SGA
Sustainable Growth Advisers

Q1 2018 U.S. Large Cap Growth Commentary

Highlights

- *SGA's U.S. Large Cap Growth portfolio returned 1.2% (gross) and 1.0% (net) in Q1 2018 compared to 1.4% for its primary benchmark the Russell 1000 Growth Index, and -0.8% for the broad market S&P 500 Index*

- *The quarter incorporated two distinct periods with January and February being led by higher price momentum stocks despite a brief 10% correction, followed by a major decline in Technology and related stocks in March; the portfolio underperformed when price momentum was rewarded but outperformed amid market weakness capturing just 88% of the downside and ranking in the 7th percentile of the Lipper Large Cap Growth Universe*

- *Increasing inflationary expectations and fears over higher than expected interest rates combined with growing concerns over protectionist policies in the U.S. and the potential for increased regulatory oversight in parts of the social media industry put pressure on stocks and caused a spike in market volatility*

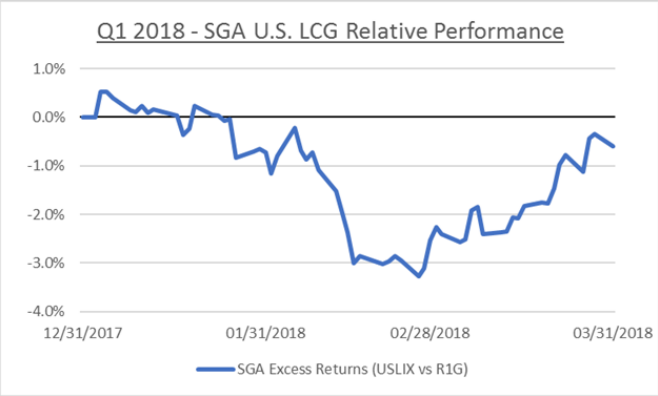
- *Smaller-cap growth companies with higher betas performed best; the return to business quality was mixed with low return on equity companies and those with no earnings outperforming, but those with lower debt also doing well*

- *The Financials and Consumer Discretionary sectors performed best in Q1, but Technology led for most of the quarter until facing intense selling pressure in March; weakness in Telecommunications, Energy, Materials and Consumer Staples negatively impacted market returns*

- *Positions in Core Labs, Chipotle Mexican Grill and Cerner were sold and new positions in Praxair and Becton Dickinson were initiated; positions in Facebook, Red Hat, Core Labs and others were reduced on strength and positions in Walt Disney, Regeneron, Equinix and Alphabet among others were added to on weakness*

Performance

SGA's U.S. Large Cap Growth portfolio returned 1.2% (gross) and 1.0% (net) in the first quarter of 2018 while its benchmark, the Russell 1000 Growth Index, returned 1.4%, and the S&P 500 Index returned -0.8%. The quarter began strong with trends (historically low volatility and high return to price momentum) evident in Q4 continuing into Q1 and the Russell 1000 Growth Index up over 7% in January and setting repeated new highs. The market briefly corrected 10% in February on interest rate and trade fears but quickly rebounded. Technology led the market in the period prior to the correction and again in the rebound, but weakened significantly in March on profit taking and news of the improper use of Facebook client data by a third party and the jawboning of Amazon by the President. Both issues raised concerns over increased government regulatory oversight in the Technology sector and related areas.



Source: FactSet. Performance presented is that of the U.S. Global Leaders Growth Fund (USLIX) relative to the Russell 1000 Growth Index.

Overall, Financials performed best (behind Utilities which have a miniscule weight in the index) on positive regulatory news and rising interest rates while Consumer Discretionary stocks performed well due largely to significant appreciation by Amazon and Netflix. "Bond proxies" in the Telecom, Real Estate and Consumer Staples sectors performed poorly as inflationary expectations rekindled and interest rates rose making their high dividend yields less compelling.

The portfolio's Q1 relative performance was driven by three main factors:

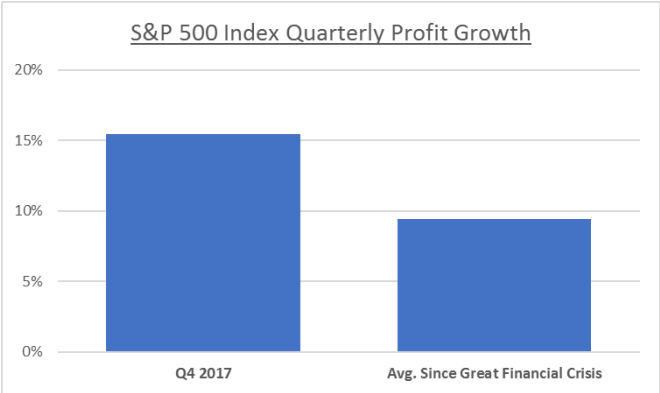
1. Underperformance in January and February as the momentum trade continued to drive Technology and related stocks higher

2. Outperformance and strong downside protection in March as market volatility increased and Technology and FAANG stocks which had led the market over the last year declined

3. Stock specific disappointments at Chipotle Mexican Grill which negatively impacted our investment thesis for the company and resulted in the sale of the position

Strong Corporate Profit Growth but High Expectations

The Bull Market turned nine years old, recording a 372% increase from the broad market's financial crisis trough on March 9, 2009. While the rebound in the economy has been slower than normal, in the last year the unemployment rate has fallen to a 17-year low and the pace of global growth has accelerated boosting estimates for corporate profit growth significantly.

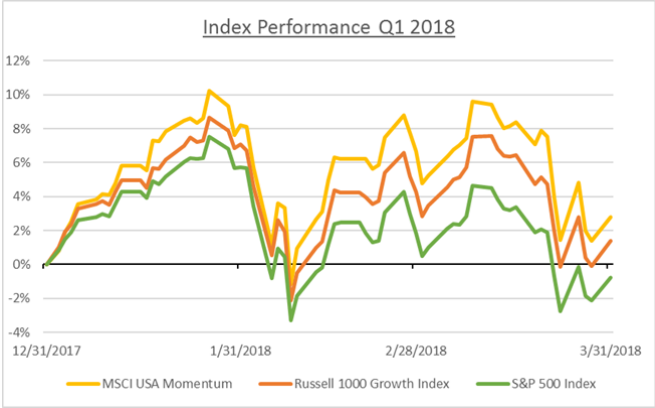


Source: FactSet. Avg. Since Great Financial Crisis measures the period from Q3 2009 to Q4 2017.

Analysts boosted their forecasts for earnings growth for 2018 to +19% versus +12% at the beginning of the year. For the 12-month period ending in February, corporate earnings growth for the broad market S&P 500 Index was on track to rise at the fastest pace seen since 2011, and forecasts for Q1 were meaningfully higher. Companies reporting positive revenue surprises hit 77%, their highest level since FactSet began tracking such surprises in Q3 2008, and the number of companies raising their guidance also set new records. Reflecting the prevalent nature of surprises, however, the reward to positive revenue surprises was low in Q1 with over half the companies reporting surprises seeing declines over the following 4-day periods.

Momentum Stocks Outperformed in January and February

Like Q4 and indeed all of 2017, stocks with the strongest price momentum led the market's performance in Q1 as the MSCI USA Momentum Index returned 2.8% to surpass the returns of the Russell 1000 Growth Index and the broad market.



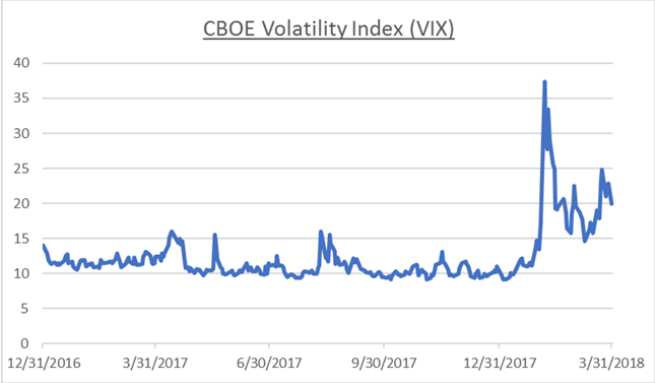
Source: FactSet.

In March, however, the momentum trade gave way to fears regarding increased government regulation in high growth social media and e-commerce companies, as well as increased concerns over the potential for a trade war with China, which would likely have a larger impact on Technology and related businesses. Our decision to reduce our weightings in these stocks in Q4 and Q1 on strength and not to own higher valuation technology stocks which do not meet our fundamental investment criteria such as Netflix, Tesla, NVIDIA and others that had previously driven strong index performance benefited the portfolio's relative performance significantly later in the quarter.

Market Volatility Increased

Following an extended period of historically low levels of volatility, the VIX experienced the largest one-day percentage increase in its history when the index jumped 116% on February 5th to close at 37.3. (This absolute level remains relatively low compared to the index' all-time high of 80.9 reached in November of 2008 but marked a substantial short-term increase.) For the quarter, the VIX rose 81%. The market set an all-time high on January 26 before experiencing its first correction since the beginning of 2016, following strong employment and wage data that fueled inflationary expectations and raised the potential for more aggressive interest rates hikes. The S&P 500 Index dropped 10.1% from its high on January 26th, and the Russell 1000 Growth Index fell 9.9% before recouping most of their losses as investors again refocused on improving earnings. While the broad market experienced only eight daily moves of 1% or more in all of 2017, it experienced 23 such days in Q1 alone. While admittedly short, during that time period, the portfolio protected client capital on down days, capturing just 88% of the downside and ranking in the 7th percentile of the Lipper Large Cap Growth Universe. We view the increase in volatility positively, as

historically our investment approach has benefited in such periods when we have been able to take advantage of shorter-term emotions, buying quality growth businesses that are temporarily priced more attractively.



Source: FactSet.

Key Performance Drivers

U.S. markets outperformed non-U.S. developed markets which were dragged down by weakness in European shares, but trailed emerging markets which were viewed as being more levered to improving global economic growth. The reward to business quality in Q1 was mixed, and the strong performance of high price momentum stocks presented a headwind (as in Q4) for our process for much of the quarter due to our valuation discipline and decisions to continue reallocating capital to more attractively valued growth opportunities. Stock selection in the Health Care sector was the main area of weakness due to positions in Regeneron, Novo Nordisk, and Cerner, and the portfolio's overweight in Energy stocks detracted. In contrast, the portfolio's overweight in the strongly performing Consumer Discretionary sector contributed positively to results. Stock selection in the Materials and Energy sectors also contributed positively. We continued to carefully manage our position sizes in strong performers such as Amazon and Red Hat to manage valuation risk and use weakness to rebuild positions in high quality growth opportunities which came under pressure.

Top Contributors

Amazon reported another strong quarter with its Web Services business sales growing 45% year-over-year (slightly better than in Q3) as margins improved and advertising growth continued to improve. The company's retail segment reported strong results, in line with aggressive expectations in the market. Overall, company sales increased 38% in Q4. Our research continues to support holding an above average position in Amazon given its dominant position in the evolving Web Services business, its highly disruptive strategy across many facets of retailing and the tremendous range of opportunities for its businesses across the globe. While we have high expectations for Amazon, we continue to be cognizant of the fact that it encompasses rapidly growing businesses with a need for investment, and a management team that, to their credit, focuses on the long-term opportunity, which isn't always consistent with the short-term focus of Wall Street expectations. Accordingly, we continue to manage our position in the stock taking advantage of shorter-term volatility to adjust our position.

Leading open source software solutions provider **Red Hat** reported attractive revenue growth in Q4, up 23% year-over-year as subscription revenue for the quarter grew 22% and billings growth rose 25%. The company raised its Q1 and FY 2019 guidance more than expectations while its backlog grew to a record $2.7 billion, up 28% from year earlier levels. It is clear that companies have become increasingly more comfortable with the benefits of Red Hat's hybrid cloud infrastructure and other open source software technologies. Subscription revenues comprised 89% of total revenues. We remain encouraged by the increasing interest being shown in the company's Open Shift technology platform which allows developers to easily build apps that can run on any infrastructure – whether on a private cloud or any of the public clouds - that use OpenShift. With it, continued vibrant growth in its hybrid cloud model, continued growth in OpenStack and improving operating leverage as the company digests recent acquisitions, we expect Red Hat to generate high-teens revenue growth and approximately 20% earnings growth over the next three years while generating increasingly attractive levels of free cash flow. Given the stock's recent strength and the expectation for fluctuations in short-term billings growth over the coming year we have trimmed the stock to an average weight position.

After being one of the larger detractors from portfolio performance in Q4, computer assisted software design leader **Autodesk** was one of the largest positive contributors to performance in Q1. The company reported strong annualized recurring revenues, and attractive growth in its billings and deferred revenues, generating better than expected cash flow from its operations. Subscription plan average recurring revenue increased 106% compared to Q4 of 2016, and total recurring revenues at the company comprised 93% of Autodesk's total revenues, up from approximately 86% in Q4 of 2016. A key metric, average revenue per subscriber, increased nicely and the company reiterated its guidance for 2018. Autodesk continues to make progress in its transition from its traditional license-based model to its new software-as-a-service

model. Our research sees increasingly attractive free cash flow generation over our 3-5 year time horizon as the company continues to execute on its strategic plan. We added to the stock on weakness in Q4 given our long-term positive outlook for the company, and maintained the position in Q1 as it reported progress in its transition to a higher quality SAAS based business.

The fourth and fifth largest contributors to portfolio performance were **Salesforce.com** and **Booking Holdings** (formerly Priceline).

Largest Detractors

Marketing and loyalty solutions provider **Alliance Data Systems** (ADS) was the largest detractor from performance. The company reported results that were better than expected but their guidance for 2018 revenues and earnings was slightly less than expected due to lingering impacts from hurricanes in late Q4 and their higher than expected reinvestment of tax benefits into the business. The company's private label credit card unit reported a standout quarter, but management cautioned that Q1 results may be "noisy" due to hurricane impacts and steps they are taking to bring their collections operations in-house. The company's digital marketing unit, Epsilon, which assists retailers in personalizing their marketing efforts via data driven techniques returned to growth after facing difficulty over the last couple years due to pressures on its traditional ad agency business and a change in product focus. Loyalty One, which designs and implements loyalty programs for a wide range of consumer businesses reported attractive results with improved profit margins and record bookings for 2018 after a disappointing 2017. Late in the quarter, the stock's performance was negatively impacted by fallout from investor concerns stemming from Facebook's data privacy and sharing policies, although initially we do not expect the impact to be material for ADS's business. We maintained a less than average weight position in the stock and did not add to it on the Facebook related weakness pending an evaluation of the likely impact to their data driven marketing unit's growth outlook.

Chipotle Mexican Grill's Q4 earnings report included a disclosure that traffic had declined by 3% during the quarter. Trends to start Q1 appeared equally weak. The longer than expected depression in traffic trends it is experiencing following the Norovirus outbreak in Sterling Virginia last summer is creating significant pressure on restaurant-level profit margins, as sales recover slower than expected and labor and occupancy inflation grows. As a result, we revised our financial forecasts for the company down to reflect lower than expected margins. The changes impacted our forecasted profitability for Chipotle's existing store base, and the expected financial returns from new units. This is likely to lead to a lower level of future unit growth.

The bigger implication from evidence of weaker than expected traffic growth was that the brand equity of Chipotle has proven to be less resilient than we had thought, especially with continued negative social media chatter. As a result, we anticipate less pent up demand from the customer base to return to the restaurants as sales initiatives including improved service levels, enhanced digital engagement, and menu innovations are rolled out. The delayed recovery in traffic trends also increases the likelihood that customers will experiment with competing restaurant concepts likely causing some to shift their behavior patterns, and increasing the risk of a more permanent loss in the company's customer base. Should this occur, their ability to reach the superior unit economics they had enjoyed in the past will increasingly come into question.

Following a Man Overboard Drill, we decided to liquidate the portfolio's position in Chipotle Mexican Grill as a result of a breakdown in our investment thesis for the company as noted above. The damage from food safety issues had always been identified as the top risk to our investment thesis for the company, and the Q4 earnings report confirmed the threat. After analyzing the latest information and conferring with the company, we reached the conclusion that the investment thesis had been significantly impaired and that our clients' capital could be invested more effectively in other opportunities which had become more attractively valued amid the market's volatility. Proceeds from the sale were used to add to existing positions in ADP, Yum! Brands, Equinix, Novo-Nordisk, and UnitedHealth.

Similar to last quarter, biopharmaceutical **Regeneron** reported solid results, which beat analyst estimates, however the stock underperformed as concerns persisted over competition to their key product Eylea. The company guided to continued major investments in new product research and development and product launches. Earnings per share grew 72% while revenues rose 29% during the period with Eylea sales in the U.S. growing 11%, and sales of Dupixent, the company's treatment for atopic dermatitis, showing good strength on its launch. Additionally, early in March, the company announced that its hypocholesteremia drug Praluent cut the risk of cardiovascular death in a high-risk patient population in a long-term trial, setting the stage for improved growth for the drug. While we acknowledge the likelihood that Eylea, which treats patients with different forms of elderly eye diseases, will face increased competition, we remain confident based on indications from

the likely competing drugs, that it will remain a front-line therapy for patients, and that the reduction in sales will be manageable given Regeneron's evolving pipeline of new drugs. Accordingly, we used weakness in the stock price to buy shares and maintain our target weight.

The fourth and fifth largest detractors from portfolio performance during the quarter were **Ulta Beauty** and **Facebook**.

Portfolio Activity

Turnover in the portfolio was slightly higher than our long-term average, with sales of oil service provider Core Labs, casual dining chain Chipotle Mexican Grill and medical IT provider Cerner funding new purchases in specialty gas provider Praxair and medical technology company Becton Dickinson.

Sales

We consolidated our position in the energy sector by selling specialty services provider **Core Labs** and adding to larger global oil services leader Schlumberger, which we expect to benefit more as international capital expenditures increase with rising exploration and drilling. Core Labs reported strong Q4 revenues and exceeded our earnings expectations as their business benefited from improved operating leverage, rising margins and attractive gains in free cash flow generation. Strength at Core's Production Enhancement business boosted results with revenues up 56% from the prior year. North American well completions grew 49% in Q4 as Core Labs helped customers get more from their existing wells. We continue to expect the company to capitalize on its growing strength in the North American market, but believe Schlumberger offers better risk/reward at these price levels in terms of its greater exposure to increased international oilfield investment.

We had begun reducing our position in **Cerner** early in Q4 due to valuation concerns. While the company remains well positioned to help its clients navigate the transition in health care reimbursement toward a more value-based approach, we expect improving revenue growth to be mitigated to an increasing degree by margin pressure. As Cerner's lower margin service businesses constitute a larger proportion of the company's business, growth in profitability will likely be limited until key new opportunities in software used for population health management and revenue cycle management reach critical mass. Finally, we were disappointed by the company's recent CEO selection and question whether he is the best person to guide the company to its next leg of growth. As a result of these concerns, we chose to sell our remaining shares and redeploy the capital to other more attractive growth opportunities.

As noted, above, we eliminated our position in **Chipotle Mexican Grill** following another disappointing report by the company and the conclusion of a Man Overboard Drill where we reexamined the key supporting factors for our thesis and determined that the stock no longer met the expectations necessary to remain in client portfolios.

Purchases

Praxair is growing its sales across North America, Europe, South America and Asia serving both industrial and non-cyclical businesses (i.e. food and beverage). With approximately 90% of its businesses generating recurring revenue streams, the oligopolistic nature of its market, and pricing power that benefits from its favorable logistics infrastructure and willingness to co-locate its operations close to its customers, the company provides more predictable and sustainable growth than most industrial businesses. With only three global players remaining after the completion of the Praxair/Linde merger, we expect to see improving operating leverage and backlogs as the business benefits from consolidation and continues to recover from the global industrial recession which began in 2013. Improvements in industrial production and capex spending due to the recent tax law changes and their stimulus to the economy should be beneficial for Praxair. Meanwhile, efficiency programs instituted by the company to control costs and enhance cash flow are expected to increasingly pay off. Moving forward, we expect the company's combination with German based Linde AG, a global manufacturer of industrial gases, to generate significant revenue and cost synergies, enhance cash productivity and pave the way for meaningful cross-selling opportunities and large share buybacks. With Linde's greater exposure to emerging markets, we expect the growth rate of the combined firm to be enhanced. The European Union has extended its anti-trust review of the deal to August 9, 2018, but we expect it to ultimately be approved with the stipulation that the merged company will divest some businesses to ensure sufficient pricing competition in their markets. We initiated a below-average weight position in the stock during the quarter with the expectation that we would build it opportunistically moving forward.

Among the risks we continue to monitor are the potential that the company's Linde transaction is disallowed, or regulators impose requirements for asset sales which may reduce the attractive synergies we expect. Being one of the more economically sensitive businesses we are invested in, we are also cognizant that fluctuations in expectations for global

growth will affect the stock's short-term performance periodically.

Becton Dickinson is a global leader in a wide range of disposable medical products such as syringes and needles. Approximately 95% of its revenues are tied to consumable products and are highly recurring. While the company's products are relatively low in price, because the cost of failure is very high (i.e. patient safety), the company has been able to maintain a dominant global market share, which is supported by reliable and high-quality manufacturing on a global scale. The large-scale manufacturing gives Becton an effective competitive cost advantage relative to peers, making it more difficult for others to compete effectively. With the ongoing development of health care systems across the emerging markets, Becton Dickinson stands to benefit from an increasing use of medical services that require its consumable products.

Among the key risks we are monitoring with regard to this investment are the degree of pricing pressure in its markets, its execution in a recently completed merger with CR Bard, and its ability to innovate to keep its portfolio of products fresh. We initiated a below average weight position in the stock during the quarter and plan to build it opportunistically moving forward.

Market Outlook

Expectations for U.S. and global economic growth and corporate profits have increased significantly over the last year as U.S. fiscal policy has become more supportive and global economic data has improved. Increasing signs of inflation in the U.S. and abroad have begun to stoke inflationary expectations and cause U.S. interest rates to rise. The reduction in monetary accommodation and resulting higher borrowing costs for businesses and consumers, are likely to offset some of the benefits expected from recent tax and regulatory reforms. The imposition of new trade tariffs and uncertainty over the fate of NAFTA pose further threats to the benefits from tax and regulatory reforms discounted by the market. A transition away from the "free money", low inflation, "goldilocks" economy of the last decade supported by a Fed "put" option which reduced the potential for significant market downside, is underway. This fundamental change in the market backdrop leads us to expect greater volatility as market participants adjust to the new environment and reprice risk.

While we expect U.S. and global growth to improve in 2018, we remain mindful of the lofty expectations which exist in the market. The potential mismatch between expectations and realities, and strong reward to high price momentum stocks over the last year, has increased the risk inherent in the market. While it hasn't shown significant benefit in recent years in a market buoyed by historically accommodative monetary policy, we are in a transition phase where the downside protection offered by the greater predictability, long runways of growth, high cash flow generation and attractive cash flow based valuation of our portfolio should begin to matter a lot more. With relative performance improving throughout the quarter as market volatility began to increase from historically low levels, we are excited by the opportunity for the portfolio looking forward. Over the next 3 years, the portfolio is forecast to generate 20.4% earnings growth versus 15.2% for the Russell 1000 Growth Index and 11.3% revenue growth compared to 7.6% for the Index.

We appreciate your confidence in our team and investment process and look forward to answering any questions you may have about the quarter.
