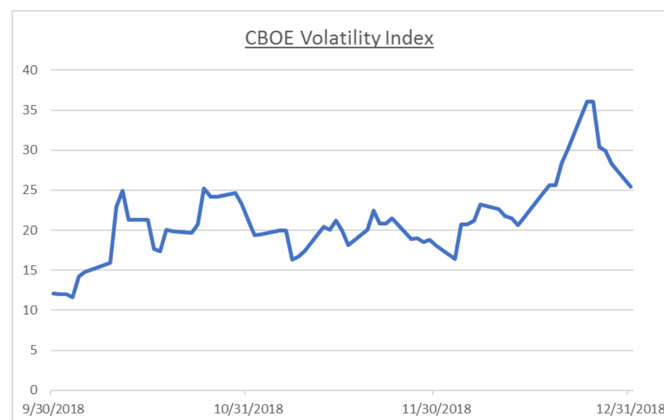
- *As volatility increased, SGA's U.S. Large Cap Growth portfolio returned -11.3% (gross) and -11.5% (net) in Q4 2018 compared to -15.9% for its primary benchmark the Russell 1000 Growth Index, and -13.5% for the broad market S&P 500 Index*
- *Concern over rising interest rates, escalating trade tensions and slowing global economic growth led to a rise in market volatility; U.S. GDP growth remained solid, but slowed from the strong pace of Q2*
- *Larger-cap, value and lower beta companies performed best; the return to business quality was mixed, but generally supportive*
- *More defensive sectors including Real Estate and Consumer Staples as well as Financials performed best while Energy declined by almost 30% and Technology and Communication Services declined by -19% and -17% respectively*
- *Stock selection and sector allocations contributed positively to relative performance; positions in J.B. Hunt, Red Hat and Schlumberger were liquidated and new positions in Facebook and Intuit were initiated*

Performance

SGA's U.S. Large Cap Growth portfolio returned -11.3% (gross) and -11.5% (net) in the fourth quarter of 2018, providing strong relative downside protection amid renewed market weakness, while its benchmark, the Russell 1000 Growth Index, returned -15.9%, and the S&P 500 Index returned -13.5%. For the year, the portfolio returned +4.6% (gross) and +3.8% (net) versus -1.5% for the Russell 1000 Growth Index and -4.4% for the S&P 500 Index.

Greater Uncertainty and Rising Volatility

Investors strongly dislike uncertainty and it showed in Q4. The CBOE Volatility Index (VIX) or "Fear Index" rose from 12.1 at the beginning of Q4 to a high of 36.1 during December as U.S. markets were on track to experience their worst Q4 since 2008 due to growing fears that higher U.S. interest rates and trade tensions would further weaken already tepid global economic growth, negatively impacting corporate profits. After many years of subdued volatility, the increases seen intermittently in 2018 are not surprising and, in our view, are likely precursors of a general rise in market volatility as we continue to move away from the historically low interest rates of the last decade.



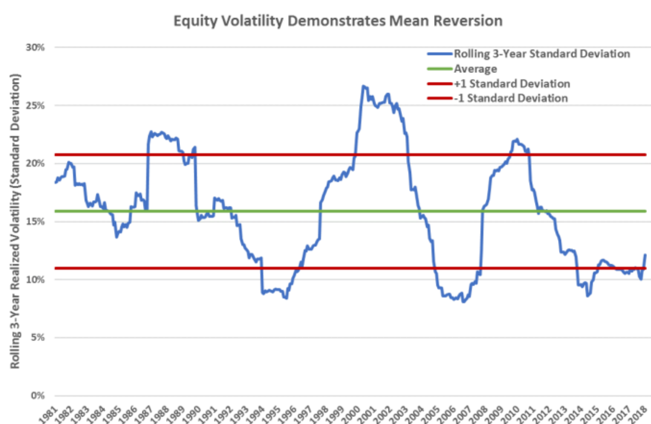
Source: FactSet.

While the economy remained relatively strong, the U.S. equity market weakened significantly in Q4 as investors became increasingly concerned that the current pace of U.S. growth would not be sustainable given continued weakening overseas, higher interest rates and signs that trade tariffs were beginning to impact domestic growth. Signs of weakening in autos, lower homebuilder confidence and, most importantly, reduced consumer confidence contributed to the weakness. This is reflected in the declining earnings estimates for the U.S. market. While the street expects earnings for the broad market (S&P 500 Index) to grow by 7.8% in 2019 according to Factset, this is down from 10.1% at the end of September and down from the estimated 22% earnings growth rate in 2018 when corporate profits benefited from tax changes and the effect of regulatory rollbacks.

Higher labor costs, rising costs for imported materials and weakening growth outside the U.S. are contributing to the slowing in corporate profit growth. There is fresh evidence that China's manufacturing base continues to weaken. On top of that, political uncertainty in France and Germany, Brexit turmoil in the U.K., and slowing among China's regional trade partners pressured many non-U.S. markets. Given these concerns as well as the strength in the U.S. dollar and its negative impact on U.S. multinational results, investors sought more defensive positioning, selling stocks and pushing capital into "safer" alternatives such as government bonds.

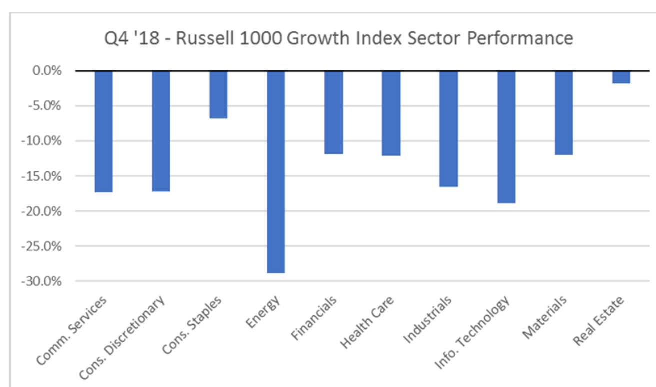
The large increase in market volatility seen in Q4 benefited our approach, as we would have expected given the way our portfolios have traditionally fared in increasing volatility environments. While the portfolio kept pace in Q3's strong market upswing, returning +9.4% (gross) and +9.2% (net)

relative to +9.2% for the Russell 1000 Growth Index, in Q4 the portfolio also performed well, protecting client capital amid the significant slide in stock prices. Overall, for 2018 the markets began to experience increasing volatility early in the year and then again later in Q4 after years of abnormally low volatility, and the portfolio responded as expected. While the change in 2018 has been meaningful, given the low base upon which market volatility increased, and given key changes in the market backdrop, we continue to expect further increases in market volatility. The chart below illustrates the 3-year rolling standard deviation for the Russell 1000 Growth Index over the last decade, and the significant room for volatility to continue to increase off current levels just to reach its long-term average. This should be a beneficial trend for portfolio performance based on the way in which our approach has fared in other increasing volatility environments historically.



Source: FactSet, Russell Investments, SGA calculations. Rolling 3-Year standard deviation of returns based on monthly return observations from January 1, 1979 through December 31, 2018.

Not surprisingly, within the Russell 1000 Growth Index, more defensive sectors including Real Estate, Consumer Staples and Financials performed best as higher priced and economically sensitive sectors such as Energy, Technology and Communications Services performed worst. Portfolio stock selection drove excess returns in the quarter, but sector allocations also contributed positively. Relative returns benefited most from stock selection in the Technology sector, while selection in the Health Care, Consumer Discretionary and Communications Services sectors was also quite strong. In contrast, selection in the Real Estate and Energy sectors detracted. The portfolio's overweight in the weakly performing Energy sector hurt relative returns while overweights in the Real Estate and Materials sectors contributed positively to returns.



Source: FactSet

The reward to business quality varied significantly during the quarter but was generally supportive for the overall period, with companies with higher returns on equity, earnings, lower betas but also higher debt performing best.

Largest Contributors

Open source software leader **Red Hat** received an offer to be acquired by IBM in a deal valued at approximately $33 billion which would mark IBM's largest acquisition ever. The stock rose as much as 50% after the announcement of the offer, its largest jump since 1999. Red Hat is expected to boost IBM's cloud computing business, which is central to management's plan to revitalize the company and return it to growth. With the relatively rich valuation offered by IBM, we deemed that a secondary offer was unlikely and gradually eliminated our exposure to Red Hat during the quarter.

Global health care company **Abbott** was the second largest contributor to portfolio performance for the period. The company reported solid Q3 results with organic sales growth of 7.8% and earnings-per-share growth of over 14% with strength across its Nutrition, Diagnostics and Medical devices segments. Its Established Pharmaceutical business posted 5.9% revenue growth which was a little slower than expected versus quite difficult year-over-year comparisons. U.S. sales, which comprise approximately 35% of sales, grew at 5% while sales outside the U.S. rose over 9%. Our research indicates an attractive runway of growth for Abbott as the company's internal innovation and acquisitions have positioned the company to participate in many growth markets within healthcare such as continuous glucose monitoring, structural heart, and diagnostic testing. We added shares to our position during the quarter, increasing our target weight to an above-average position.

Yum! Brands was the third largest contributor to performance in Q4 as Yum's business continued to rebound from one-time

issues earlier this year the company posted strong Q3 results including upside at Taco Bell and Yum China as a disruption in the company's supply of chicken in the U.K. was resolved. Global system-wide sales increased about 5% in the third quarter compared to approximately 4% in each of the first two quarters, and continues to be on track toward reaching the company's long-term goal of 7% growth, fueled by accelerating unit growth. While Pizza Hut continues to be a trouble spot for Yum, there is reason to expect improvement in the business over time, driven by investments in technology and store operations and improved advertising in the US, as well as a shift in store mix from outdated dine-in units to more contemporary delivery-oriented units internationally. Importantly, while the turnaround at Pizza Hut will take time, the business represents just 20% of total company profits and the challenges in the business are more than offset by strength at KFC and Taco Bell. In addition to reporting strong operating results, the company also hosted an optimistic and well received analyst meeting later in the quarter which reinforced our conviction in the long-term growth opportunity for the company. With a continued strong consumer backdrop in most key markets across the world, earnings growth is expected to accelerate in 2019 as temporary one-time issues recede and the benefits from recent re-franchise agreements strengthen the business. Our research indicates a compelling long-term growth outlook for the business, and we expect the stock to be rewarded for its attractively valued and diversified growth opportunities as well as the high degree of predictability in earnings and cash flow provided by its royalty fee-based revenue stream. We maintained an above average size position in the stock during the quarter.

Novo Nordisk and **Linde** were the fourth and fifth largest contributors.

Largest Detractors

Over the last quarter we determined that our investment thesis for oil service leader **Schlumberger** had materially changed due to the increased lack of revenue and earnings predictability from the company's recent expansion into more capital-intensive and more commoditized areas of oil services. This lack of visibility was highlighted during the recent pullback in oil prices brought about by the oversupply in the oil markets caused mainly by Saudi Arabia and Russia in anticipation of stricter Iranian sanctions that did not happen, requiring a production cut later and further delaying expected increases in capex spending by U.S. and international producers. Schlumberger had forecasted tighter service capacity, which should have led to increased pricing power in the near term, but with less activity, its expanded under-utilized fixed cost base (especially more recently in North America) meant larger earnings misses. Given the significant increase in market volatility and the improved opportunities to invest the capital in Schlumberger in higher confidence, higher secular growth businesses which had become more attractively valued, we sold Schlumberger and redeployed the proceeds.

Alliance Data Systems (ADS) was the second largest detractor from returns in Q4 despite the fact that its Q3 results beat core EPS estimates with strong card services results, continued weakness at its digital marketing unit Epsilon, and improving results at its Loyalty One unit which creates and services loyalty programs for companies across North America. As the third largest and fastest growing private label credit card issuer in the U.S., growing concerns over slowing U.S. economic growth and the potential for it to eventually impact the company's U.S. growth hurt the stock in the quarter. Ongoing disappointment at Epsilon's results and uncertainty over the ability of the company to fix or sell the unit at an attractive valuation added to investor concerns. Our thesis for ADS was based on the company's strong private label credit card business, 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. Today, the firm's credit card business continues to perform well and Loyalty One has rebounded as expected, however Epsilon remains under pressure due to extended weakness among the consumer-packaged goods customers it serves. We expect the company to sell Epsilon and redeploy the proceeds advantageously, however given the increase in market volatility and growing concerns over economic growth, this may impact such a sale. Accordingly, we continue to review the opportunity in ADS relative to other secular growth businesses on our Qualified Company List amid the rise in market volatility and lowered our position target to a below-average weight.

Global E-commerce and cloud computing leader **Amazon** reported strong profitability across its businesses with higher margins in its key Amazon Web Services (AWS) business, as well as lower than expected losses in its burgeoning international businesses. However, the stock declined on the report as sales were a little lower than the street consensus due solely to weakness in international sales and what some considered to be cautious guidance. We were pleased to note that sales in all of Amazon's other business segments were in line with rather high expectations. Likewise, we were pleased with the company's advertising growth and indications that operating margins in its AWS unit may have been an all-time high despite continued price cuts. While we have been disciplined in managing our position size in Amazon given its extraordinary strength over the past few years, we took advantage of the

recent weakness to add to our position, increasing the target given its more attractive valuation. We fully realize that Amazon will not beat expectations and raise guidance every quarter, however we remain highly optimistic about the company's future growth opportunities.

The fourth and fifth largest detractors from performance in Q4 were **Equinix** and **TJX Companies**.

Portfolio Activity

Turnover in the portfolio was in line with our long-term average, with the sale of open source software leader Red Hat, intermodal trucker J.B. Hunt, oil service leader Schlumberger and the purchase of social media leader Facebook and financial management and tax preparation software provider Intuit. We took advantage of market volatility in several instances, reducing exposure to Alliance Data Systems (ADS), TJX Companies and Ulta Beauty, while adding to positions in Google, Equinix and Autodesk, and increasing exposure to United-Health, Ecolab, Yum Brands, Visa, Salesforce.com, Amazon and others.

Sales

Our position in **J.B. Hunt** was liquidated as the company reported strong results with revenues up 20% (and 13% ex-Fuel) as driver shortages continued to support strong pricing. While operating profits grew only 13% due to a higher rate of accidents, poor weather and start-up costs for new relationships, we expect the headwinds from these short-term issues to abate leading to improving margins. However, our concern about economic activity being pulled forward into 2018 from 2019 due to the imposition of higher tariffs also seems to be playing out, leaving the stock's price significantly lower today than where we had sold it. As one of the more economically sensitive growth businesses in our portfolio, we were particularly focused on locking in our gains in the stock as the company reported better than expected revenue and earnings growth, and its valuation began to look less attractive. Accordingly, with the stock being increasingly susceptible to speculation over the pace of U.S. economic growth in 2019, as well as trade related issues, we reallocated the capital to other more attractive secular growth opportunities which presented themselves in the market's weakness.

Red Hat was removed from the portfolio following the announcement of IBM's takeover offer, after we concluded that the likelihood of a higher competing offer was low.

As noted above, **Schlumberger** was sold from the portfolio during the quarter to reallocate the capital to higher confidence, higher secular growth businesses on our Qualified Company List that had become more attractively valued.

Purchases

Facebook was reintroduced to the portfolio during the quarter after significant price deterioration in recent months tied to the overall weakness in Technology and related shares, and the controversies facing the company regarding data privacy, nefarious political advertising and its ability to continue to meet expectations regarding the monetization of the data it collects. With over 2 billion people using its services every day, and over 2.6 billion using its services each month, our research sees the company retaining a tremendous asset in the data it collects and the willingness of advertisers to continue shifting marketing dollars from more traditional venues toward its businesses. Their customer scale, the lack of any true competition, and the frequency of use by their client base provides the strong pricing power and recurring revenue streams we seek in candidate businesses. We expect Facebook to benefit from its scale, and strong portfolio of assets including Facebook, Instagram, Messenger and WhatsApp as well as its fast-following capabilities to rapidly evolve these services to employ the popular Story format and better maintain user engagement. With a valuation opportunity that ranks in the top third of our Qualified Company List, our research indicates that the adverse consequences of possible regulatory changes, a slowing in user engagement gains and higher spending on content, systems and security are likely largely reflected in the stock's current price. Given this, and the company's still fast-growing portfolio of businesses, strong advertising growth opportunity and innovative management team, we saw an attractive basis for reinstituting the position.

The company reported solid Q3 results, consistent with the guidance it provided in Q2, with revenues growing 34%, daily active users rising 10% on a normalized basis and operating profits rising 11% as the company continued to invest in better securing its platform.

While the secular growth opportunity remains attractive to us, we fully acknowledge that the company faces risks tied to user growth and the potential for greater regulation of its privacy and data sharing policies in the U.S. and Europe. Also, trends toward greater video consumption which favor Google's YouTube at the margin will continue to require increased investment in their systems to enhance security over the course of 2019 and possibly beyond. We accept that market share in the global online advertising market, while still growing, will

likely peak over our time horizon while operating margins are likely to decline from their peak of approximately 50% to the mid-to-low 30% level before stabilizing given expected investments in video, systems and security.

We expect to continue building the position opportunistically moving forward.

Financial management and tax preparation software provider **Intuit** was added to the portfolio in Q4. The company's businesses include QuickBooks SMB accounting software which comprises about 50% of its revenues, ProConnect professional tax software which comprises about 5% of revenues today and facilitates accountants referring small to medium size businesses to Intuit's QuickBooks, and its Consumer segment which is highlighted by TurboTax tax preparation software and its nascent Mint and Turbo consumer financial services businesses.

Intuit serves a broad, interconnected ecosystem of customers, accountants, financial institutions and government entities who trust their products to manage highly sensitive financial information. The company has earned its ability to increase the price of its products through maintaining this trust and gradually adding additional functionality to its offerings. This trust, and added functionality, together with the interrelated parties it serves, makes switching from Intuit to a competitor more costly and risky for current clients. Intuit's strong referral network within the accounting market and its significant scale advantages in the data it is trusted with should allow the company to use machine learning and artificial intelligence (AI) to even more effectively automate workflows relative to peers.

As a result of its strong reputation, high switching costs and risks, and its efforts to shift a majority of its small-mid size business accounting clients to recurring online subscriptions, Intuit enjoys a highly recurring revenue stream. These recurring revenues are supported by long runways of growth driven by the longstanding secular trend toward "do-it-yourself" (DIY) tax preparation. Given its dominant position in this and the domestic small-mid financial management market, the company expects to be able to sustain organic double-digit revenue growth and faster operating profit growth over our 3-5 year investment horizon while enjoying high cash flow generation due to its capital light business model and timely billing of subscription fees.

Competition, tax code or filing simplification, management change and seasonality are among the key risks we are monitoring with Intuit. Interestingly, the recent increase in the US standard deduction is expected to be a net positive in that it will encourage more consumers, especially first-time, tech-savvy millennial filers, to begin with DIY and Assisted solutions from the company – rather than ever developing a relationship with a tax accountant. Given Intuit's long runway of growth and its high predictability of revenues, we increased the position to an average weight target.

Outlook

As volatility ramped up significantly in Q4 in response to increased uncertainty over macro-economic and geo-politically oriented issues, the quality and ability of our portfolio businesses to grow their revenues and earnings in a sustainable manner enabled SGA's portfolio to protect shareholder capital relative to index benchmarks. The careful attention paid to valuation and the benefit our companies have in generating strong repeatable cash flows also contributed to this protection, as investors moved away from the high momentum stocks that had led market indices in recent years. We were pleased with the ability of the portfolio to protect capital on the downside, as it has historically. Equally important, we were pleased with the opportunity to take advantage of widespread fear to buy high quality secular growth businesses previously considered to be too expensive, as well as the chance to add to positions in strong franchises that we already owned which had come under selling pressure. The discipline to carefully manage position sizes in strong growth businesses in the good times as investor optimism and momentum driven allocation algorithms drive them higher, together with the willingness to capitalize on volatility and step up to leverage our 3-5 year time horizon to buy, or increase positions in attractive secular growers that our research indicates are temporarily under pressure allows us to generate attractive absolute and relative long-term results for our clients.

After a decade of unprecedented monetary accommodation and high levels of stock correlations, we strongly believe that we are in the early innings of what will be a more volatile environment as investors react to greater uncertainty over U.S. monetary and trade policy, the dollar, the debt ceiling, divided government, and potentially fragile global growth. With an enterprise yield of 4.1% at year end, meaningfully higher than the 3.3% seen at the beginning of 2018, and three-year forecasts of revenue and earnings growth of 9.7% and 17.8% respectively, well above that of the Russell 1000 Growth Index, together with higher cash flow generation, less debt and stronger margins, we are highly optimistic over the opportunity present in the portfolio today.

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