SGA
Sustainable Growth Advisers

Q4 2017 U.S. Large Cap Growth Commentary

Highlights

- *SGA's U.S. Large Cap Growth portfolio returned 5.4% (gross) and 5.2% (net) in Q4 2017 compared to 7.9% for its primary benchmark the Russell 1000 Growth Index, and 6.6% for the broad market S&P 500 Index*

- *Equities responded to improving earnings growth and the rising likelihood for tax reform, generating strong absolute returns; stock dispersion (as measured by the cross sectional volatility of the constituents of the Russell 1000 Growth Index) continued to be low*

- *The payoff to business quality was mixed; higher return on equity companies and those with higher betas were rewarded while companies with earnings underperformed as did those with lower debt*

- *The portfolio's relative performance was negatively impacted by our attention to valuation and the reallocation of capital to holdings deemed to offer more attractively valued forward looking 3-5 year earnings growth, as price momentum delivered its best performance since 1999 in 2017*

- *Market volatility, historically a tailwind for the relative performance of our approach, reached record lows in 2017*

- *The Consumer Discretionary (+10.6%) and Industrials (+10.1%) sectors performed best while Health Care (+0.8%) trailed all other sectors by a wide margin; stock selection in the Consumer Discretionary and Financials sectors detracted most from performance while sector allocations had a marginal impact*

- *A position in State Street was sold on strength as banks benefited from rising expectations for regulatory relief and new positions in YUM! Brands and Walt Disney were initiated; positions in J.B. Hunt, FleetCor and Alphabet were reduced on strength and positions in Autodesk, Regeneron, Ulta Beauty and Schlumberger were added to on weakness*

Performance

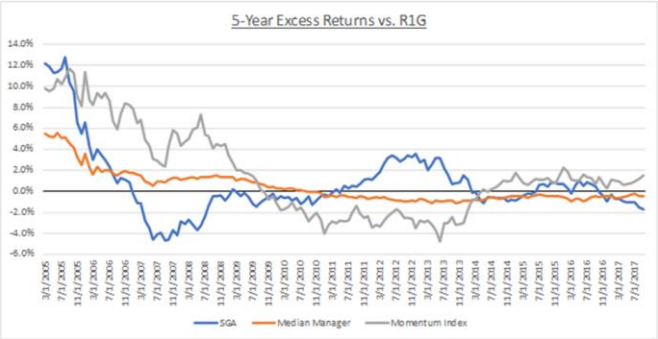
SGA's U.S. Large Cap Growth portfolio returned 5.4% (gross) and 5.2% (net) in the fourth quarter of 2017 while its benchmark, the Russell 1000 Growth Index, returned 7.9%, and the S&P 500 Index returned 6.6%. In 2017, the portfolio returned 26.5% (gross) and 25.6% (net) compared to 30.2% for the Russell 1000 Growth Index and 21.8% for the S&P 500 Index. Q4 and 2017 saw multiple market record highs as investors responded to improving corporate earnings, the prospect of major individual and corporate tax reform in the U.S. (which became law in late December), a sizeable reduction in the regulatory burden for businesses and the expectation that monetary tightening would be gradual and not disruptive. On top of this, indications that federal government spending would increase in 2018 after years of sequestration also benefited equities and helped offset investor concerns over geopolitical challenges on the Korean peninsula and in the Middle East, a flattening yield curve, rising delinquencies for student debt and auto loans, and the fact that consumers, while spending freely, were doing so by reducing their savings (from 6% of GDP two years ago to 3.2% today). A favorable global backdrop with better than expected economic growth in China and Japan further buoyed returns. U.S. markets trailed non-U.S. and emerging markets which were more levered to the rising tide of economic optimism benefiting global equity markets.

Strongest Momentum Market Since the Tech Bubble

Roughly $3.9 trillion was added to the U.S. equity market's capitalization during the year, with about 20% of it coming from the so called "FAANG" companies: Facebook, Apple, Amazon, Netflix and Alphabet. The MSCI USA Momentum Index posted its strongest return in 2017 (+37.2%) since 1999 when it returned +40.3% following four years of unprecedented strength. For the year, Technology (+38.8%) was the strongest performing sector in the broad market, contributing nearly 40% of the S&P 500's return. On a global basis, Technology stocks also played a leading role in lifting Chinese markets, with Baidu, Alibaba, and Tencent being primary drivers and spawning their own acronym ("BAT's"). Non-U.S. stocks in the technology/e-commerce fields had a tremendous impact on some U.S. portfolio returns during the year, with the Wall Street Journal reporting in early December that 89% of U.S. Large Cap Growth portfolios holding shares in Alibaba were beating their benchmark as opposed to only 52% of those which did not hold the stock.

Within the Russell 1000 Growth Index, Technology (+41.5%) performed strongly for a majority of the year, while Financials (+31.6%) and Industrials (+31.4%) provided the next best returns, as investors anticipated regulatory and tax reform to significantly enhance their profitability. Technology, Financials and Industrials were the only sectors to outperform the index for the year although all sectors, except Energy (-6.7%) and Telecom (+4.8%), provided attractive double-digit returns given the synchronized global expansion which became more apparent as the year progressed.

In more exuberant, momentum oriented markets SGA's approach tends to generate attractive absolute returns as our stocks also benefit from the markets' optimism. However, consistent with our focus on taking into account cash flow based valuation, in such periods we are typically actively reallocating capital from stocks that have become less attractive due to valuation to other stocks which our research indicates have a more attractive forward looking 3-5 year risk/return profile. This often hurts our relative returns in the short-term, but our experience has shown, sets up greater opportunity over the long-term. The chart below illustrates the low correlation (12.4% R-squared) our excess return generation has to momentum markets over time, and the high correlation (75.9% R-squared) the median manager's excess return generation has to such markets. We believe this is due to the fact that our portfolios are built from the bottom-up based solely on the forward-looking opportunities we identify. With no more than 30 stocks, they look very different from the index benchmark and we accentuate that by actively reducing or replacing positions in outperformers where valuations have become less attractive with those that the market hasn't yet fully embraced.

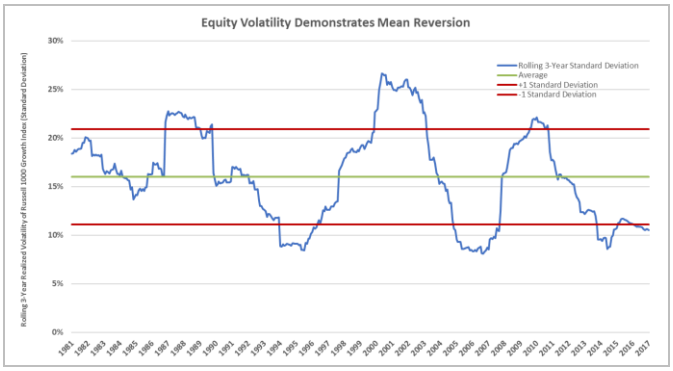


Source: FactSet, SGA Calculations. Data for the SGA U.S. Large Cap Growth portfolio. Median Manager from the Investment Metrics U.S. Large Cap Growth Universe. Momentum Index is the MSCI USA Momentum Index.

There is no guarantee that such a relationship will persist in the future, but given the continuity of our team and our approach, and our clear focus on owning attractively valued high quality long-term secular growth businesses, we are comfortable in saying that this type of return pattern is consistent with our expectations.

Equity Volatility Remained at Historic Lows

As investors became increasingly optimistic regarding the economic outlook, the cross-sectional volatility of stocks in the Russell 1000 Growth Index remained low. Historically, the portfolio's relative performance has suffered in periods of low volatility but benefited from increases in market volatility. As shown in the chart below, equity volatility approached levels last seen in 2013-2014 and 2006—2007. With volatility at historically low levels, and unprecedented levels of monetary accommodation now gradually easing, we believe the likelihood of increased volatility in the future is strong which should be beneficial for our approach if history is any indication.



Source: FactSet, Russell Investments, SGA Calculations. Rolling 3-Year standard deviation of returns based on monthly return observations from January 1st, 1979 through December 31st, 2017.

Key Performance Drivers

Stock selection was the primary detractor from performance in Q4 while allocations accounted for about 75% of the portfolio's underperformance for the year. The vast majority of the negative allocation effect for the year was due to an overweight in energy service companies which detracted roughly -1.8% in performance relative to the benchmark. For the quarter, stock selection in the Consumer Discretionary sector was weakest due mainly to holdings in Chipotle Mexican Grill, Priceline Group and Ulta Beauty which we recently introduced to the portfolio to take advantage of a valuation opportunity. We see attractive long-term growth opportunities in each of these companies based on our internal research, looking beyond the shorter time horizon of the typical investor. Fleetcor and Nike contributed most positively to performance for the quarter after being amongst the largest detractors from performance results earlier in the year. Consistent with our approach, we had used that weakness to refill both positions based on our positive long-term outlooks for each. Amazon was also a strong contributor during the quarter as its cloud and retail businesses continued to flourish.

Largest Detractors

Biopharmaceutical firm **Regeneron** reported attractive Q3 earnings per share growth of 27%+ as the company benefited from solid growth in Eylea (12%+) and strong acceptance of Dupixent, its newly launched treatment for atopic dermatitis. The stock was weak during the quarter as data from

Regeneron's Eylea follow-on compound disappointed in its phase 2 results, which implies increased competitive pressure to Eylea in the next 2-3 years. We recognize the eventual maturation of the Eylea franchise, however, we view the drug as still maintaining a strong competitive position relative to other treatments. Given other pipeline assets that should launch over the next couple of years including Cemiplimab for oncology as well as the new launch of Dupixent for the treatment of asthma, and Kevzara for rheumatoid arthritis, we used the weakness during the quarter to build our position in the stock back to an average weight of about 3.5%.

Chipotle's stock price was negatively impacted by two events during the quarter. In late October, the company reported Q3 results roughly in line with expectations, but also guided to a deceleration in unit growth next year from 8% to 6%, raising concerns that the reduced guidance reflected a loss of management's conviction regarding the long-term growth opportunity of the business. However, after meeting with management and reviewing the new-unit economics of the business, we believe that the deceleration was motivated by a welcomed near-term focus on improving service levels at existing units and that a reacceleration of unit growth will return later in 2019. The second negative incident for the stock during the quarter was the report of an outbreak of influenza at a unit in California. The negative headline pressured the stock for two days, but subsequent details, including quick containment of the issue as a result of strictly following the company's new food safety protocols, gave us comfort that the matter was satisfactorily resolved. On a positive note, mid-quarter the company announced the search for a new CEO to replace founder Steve Ells, who will remain executive chairman. While Steve Ells deserves significant credit for building the business over the last 25 years, the company has grown to a point where it could benefit from a fresh perspective, and we are confident that the board of directors will be able to recruit a talented leader. Lastly, with nearly 100% of profitability generated domestically, the company is a significant beneficiary of the U.S. tax reform which we expect will translate into a combination of both increased investment back into the business and a lift to earnings and cash flow. We maintain an average target weight in the portfolio.

Healthcare information technology and services provider **Cerner** was the third largest detractor from performance during the quarter after the company reported delays in bookings in Q3 and lower than expected EPS guidance for 2018. The company continues to be well positioned to help its clients navigate the changing landscape as health cost reimbursement transitions to a more value-based process, however this is mitigated to some degree by the fact that Cerner's bookings and revenues are becoming somewhat more volatile on a quarterly basis. While we are optimistic regarding the long-term position of the company and its growth opportunity, given valuation which had risen during the year, we trimmed our position to a below-average weight.

Autodesk and **Priceline** were the fourth and fifth largest detractors from portfolio performance during the quarter respectively.

Top Contributors

FleetCor, a leading provider of expense specific payment products and services to businesses, was the largest contributor to portfolio performance during the quarter as it reported attractive growth across its Lodging, Toll and Payment portfolios. The company also benefited from improvements in the economic situations in Brazil and Russia, and improved cross sales growth. In addition, the company noted that it had signed Walmart as a new customer and they will begin to accept FleetCor's fuel cards across their fuel locations. Likewise, the company will begin using FleetCor's cards for their light vehicle needs. The company also announced a new outsourced partnership with a Russian oil company in its fuel card business whereby it will provide a range of transaction processing and program management services, and announced a small acquisition which we expect to be positive. With oil prices gradually rising, the company continuing to build its brand via new partnerships and acquisitions, and improving economic growth in emerging markets, our research indicates that FleetCor continues to be well positioned for attractive growth moving forward.

Athletic apparel leader **Nike** was the second largest contributor to performance in Q4 as the company reiterated its long-term growth projections at its recent Analyst Day, despite Street expectations that they may be reduced. The company expects high-single-digit revenue growth and mid-teens earnings growth over the next 5 years, in line with our projections. While this growth will be influenced by the nature of the retail segment, Nike is taking steps to move away from undifferentiated traditional retail and sell directly to consumers instead. It also announced a relationship with Amazon whereby the company will be able to better access the growing number of shoppers purchasing products via e-commerce as opposed to going through traditional brick and mortar retailers. Nike also announced plans to focus its shoe brand, reducing the number of styles it offers while building its membership club significantly over the 5-year period. Consistent with our financial modeling, the company also pointed out that a large portion of its expected sales growth will come from outside the

U.S. A key assumption within our thesis for the company has been that the athletic-leisurewear trend had significant growth potential outside the U.S, and particularly in China. Following the strong rebound in the stock, we trimmed the position back to an above-average weight target.

Amazon.com was the third largest contributor to performance during the quarter as it posted strong results for Q3, beating revenue and earnings estimates, raised Q4 guidance and benefited from indications of an increasing share of holiday sales. North American and international sales were strong across the board, while Amazon Web Services posted 42% sales growth, in line with our expectations. The company continues to spend heavily on building their brand across multiple venues, most recently adding natural and organic food retailer Whole Foods and investing in price reductions. With growth showing acceleration in many segments and AWS margins increasing sequentially, our research continues to view Amazon as a significant disruptor across the retail segment. We continue to manage our position in the stock actively taking profits on strength and redeploying capital opportunistically.

Lowe's and **UnitedHealth** were the fourth and fifth largest contributors to portfolio performance during the quarter respectively.

Portfolio Changes

Purchases

Media and entertainment conglomerate **Walt Disney** was re-purchased in the portfolio after a nearly two-year hiatus following the announcement of its planned acquisition of certain Fox assets. At the time we sold it in Q1 of 2016, after having owned the stock for several years, we had become concerned by its high valuation especially in light of heavy capex spending we anticipated in its Theme Parks Division, and tough comparisons due to the huge success of films Frozen and Star Wars. Additional concern included growing uncertainty regarding the monetization of its content, including ESPN and traditional Disney content, through multichannel video distributors as well as increased unbundling with traditional cable. Today, the comparison issue has played out and valuation is more attractive. Most importantly, we now see much greater visibility into the company's ability to monetize their content in a multichannel video distributor world where they can sell their media directly to the consumer over the internet as a standalone product bypassing telecommunications, cable and broadcast television providers that traditionally controlled access to such content. Consistent with this, we view the new acquisition of Fox's assets including its movie studio, cable networks, Star India, control of Hulu, and the potential full ownership of Sky Europe, to be highly complementary to Disney's global expansion plan as well as its direct to consumer strategy for ESPN and traditional cable content. The deal should also be beneficial to its Film business due to the consolidation of movie franchises including Marvel characters. Disney can also monetize Fox's strong intellectual property within the Park and Consumer Products segments. In addition to the strategic benefits noted, we see the new deal enhancing cash generation and the predictability of revenues while also providing cost synergies.

The company continues to face risks associated with cable unbundling, the Parks (terrorism, pandemics, and the economy), and the possibility that its Films business may stumble periodically, but we view Disney as being in a much stronger position, post the completion of this acquisition, to deliver its tremendous treasure of content to the modern-day consumer much more effectively.

YUM! Brands is one of the world's largest restaurant companies with overall sales of more than $45 billion, and 45,000 stores in over 135 countries. The company's brands include Kentucky Fried Chicken (KFC), Pizza Hut and Taco Bell. Over 97% of its stores are franchised, providing the company with a strong stream of recurring revenues. This is enhanced by the company's affordable price points, geographic and brand diversity, and ongoing menu innovation. YUM's pricing power is enhanced by the company's operating excellence driven by strong franchise partners committed to superior service and positive customer experiences. The company's asset-lite franchise model significantly reduces the level of operating volatility expected from the business. The ability to triple the number of stores in YUM's system combined with compelling new-unit economics and attractive opportunity to further penetrate emerging markets (which today comprise about 40% of franchise fees), provides attractive long runways for future growth.

As in any restaurant oriented business food safety is a primary risk associated with this investment. However, the franchised nature of the business reduces the potential impact from such risk, with approximately 80% of profits coming from franchise fees and the balance from company owned stores. Likewise, the global nature of the company's sales will create additional currency risk which must be taken into account. We have held the company in the portfolio in the past and our research indicates the combination of strong fundamentals and attractive valuation warrants YUM's inclusion in the portfolio.

Sales

State Street was sold from the portfolio after appreciating following the 2016 presidential election on growing expectations for regulatory relief and rising interest rates. The high cost of regulatory compliance following the implementation of Dodd-Frank and an extended period of low interest rates, which negatively pressured the company's net interest margin, put pressure on the stock in recent years. Given the expected reversal in each of these trends and the appreciation of the stock, we took advantage of the strength to transition capital to other higher expected return opportunities.

Summary

After a strong rebound earlier in the year, where higher quality growth stocks regained leadership from deep cyclicals and financials which had benefited from euphoria over hopes for more pro-growth policies from the new Trump administration and Congress, short-term company specific issues and our discipline to reallocate capital away from high momentum stocks where valuations had become less attractive detracted from the portfolio's relative return. We reallocated client capital to stocks where our analysis of their forward looking 3-5 year opportunities indicated more attractive share price appreciation potential. We understand disappointment over the short-term impact these decisions had on relative performance but strongly believe that respecting our valuation discipline and taking advantage of great growth businesses that the market hasn't yet rewarded offers the best opportunity for superior absolute and relative long-term returns. In a market consistently setting new highs, where growth stocks are said to be rich in value, approximately 15% of our portfolio today is invested in high quality long-term secular growth businesses which are at least 20% off their highs. We see great forward-looking growth potential in our portfolio businesses, and are confident that remaining disciplined in the implementation of our approach is what clients expect. Your portfolio is forecast to generate 22% earnings growth over the next three years with more predictability and better cash flow based valuation while the Russell 1000 Growth Index is forecast to generate 14%. Over the long-term, we continue to believe superior and more predictable earnings growth will drive stock prices in an increasingly more volatile market than what we have experienced in recent years.

We thank you for your confidence in our team and wish you a healthy and successful New Year. We look forward to speaking with you in more detail about the portfolio.
