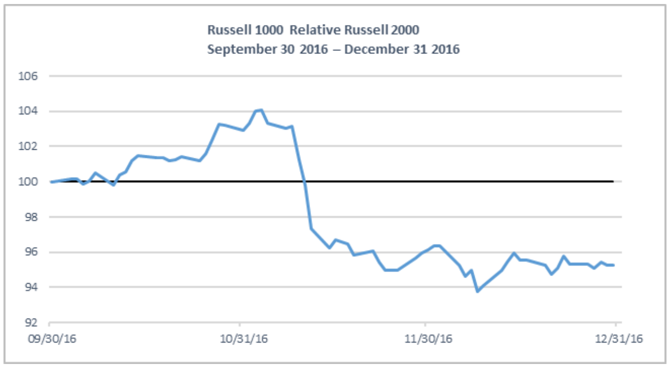
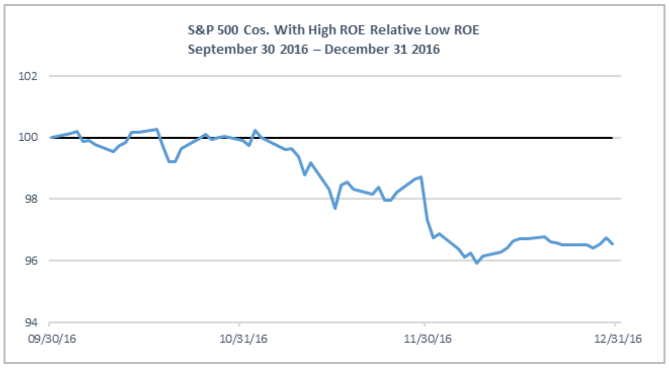
Q4 2016 U.S. Large Cap Growth Commentary

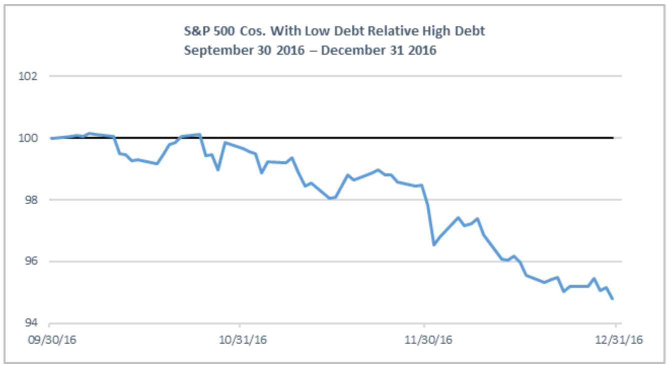
SGA
Sustainable Growth Advisers

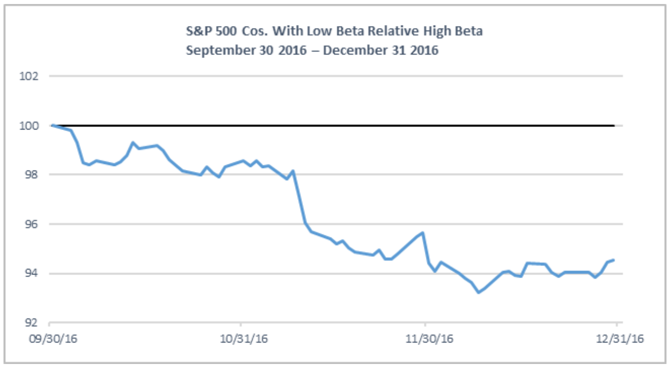
Highlights

- *SGA's U.S. Large Cap Growth portfolio returned -3.6% (gross) and -3.8% (net) in Q4 2016 compared to 1.0% for its primary benchmark the Russell 1000 Growth Index, and 3.8% for the broad market S&P 500 Index.*
- *Stock indexes hit successive new all-time highs following the surprise election of Donald Trump and expectations for more pro-business policies and better U.S. economic growth.*
- *SGA's investment approach faced intense headwinds as smaller cap, lower quality, cyclical companies in the industrial and financial services sectors outperformed; investors looked to include more economic sensitivity into their portfolios with reports of stronger economic data and hopes for stimulative policies from a Trump administration.*
- *UnitedHealth was added to the portfolio to capitalize on its ability to bring an integrated healthcare, pharmacy and insurance solution to a post Affordable Care Act (ACA) health care market where cost savings are key.*
- *SGA's performance was negatively impacted by disappointing quarterly reports from Cerner, FleetCor and Red Hat, and the significant post-election shift toward industrial cyclicals, banks and energy stocks.*
- *Underperformance from the market's capitalizing of hope presents an attractive opportunity for sustainable growth moving forward as actual changes may be less dramatic than what is currently discounted.*







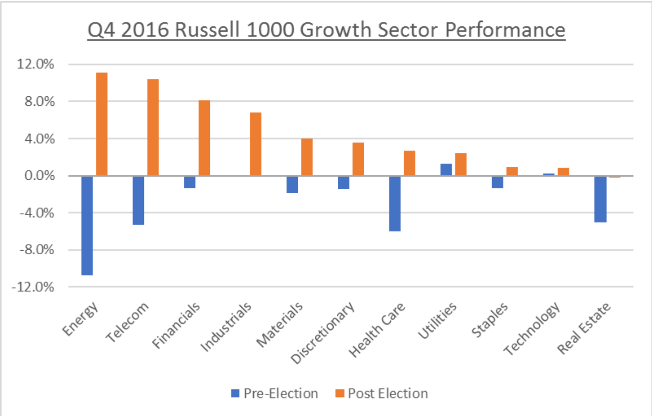


Performance

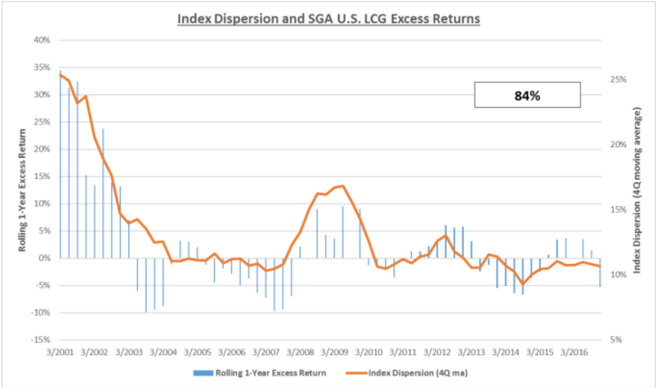
SGA's U.S. Large Cap Growth portfolio returned -3.6% (gross) and -3.8% (net) in the fourth quarter of 2016 while its benchmark, the Russell 1000 Growth Index, returned 1.0%, and the S&P 500 Index returned 3.8%. The portfolio's underperformance resulted from a major shift in investor preferences toward smaller, lower quality, more cyclical companies, and stock specific instances where company quarterly reports were deemed to be disappointing.

Coming into the fourth quarter, investors were pleased that economic growth was showing signs of improvement after a very weak start to the year. Q3 economic growth showed strength on the back of increased inventory rebuilding, improved agricultural exports and continued strong consumer spending. The quarter's initial GDP report of 2.9% was revised upward to 3.5% in December and marked the best economic growth reported since Q3 2014. The drivers of the improvement make us less confident of its sustainability given that inventory rebuilding is typically a short-lived growth driver and agricultural exports are also very volatile. While consumer strength has been formidable in recent quarters and is likely to continue to be a positive driver of growth, higher gasoline prices and borrowing costs are likely to offset some of the expected benefits from cheaper imports and higher wages.

The unexpected election of Donald Trump and the Republicans' ability to retain control of the Senate while maintaining a majority in the House contributed to an environment that penalized larger, higher quality, more predictable long duration growth businesses and favored smaller, lower quality and more cyclical businesses. The post-election rotation from defensives to pro-cyclical more economically sensitive stocks constituted the largest shift in market focus since the financial crisis. It resulted in a major shift in investor preference mid-quarter whereby companies in the Energy, Financial Services and Industrial sectors outperformed on expectations for lower corporate tax rates, less regulatory burden, a repeal of the ACA and major spending increases on infrastructure and defense projects. High dividend yielding defensive stocks and higher quality businesses that generate above average and more predictable revenue and earnings growth trailed. The smallest businesses in the Russell 1000 Growth Index and those with the lowest forecast growth performed best.

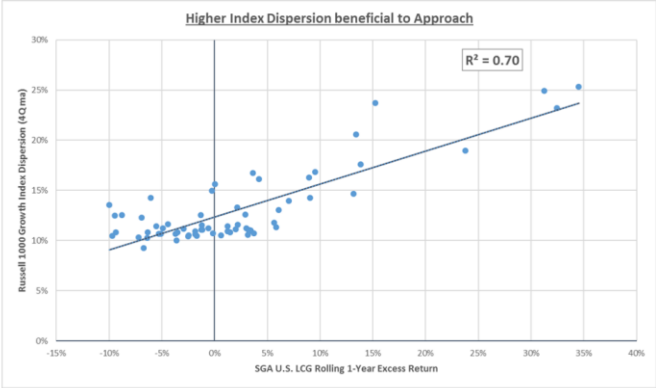


While the 65-day correlation among S&P 500 stocks fell to a 10-year low late in the quarter, Index dispersion, which is the weighted standard deviation of the underlying index components, remains low for the Russell 1000 Growth Index. Below we have charted the historical relationship between index dispersion and SGA's relative returns over time, showing a high correlation between the two. We expect dispersion to increase amid the uncertainties related to trade and fiscal policy which are inevitable over the coming year, and as growth remains modest.



Performance data based on SGA U.S. Large Cap Growth composite since inception, 4/1/2000 – 12/31/2016. Index Dispersion measured as 4-quarter moving average using quarterly data for Russell 1000 Growth Index and iShares Russell 1000 Growth ETF (IWF). Source: SGA and FactSet.

While past performance is no guarantee of future results, as dispersion among stocks increases this has historically been positive for SGA's performance as can be seen in the chart below:



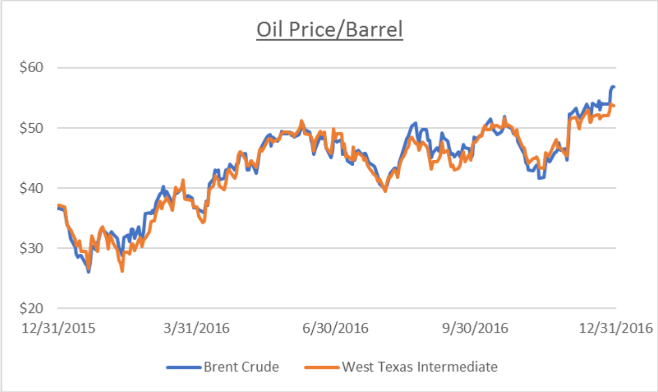
Capitalizing Hope

While we concur that more pro-growth policies such as lower corporate tax rates, reduced regulation and increased fiscal spending should enhance U.S. GDP growth in the coming years, we also believe there is danger in extrapolating the euphoria which has supported the market since the November election. We are less certain the changes will enhance growth outside the U.S. where problems of overcapacity, high debt, and nationalist pressures are likely to continue to temper a meaningful pick-up in growth. With the tremendous economic stimulus China has been applying now being retracted, the European Union showing few signs of strength despite quantitative easing, and the U.S. dollar at a 14-year high supported by an increase in interest rates in the U.S., there are clearly impediments to growth. Three key changes in the macroeconomic environment appear to us to suggest caution when considering the future path of U.S. and global GDP and corporate profit growth:

- The surge in the U.S. dollar to its strongest level since 2002 relative to a basket of currencies will have positive implications for U.S. consumers who will be able to buy foreign made products more cheaply, but it can be expected to pose a strong headwind for U.S. exporters trying to sell their products and services outside the U.S.

- The rise in the 10-year Treasury yield almost matched the sell-off faced in the 2013 taper tantrum when the U.S. Federal Reserve indicated that it may begin scaling back its quantitative easing program. Following that rise in interest rates, housing and its related businesses showed significant weakness. Today's rise in rates, and the Fed's announced plans for as many as three rate increases in 2017, may increase pressure on U.S. consumers who are already having trouble paying their auto loans, and more heavily levered companies. Higher interest rates also pose a threat to stability and future growth prospects in China where capital outflows are already a serious problem, and emerging markets which have large dollar denominated debt obligations. Should interest rates remain at current levels or rise further, U.S. exports to weakening emerging markets will likely be impacted.

- Gasoline prices have risen by over 16% in 2016, and pose a possible threat to U.S. consumer spending. Just as the decline in prices served as a tax cut, the increase in prices will serve as a tax hike and reduce cash flow available for other purchases. The recent OPEC agreement to restrict member output has the potential to cause prices to move up further, however we are skeptical that prices will move significantly higher given the readiness of U.S. shale producers to reenter the market. We remain positive on the outlook for unique oil service businesses such as Core Labs that can help oil producers be more productive in maximizing output from existing and new wells but are cognizant of the rise in prices already seen.



Key Performance Drivers

Stock selection drove the vast majority of underperformance in the portfolio for the period as SGA's investment approach was strongly out of favor given investors' preferences for more economically sensitive stocks. Selection was weakest in the traditional growth oriented sectors of Information Technology, Health Care and Consumer Discretionary. In contrast, stock selection in the Energy, Financial Services and Real Estate sectors contributed positively to performance. Despite large sector weighting differences from the benchmark, which are standard for SGA's opportunity-driven strategy, allocations played a minor role in portfolio performance for the quarter. Stocks that contributed most positively to relative performance, tended to be those which were beneficiaries of stronger economic conditions.

Largest Detractors

Over the course of the quarter, disappointing quarterly reports at a few select companies within the portfolio negatively impacted performance:

Cerner reported a disappointing third quarter with sales and bookings trailing consensus expectations. Customer order delays were noted as the surge of electronic health record purchases driven by federal regulatory demands declined and new orders displacing existing service providers are taking longer to close. The stock declined further after the U.S. presidential election as the surprise Republican sweep and the increased likelihood of the ACA being repealed in 2017, created uncertainties at Cerner's U.S. hospital clients which had benefitted from the expansion of ACA coverage.

Our research continues to indicate that Cerner has a large opportunity to grow with continued market share gains in electronic medical record and back office (revenue cycle) solutions, and also is well positioned in its client base with its cloud offerings of population health (which will enable hospital clients to better manage their operating and financial risk). Population health is nascent now but is expected to become a significant market over the next decade. While the future of the ACA appears murky at best, we do not anticipate a change in the trend towards providers increasingly being paid for positive patient outcomes, and having to take on some amount of risk in managing the health of the general population. We expect Cerner to continue to benefit from clients' growing needs for the technologies required to successfully operate in this emerging environment.

However, we acknowledge that there is some near-term uncertainty as hospitals pause to assess the new administration's healthcare policies, and that Cerner's business is less predictable than it was at the beginning of our investment when it benefited from the Obama Administration's economic stimulus program and the hospital IT market being significantly less penetrated. Accordingly, we reduced our position in Cerner during the quarter to account for the increase in near-term uncertainty and the increased maturity of its core markets.

FleetCor reported revenue and earnings modestly above expectations due primarily to a lower tax rate for Q3, but management then lowered their guidance for Q4 2016 disappointing some investors who have become accustomed to the company beating and raising guidance. The company continued to face adverse currency translation effects, lower revenues due to lower oil prices, and be negatively affected by the recession in Brazil and pronounced economic weakness in Russia. Despite this, however, we think it is important to point out that even though same store sales in Brazil are down about 10% for the year, FleetCor's business continues to grow in that country at a mid-to-high teens rate. The stock declined later in the quarter on the news that a competitor, WEX, had signed an agreement with FleetCor customer Chevron to issue commercial fleet cards. While a disappointment, we are comforted by the fact that FleetCor's three largest relationships with major oil companies comprised less than 7% of its revenue base in 2015. The loss of Chevron as a client is not expected to impact the company's results until 2018. Looking forward, we see the stock's valuation as quite attractive and remain confident in the company's outlook as it benefits from higher oil prices, begins to see positive contribution from their acquisition of Brazilian toll company STP, the second largest toll card company in the world, and ramps up their new Speedway card relationship. We expect the company to achieve high-teens revenue and EPS growth over the coming three years as the company benefits from a fertile environment globally for productivity enhancing products and services.

Leading open source software provider **Red Hat** reported disappointing quarterly results in December reflecting weaker than expected billings and revenue growth. A reduction in operating cash flow guidance by management also disappointed investors. Riding optimistic street expectations for faster sales growth following a positive report last quarter, Red Hat's stock was severely penalized. Near the end of Q3, we had reduced our position in the company to take advantage of the strength and increase our weight in another portfolio company. However, we maintained an average weight position in the stock during Q4, which negatively impacted our portfolio's performance. Our research indicates that Red Hat continues to be in a good position to benefit from the long-term transition of corporate infrastructure software needs to the cloud approach. It has also continued to benefit from strong growth in its application development and emerging technology segments.

Billings growth has become more volatile and been temporarily slowed by the company's gradual movement toward larger, longer-term orders. Operating margin improvement has also been less robust than expected due to this evolution and the company's digestion of recent acquisitions which we believe should be additive to sales and earnings over time. Finally, Red Hat's investment in a larger sales team approximately nine months ago, to take advantage of its strong product offerings and drive billings growth has yet to see the expected benefits. As order sizes increase and become longer-term in nature, we acknowledge that the predictability of the company's billings growth is likely to be less than earlier levels. We continue to expect Red Hat to benefit from its enhanced sales effort and strong product positioning as it capitalizes on corporate demand for more cost-efficient IT solutions, but remain cognizant of its valuation even following this quarter's stock price movement, and decided not to add to the position.

Amgen and **Colgate-Palmolive** were the fourth and fifth largest detractors from performance.

Top Contributors

Global leader in human capital management services, **Automatic Data Processing** (ADP) benefited from continued stronger employment data and rising interest rates. The company exceeded consensus EPS estimates on in-line revenue growth and new business bookings, and raised FY2017 guidance as it expects to continue to migrate clients toward its more profitable strategic cloud platforms. With an average float of around $20 billion to conservatively invest, resulting from the time delay between processing client payrolls and remitting the withholding to tax authorities, the company is one of the portfolio's more levered businesses to higher interest rates. Investors rewarded the shares given the steep rise in interest rates seen in the period since the election, and the likelihood of more reflationary policies under the Trump administration. We maintained an average weight position in the company during the quarter.

While **Core Labs** reported weaker than expected revenue and earnings growth for Q3, and remained cautious in their outlook given corporate reticence toward increasing capex spending plans, the company continued to participate in many significant projects, benefit from increased automation within their business, and see improved uptake of their products and services by clients. A key inflection point in the stock's performance during the quarter came with the U.S. presidential election and the likelihood that energy-related companies would benefit from less stringent government regulation. OPEC's agreement on November 30th to reduce output further benefited Core Labs' stock price as this implied a more stable crude oil pricing environment moving forward, and North American shale producers and others became more likely to increase their spending on extracting more oil from existing and new wells. We added to the portfolio's position in the stock on weakness early in the quarter.

Natural and organic food retailer **Whole Foods** was the third largest contributor to portfolio returns in Q4, propelled by several factors. The company reported quarterly results in line or slightly better than expectations, which included further evidence that recent price investments are beginning to resonate with consumers and driving increased purchases. In addition, the company announced it was moving from a co-CEO to a single CEO structure and that Walter Robb would step down leaving John Mackey as the sole CEO. Investors expect a more streamlined organization under Mackey's leadership, resulting in more decisive actions to expedite the strategic initiatives Whole Foods has set forth to address the increased competition they face from traditional grocers. Lastly, given its U.S.-centric operations and relatively high tax rate, Whole Foods should be a net-beneficiary of growth and tax policies under the incoming Trump administration. We maintained an average weight position in the stock.

State Street and **Schlumberger** were the fourth and fifth largest contributors to returns in Q4.

Portfolio Changes

UnitedHealth was the only new position initiated during the quarter. However, this masked a high level of activity trimming positions which had become more expensive or less attractive, and adding to positions where we sought to take advantage of price weakness and increased volatility. We trimmed positions in strong performers including Schlumberger, Priceline.com, Equinix and Apple, and added to positions in Novo Nordisk, Kansas City Southern, Facebook, and Amazon among others on weakness.

Purchases

We initiated a below average weight position in healthcare insurance benefits and services provider **UnitedHealth** during the quarter. Our research indicates that the company offers a strong and well differentiated value proposition in an environment where corporate and government payers are seeking to control or lower medical costs. Its size and scale allow it pricing power benefits from a network choice standpoint in terms of purchasing leverage, better actuarial data, and more diversified risk, while its Optum subsidiary offers clients the ability to reduce costs and complexity through an integrated physician network (OptumHealth) and their leading pharmacy benefit manager (OptumRx). The business offers strong recurring revenues resulting from the ongoing demand for health care services across their broad network. We see Optum's external business growing its revenues and profits faster than UnitedHealth's core business for the foreseeable future, benefiting from the broader desire of businesses and people to control their health care expenses. The business offers long runways of growth in the U.S. and potentially abroad. Management sees a $700 billion market opportunity domestically and the possibility for another $500 billion opportunity internationally as other nations work to develop a more economical approach to controlling their health care costs. Our work indicates significant growth potential for Optum here and abroad, however given the uncertainty related to possible international opportunities, our models do not incorporate any potential benefit from such moves.

Overall, we expect UnitedHealth to generate consistent top-line growth in the mid-to-high single digit range with profit growth in the low double-digit range as the company benefits from margin expansion from improved operating leverage. Such growth does not come without risk, particularly in today's uncertain healthcare landscape. The potential for other large insurers to merge with pharmacy benefit managers to create a competing entity poses a risk. As examples, the Aetna-Humana merger or the Anthem-CIGNA merger would have created significant competitors to UnitedHealth. Should these or other deals ultimately be approved, it could impact the company's scale advantages. Changes in regulations and government policy toward Medicare and Medicaid could also negatively impact the business, and a move to a single-payer program would definitely pose a serious problem. However, given the new administration's desire to reduce regulation, increase private industry participation, move away from a single-payer approach, and repeal and revise the ACA we are confident that UnitedHealth should be in a strong position to assist businesses in better understanding their health care experiences and managing the programs to reduce costs and enhance outcomes. Given strength in the stock post the election, we initiated a below average weight in the stock and expect to build it opportunistically as the new administration and Congress begin to address the nation's health care policy.

Summary

Q4 2016 was a difficult period for SGA's larger cap, high quality growth strategy as more economically sensitive, small capitalization, lower quality companies were strongly rewarded based on hope for new pro-growth policies by the Trump administration. The smallest and the lowest quality businesses within the Russell 1000 Growth Index outperformed the most during the quarter, making it unlikely that our strategy would keep pace with the market benchmark. However, even in difficult periods of performance like this, the portfolio continues to generate the consistently high and predictable revenue and earnings growth which is the foundation for our approach. In addition, the portfolio's valuation has gotten even more attractive with an enterprise yield of 3.9% compared to 3.5% for the Russell 1000 Growth. We continue to believe that attractively valued earnings growth drives stock price appreciation over the long-term, and the portfolio is well positioned to continue to generate consistent, predictable above average revenue and earnings growth over our 3-5-year time horizon. At year-end, the portfolio was forecast to generate 11.1% revenue and 23.4% earnings growth over the next three years while the Russell 1000 Growth Index was forecast to generate 6.3% and 11.7% respectively. In what is likely to remain a slow to moderate growth global economy over this period, such growth should remain attractive to investors as the reality of world economics begins to replace the hope of the moment. While there cannot be any guarantee, if history is any indication, periods of significant quarterly underperformance driven by exogenous macroeconomic or geopolitical events, have often been followed by periods of meaningful outperformance, presenting an attractive opportunity for investors who seek the benefits that investing in high quality growth businesses can offer over time. We've been fortunate to see old and new clients show faith in our strategy and take steps to capitalize on the recent underperformance, and we look forward to speaking with you more about the attractive opportunity we see in the portfolio today.

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

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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.