SGA
Sustainable Growth Advisers

Q4 2019 U.S. Large Cap Growth Commentary

Highlights

- *The portfolio generated strong absolute returns in Q4 but trailed the Russell 1000 Growth Index as markets rose sharply on expectations for a trade war truce, new monetary accommodation and improved profit growth.*

- *For the year, the portfolio generated a return of 34.6% (gross) and 33.6% (net) while the market returned 36.4% driven by Price/Earnings multiple expansion as Index earnings remained roughly flat.*

- *Stock selection was the primary detractor from relative returns for the quarter and year; in Q4 selection in the Information Technology sector detracted most due mainly to positions in Intuit, Workday and FleetCor; conversely Autodesk, one of last quarter's detractors, was one of the portfolio's largest contributors.*

- *Not owning Apple cost the portfolio about -1.4% of relative return for the quarter and -2.6% for the year; the level and predictability of our forecast earnings growth continues to look less attractive than other opportunities on our Qualified Company List.*

- *Sector allocation effects detracted from performance; market leadership was very narrow for the quarter with only the Health Care, Information Technology, and (to a much lesser extent) Communications Services sectors outperforming the overall Index.*

- *A new position in Ulta Beauty was initiated with proceeds from the sale of Lowe's; positions were trimmed in ADP, Alphabet, Autodesk, Estee Lauder and Novo Nordisk while we bought additional shares in Amazon, Intuit, Illumina, PayPal, Salesforce.com, and YUM! Brands.*

Performance

SGA's portfolio returned 8.1% (gross) and 7.9% (net) in Q4 versus 10.6% for the Russell 1000 Growth Index and 9.1% for the S&P 500 Index, participating strongly in the market's Q4 rebound, 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. Not owning Apple cost the portfolio about -1.4% of relative return for the quarter.

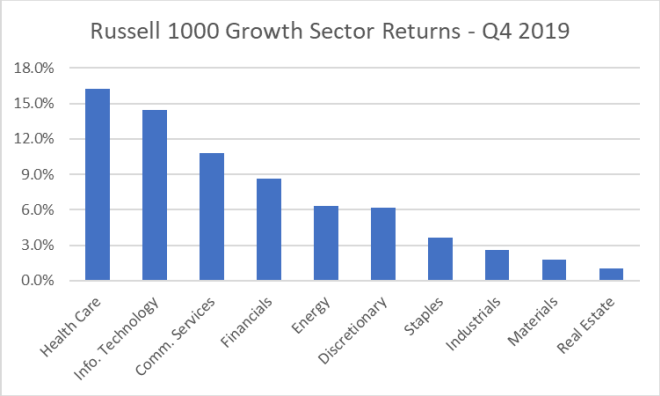
For the year, the portfolio returned 34.6% (gross) and 33.6% (net), while the Russell 1000 Growth Index returned 36.4%, and the S&P 500 Index returned 31.5%. While periodic macroeconomic growth scares temporarily impacted stocks in 2019, markets climbed a wall of worries ranging from the potential for higher interest rates, trade tensions, weakening global economic growth and speculation over the possibility of global recession. Just as for the quarter, Apple strongly influenced relative returns for the year. In the case of this portfolio, not owning it due to our concerns about its tepid earnings growth prospects over our 3-5 year time horizon cost about -2.6% in relative return. Over the course of 2019 Apple's earnings multiple expanded dramatically, despite minimal earnings growth on the expectation that the iPhone 11 cycle would be a big success. With slower growth and a less attractive valuation, this made the stock less attractive to us relative to other more predictable, higher growth opportunities on our Qualified Company List. Given our long-term focused approach of investing in more predictable and sustainable growers which appear to be attractively valued based on cash flow, and our emphasis on upgrading the portfolio with the most attractively valued quality growth businesses on our Qualified Company List, the portfolio performed in line with what we would have expected in the strong upward momentum experienced for the year.

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), investor risk appetites increased, leading to a strong narrowly driven upward move 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 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.

Market and Portfolio Attribution

Market returns to style, capitalization and business quality varied widely over the course of the quarter, and sector leadership for the Russell 1000 Growth Index was quite narrow. Smaller-cap growth companies with higher betas and no earnings performed best, with the reward to higher quality metrics mixed overall. The Health Care sector, which had lagged other sectors through most of 2019, was the best performer in Q4 as investors sought attractive valuations. The Information Technology and Communications Services sectors provided the next best returns, while all other sectors underperformed the Index. Real Estate, Materials and Industrials generated the weakest returns for the period. For the year, leadership was likewise narrow with only the Information Technology sector outperforming the Russell 1000 Growth Index. In contrast, Energy, which has a small weight in the Index, was the only sector to post single-digit returns for the year.



Source: Russell. FactSet.

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At the portfolio level, stock selection was the primary detractor from portfolio performance during the quarter due mainly to selection in the Information Technology sector which accounted for almost three quarters of the shortfall due primarily to weakness in Intuit, Workday and FleetCor. Selection in the Consumer Discretionary sector was also a key detractor due to a position in YUM! Brands. Selection in the Industrials sector contributed positively due to a position in IHS Markit. Sector weights also detracted from relative returns due to the portfolio's overweights in the Materials and Consumer Discretionary sectors, and an underweight in the strongly performing Information Technology sector. Over the course of 2019 we continued to trim our exposure to companies in the Information Technology sector as we evaluated the valuations of our holdings and periodically reallocated capital away from those stocks which had become less attractively valued and toward other more attractively valued growth businesses. The portfolio's underweight in the weakly performing Industrials sector and overweight in the strongly performing Health Care sector benefited relative performance.

Largest Contributors

Health insurance and services company **UnitedHealth** was the largest contributor to portfolio performance in Q4 as concerns over drastic changes to their operating environment faded as some of the more radical rhetoric over health care policy among the Democratic presidential candidates moderated at least temporarily. Fundamentally, the company continued to report solid results in Q3, with 6.7% revenue growth and 14% earnings per share growth. UnitedHealthcare, which accounts about 52% of profits, reported relatively flat enrollment figures while revenues grew about 5%. Optum, which accounts for about 48% of profits, continued to lead the company's growth with 16% profit growth resulting from solid results from OptumRx (pharmacy benefit management), OptumHealth (health services), and OptumInsight (tech led services)

segments. Concerns which impacted the stock last quarter over the company's medical loss ratio were mitigated by improved results this quarter. The company provided 2020 guidance toward the lower end of the expected range, however this was considered adequate given the return of the health insurance tax in 2020. We continue to see UnitedHeath as playing an important role in the evolving healthcare system in the United States as rising costs continue to pose a significant problem. They are well positioned to help more people obtain quality affordable care through their integrated model and data driven services.

Design and Build related software company **Autodesk** reported a solid quarter 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 relative to full year guidance. Billings and free cash flow generation continued to be strong and our confidence for the full year period rose. With our longer-term thesis for the business playing out we continue to have high confidence in Autodesk's opportunity, but trimmed the position on 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 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. Accordingly, given its attractive valuation, we continued to maintain a below-average position in the stock.

Microsoft and **Facebook** 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 payment 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 water, cleaning, sanitation and energy technologies company **Ecolab** was the second largest detractor from portfolio returns in Q4 despite the company reporting earnings per share growth in line with our and consensus expectations. Softer top line growth was offset by stronger than expected margin improvement. The soft top line growth was due primarily to results in Ecolab's Industrial and Energy business segments which faced macro related headwinds while its Institutional and Pest Control segment results were in line. We were pleased to see margin expansion being driven by solid pricing increases. Management slightly reduced the upper end of its 2019 guidance due to concerns over macroeconomic headwinds for its water and energy businesses and currency effects, but for 2020, our expectation of low double-digit earnings per share growth remains intact. The company shifted its sales effort earlier this year to focusing on pushing new business development, and that seems to be paying dividends with new business wins up 40% year-over-year in Q3, and we expect volume growth to accelerate in 2020. We continue to think highly of Ecolab's business and its fit with the key criteria

we seek, and added to the position on weakness, maintaining an average weight position.

Leading human capital management software-as-a-service company **Workday** reported strong quarterly results which temporarily buoyed its stock. However, following conservative management guidance for fiscal year 2021, the stock sold off as more momentum driven investors refocused on the company's deceleration in growth from the unsustainable 30%+ levels seen in recent years. This weakness created an opportunity for us to leverage our longer-term time horizon and thesis for the business and gradually build our position on weakness. We continue to see the company entering a multi-year period of sustainable 20% plus top line growth in addition to the likelihood of attractive margin expansion driven by its continued shift toward international business opportunities as well as the increasing acceptance of its new Financials/Planning/Analytics offerings. At quarter-end, we held a larger but below average weight position in the stock.

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

Portfolio Activity

During the quarter we sold the remainder of the portfolio's position in home improvement retailer Lowe's and reallocated the capital to a new position in leading beauty retailer Ulta Beauty. In addition, we took advantage of the strength in a number of stocks to trim positions where valuations had become less attractive. These included ADP, Alphabet, Autodesk, Novo Nordisk and Estee Lauder. We purchased additional shares in a number of existing holdings including Amazon, Intuit, Illumina, PayPal, Salesforce.com, and YUM! Brands.

Sales

We liquidated the portfolio's position in home retailer **Lowe's** late in the quarter. While the backdrop for home improvement in the U.S. remains positive, we do see this tailwind for Lowe's as being in its later innings. We believe in new CEO Marvin Ellison and his team, and see company specific operational improvements that they can make which will improve future revenue and earnings growth, but we also see the window for the opportunity narrowing as its chief competitor Home Depot reaps the benefits of its current investment cycle and extends its lead over Lowe's in terms of omni-channel and with professional customers, the two most significant growth opportunities in home improvement. Consistent with our 3-5 year outlook, and the reality that we have no more 30 positions in the portfolio, we liquidated the position in favor of other opportunities on our Qualified Company List.

Purchases

Ulta Beauty (Ulta) is the largest specialty beauty retailer in the U.S. and had been owned in this portfolio until April of 2019 when it was sold due to valuation. Given a significant pull back in the stock's price in recent quarters due to concern over a slowdown in their prestige cosmetics sales, we saw an opportunity to reintroduce the stock to the portfolio at an attractive valuation while the nature of our thesis remains similar. Ulta continues to provide a differentiated value proposition to beauty enthusiasts by offering a wide assortment of classic and emerging cosmetics, fragrances, skin and hair care brands across many price points in over 1,200 stores and through its e-commerce portal. With only 6% market share in the beauty category, and a favorable demographic trend among younger consumers starting beauty consumption early in life, Ulta has a long runway of growth, and continues to be a beneficiary of the disintermediation of the department store distribution channel due to weaker mall traffic. The business generates an attractive stream of repeat revenues from a passionate customer base and its impressive loyalty program with over 30 million members provides powerful data insights that help Ulta enhance its value proposition and engage more deeply with customers to gain wallet share. The company operates in an attractive margin category and is increasingly viewed by beauty vendors as a preferred distribution partner. This along with its growing scale helps Ulta to maintain pricing power and attractive gross margins. In addition, Ulta has a strong management team led by CEO Mary Dillon, who has been in the CEO position since 2013 and has led many successful initiatives including the loyalty program.

The company's position in the market is protected by its strong relationships with over 300 vendors across products (some of which are exclusive), its "all things beauty" store experience, and its established loyalty program, which make it more difficult for other retailers to mimic the concept and experiences it offers. While salon service is currently only 6% of sales, we view the service element as a strong differentiator versus online competitors, and the new service menu introduced last year has the potential to help improve store traffic and comp sales. Investors are more focused on the recent slowdown in color cosmetic sales, which was due to the lapping of the company's strong innovation wave in 2015-2017. Our analysis indicates that the current down trend will gradually return to growth, as store traffic and consumer interest in shopping at Ulta remain healthy, and many brand

partners are working with Ulta to introduce new innovative cosmetics products. As showcased by the recent quarter where Ulta delivered strong results in skincare and haircare to offset slowing in color cosmetics, we think the company with its broad merchandising categories and strong cash flow productivity will be able to maneuver the current situation in color cosmetics and, over the long-term, continue to ride the secular trend of more and younger women embracing beauty care products.

Among the risks to our investment thesis is the possibility that Amazon gains the confidence of key beauty brands by changing the shopping experience to more closely mirror the experiential nature of a trip to an Ulta store or to its e-commerce portal. Also, if store comps continue to slow while management continues to make investments to enhance customer in store experiences and grow ecommerce sales, then operating margins could be at risk.

Summary

2019 ended strongly, with the market generating double digit returns in Q4 as it rode a wave of optimism over an expected reduction in trade tensions, an improved global economic environment, rising corporate profits, and a belief that monetary authorities would support an extension to this now unprecedented bull market. The portfolio performed well, generating strong absolute returns amid the sharp rebound in optimism, while trailing the Russell 1000 Growth Index by about 2%. While market expectations and growth rates vary widely, this portfolio continues to generate double-digit revenue and earnings growth, regardless of the market's variations in expectations. In periods such as this, the steadier, more predictable mid-teens earnings growth of our portfolio isn't always as compelling to investors when faced with the chance for sharp increases in profitability for more economically sensitive stocks that typically benefit most in periods of rising optimism. However, as we've noted before, the steady and predictable revenue and earnings growth of the portfolio, together with its strong absolute return generation in such periods, helps set the stage for superior long-term returns, and protect client capital in periods of greater uncertainty. We strongly believe that the new decade will be very different from the last as market volatility increases and investors see greater differentiation between businesses as we make our way through the latter innings of the current extended bull market. If history is any precedent, this bodes well for all of SGA's portfolios which continue to be managed in the same exact manner utilizing our one team, one philosophy and one strategy.

Thank you for your continued confidence in our team and investment process. We look forward to answering any questions on the portfolio that you may have.
