SGA
Sustainable Growth Advisers

ESG Friendly Investing Naturally

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Executive Summary

- When Sustainable Growth Advisers was formed in 2003, ESG investing was in its infancy; our objective then and now has been to generate the best risk-adjusted long-term portfolio returns for clients

- Our focus on business quality, long-term sustainable growth and risk control has naturally led us toward businesses that tend to be highly regarded in terms of their ESG factors; Barron's, in a January 4th, 2019 article, ranked SGA's U.S. Growth portfolio in the top 5 of 200 of the best sustainable U.S. growth portfolios in existence today

- Deep fundamentally driven, bottom-up proprietary research, including periodic engagement with management on topics such as ESG, is central to our investment process

- In combination with the added perspective resulting from our incorporation of independent third-party analyses of the specific ESG issues at each company, our approach ensures broader perspective that ultimately helps us build diversified portfolios

- SGA's time-tested approach offers an opportunity to invest in ESG friendly businesses without compromising on generating, historically attractive, risk-adjusted returns

The ESG Landscape

The ESG landscape has evolved significantly since 2004 when UN Secretary General Kofi Annan first wrote to the CEO's of 50 major financial institutions inviting them to participate in a joint initiative to integrate ESG into capital markets. Today, the UN backed Principles of Responsible Investing (PRI) is a global initiative with over 1600 members representing over $70 trillion in assets under management. According to a PriceWaterhouseCoopers survey of 162 institutional investors across 35 countries, ESG and sustainable development are becoming increasingly important priorities for investors. Over 80% said they currently report ESG matters to their boards at least once per year, and a third reported doing so more frequently. 91% have an ESG policy in place or in development, and of these 78% track and report progress towards responsible investment ESG policies. Finally, among retail investors, 76% of high-net-worth millennial and Generation Z investors have reviewed their assets for ESG impact. With the growth in demand for ESG focused investment products, negative screening to avoid companies deemed to be offensive has evolved to include more sophisticated approaches where ESG factors are explicitly built into investment processes. More recently, Impact Investing has gained interest as investors seek to support specific projects consistent with the UN's 17 Sustainable Development Goals, including things such as alleviating the problems of poverty and hunger, supporting good health, clean water, affordable clean energy, climate change and other causes.

While this evolution offers investors seeking more ESG compatible investment opportunities more options to consider, it also creates greater uncertainty as they try to differentiate between products and determine which ESG focused products meet their ethical, risk, and investment return requirements. Similarly, trustees responsible for carrying out fiduciary duties on behalf of shareholders are faced with important considerations relative to risk, and the potential financial cost to limiting a portfolio's focus to a predetermined list of ESG friendly companies. With a myriad of supposedly ESG friendly products now available, investors must determine the most effective means for accomplishing such an objective. Unfortunately, today there are no clear standards by which to make such decisions, and significant debate remains around the possible trade-off between ethical investing and financial returns. Traditional Socially Responsible Investing (SRI) options which focused on implementing negative screens are simple and easy to implement. However, they also severely limit the opportunity set and fail to incorporate broader elements of businesses related to the way companies incent and treat their employees, obtain their resources, govern their management, and generally contribute to society.

Narrowly defined Impact Investing satisfies the ethical desires of investors seeking to support certain causes or issues, but raises uncertainty regarding the trade-off between ESG considerations and portfolio returns. We believe that a fundamental approach incorporating deep company research, and a reasoned evaluation of company-specific ESG related issues and their impact on the ability of the business to grow sustainably over the long-term, can provide investors with a portfolio which blends a high quality ESG profile and strong risk-adjusted returns.

Natural ESG Compatible Investing

When Sustainable Growth Advisers was formed in 2003, ESG investing was in its infancy, and our focus on sustainable growth was not tied to the concept of ESG as it is known today. The basis for the name we chose for our firm was a deep belief in a time-tested process for identifying successful long-term sustainable growth businesses that had rewarded clients well for many years. Our objective then and now has been to generate the best risk-adjusted long-term portfolio returns for clients. We have always defined risk as the permanent destruction of capital as well as the volatility of returns. We seek to minimize risk through limiting (a) business risks inherent in the companies we own, and specifically the risk of an interruption of growth for the business; (b) human risks inherent in any decision-making process; and (c) price risk through the application of a cash-flow based valuation discipline.

Our focus on business quality, long-term sustainable growth and risk control has naturally led us toward businesses that tend to be highly regarded in terms of their ESG factors. (Consistent with this, Barron's, in a January 4th, 2019 article, ranked SGA's U.S. Growth portfolio in the top 5 of 200 of the best sustainable U.S. growth portfolios in existence today.) Our concern with business quality and forward-looking-risk has always steered us away from companies whose products we deem to be detrimental to users or society, or are managed in an irresponsible way. Demand for such products, and society's reaction to detrimental products or negative corporate behavior often lead to costs (legal) and limitations on marketing which, in turn, can lead a franchise to suffer. Tobacco stocks are an example of such businesses that we have not owned as they are not truly sustainable growth businesses. Despite generating significant free cash flow, their pool of consumers was declining, they seriously damaged people's health and faced significant risk from ongoing legal challenges.

From the start, SGA's founders, Rob Rohn, Gordon Marchand and George Fraise, understood that there were enduring elements that contributed to the ability of businesses to grow more predictably and sustainably at higher than average rates, and that high-quality companies that promote advancement, and good for society in general, often generate more attractive long-term returns. We recognize that social, governance and environmental factors inherently impact a company's brand equity, employee satisfaction, competitive position, financial performance and ultimately long-term shareholder value.

Visa is a good example of a company SGA has owned in its portfolio for an extended period of time, since its IPO in 2008, that meets each of the business quality criteria we seek while positively impacting a broad array of customers and communities around the world. Visa possesses attractive pricing power given its strong position in electronic payments relative to peers, generates highly recurring revenues, offers long runways of growth through its business of processing and digitizing consumer payments, generates strong free cash flow and is managed effectively for shareholders while promoting the advancement of commerce and economic development, and helping to serve a growing middle class which is evolving in emerging countries around the world.

In support of our focus on the key drivers of long-term business quality noted above, SGA's investment process entails several elements that help us identify attractive businesses and manage client portfolios more effectively:

- SGA's Proprietary Research and Periodic Engagement with Management
- The Incorporation of Objective 3rd Party ESG Analyses
- Proxy Voting to Support Long-Term Shareholder Interests

SGA's Proprietary Research

Deep fundamentally driven, bottom-up proprietary research, including periodic engagement with management on topics such as ESG, is central to our investment process which has focused on the same key drivers of business quality since our inception. These attributes include superior pricing power, predictable revenue generation, strong cash flow generation and less levered balance sheets, long runways of growth opportunity, and management teams that have proven to be good stewards of shareholder capital and are likely to be able to responsibly execute their plans. Very few businesses offer all such attributes, and it is the reason that our Qualified Company List, the "buy" list that we select all stocks for portfolios from, remains highly selective with only 100 or so businesses making the list.

Pricing power is an incredibly important quality for a business to have, particularly in a low inflationary environment such as the last decade when price increases have been difficult to implement for businesses across a wide spectrum of industries. It indicates that the business has something unique to offer relative to its peers. Pricing power is affected by the nature of the products or services a business offers to customers, often by the level of innovation it displays, and indirectly by the way a company treats its employees since higher rates of turnover in key staff, or a lack of clear direction or motivation on the part of associates can negatively impact the value perceived in a product or service by customers. In the case of tax preparation and accounting software maker Intuit, a recent purchase, the company has placed on Fortune's Best Places to Work list for 15 years, and on Glass Door's top 30 Place to Work. Support for entrepreneurial thought is emphasized at the company and their attention to their workforce has enabled it to compete effectively as they continue to broaden the scope of their business.

Consistent, more predictable revenue generation enables businesses to better weather fluctuations in macro-economic growth, and is supportive of better long-term sustainable earnings growth. Greater predictability in revenue generation and growth, while heavily influenced by the type of product or service being sold, benefits from a company having a strong and stable culture which allows it to successfully implement its business plan on a consistent basis. Companies that properly incent and respect their employees, and experience lower turnover, and companies that manage their operations in a responsible manner partnering with their customers and supply chains, accessing their resources responsibly with the long-term in mind, have a better chance at generating the more repeatable revenue generation and earnings growth that we seek. Software as a service leader Salesforce.com, a core holding, has achieved "net-zero" greenhouse gas emissions globally today, and delivers a carbon neutral cloud product to its customers, ranking in the top 5 of Barron's Most Sustainable Companies list in a January 4th, 2019 article. Likewise, they have continuously invested in their people, ranking #2 on Fortune's Best Places to Work and Glassdoor's Top 15 Places to Work. As a visible leader in corporate philanthropy with 1% of profits being distributed to various charitable causes, the company clearly invests in its communities. While we focus heavily on only owning businesses that meet our quality and growth criteria, however, as their stock prices appreciate and become less attractive from a valuation perspective relative to other growth candidates that meet our quality criteria, we actively reduce our exposure to them and eventually may remove them from our portfolios due to valuation. We have exited the position in Salesforce.com at times in the past as our valuation discipline led us to better options.

Strong balance sheets and attractive cash flow generation clearly benefit businesses relative to their peers, as less levered balance sheets allow them to compete more effectively and be less impacted by macroeconomic fluctuations. Strong management teams, to us, are good stewards of shareholder capital, incented to make the best long-term decisions, and governed by an independent board that has a broad perspective with appropriate checks and balances. Such management teams are more likely to make sound long-term pro-shareholder oriented decisions.

Each of these key business quality factors enhances the likelihood a company may experience longer runways of growth in revenues and earnings. While a company's business quality metrics will likely vary to a degree over time, if it has a responsible long-term vision and the commitment by management to implement it, the chances that a company will be successful for its employees, customers and shareholders over time is enhanced.

In order to ensure that businesses approved for our Qualified Company List have these long-term quality characteristics that reduce risk and enhance the sustainable growth opportunities we seek, we assign a primary and a secondary analyst to each company. Each analyst is responsible for researching the business and forming their independent opinion regarding the quality standards we deem so important. This proprietary research encompasses deep analysis of the company's operating environment, peers, culture, management, governance, unique growth drivers, and financial strength. Inherent in this evaluation is developing an understanding of the ability of the business to grow in a sustainable manner and all the factors which influence this. When we invest in businesses, it is for the long-term, with an average holding period in the 3-5-year range, with many stocks held much longer. Examples of this include companies such as Ecolab, Automatic Data Processing, and Visa which all score high on ESG factors and have been owned in our U.S. Large Cap Growth portfolio for many years.

Objective 3rd Party ESG Analysis

Beginning in 2014, we developed an even broader perspective regarding the business quality of each company under consideration, by incorporating evaluations of ESG factors from independent third party ESG and Corporate Governance leader Sustainalytics. We then combine the proprietary research by our analysts with the independent third-party views received from Sustainalytics to enhance our overall perspective on the key sustainability issues and business quality we seek. We apply a 50% weight to SGA's and a 50% weight to Sustainalytics' score, and arrive at an overall ESG quality score. Inevitably, differences will occur between our thoughts and those of Sustainalytics. When differences occur, the scores of each are re-examined to ensure that we fully understand the nature of the differences and that all key issues are appropriately vetted. In some cases, we will reconsider our thoughts and adjust our company thesis if necessary, and in other cases we will decide to disagree with the Sustainalytics scoring, and make no change to our thesis.

Such scores do not, in themselves, determine whether a stock will be purchased or sold. We do not rank businesses and build our portfolios solely on such ranks. The purpose of the ESG quality scoring process is to ensure that the key issues surrounding companies are fully discussed and that we can arrive at the best possible overall understanding of a business and the sustainable growth it offers. We believe this approach enhances our overall understanding and perspective of businesses, and ultimately leads to more robust decisions when considered alongside our analyses of the company's pricing power, recurring revenues, runways of growth, cash flow generation, financial quality, and management quality. After a discussion around these key topics, should a company be placed on our Qualified Company List, these issues will be monitored and reevaluated on an ongoing basis, regardless of whether the stock is included in an SGA portfolio or not.

Proxy Voting to Support Long-Term Shareholder Interests

We seek to represent our clients' interests through a responsible implementation of our proxy voting policy. SGA's proxy voting procedures are designed and implemented in a way that is expected to ensure that proxy matters are conducted in the best interest of our clients. The policy and procedures are updated as appropriate to take into account new developments in the law, best practices in the industry, studies of corporate governance, and refinements deemed appropriate by SGA.

We consider the litmus test of any proposal, whether it is advanced by management or by one or more shareholders, to be whether the adoption of the proposal allows the company to carry on its affairs in such a manner that the clients' best interests will be served. Judgmental issues are reviewed by senior investment professionals to determine if adopting the proposal is in the best interest of our clients. Any material conflicts are resolved in the best interest of clients or in accordance with client directives. Even in the case of companies we view very favorably, we will vote against management when we determine shareholder interests may be served better by doing so. As an example, recently we determined it was in the best interests of our clients to vote against the management position of a very successful Latin American e-commerce company we think highly of, after the company nominated the brother of the CEO to become a Director on their board. While we highly respect the management team at this company, in the best interests of good governance, we determined that a non-related Director may be more effective.

Summary

As the level of interest in ESG investment solutions continues to grow, it will be critical for investors seeking such exposure to carefully evaluate the best way to implement it. The implications of an approach utilizing a negative screening process differ significantly from undertaking a high impact approach. While the best way to implement a socially conscious investment program will vary by participant and their unique objectives, we believe an approach incorporating fundamental research focused on key time-tested business quality drivers can be more beneficial to investors while accomplishing the same objective. SGA's approach naturally gravitates us in the direction of more ESG friendly businesses rather than relying on negative screens or targeted themes which fail to take into account portfolio risk and do little to optimize overall risk-adjusted returns. In combination with the added perspective resulting from our incorporation of independent third-party analyses of the specific ESG issues at each company, our approach ensures broader perspective that ultimately helps us build diversified portfolios of 35 or fewer high quality long-term secular growth businesses. When combined with our attention to reducing human risk by incorporating the views of a primary and secondary analyst for each business we research, and a reduction in price risk due to our cash flow-based valuation metrics, this time-tested approach offers an opportunity to invest in ESG friendly businesses while generating, historically attractive, risk-adjusted returns.

Thank you for your interest in SGA and our approach to investing in high quality, responsible long-term growth businesses.
