SGA
Sustainable Growth Advisers

Q4 2019 Global Growth Commentary

Highlights

- *The portfolio generated strong absolute returns in Q4 but trailed the MSCI All Country World Index (ACWI) as global markets rose sharply due to rising optimism over future global economic growth; smaller-cap growth companies with higher betas, lower returns on equity and no earnings performed best.*

- *For the year, the portfolio generated a return of 33.4% (gross) and 32.3% (net) while the MSCI ACWI returned 26.6% driven particularly by strength in the Information Technology sector.*

- *Stock selection was the primary detractor from performance in Q4 due primarily to selection in the Information Technology and Consumer Staples sectors where positions in Infosys, Danone and Heineken detracted most.*

- *For the year, the portfolio's outperformance was driven heavily by stock selection in the Consumer Discretionary and Real Estate sectors where positions in New Oriental Education, MercadoLibre, Alibaba and Equinix posted strong returns.*

- *While sector allocations are a bi-product of stock selection in our approach, they contributed positively to performance in both periods; market leadership was quite narrow with Information Technology being the strongest performer for the quarter and year.*

- *A new position in Thai convenience and wholesale store operator CP All was initiated; positions in Autodesk, Alphabet, HDFC Bank, and New Oriental Education were trimmed on strength while additional shares in Amazon, Salesforce.com, YUM! Brands and others were purchased on weakness.*

Performance

SGA's portfolio returned 8.0% (gross) and 7.7% (net) in Q4 versus 9.0% for the ACWI Index and 10.2% for the ACWI Growth Index, participating strongly the Q4 rebound of global markets, but trailing the Index as our valuation discipline led us to continue to take profits in strong performers and reallocate capital to other more attractively valued growth opportunities.

Global equity markets rebounded sharply in Q4 as uncertainties that had weighed on stocks in Q3 receded with a trade truce between the U.S. and China looking more probable (and a phase one deal ultimately being agreed upon), uncertainty over Brexit disappearing with Boris Johnson's landslide victory in British Parliamentary elections, U.S. economic data coming in better than expected and the Federal Reserve indicating it would remain accommodative for the foreseeable future. With the uncertainty over issues that could heavily influence future economic growth receding (at least temporarily), investors were willing to take on additional risk, leading to a strong narrowly driven upward movement in the market. Interestingly, gold, which usually increases in price as investor confidence in global growth weakens, was on track to post its best annual performance since immediately after the financial crisis in 2010. While Q4 saw a respite from the deep concerns investors had over weakening global growth and profits, great uncertainty remains over the impact of the phase one U.S.-China trade deal, rising Middle East tensions and their impact on oil prices, the effect of the pending January 31st Brexit on the UK and the rest of Europe which continues to experience sluggish growth, and the outcome of the 2020 U.S. Presidential election which has major ramifications for U.S. fiscal, trade and regulatory policies over the coming years. With these and myriad other macroeconomic and geopolitical uncertainties, we continue to believe there is ample reason to expect continued higher levels of volatility in the markets. If history is any guide, the greater differentiation between businesses which often takes place during such periods should be positive for the portfolio's focus on more predictable, above average growth businesses with attractive cash flow based valuations.

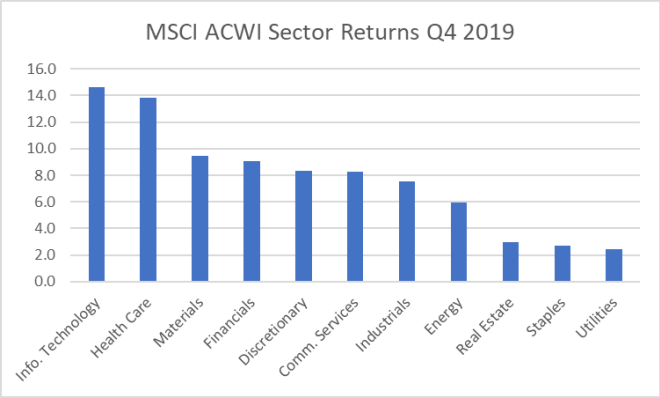
For the year, the portfolio returned 33.4% (gross) and 32.3% (net), while the ACWI Index returned 26.6%, and the ACWI Growth Index returned 32.7%. While growth scares related to ongoing weakness in China, the potential impact of the trade war between the U.S. and China and weakness in Europe and Japan negatively impacted global equities at times throughout 2019, markets climbed a wall of worry to generate some of the strongest returns seen for the decade. Given our long-term focused approach of investing in more predictable and sustainable growers which appear to be attractively valued based on cash flow, the strong momentum upwards presented a headwind for our approach but the portfolio performed in line with what we would have expected for the quarter and somewhat better than what we would have expected for the year.

Market and Portfolio Attribution

Market returns to style, capitalization and business quality varied widely over the course of the quarter, and sector leadership within the ACWI Index was relatively narrow. Investors' willingness to accept more risk during the quarter

given great optimism led to a market environment that was less favorable for our approach to growth investing. Smaller-cap growth companies with higher betas, lower returns on equity and no earnings performed best. The Information Technology and Health Care sectors generated the strongest returns for the period, far outpacing the returns of other sectors in the Index. Materials also marginally outperformed the overall Index while Financials performed in line. In contrast, more defensive sectors including the Utilities, Consumer Staples and Real Estate sectors performed the worst as investors preferred areas with higher expected growth and more economic sensitivity given their more upbeat expectations for economic growth. Emerging markets outperformed U.S. and non-U.S. Developed Markets in Q4, with the portfolio's overweight in Emerging Markets benefiting results.

For the year, only the Information Technology and Consumer Discretionary sectors outperformed the Index. Information Technology, was the strongest by a wide margin returning 47.5%, far outpacing all other areas of the market. Energy was the weakest performer for the year given plentiful oil and low prices.



Source: FactSet, MSCI.

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For the quarter, stock selection detracted from performance with weakness in selection in Information Technology being the largest detractor. Portfolio positions in Infosys and FleetCor detracted from results while the absence of Apple in the portfolio hurt relative results. Performance in the segment was boosted by strength in Autodesk which we added to on weakness in Q3 as our thesis for the business continues to play out. Selection in the Consumer Staples also detracted from performance as positions in Danone, Heineken, Mondelez and Nestle saw little interest from investors expecting an acceleration in global growth. The portfolio's overweight in Information Technology benefited results while its overweight in more defensive Consumer Staples mitigated most of the benefit. U.S. markets outperformed non-U.S. markets by a wide margin for the year as U.S. economic growth continued to show strength on the back of tax and regulatory reforms combined with accommodative monetary and fiscal policy. Stock selection across geographic regions contributed positively to performance for the year with selection in the Emerging Markets contributing most to results.

Largest Contributors

Chinese e-commerce and cloud computing leader **Alibaba** was the largest contributor to performance for the quarter. Alibaba's shares continued to rise following better-than-expected fiscal Q2 results released in November. Revenue growth was solid while profits and cash generation exceeded our expectations. The company's cloud segment posted 64% revenue gains, slightly under the 66% growth reported last quarter, while Core Commerce, Digital Media and other initiatives also posted attractive results. After delivering 40% revenue growth and 35% profit growth during the first half of FY 2020, the company is aggressively reinvesting back into their business in the second half of the year in order to continue to widen the moat relative to their competitors. We welcome the company's long-term focus, although some shorter-term investors were put off by management's plan for another round of investments. As consumption continues to grow as a percentage of GDP and online commerce penetration continues to increase in China, Alibaba remains exceptionally well-positioned to benefit from this growth given the dominant size of its e-commerce platforms and the resulting network effect. Meanwhile, Alibaba continues to expand its global e-commerce and logistics footprint and invest in regions where e-commerce penetration is still low, such as South East Asia, Russia and Europe, which can augment its long-term growth opportunities. In addition, we expect Alibaba, the largest cloud computing provider in China, to capitalize on its scale advantage given its 50% market share, and expand its markets outside China, further boosting future growth.

Design and build related software company **Autodesk** was the second largest contributor to portfolio performance as the company reported solid quarterly results which beat expectations on all key metrics, but disappointed some investors on the headline guidance for annual recurring revenues. A currency headwind for Q4 and subscription revenues that had to be recognized in Q3 as opposed to Q4 due to accounting rules, impacted expectations for Q4 revenues. Billings and free cash flow generation continued to be strong and our expectations for the full year rose. With our thesis for the business playing out and valuation still attractive, we continue to like the position, but trimmed it back to target given its recent strength.

Biopharmaceutical company **Regeneron** and health care stocks in general rebounded in Q4. Regeneron reported 3Q adjusted earnings per share growth of 14%, which beat the average analyst estimate and ours, and announced a $1 billion share buyback program. Dupixent, a drug for atopic dermatitis and asthma continued to deliver strong results with 140% sales growth, while its mainstay drug Eylea posted 17% revenue growth. Pipeline updates were well received by the market. During the quarter, the company also announced a restructured agreement with Sanofi for Praluent, a drug for hypercholesterolemia, and Kevzara, a drug for rheumatoid arthritis, which should improve profitability for those drugs in 2020. While the stock continues to be highly susceptible to short-term fluctuations in value due to frequent negative rhetoric regarding drug prices, and potential changes to Medicare part B reimbursement, we continue to see opportunity in the company's pipeline and its ability to continue to replenish its stable of attractive new drugs.

HDFC Bank and **IHS Markit** were the fourth and fifth largest contributors to portfolio performance.

Largest Detractors

Global restaurant company **YUM! Brands** was the largest detractor from portfolio performance in Q4 as Q3 results failed to match the strength of the business' first half trends. Continued weakness in the US Pizza Hut business and increased franchisee bad debt expense raised speculation that new CEO David Gibbs may take actions, potentially including capital infusion, to address Pizza Hut's issues. In addition, Q3 results were also weighed down by a temporary issue tied to the weak launch of a limited time offering. Our YUM thesis acknowledges weakness in Pizza Hut US due to its outdated dine-in unit base and significant competition in the food delivery. However, it is important to keep the business in proper perspective considering it represents only ten percent of total YUM profits. Further, while signs of weakening franchisees at Pizza Hut U.S. are noteworthy, the number of franchisees involved is small, and YUM has a very conservative policy of writing down all of a past due receivable if any of it is more than 60 days past due. In fact, it is likely that YUM may have chosen to make an example of the group to send a message to all U.S. franchisees and their lenders that they are expected to pay their bills on time or the company will take action. Overall, we see a low likelihood that the Pizza Hut US business will require a significant capital investment. Besides Pizza Hut US, the rest of YUM's businesses are performing well and we maintain high conviction in the company's growth prospects and overall investment thesis. As a result of this conviction, combined with an attractive valuation, we maintained an above-average weight in the portfolio and added on weakness.

Leading seller of fresh dairy products **Danone** was the second largest detractor from portfolio returns for the quarter. Despite indications that company sales were expected to accelerate in the second half of the year, management announced disappointing Q3 sales due to weakening North American and Russian dairy sales, and trimmed their outlook for full year comparable sales. Water sales, which have been resilient amid the weakness in other areas of the business also failed to meet expectations as a result of cool weather in Europe. On the positive side, long expected improvements in European dairy materialized as restructuring which has taken place in the business benefited results as we had expected. Chinese early nutrition also rebounded as expected growing double-digits after an extended period of weakness. While underlying results were mixed, management credibility suffered as the recent acquisitions of Whitewave and Unimilk failed to benefit the company's North American and Russian businesses, and the improvement in sales communicated by management didn't materialize. We will be closely monitoring the company based on these results, and are maintaining an average weight in the stock for now.

Indian information technology vendor **Infosys** was the third largest detractor from portfolio performance. While the company posted a solid report on most key metrics and increased their annual guidance marginally, it was not sufficient for some investors with more aggressive expectations who had pushed the stock's price up earlier in the period. Revenue growth on a constant currency basis was strong, rising by 11.4%, while Digital revenues continued to grow at a 30%+ rate. Margins continued to expand with improving team utilization, lower employee turnover and strong new business signings. With some concern over the weakness of a competitor, billings that weren't as strong as the consensus may have expected, but reasonable in our view, and conservative guidance, the

stock failed to keep up with the upward momentum of the markets.

Additionally, there was an allegation from a whistleblower during the quarter that was blown out of proportion in our view due to media mismanagement. We have known Infosys for many years and whistleblower issues are neither new to it or to other companies in our coverage. In fact, they highlight the strength of the corporate governance that exists which ensures that such issues are brought up to the board as well as investors.

We have analyzed the specific issues cited in the current whistleblower case, and it was not clear if management was at fault. Topics related to the recognition of costs and taxes often lead to back and forth exchange between companies and their auditors. Likewise, investors already know that some of their large deals don't have significant profitability upfront. The manner in which investors learned about the issues from the media, rather than the company itself, caused surprise and lowered the confidence of investors in management. While we understood that increased volatility due to news flows could divert attention away from the underlying strong fundamentals of the company's growth, the investment opportunity which existed after the stock's weakness caused us to increase our weighting. Subsequent to the end of the quarter, the company announced that its board and the investigation committee established did not find any wrongdoing, and the company will continue to work with the SEC and SEBI regarding their questions until the issue is resolved completely.

Heineken and **Nestle** were the fourth and fifth largest detractors from portfolio performance.

Portfolio Activity

During the quarter we initiated a new position in Thai convenience and wholesale store operator CP All. In addition, we took advantage of the strength in a number of stocks to trim positions where valuations had become less attractive. These included positions in Autodesk, Alphabet, HDFC Bank, and New Oriental Education. Additional shares in Amazon, Salesforce.com, and YUM! Brands among others were purchased on weakness.

New Positions

We initiated a position in **CP All** on macroeconomic related weakness as well as concerns that Tesco Lotus is looking for an acquirer and speculation that CP All could be a buyer. Should they be the acquirer, there could be an initial impact to EPS due to the cost of additional debt that could be incurred, but our analysis indicates that this is likely already reflected in the stock's price. Established in 1988, CP All is the sole operator of 7-Eleven stores in Thailand and also owns Makro, a wholesale cash and carry store. The company has pricing power due to its huge scale and vertical integration, recurring revenues from the highly repeatable business of convenience goods and cash and carry products, a long runway of international growth potential, as well as a well tenured and experienced management team.

Among the key risks we are monitoring with regard to CP All are the likelihood that their international expansion will not be profitable for 3-4 years. Additionally, the 7-Eleven format will be limited in its expansion from Thailand pending approval from 7-Eleven for other countries.

Summary

Rising optimism among investors generated strong equity market returns in Q4 as the concerns of Q3 seemed less troubling given the recent phase one trade agreement between the U.S. and China, greater certainty regarding Brexit and continued strong U.S. employment data. This fed a willingness to own smaller cap, lesser quality companies and created a headwind for our focus on more predictable and sustainable businesses with above-average revenue and earnings growth rates. Today the portfolio's forecast earnings growth rate for 2020 is 18.5% versus 9.6% expected for the ACWI. Over the next three years, the earnings figures are 19.0% and 9.2% respectively. In a world experiencing the 12th year of a global expansion, with muted economic growth across key economies despite unprecedented and massive monetary and fiscal stimulus, we are confident that the superior revenue and earnings growth of the businesses in our portfolio will stand out to investors over our 3-5 year time horizon and be amply rewarded. Quarter to quarter and even year to year returns can be affected tremendously by changes in investor emotions similar to those seen in Q4. Given such variability, we remain focused on implementing a disciplined investment process aimed at reducing the variability of the portfolio's earnings growth over time and generating strong absolute and relative returns that will protect capital in periods of weakness and participate strongly in periods of optimism. Whether or not in favor from quarter to quarter, the approach has served our clients well over time and our team remains excited by the opportunities we see over the coming years.

We thank you for your continued confidence in our firm and look forward to answering any questions you may have on the portfolio.

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