SGA
Sustainable Growth Advisers

Q1 2017 U.S. Large Cap Growth Commentary

Highlights

- *SGA's U.S. Large Cap Growth portfolio returned 10.3% (gross) and 10.1% (net) in Q1 2017 compared to 8.9% for its primary benchmark the Russell 1000 Growth Index, and 6.1% for the broad market S&P 500 Index*

- *Equities generated their highest first quarter return in four years setting successive new all-time highs in the first half of the quarter, until optimism over the ability of the new administration to enact pro-growth policies began to slip in March with the inability of Republicans to repeal and replace the Affordable Care Act (ACA)*

- *Strong pro-cyclical value headwinds in Q4 2016 were replaced by broader large cap growth leadership; business quality factors were generally positive as companies with higher ROE's, lower debt and earnings performed better; however, C and D ranked stocks outperformed those ranked A and B indicating returns were more stock specific*

- *Sector leadership was narrow with only the Technology and Consumer Discretionary sectors outperforming, while Energy stocks declined the most on concerns over building inventories and whether OPEC members would respect announced production cuts*

- *Strong stock selection particularly in the Consumer Discretionary and Technology sectors drove the portfolio's outperformance; an overweight in Energy stocks detracted about 0.9%*

- *Amgen was sold to fund other more attractive growth opportunities while positions in Mondelez, Starbucks, UnitedHealth and others were added to and positions in Alphabet, Apple, Colgate-Palmolive and Lowe's were trimmed on strength*

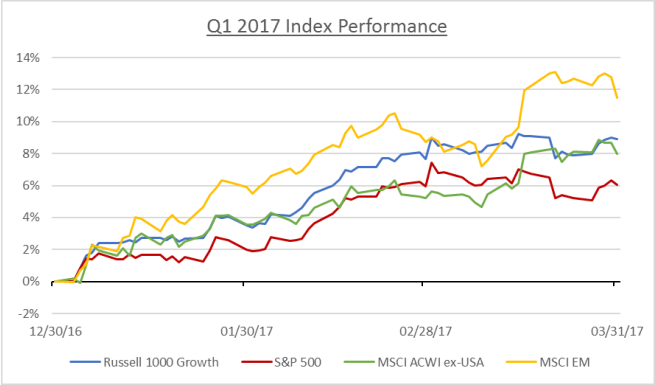
Performance

SGA's U.S. Large Cap Growth portfolio returned 10.3% (gross) and 10.1% (net) in the first quarter of 2017 while its benchmark, the Russell 1000 Growth Index, returned 8.9%, and the S&P 500 Index returned 6.1%. In contrast to Q4, which was driven by a rally in lower quality, more cyclical value stocks, market leadership in Q1 came from larger cap, growth businesses with higher ROE's, lower debt, and earnings. Meanwhile, lower quality, C and D ranked companies also outperformed, indicating that stock specific characteristics, as opposed to broad macro themes, played a larger role this quarter in determining stock price movements.

The Rally Continued Until Reality Began to Set In

The rally which began the day after the presidential election in November continued through much of the first quarter leading the Russell 1000 Growth Index to rise about 7.7% through February as volatility remained abnormally subdued, with daily readings of the VIX near their all-time lows. In March, investors began to question the new administration's ability to deliver the pro-growth changes to tax, health care and fiscal policy expected. Their inability to repeal the Affordable Care Act (ACA) and enact the American Health Care Act (AHCA) added to uncertainty, raising questions regarding the potential for other pro-growth policies to be enacted. While the market continued its advance in Q1, the underlying drivers of the rally changed markedly. Following the cyclical rally in Q4, investors began to again show more interest in higher growth and somewhat higher quality businesses, particularly in the Technology and Consumer Discretionary areas. All other sectors of the benchmark underperformed and Energy stocks declined sharply (down over 9% in Q1) due to lower oil prices driven by concern over increases in U.S. inventories and speculation about the ability of OPEC and select non-OPEC producers to maintain their agreed upon production cuts. Financials gave back some of their Q4 gains as investors expecting a quick overhaul of Dodd-Frank regulations grew more skeptical.

For 2016, the U.S. economy grew at a 1.6% rate, significantly lower than the 2.6% rate experienced in 2015. This slowing combined with expectations for higher interest rates, and higher oil prices led expectations for corporate profit growth in 2017 to moderate from nearly +12% at the beginning of the year to +10% later in the quarter. Q1 2017 expectations showed a larger decline, moving from +14% to +10%, and we believe these figures will likely decline further given growing skepticism over the new administration's ability to affect positive change and the margin impact of higher labor costs. While the dollar fell back to levels last seen in November due to slower economic growth forecasts, we expect it to continue to be a headwind for U.S. multinationals over the coming year. We continue to be of the view that the U.S. economy is likely to see improving trends as we move further into 2017 and in 2018, but the magnitude of the improvement may disappoint those who are expecting a rapid inflection.



Non-U.S. markets led by emerging markets outperformed U.S. stocks for the quarter. Foreign stocks took the lead from U.S. stocks as political concerns shifted away from Europe where the focus had been on potential nationalist, anti-EU, gains in key elections in the Netherlands, France and Germany, and to the U.S. where the political divide in Congress threatened to at least postpone the enactment of pro-growth policies expected to drive U.S. growth higher. Dutch Prime Minister Rutte's victory over nationalist candidate Geert Wilders, polls showing declining support for French populist candidate Marine Le Pen, and a victory by Angela Merkel's Conservative party in German regional elections moderated investor concerns of a nationalist wave sweeping Europe and threatening the Eurozone. Great Britain triggered Article 50 of the Lisbon Treaty leading to negotiations over its exit from the European Union, and markets barely reacted. As immediate political concerns lessened, signs of stabilization and stronger economic data in Europe buoyed investors. The March IHS Markit Purchasing Managers Index (PMI) for the Eurozone showed the strongest economic conditions in six years, while the U.S. Composite PMI, fell to a six-month low. At the same time, concerns over Chinese economic growth resurfaced following weaker economic data and moves by the government to scale back the massive economic stimulus it had applied in 2016. To the extent that European growth continues to gradually improve, we expect this to be beneficial for many of the companies within the portfolio, given their sales to those markets.

Key Performance Drivers

Strong stock selection offset the negative impact from sector allocations on portfolio performance for the period. In contrast to last quarter, stock selection was strongest in the traditional growth oriented sectors of Consumer Discretionary and Technology. Selection in the Consumer Staples, Financials and Industrials sectors detracted from performance while the portfolio's overweight in Energy of approximately 4.5% during the quarter was the largest detractor from performance, costing almost 0.9%. In contrast, stock selection in the Energy sector contributed positively to portfolio performance.

Top Contributors

Apple reported record iPhone shipments of 78.3 million units during the 4th quarter, exceeding consensus expectations helped by stabilization in mainland China sales. Similarly, Mac unit sales growth stabilized, however iPad sales continued to decline. Overall, the company reported revenues and earnings per share slightly ahead of expectations. We continue to see Apple generating high single digit earnings growth on low single digit sales growth over the next three years. While valuation based on current earnings is by no means excessive, the stock's recent movement discounts a fair amount of positive future developments tied to capitalizing on their large installed base of iOS users, and excitement about their next iPhone 8 Anniversary launch later in the year. We have trimmed the position to reflect recent share price strength and are measured in our expectations for the upcoming iPhone 8 product cycle.

Following Q4 weakness in its stock price due to the election rally which benefited slower growth and more cyclical companies, **Facebook** reported a strong quarter in terms of user engagement, revenues, margins and earnings. Despite concerns over measurement of advertising benefit, fake news and competition from Snapchat, the company continues to execute very well and address these and other concerns. While 2017 is likely to pose some incremental uncertainty given significant investment expected by the company focused on increasing video content, our thesis remains intact with Facebook continuing to benefit from its market leading communications businesses including Facebook, Instagram, WhatsApp, and Messenger. With billions of daily users covering a wide range of demographics and geographies, Facebook offers a unique and highly attractive platform for advertisers shifting from traditional venues to mobile applications.

After disappointing in 2016, open source software leader **Red Hat** posted its strongest quarter in a couple years, with billings reaccelerating to 29%, cash flow growing 28%, and positive guidance for renewed margin expansion as headcount growth slows. Red Hat's backlog improved with customers increasingly seeking to do larger deals with the company, albeit at more favorable payment terms. Interestingly, about half of the 30 largest deals Red Hat signed during the quarter involved customers buying five or more products, confirming a key element of our thesis that the company would be able to effectively cross-sell a growing portfolio of its products. We

were also pleased to see that about a third of its top orders included the company's Open Stack product, which Hewlett-Packard and IBM are now distributing as opposed to competing against, as they have in the past.

Salesforce.com and **Amazon** were the fourth and fifth largest contributors to portfolio performance.

Largest Detractors

Oil service companies continued to face headwinds in Q4 of last year amid reduced activity by producers. Sentiment changed following the November election as investors anticipated reduced regulation in the energy industry. This optimism was enhanced as OPEC announced that it would cut output levels. In Q1 of this year, however, oil prices declined as doubts surfaced over the impact of OPEC's production cuts given continued high inventory levels in the U.S., and questions over compliance by OPEC and non-OPEC members. Our research indicates that U.S. oil inventory levels are high due primarily to seasonal factors (such as refinery maintenance), as well as excess oil production by OPEC members in the period after the announcement but prior to the cuts being implemented at the beginning of the year. As such, we remain of the view that the backdrop will improve for the companies we are invested in as we move further into 2017.

Schlumberger was the largest detractor from performance in the quarter as the Energy sector as a whole came under pressure from investors reacting to declining oil prices. The company however, reported a quarter that was broadly in line with expectations and provided a more positive outlook relative to prior quarters. Revenues increased modestly, marking a change from the declines experienced in previous quarters. We expect Q1 to show the first year-over-year increase in the last two years, and expect further improvements in free cash flow generation. Following the completion of its latest round of cost reductions, Schlumberger is more efficient and likely to benefit as oil prices stabilize and companies move ahead with increased capital spending. With contributions to earnings from international projects down by over 70% since Q4 2014, we see the company being well positioned to benefit significantly from new non-U.S. opportunities which arise. Schlumberger has also added to its North American presence with a recent joint venture with Weatherford, matching the size and scale of Halliburton in the U.S. While we remain positive on Schlumberger's outlook, we are also very cognizant that the improvement will not be linear and that international markets may take longer to recover.

Reservoir description, production enhancement and management provider **Core Labs** reported a quarter that affirmed, in our view, its strengths and illustrated the degree to which it has gained market share and greater customer penetration amid the weakness in the oil sector over the last few years. Reported revenues for the quarter increased 4% sequentially, while still being down about 18% on a year-over-year basis, beating our expectations. The company continued to see a rebound in activity levels from existing clients and new projects. In North America, a 2% increase in well completions in Q4 generated a 13% rise in revenues, providing solid evidence of the company's ability to outperform the industry and gain share as the environment improves. Internationally, the company is beginning to see improvement as well, with increased investment approvals in international and offshore projects moving ahead this year after several years of deferrals.

Whole Foods was the third largest detractor from portfolio performance in the quarter, as the business continues to face increased competitive pressures resulting from the proliferation in availability of natural & organic products across an expanding range of retail channels and price points, as well as significant deflation across perishable food input costs. In addition, a partial unwinding of expectations for significant corporate tax reform in the U.S. may have also contributed to the stock's weak performance given the company's domestic focus and high tax rate. However, despite weaker than expected sales growth and a reduction for fiscal 2017 full-year guidance, the company's earnings report during the quarter was a positive catalyst for the stock due to a pivot in strategy announced by management that included 1) an acceleration in much needed operational investments such as category management capabilities, 2) a refocus on core customers, 3) a partnership with dunnhumby, a highly effective customer science company, involved in the development of Whole Foods' customer loyalty program, and 4) a deceleration in unit growth. We welcome the adjustment in strategy because we believe it should enable the company to more decisively address desperately needed operational upgrades and play to its core merchandising strengths while re-emphasizing the focus on comparable store sales, cash flow and returns. We continue to believe that improving traction with the company's core initiatives combined with a normalization in the input cost environment should help drive a recovery in the business later this year, and, combined with an attractive valuation, we maintained an average weighting in the portfolio.

Novo Nordisk and **Mondelez** were the fourth and fifth largest detractors from portfolio performance.

Portfolio Changes

No new positions were initiated in the portfolio during the quarter, however we sold our position in Amgen. We also actively trimmed positions where valuation had become less attractive, and added to positions where we sought to take advantage of price weakness or increased volatility. We trimmed positions in strong performers including Alphabet, Apple and Lowe's and added to positions in Facebook, Kansas City Southern, Mondelez, Novo Nordisk and Starbucks on weakness.

Sales

While leading biotech company **Amgen** continues to meet our business quality criteria, we sold our position in the stock in order to redeploy the proceeds to other portfolio companies offering more attractive growth opportunities. The company has an attractive pipeline of innovative and biosimilar drugs that should reach the market over the next 2-3 years, but continues to face erosion within its base businesses due to patent expirations. With pressure on drug pricing in general likely to persist, Amgen's growth is expected to remain limited as the company gradually transitions from its current suite of products into new therapies in various levels of clinical trials to treat osteoporosis, migraines and cancer as well as Repatha, their new drug to treat patients with hypercholesterolemia.

Summary

The dramatic "capitalization of hope" we referred to in Q4 continued through the first part of this quarter, finally ending in March as investors began to question the ability of the new administration to enact the tax overhaul, infrastructure spending and regulatory reduction programs which had caused stocks to rally so strongly beginning last November. The market's move toward smaller cap, lower valuation, more cyclical stocks was abrupt and dramatic following the election, and caused our portfolio to underperform significantly in Q4. Barring some significant outside event, the readjustment in expectations now taking place is unlikely to be as quick or dramatic as the President's agenda begins to move through the often-messy political process. We expect periods of renewed optimism and disappointment amid continued harsh rhetoric. We will continue to take advantage of volatility resulting from news flows and fluctuations in emotions to enhance the business quality, growth and valuation of our portfolio, while actively responding as new opportunities present themselves. As it becomes clearer that U.S. and global economic growth is likely to remain variable and modest, the superior predictability and sustainability of the growth of our companies should be rewarded. As of March 31st, the portfolio is forecasted to generate 11.2% and 21.9% revenue and earnings growth respectively over the next three years, while companies comprising the Russell 1000 Growth Index are expected to generate 5.8% and 10.5% revenue and earnings growth over the same period. At the same time, the portfolio remains attractively valued based on our enterprise yield and discounted cash flow valuation metrics.

We thank you for your continued confidence in our team and process at SGA, and look forward to answering any questions you may have.
