SGA
Sustainable Growth Advisers

Q3 2018 U.S. Large Cap Growth Commentary

Highlights

- *SGA's U.S. Large Cap Growth portfolio returned 9.4% (gross) and 9.2% (net) in Q3 2018 compared to 9.2% for its primary benchmark the Russell 1000 Growth Index, and 7.7% for the broad market S&P 500 Index*
- *Concern over escalating trade tensions between the U.S. and China increased, but was overshadowed by strong U.S. economic data; international stocks and emerging markets in particular felt more pressure*
- *U.S. GDP growth in Q2 posted its strongest gain in years as benefits from recent tax cuts, regulatory reform and repatriation of overseas profits contributed to higher business and consumer confidence*
- *Larger-cap U.S. growth companies performed best along with those with higher betas; the return to business quality was mixed with high return on equity companies and those with earnings outperforming, but those with high debt also outperformed*
- *Technology, Health Care and Industrials performed best; after leading in Q2 the Energy sector trailed the index by a wide margin*
- *A new position was initiated in Abbott while positions in Starbucks and SAP were sold; positions in Ecolab, Estee Lauder, Praxair and Schlumberger were added to on weakness while positions in Autodesk and Ulta Beauty were trimmed on strength*
- *We continue to expect volatility to increase going forward which has historically provided a tailwind for our approach*

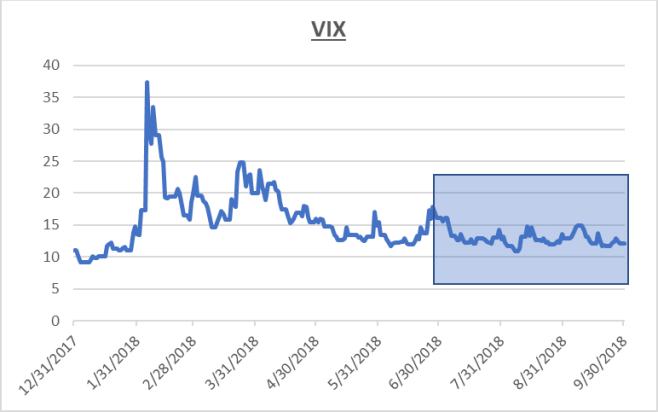
Performance

SGA's U.S. Large Cap Growth portfolio returned 9.4% (gross) and 9.2% (net) in the third quarter of 2018 while its benchmark, the Russell 1000 Growth Index, returned 9.2%, and the S&P 500 Index returned 7.7%. On a year-to-date basis, the portfolio has returned 17.3% (net) versus 17.1% for the Russell 1000 Growth Index and 10.6% for the S&P 500 Index.

U.S. Economic Growth Surged

U.S. GDP growth surged to 4.2% in Q2 (up from 2.2% in Q1), marking the strongest economic growth since Q3 of 2014 and far surpassing the average rate of growth since the financial crisis in 2008-2009. Corporate profits increased 16.1% year-over-year, marking the strongest reading since Q1 of 2012 as companies benefited from strong personal consumption expenditures and business investment spurred by pro-growth tax, regulatory and fiscal policies. With growth looking attractive, unemployment near an 18 year low, but wage growth continuing to be modest, concerns over well telegraphed plans to gradually raise interest rates in the U.S. moderated during the period and market volatility remained low.

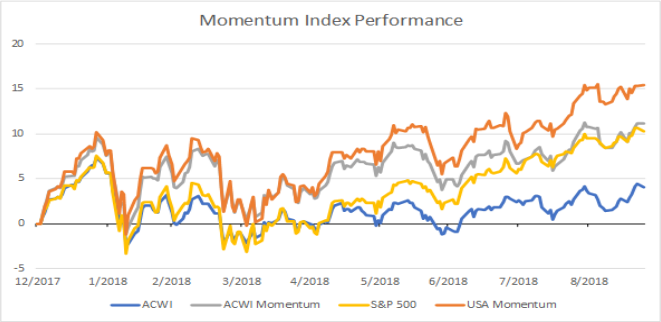
While the U.S. saw attractive economic growth, European economic activity slowed following an expansion in 2017 which was the best in a decade. Poor weather and labor unrest in Germany and France contributed to the weakness, however trade tensions, capacity constraints, political uncertainty and a currency crisis in Turkey also negatively impacted business sentiment and corporate investment in the European Union. Concerns over the impact of slowing growth in China was also on investors' minds given the significant trade relationship between the EU and China. These factors combined with ongoing concern about the lack of a Brexit agreement given the pending deadline negatively affected European stocks. Market volatility remained low in the U.S. due to positive economic news, an agreement with Mexico on an updated NAFTA accord and an agreement with Canada on the last day of the quarter. Resolution of the NAFTA negotiations was cheered by investors as it removed a key stumbling block to trade and economic growth in North America. However, this was tempered by a growing understanding that trade tensions with China would likely extend longer than originally expected and negatively impact global growth.



Source: FactSet.

Key Performance Drivers

The U.S. market performed strongly in Q3 on an absolute basis and relative to the rest of the world. The best GDP growth (+4.2%) in years, strong consumer confidence, high business confidence, and expectations that recent tax cuts, regulatory reform and repatriation will spur further growth over the coming year benefited stock returns. Investors rewarded larger-cap, higher quality stocks as the quarter progressed as concerns over rising interest rates, escalating trade tensions, slowing in European and emerging market growth, and uncertainty over the likely results of the mid-term elections mounted. The momentum trade in the U.S. weakened a bit with the FAANG's returning only 5.5% for the quarter due to weakness in Facebook (-15.4%) and Netflix (-4.4%). It still, however, continued to be stronger in the U.S. than elsewhere given weakness in the Chinese BAT's with Baidu declining -5.9%, Alibaba declining -11.2% and Tencent declining -17.7% for the quarter. Over the 1-year period the FAANG trade returned over 56%, well outpacing U.S. market averages.



Source: FactSet, MSCI.

Within the Russell 1000 Growth Index, a diverse grouping of stocks in the Technology, Health Care and Industrials sectors performed best in Q3 while stocks in the more commodity-oriented areas such as Energy and Materials, and the interest rate sensitive Real Estate sector generated the weakest returns. Stock selection in the portfolio contributed positively during the quarter while sector allocations, which are purely a by-product of selection, detracted. The portfolio's relative return benefited most from stock selection in the Consumer Discretionary, Materials, and Communication Services sectors, while selection in the Technology sector was the largest detractor. The portfolio's sector weights detracted from relative returns due to overweights in the weakly performing Energy and Materials sectors where positions in oil service leader Schlumberger and industrial gas provider Praxair underperformed.

The reward to business quality varied significantly over the course of the quarter but was mixed for the overall period, with higher return on equity, higher debt and higher beta large cap growth companies with earnings performing best.

Largest Contributors

Computer-aided design software leader **Autodesk** posted a solid Q2 earnings report and boosted their forecast amid attractive cloud subscriber growth as the company's digital transition gained strength. Its annualized recurring revenues were slightly higher than what the consensus, and we, expected based on higher average revenue per user. While the transition to a software as a service model will result in some added volatility to revenue and earnings growth metrics in the short-term, our expectation is that it will lead to higher quality, more predictable revenue and earnings growth over our 3-5 year investment horizon.

Yum! Brands was the second largest contributor to performance in Q3 as the stock rebounded from one-time issues tied to chicken supplies in the UK in the first half of the year, unit growth continued its accelerating trend, and management provided a positive outlook on the current quarter. With a strong consumer, and earnings growth which is expected to accelerate in 2019 as temporary one-time issues recede and the benefits from recent re-franchise agreements strengthening the business, the stock appears to be gaining appreciation for its attractively valued and diversified growth opportunities as well as the high degree of predictability of its earnings and cash flow due to its royalty fee-based revenue stream.

Amazon's shares continued to rally in Q3, following a solid second quarter earnings release in July. The company's dominant leadership positions in e-commerce and cloud computing, along with high growth in its advertising revenues and a growing Prime membership customer base provides the company with long runways of growth combined with significant visibility. The company's cloud computing division, Amazon Web Services (AWS), grew 49% in the second quarter and is now a $24 Billion business for Amazon. Advertising revenues also showed continued strength. We remain cognizant of its higher-than-average cash-flow based valuation level and have actively managed our position size accordingly, but continue to view the company's multiple long-term growth opportunities favorably over our 3-5 year time horizon.

The fourth and fifth largest contributors to portfolio performance were **Lowe's** and **Regeneron**.

Largest Detractors

Global oil service leader **Schlumberger's** stock was negatively impacted by a reduction in guidance by competitor Halliburton, which triggered a sell-off for the broader oil service sector. Halliburton's reduction in guidance was tied largely to a short-term slowdown in North American oilfield activity due to a lack of pipeline transport capacity in West Texas to carry away all the oil being produced resulting in a depressed regional pricing environment and a pullback in activity causing oil producers in the region to realize less for their oil. This, combined with fears over the potential impact of trade tariffs on global economic growth and oil demand contributed to the weakness. Our research indicates an attractive 2019 for the company with significant growth in international capex as oil companies have already resumed investments to meet a growing supply/demand imbalance after years of underinvestment. Expected production declines in Venezuela and Iran exacerbate this imbalance while incremental production from current levels in OPEC nations and Russia will be difficult. We see pricing power growing as equipment and service capacity are sold out by year-end, and Schlumberger's restructurings during the downturn supporting higher margins, more positive free cash flow generation and significantly greater earnings growth. We purchased additional shares on the weakness given our positive outlook.

Online travel agency **Booking Holdings** reported strong Q2 results but offered more cautious Q3 guidance which overshadowed the results and put pressure on the stock. Q2 results demonstrated the company's progress in transitioning to a stronger brand with more direct traffic leading to more operating leverage and higher profitability. Organic revenue growth, profit and cash flow growth all exceeded our estimates as well as those of the consensus. 50% of their traffic was sourced directly, representing their fasted growing segment, as opposed to through intermediaries such as Google or metasearch engines as it had been historically. While management is deliberately slowing growth to a degree to focus on higher value, higher margin direct traffic, we are also cognizant that the core growth of Booking's business is gradually slowing due to the law of large numbers. With continued opportunities to enhance monetization and benefits from increased direct traffic, we expect the company's profits to grow in the mid-teens over the next 3-5 years, with conservative guidance by management likely to continue. We maintained an average weight position in the portfolio during the quarter.

Intermodal trucking pioneer **J.B. Hunt** reported strong revenue and earnings growth for Q2 with revenues rising 24% and profits up 31%, constituting some of the best growth the company has seen in the last 15 years. Intermodal pricing exceeded its prior peak in 2006 even as intermodal loads volumes disappointed due to congestion on the Burlington Northern Rail network which is a critical supplier to J.B. Hunt. Trucking loads declined due to driver shortages but saw strong pricing. With the stock responding strongly to gains in pricing and strong revenue and profit growth, we have trimmed our position in the company earlier in the year and are highly cognizant that it may face difficulty in sustaining the level of growth currently being seen. Accordingly, we are closely evaluating the attractiveness of the position relative to other opportunities on our Qualified Company List.

After the three stocks noted above which detracted from performance in the quarter, **Red Hat** and **Praxair** were the smallest contributors to performance.

Portfolio Activity

Turnover in the portfolio was slightly below our long-term average, with the sale of global coffee retailer Starbucks and German software provider SAP, and the purchase of healthcare company Abbott. In addition to these, several other positions were trimmed or added to during the quarter. Specifically, positions in Autodesk and Ulta Beauty were trimmed on strength while shares in Ecolab, Estee Lauder, Praxair, Schlumberger and Yum! Brands were purchased on weakness.

Sales

We liquidated the portfolio's position in **SAP** and reallocated the capital to existing positions in higher expected return holdings Microsoft and Praxair. SAP continues to benefit from its strengthening cloud business and remains on our Qualified Company List.

We sold our remaining shares in **Starbucks** in order to reallocate the capital to fund our purchase of Abbott Labs. Starbucks has been held since the portfolio's inception and provided a very attractive return since its purchase as the company expanded its business globally and showed innovation in bringing coffee and tea drinks to consumers. While we continue to view Starbucks as a very high-quality business, and the stock remains on our Qualified Company List, we became increasingly concerned about its ability to continue growing its comparable store sales at attractive rates in its key markets in the U.S. and China. With the departure of CFO Scott Maw and less confidence in its ability to build its off-hour traffic and innovate sufficiently to grow sales, our research indicated that

the capital could be more attractively invested in other candidates.

Purchases

Abbott is a diversified global healthcare company which has 4 major operating segments: nutritionals (23% of sales), branded generics in emerging markets (15% of sales), diagnostics (25% of sales), and medical devices (37% of sales). Abbott currently operates in 150+ countries, with 40% of its sales coming from emerging markets, 35% from the U.S., and 25% from other developed markets.

We consider approximately 30% of Abbott's businesses to be lower growth businesses which provide steady cash flow and have high barriers to entry, but likely offer limited growth due to maturing markets. Its U.S. nutrition, vascular (stents), cardiac rhythm management (pacemakers) and legacy diabetes (blood glucose monitoring) businesses fall into this category. Abbott's remaining businesses in international nutrition, global diagnostics, emerging market branded pharmaceuticals, continuous glucose monitoring, and some of the other med-tech businesses, are faster growing driven by secular drivers such as demographic trends, pressures to reduce labor costs, the growth of emerging market middle classes and rising consumer demand. Other growth businesses while growing at high rates, don't necessarily offer the high recurring revenues we seek so are not likely reliable growth drivers in the very long-term and we discounted these in our evaluation of the overall business.

While we do not expect pricing pressure in health care to abate over our investment time horizon, we are impressed by Abbott's sustainable growth opportunities and room for margin expansion as the company benefits from cost savings from recent acquisitions of St. Jude Medical and Alere. We expect management to continue to reposition the company to higher growth markets within healthcare, with a rising emphasis on emerging markets and innovation driven growth.

In addition to ongoing pricing pressure and reimbursement risk, mainly in the U.S., risks include the potential for management execution issues as it goes about making and synergizing acquisitions and the competitive nature of the businesses the company operates in. Given the international scope of its growth businesses, trade tensions and currency fluctuations pose additional risks, particularly in the short-term.

We initiated a below average weight position in the stock and expect to build it opportunistically moving forward.

Outlook

The strong absolute returns generated in the U.S. market in Q3 are not surprising given the weaker economic backdrop in other developed and emerging markets. While the U.S. market has been driven by a narrow group of high momentum social media and e-commerce stocks in recent years, this quarter, market leadership broadened significantly with Health Care, a sector which had trailed the indices in recent years, attracting investor attention given its secular growth opportunities and more attractive valuations. With the broadening of the market's advance and the greater differentiation between businesses which contributed to it, the portfolio benefited despite continued low levels of volatility. We expect to see greater differentiation between businesses as the unprecedented monetary accommodation of the last decade recedes. Business quality and considerations of underlying risk, which were overshadowed by the Bernanke and Yellen "puts", will again matter as rising financing costs pressure more levered and sub-par businesses which thrived in the environment created. While the transition won't be linear, we do strongly believe that the new trend toward greater differentiation by investors is securely in place. Adding weakening global growth, continuing geopolitical concerns and the spectacle of rising trade tensions between the U.S. and China to the mix, increasing volatility and differentiation seems likely in 2019 and beyond.

With our continuing focus on underlying drivers of business quality such as strong pricing power, recurring revenue streams, high free cash flow generation and long duration growth opportunities, we are confident that our portfolio companies will benefit in such a change. At September 30th, the portfolio was forecast to generate 18.5% earnings growth over the next three years with superior quality in terms of higher cash flow generation, less debt and better profit margins with a more attractive cash flow based valuation than its benchmark. Combine this with the strong downside protection our approach to growth investing has historically provided and we are truly excited by the opportunity the portfolio offers looking forward over the next several years as markets readjust to the post quantitative easing environment.

Thank you for your continued confidence in our team and approach.

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Results are presented gross and net of management fees and include the reinvestment of all income. The Net Returns are calculated based upon the highest published fees. The net performance has been reduced by the amount of the highest published fee that may be charged to SGA clients, 0.75%, employing the U.S. Large Cap Growth equity strategy during the period under consideration. Actual fees charged to clients may vary depending on, among other things, the applicable fees schedule and portfolio size. SGA's fees are available upon request and also may be found in Part 2A of its Form ADV. The performance record presented for periods prior to July 1, 2003 occurred 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.