SGA Sustainable Growth Advisers

Q2 2017 U.S. Large Cap Growth Commentary

Highlights

- *SGA's U.S. Large Cap Growth portfolio returned 6.6% (gross) and 6.4% (net) in Q2 2017 compared to 4.7% for its primary benchmark the Russell 1000 Growth Index, and 3.1% for the broad market S&P 500 Index.*

- *Equities generated high absolute returns despite mixed signals for U.S. economic growth, political division in Washington, weakness in the price of oil and energy related businesses, less monetary accommodation by the U.S. Federal Reserve and many geopolitical concerns.*

- *Large-cap growth stocks with higher quality business characteristics outperformed domestically; Emerging markets outperformed non-U.S. developed and U.S. markets.*

- *Energy stocks declined significantly on renewed concerns over higher U.S. shale oil production and the potential for continued oversupply; the portfolio's overweight to the sector detracted about 0.7% from relative returns.*

- *Strong stock selection in the Health Care and Consumer Staples sectors were the largest contributors to the portfolio's outperformance; Whole Foods, Regeneron and Novo Nordisk were the largest contributors; positions in Schlumberger, Core Labs and Lowe's detracted most.*

- *Positions in Apple and Colgate-Palmolive were sold and positions in Autodesk and J.B. Hunt were added; our position in Whole Foods was significantly reduced following Amazon's acquisition offer; we added to positions in Chipotle Mexican Grill, Schlumberger and UnitedHealth among others on weakness and trimmed positions in Amazon, Kansas City Southern and Red Hat among others on strength.*

Performance

SGA's U.S. Large Cap Growth portfolio returned 6.6% (gross) and 6.4% (net) in the second quarter of 2017 while its benchmark, the Russell 1000 Growth Index, returned 4.7%, and the S&P 500 Index returned 3.1%. Following the euphoria in the market in Q4 2016 regarding the potential for significant tax overhaul, regulatory reform and massive new fiscal stimulus, and continued optimism to start 2017 (albeit wavering to some extent), Q2 saw greater skepticism over the likelihood of major change occurring. There were also initial signs that growth in the U.S. may be about to be eclipsed by improvement in Europe and the emerging markets. Such a change may bode well for SGA's growth approach given our emphasis on businesses with longer duration growth opportunities which often entail greater exposure to non-U.S. markets.

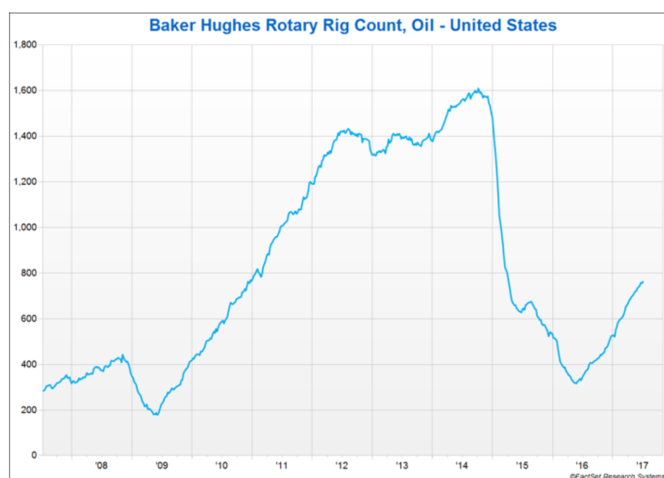
Attractive Absolute Returns but Confidence in Stimulus Beginning to Wave

Following a weak first quarter GDP report, the third interest rate hike in six months, little progress on the Trump administration's pro-growth agenda, the largest drop in U.S. retail sales in 16 months, oil prices declining (again) to bear market territory, signs of lower than desired inflation, and little hard economic data pointing to an improvement in future growth, investors shied away from the higher risk, more cyclical stocks which outperformed so strongly in Q4 2016. As the realization materialized that U.S. growth may fall short of expectations, investors continued to favor businesses that offered better quality profiles and above average growth characteristics. Not surprisingly, Q2 earnings expectations for the S&P 500 Index continued to decline, falling from +11.3% at the beginning of the year to +6.9% expected now. 10- year U.S. Treasury yields likewise declined as growth and inflation expectations moderated, leading to a flattening of the yield curve, another potentially concerning indication of future U.S. growth. Consistent with growing uncertainty over the path of future growth, larger companies with higher returns on equity, less debt, positive earnings and the highest forecast growth performed best.

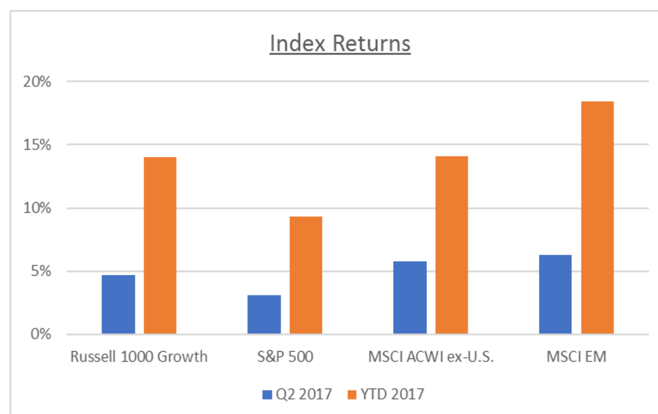
The Russell 1000 Growth Index generated an attractive absolute return of 4.7% with investors believing that slow growth and low inflation may limit the amount of monetary tightening seen for the remainder of the year. Hope that a tax overhaul bill would eventually be passed by Congress and provide stimulus for strong economic growth in 2018 continued to buoy stock prices although cracks in that thesis widened. Health Care and Technology stocks led the market for much of the quarter until the Technology sector came under increasing pressure in the final weeks of the quarter. Financial stocks, and particularly large banks, showed strong performance as regulators announced positive stress test results for all large U.S. banks, and approved more liberal dividend payout policies. Consumer stocks underperformed as more signs of weak consumer spending and distress in the retail segment put many of them under pressure.

Energy was by far the weakest performing sector in the Russell 1000 Growth Index during the quarter, declining 8.9%. With expectations for global economic growth still modest, U.S. shale producers coming back to the market more quickly than anticipated, and mixed signals over U.S. drawdowns on oil

inventories, investors sold energy and related stocks to levels last seen in the first quarter of 2016. After declining dramatically in 2015 (see the chart below) and bottoming in 2016, the U.S. rig count has now regained about a quarter of its decline. With financing increasingly tight for many lesser producers, we expect the growth in rigs to slow. In addition to North American shale production, higher than expected output by OPEC members Libya and Nigeria contributed to supply concerns (neither were subject to OPEC output cuts) as did ongoing speculation over the likelihood of the cartel's willingness to renew its production restraints in conjunction with Russia.



Emerging Market stocks outperformed U.S. and non-U.S. Developed markets on signs of improvement in some of the more major economies. Similar to the U.S., higher business quality outperformed in non-U.S. developed countries as well as in the emerging markets. This outperformance by non-U.S. stocks was generally beneficial for SGA's approach which seeks to extend the magnitude and duration of growth in our portfolio companies by investing in businesses which sell their goods and services widely, often taking advantage of faster growth opportunities outside the United States.



Source: FactSet

Key Performance Drivers

Strong stock selection was responsible for all of the portfolio's outperformance. Selection was strongest in the Health Care and Consumer Staples sectors while weakest in the Energy and Consumer Discretionary sectors. Sector allocations negatively impacted performance as an overweight in oilfield service stocks detracted from relative results by about 0.7%.

Largest Contributors

Leading natural and organic food retailer **Whole Foods** was the largest contributor to performance in the quarter. It received an offer from Amazon to purchase the company for $42 per share in cash. The stock appreciated by 29% on the day of the offer and gradually traded above it given the highly disruptive nature of the combination and the potential for other competitors to make a competing higher offer.

A buyout by a strategic or financial buyer was never core to our investment thesis for Whole Foods, although the combination of the recent involvement of JANA Partners and the attractive valuation of the stock (6% enterprise yield) made the announcement of Amazon's offer to purchase the company less of a surprise. Our thesis was based on the view that Whole Foods' management was taking appropriate, decisive action in critical areas such as pricing, sourcing, cost savings initiatives and customer engagement to more effectively respond to rising competition in the natural & organic food sector. For Whole Foods, the Amazon deal is compelling from both a strategic and financial point of view, as it will enable the company to leverage Amazon's technology and distribution expertise to accelerate strategic initiatives such as category management, supply chain and customer affinity programs, while enabling management to truly focus on running the company for the longer term away from the spotlight of public shareholders.

While recent developments at Whole Foods, including their upgrade at the CFO position and the change in the composition of their Board of Directors as well as the further acceleration in their strategic and financial initiatives are undoubtedly positive, we believe Amazon's offer of $42 per share represents a fair price based on valuation metrics which exceed industry M&A precedents. We significantly reduced our exposure to Whole Foods following the offer, but maintained a small position in the stock at quarter end given the potential for other higher bids to emerge.

Biopharmaceutical company **Regeneron** posted a quarter within our expectations. Eylea, the company's treatment for patients with wet macular degeneration, showed stable growth of 9% in the U.S. and 12% globally, and the company reported 22% earnings growth for the first quarter of 2017. More importantly, Regeneron reported that the launch of its new drug Dupixent, for the treatment of atopic dermatitis, is going well. This caused the stock to surge over 7%, as expectations are rising for this new drug in a category with limited treatment options. The company also won FDA approval for Kevzara, its treatment for moderate to severe rheumatoid arthritis, after having resolved the manufacturing deficiencies which had delayed its approval previously. We continue to view Regeneron's opportunity to bring important new drugs to the market in a number of key areas over our 3-5 year time horizon as being highly attractive. We raised the target for the stock while also trimming the position on strength during the quarter.

Global pharmaceutical company **Novo Nordisk** reported slightly better Q1 results with 3% sales growth (4% sales growth normalizing for inventory/rebates adjustment) and 6% operating profit growth. Its diabetes business posted growth of 11% in constant currency (led by strong growth in sales of new generation insulins 163%+, Victoza 22%+). This, however, was offset by declines in growth in its hormone and hemophilia franchises. We expect Novo's hemophilia franchise to continue to decline in the near term as growth from new drugs (factor VIII, and factor IX) will likely not be able to offset the competition to its Novo-seven product at this point. In diabetes, while pricing pressure in the U.S. will continue, Novo is executing well on its new launches and we expect approval of the company's once weekly GLP-1 drug semaglutide, likely later in 2017, to help the company continue to grow its diabetes franchise despite competitive pressures. Valuation remains attractive, and while we wait for the approval of semaglutide, we maintained an average weight in the stock.

Railroad **Kansas City Southern** and computer assisted design software provider **Autodesk** were the fourth and fifth largest contributors to portfolio performance during the quarter.

Largest Detractors

Oilfield services provider **Schlumberger** was the largest detractor from portfolio performance during the quarter. The price of oil fell on continued concerns over excess oil supply and slower than expected U.S. oil inventory declines negatively impacting Schlumberger's stock price. While U.S. oil inventories continue to be the center of much focus given their greater transparency and frequency of data, oil inventories in most OECD countries have actually been declining while U.S. imports from OPEC nations have remained at historically high levels. Until more recently, U.S. oil inventories had declined at an accelerated pace year-to-date, virtually eliminating the oil inventory surplus over year ago levels. Continued excess supply and potentially weaker demand remain concerns in the market over the near term, but over the longer-term, several energy companies and consultancies are already warning of underinvestment and the potential for supply shortfalls, and the inability of shale alone to offset production declines.

Despite near term concerns, energy companies have begun to expand their capex spending by increasing efficiencies and lowering their project breakeven costs, both in North America and globally. For example, Exxon most recently approved a Final Investment Decision for a major offshore project off the coast of Guyana, while Statoil, the Norwegian oil company, has retooled almost all of their offshore oil projects to produce positive economic returns at prices below $30 per barrel of oil (from prior levels of $70 per barrel in 2013) and are moving ahead with their capex plans. Both are large customers of Schlumberger, and year-to-date, there have already been twelve major projects that have been sanctioned (compared to approximately five for all of 2016). We took advantage of weakness in the stock during the quarter to add to our position.

Reservoir description, production enhancement and reservoir management provider **Core Labs** was the second largest detractor from returns in Q2. Its stock declined during the quarter due to the same macro and energy industry factors noted above. We remain positive on Core Labs' ability to help production companies maximize output from their existing wells and benefit from gradual improvement in oil exploration activity. The company has reduced its cost structure, as have many of their clients, and is well positioned to benefit from any increases in capex spending moving forward both from U.S. unconventional shale players and global energy companies. Energy companies are beginning to gradually expand their capex budgets but are increasingly seeking to improve returns on their spending, and service companies such as Core Labs are increasingly in the position to offer higher value-added services that meet those needs. While we believe our thesis for

improving equilibrium between oil supply and demand remains on track today, and that oil companies will increasingly need to adopt technologies and practices that improve their returns, we acknowledge that markets are very fluid, and we continue to monitor events to ensure our expectations are being met.

We took advantage of weakness in the stock during the quarter, and rebuilt our position on the expectation for continued movement toward supply/demand equilibrium and gradually improving capex spending.

Home improvement retailer **Lowe's** reported Q1 results below expectations with comparable store sales up 2%, which was lower than expected and far short of peer Home Depot's 6% report. Earnings per share grew 18%, but also fell short due to lower than expected margins at RONA, Lowe's recently acquired Canadian home improvement business, inflation pressures in lumber, and mis-execution around its promotional spending and price investments. Poor weather negatively impacted Lowe's more than Home Depot due to its greater exposure to outdoor seasonal products, and its lower exposure to the professional construction/renovation business which was quite strong for both it and Home Depot. Company management reiterated their full year comparable store guidance and we remain confident in their ability to correct the issues regarding promotion spending and pricing investments. In addition to company driven improvements, our research indicates that the company should continue to benefit from favorable macro-economic trends in employment and housing. Accordingly, we refilled our position in the stock on weakness during the quarter.

Leading provider of expense specific payment products and services **FleetCor** and **Chipotle Mexican Grill** were the fourth and fifth largest detractors from portfolio performance during the quarter.

Portfolio Changes

Turnover in the portfolio was slightly higher than average in the quarter including two new purchases and two full sales. In addition, we significantly trimmed back our position in Whole Food Markets following Amazon's $42 per share offer to purchase the company, and also trimmed positions in Alliance Data Systems, Amazon, Kansas City Southern, Novo Nordisk, Priceline and Red Hat on strength. In contrast, positions in Alphabet, Lowe's, Nike, Schlumberger and UnitedHealth were added to on weakness. Consistent with our valuation discipline, we will manage position sizes opportunistically in strong growth businesses when market price movements overshadow what our fundamental valuation analysis warrants in the short-term.

Purchases

J.B. Hunt was the originator of the intermodal industry (which combines the transportation of goods via rail, truck and ship). Founded in 1961, the company surprised industry peers in 1989 by partnering with the Burlington Northern Santa Fe Railroad (today owned by Warren Buffet's Berkshire Hathaway) for the long-haul shipment of containers, and instead choosing to focus its trucking operations primarily on drayage (the local pickup and delivery of goods). The resulting truck-rail-truck "intermodal" model operated at a significantly lower cost than long haul truckload competitors (albeit at slightly slower delivery times). Since then, the intermodal industry, led by J.B. Hunt, has consistently taken market share from the long-haul trucking industry. This more efficient manner of transporting products, has lowered J.B. Hunt's cost and enhanced its pricing ability relative to other competing providers. The company's business is less focused on highly cyclical industrial and energy related markets, and instead has greater exposure to more consumer and retail oriented shippers. Given the long-haul trucking industry's ongoing challenges with driver recruiting and retention, driver safety regulations, and increasing highway congestion we expect J.B. Hunt's intermodal model to continue to take market share over the next decade. Over the last 10 years, intermodal volumes have grown at a double-digit rate. While free cash flow generation has been modest and erratic in recent years as the company has continued to build capacity, the company's management, has stated that capital expenditures for the next five years will be stable in absolute dollars. As such, we expect the company's Cash-Earnings ratio to improve from ~50% over the last three years, back to the prior decade's historical levels in the 70% or higher range.

While offering strong pricing power, attractive recurring revenues and long runways of growth, the company is marginally more sensitive to macroeconomic trends than other companies on our Qualified Company List. In addition, their reliance on rail traffic and sensitivity to fuel price fluctuations pose potential threats to short-term company results. Longer-term, we are also cognizant of the possible threat posed by the advent of autonomous, driverless trucks, although this could also be an opportunity for the company which has a culture of evolving its processes to best meet client needs. Considering these risks relative to the stock's growth opportunity, we have taken advantage of volatility in the stock to opportunistically build an average weight position.

Autodesk is a leading provider of computer assisted design (CAD) software catering to the architecture, engineering and construction as well as the manufacturing and media industries. Over time, Autodesk has expanded its line-up of products to

address more applications within these segments. Consistent with industry trends, the company is going through a major transition from its conventional license based revenue model to a software-as-a-service (SAAS) revenue based model, which will significantly increase the repeatability of revenues and thereby increase the quality of the business over the long-term. In the short-term, it will depress revenue generation as the company makes the transition. Autodesk offers attractive pricing power due to an industry structure where end customers are more attracted to relevant functionality and ease of use based on prior learning than to pricing discounts. The company prices entry-level products lower for those learning to use its products, and thereby builds its user base on an ongoing basis. The complex nature of the company's business, and the need for users to climb a steep learning curve, limit the amount of product switching which goes on. Today, about 75% of the company's revenue can be considered recurring, and we expect that level to increase each quarter moving forward. We are excited by the long runways of growth open to Autodesk given that the global market for its CAD software is considered to be about 10 times its revenues, and we expect this market to continue to grow as automation is pursued in more industries over time. Over the next five years, this company has a great opportunity ahead of itself to transform into a recurring business model and in parallel extract better price from its customer from providing more value. At the same time, long term valuation will also reflect the higher quality of the business model. Accordingly, we initiated a smaller than average weight position in the stock and expect to build it opportunistically as we continue to gain confidence that the company's transition to the SAAS model is progressing well.

Sales

Apple was sold during the quarter in order to fund other more attractive opportunities after the stock's strong performance since its reentry into the portfolio in May 2016. At the time we repurchased the stock, we cited the company's tremendous operating base of iOS users, and the all-encompassing ecosystem they had developed, reducing the likelihood that iPhone users would switch to alternative products in the future. While the stock appreciated significantly as investors realized that Apple still possessed growth potential and wasn't a declining business as had been speculated last year, our estimates of its earnings power did not change meaningfully, causing the stock's multiple to expand. Without significant changes in earnings power, we were well aware that multiple expansion would only carry the stock so far going forward and the stock's higher multiple already, to an extent, recognized the higher quality of the business. While not expensive by our measures, given higher expectations and its relatively slow growth rate (compared to other opportunities on our Qualified Company List), we sold the stock to fund other more attractive opportunities.

Colgate-Palmolive was sold during the quarter as our forecast growth for the company continued to moderate and its valuation became less attractive following Kraft's bid for Unilever and speculation that Colgate could be a target as well. Accordingly, we reallocated the capital to other higher growth, more attractively valued opportunities where we expect better long-term returns. The company continues to have the business quality characteristics we seek, but its expected future growth rate was at the low end of the range we generally find attractive.

Summary

While future growth expectations continue to vary widely by quarter based on conflicting economic data releases, huge fluctuations in the price of oil, and geopolitical events, the expected sales and earnings growth for businesses owned in this portfolio remain less volatile. As a whole, the portfolio continues to generate significantly greater sales and earnings growth than the broad market, and you should expect that to continue to be the case moving forward. In times such as these where there is great uncertainty over the global macroeconomic picture, and some companies are losing the benefit they have enjoyed over the last eight years from highly accommodative monetary policy, we expect business quality and the strong pricing power, highly recurring revenues and long runways of growth to continue to be valued by investors. While standard earnings based valuation metrics may appear to be full for some of these businesses, in a market where the average rate of earnings growth is significantly less than theirs, we believe that the consistently superior earnings growth of our businesses should be worth more. In addition, when we value them using a conservative cash flow based metric, which we think is much more appropriate given that free cash flow is the life blood of successful businesses, they appear more attractive. As of quarter end, the portfolio is forecast to generate revenue and earnings growth of 12.4% and 23.5% respectively, compared to 6.8% revenue growth and 12.5% earnings growth for the Russell 1000 Growth Index over the next three years. With interest rates gradually rising, inflation modest at best, and few signs of rapidly accelerating growth in the U.S. or globally, we expect that this type of long-term secular growth portfolio should be amply rewarded, but remain cognizant of the fact that absolute returns in the market, and by this strategy have been strong and significant macroeconomic and geopolitical uncertainty exists which could negatively impact investor confidence and multiples. While

there will inevitably be periods where our strategy will be out of favor due to fluctuating macroeconomic growth expectations, or a spike in fear over geopolitical issues, our approach will continue to identify what we see as superior long-term business quality and attractively valued, above average sales and earnings growth that is repeatable over time.

We thank you for your continued confidence in our team here at SGA and look forward to speaking with you about your portfolio.

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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.