SGA
Sustainable Growth Advisers

# Q2 2020 Global Growth Commentary

## Highlights

- *The portfolio generated strong absolute and relative returns as global equity markets rebounded in response to hopes for a faster than expected economic recovery as countries allowed businesses to re-open, and significant monetary and fiscal stimulus was applied*

- *The market advance was driven by a narrow group of retail and e-commerce related consumer and technology stocks; we used increased market volatility to lock-in gains where valuations had risen and traded up in terms of growth and cash flow visibility*

- *Stock selection and residual sector allocations each contributed positively to the portfolio's outperformance; selection was strongest in Information Technology where positions in PayPal and Autodesk contributed most; overweights to the strongly performing Consumer Discretionary and Information Technology sectors contributed positively*

- *New positions were initiated in Facebook and Kansas City Southern while the portfolio's positions in Nestle, Booking Holdings and TJX Companies were sold; positions in Amazon, MercadoLibre, Nike, PayPal, SAP and Tencent were trimmed on strength while positions in Alphabet, Linde, New Oriental Education and Visa were added to*

- *Given the superior business quality and predictability of our companies, the portfolio is expected to generate significantly greater revenue and earnings growth than the MSCI ACWI Index benchmark over the coming three years despite significant uncertainties over the pandemic, economic growth, and other uncertainties*

- *We are pleased to announce that HK Gupta will join our Global Growth equity portfolio management team effective January 1st, 2021 given the strong contributions he has made in research and portfolio management since joining SGA in 2014 and co-managing our Emerging Market and Global Mid-Cap portfolios; we are also pleased to announce that Peter Knudsen was promoted to Client Portfolio Manager effective July 1st*

## Performance

Global markets posted strong absolute returns for the quarter with the U.S. market outperforming Non-U.S. Developed and Emerging Markets. SGA's portfolio returned 25.6% (gross) and 25.3% (net) in Q2 versus 19.2% for the MSCI All Country World Index (ACWI). The market advance was relatively narrow with Information Technology, Consumer Discretionary and Materials companies leading. Retailers and those businesses most levered to the re-opening of economies benefited most, as well as Information Technology and e-commerce.

## Continued Uncertainty but Hope

With continued uncertainty over the path of the COVID-19 pandemic and associated economic weakness, the International Monetary Fund (IMF) lowered its forecast for World GDP growth to -4.9% for 2020, and projected U.S. GDP to shrink by 8%. Similarly, the UK, European Union, Japan, India, Latin America and South Africa all saw their respective GDP's decline meaningfully in Q1, and expected further weakness moving forward, while China's GDP was forecast to grow by only 1%. Meanwhile, the World Bank forecasted World GDP to decline by 5.2% in 2020, marking the fourth deepest recession since 1900 and the worst since World War II.

Unemployment posed a headwind to most economies as manufacturing and services were negatively impacted by unprecedented lockdowns. As a reflection of this, 20.5 million Americans lost their jobs in April, compared to 8.6 million who lost their jobs during the entire Great Financial Crisis of 2008-2009. Eurozone unemployment jumped to 7.3% in April. However, later in Q2, glimmers of hope began to appear as businesses and economies took steps to re-open. In a sign of gradual progress, U.S. unemployment unexpectedly dropped from 14.7% to 13.3% in May as 2.5 million people were added to payrolls, and in June, the U.S. and Chinese Manufacturing PMI's each rose back into expansion ranges due to new orders rising.

Following Q1's market weakness, global equity markets sharply rebounded in Q2 as investors reacted to faster than expected business re-openings and significant stimulus from monetary authorities and governments. With the strong rebound in stock prices, the CBOE VIX Index declined 43% from elevated levels at the beginning of the quarter, but its average remained high at 34.5. Given continued sporadic virus outbreaks, fluctuating re-opening plans and persistent fears over a second wave, we continue to see the ingredients for elevated volatility in global equity markets to persist. This is further underlined by the upcoming U.S. Presidential and Congressional elections with their important implications for future tax, regulatory and trade policies. Such volatility has historically created opportunities for our approach to growth investing and we see the current situation as no different with the portfolio well positioned to provide the predictable and sustainable revenue, earnings, and

cash flow growth investors tend to seek in periods of economic uncertainty.

### Market and Portfolio Attribution

With corporate profit growth expected to plunge in 2020, growth stocks outperformed value stocks as investors sought businesses that could generate attractive earnings growth despite widespread economic weakness. Within the ACWI Index, consistent with investors' more positive evolving outlook, higher beta stocks, companies with lower returns on equity, lower levels of debt and no earnings performed best during the quarter. Developed Markets led by Australia, New Zealand and Germany outperformed Emerging Markets despite strong performances by South Africa and Brazil. The UK and Hong Kong were among the weaker performers during the quarter, while China trailed the ACWI Index.

Leadership in the market was relatively narrow with the Information Technology, Consumer Discretionary and Materials sectors performing best in the rebound led by retailers and companies most levered to business re-openings as well as e-commerce companies which continued to benefit from increased traffic. In contrast, more defensive sectors such as Utilities, Consumer Staples and Real Estate performed the worst.

Within the portfolio, stock selection and sector allocations contributed to the portfolio's outperformance. Selection in the Information Technology sector was the strongest contributor driven by positions in PayPal, Autodesk and FleetCor. Selection in the Health Care, Consumer Discretionary, and Communication Services sectors also contributed positively to results due largely to positions in Illumina, MercadoLibre, and Tencent. In contrast, selection in materials detracted very slightly from returns.

### Largest Contributors

Digital and mobile payment leader **PayPal** was the largest contributor to portfolio performance in Q2. They reported an in-line quarter showing resilient growth, strong operating leverage and free cash flow generation. Management's comments regarding accelerating growth and new user adds, including 7.4 million in April, and their expectation for a total of 15-20 million new adds in Q2 was positively received by the market. Continued signs of Pay with Venmo gaining traction, increased use of Venmo for tipping, donations and family sharing, and adoption of Pay with QR codes which unlocks a massive offline market that PayPal had very low penetration to in the past, contributed positively to the market's assessment. From a more general standpoint, investors are recognizing that the current environment has altered consumer behavior and accelerated adoption of e-commerce and digital payments, and PayPal, with over 300M users on its platform, is favorably positioned to capture these trends. We trimmed the position on strength during the quarter and maintained an average weight in the portfolio.

Latin American e-commerce and Fintech company **MercadoLibre** was the second largest contributor to portfolio performance. The company posted mixed, but better than expected Q1 results, and provided highly bullish Q2 data that propelled the stock higher. The company's results were buoyed by a COVID-19 induced acceleration in growth as consumers turned increasingly to e-commerce. At the same time, management reduced marketing spending, strengthening margins. Brazilian revenue decelerated, as approximately 1/3 of its merchant listings needed to be pulled due to an inability for orders to be fulfilled due to the virus. Weakness in Brazil, however, was more than offset by strong results in Argentina, Mexico, Chile and Columbia illustrating the attractiveness of MercadoLibre's Latin American model. Significant progress in logistics with 50% of shipments now traveling on its own network versus only 2% two years ago, as well as improvements in its fulfillment capabilities and better inventory control, enhanced the company's results and points to further gains looking forward. We were also pleased to see the company's Fintech offerings – merchant payment, mPOS, QR and asset management all executing well despite the virus-induced slowdown seen in late March. This speaks to the strength of their disruptive business model and the potential in their FinTech opportunity moving forward. While our conviction in MercadoLibre and its opportunity in e-commerce and FinTech remain strong, given recent appreciation and valuation we trimmed the position and maintained a below-average weight.

E-commerce and cloud computing leader **Amazon** was the third largest contributor to portfolio performance. The company continued to benefit from increased demand for its retail and cloud services as consumers preferred to shop on-line versus in stores, and its cloud business also benefited from increased demand. Advertising revenues continued to be in line with our expectations as some verticals withdrew, but others increased their usage. We continue to see Amazon benefiting from long-term trends, but expect short-term expenses to rise due to spending on COVID-19 related needs as well as increased capex reflecting increased datacenter and warehouse demand. We trimmed the position on strength during the quarter, but maintained an above-average weight position.

The fourth and fifth largest contributors to portfolio performance in Q2 were **Autodesk** and **Illumina**.

**Largest Detractors (i.e. Smallest Contributors)**

Food and nutrition company **Nestle** was the smallest contributor to portfolio performance. Given its more defensive characteristics and relative strength during the Q1 market weakness, we began liquidating the position due to valuation later in the quarter, reallocating the capital to other higher opportunity stocks from our Qualified Company List. The small remaining position in Q2 was liquidated, but had little impact on portfolio performance for the period.

North American freight railroad **Kansas City Southern** was added to the portfolio in Q2 and had only a very small contribution to results for the period. An explanation of our thesis for the company is provided below in the Purchases section.

Global social networking leader **Facebook** was also purchased in the quarter, and had the third smallest contribution to portfolio performance. An explanation of our thesis for Facebook is provided below in the Purchases section.

The fourth and fifth smallest contributors in the quarter were **AIA Group** and **Novo Nordisk**.

**Portfolio Activity**

Turnover in the portfolio declined from Q1's high level as stock prices rose, but remained elevated. Higher than normal turnover, of about 25% on a year-to-date basis (51% annualized), reflected the more volatile nature of the markets and the opportunity we continued to take advantage of in Q2. We improved the portfolio's growth, valuation and visibility liquidating positions in food and nutrition company Nestle, on-line travel agency Booking Holdings, and off price retailer TJX Companies while initiating positions in positions in social networking company Facebook, and railroad Kansas City Southern. We trimmed positions in Amazon, MercadoLibre, Nike, PayPal, SAP and Tencent among others, and reallocated capital to Alphabet, Linde, New Oriental Education and Visa among others.

**New Positions**

**Facebook** was added to the portfolio in Q2 on weakness caused by an expected downturn in their advertising revenues as a result of the global COVID-19 pandemic and its impact on users' spending. With over 2 billion people using its products (Facebook, Instagram, Messenger, and WhatsApp) daily, the company continues to offer a highly attractive medium for businesses to reach potential new customers. Its broad data set gives marketers an unprecedented means to conduct personalized marketing campaigns on a global scale.

Facebook's pricing power benefits from multiple self-reinforcing network effects with increases in user connections, posted content, and third party site integrations and log-ins all contributing to further growth in the years ahead. These network effects continue to strengthen Facebook's brand and further enhance its barriers to entry. With an expanding user base that further increased usage of its products during social quarantining, the company generates strong repeat revenues due largely to the advertisers and direct targeting marketers who seek to access those consumers. We see continued growth in Facebook's advertisers as it benefits from the secular shift of over $700 billion of global advertising and marketing budgets from traditional offline to online and mobile venues and as the company increases its payment and e-commerce capabilities. The deployment of 4G and 5G mobile networks makes mobile video content consumption increasingly compelling to advertisers and users. With meaningful room to further monetize Instagram, video and WhatsApp, and the ability to penetrate emerging markets more, we see attractive long-term secular growth potential for the company.

While Facebook offers significant potential for long-term cash flow and earnings growth, the company faces risks of increased regulation over user privacy and its control over content. Intense regulatory scrutiny in the U.S., Europe and elsewhere will be a headwind for the foreseeable future. However, we expect the company to weather these issues and capitalize on its significant user data and ability to access 2 billion users daily over the long-term. Recent advertising boycotts by companies concerned about Facebook's control of hate speech pose a headwind in the short-term, but are unlikely to lead to significant long-term slowing in advertiser direction of marketing dollars toward the company given its past record of making adjustments to its products, policies and practices as necessary. Importantly, increased regulation has also had the unintended consequences of increasing barriers to competition.

We initiated a below-average weight position in the company and later increased to an average weight position.

**Kansas City Southern (KSU)** was purchased in the portfolio on weakness due to concern over weak economic activity tied to the COVID-19 pandemic. The company's integrated U.S. and Mexican operations are strategically focused on the growing

north-south freight corridor connecting key commercial and industrial markets in the central U.S. with major industrial cities in Mexico. Its business is well diversified with about 25% of its revenues tied to transporting Industrial and Consumer products, 20% to Chemicals and Petroleum, 19% to Agricultural and Minerals and 17% to Intermodal business.

The company offers attractive pricing power, being able to consistently realize price increases higher than inflation due to the duopolistic nature of the North American rail industry and continued highway trucking cost inflation. The company's implementation of Precision Scheduled Railroading concepts has enhanced the productivity of their equipment and margins further, and we expect that serving clients in a timelier manner will lead to incremental new business. With the company being deemed an "essential service", the recurrence of its revenues is higher than seen with other more economically sensitive businesses. With cross-border trade continuing to grow as well as rising Mexican industrialization, we see attractive sustainable growth for KSU in refined gas, intermodal, plastics and chemical/industrial products.

Among the key risks we are monitoring for KSU are the regulation it faces relative to pricing, labor relations and safety both in the U.S. and Mexico. Competition from other rails as well as trucking and cargo shipping also pose a risk, although we see trucking as least likely to pose a threat other than the possible implementation of autonomous trucking. While a risk, current technological limitations as well as the likely difficulty in obtaining regulatory approval for autonomous trucking reduce its potential to threaten our thesis over our 3-5-year investment horizon. Indeed, we see the potential for autonomous railroading as more likely, and this would further enhance the company's margin structure and long-term profitability. Finally, while the company's products are largely consumed on a regular basis regardless of the macro economic environment, some of its traffic is more economically sensitive.

We initiated a below-average position in the company in May, and continued to gradually build the position opportunistically over the balance of the quarter.

**Sold Positions**

The portfolio's position in internet travel agency **Booking Holdings** was sold to fund other opportunities which offered higher long-term growth visibility with a higher level of confidence. We continued to see Booking Holdings as a strong competitor in a long-term growth market, but also acknowledged rising concerns over the highly uncertain outlook for global travel demand over the next couple years. Considering the stock's valuation and limited upside to our price target, we took advantage of strength to liquidate the position and reallocate the capital.

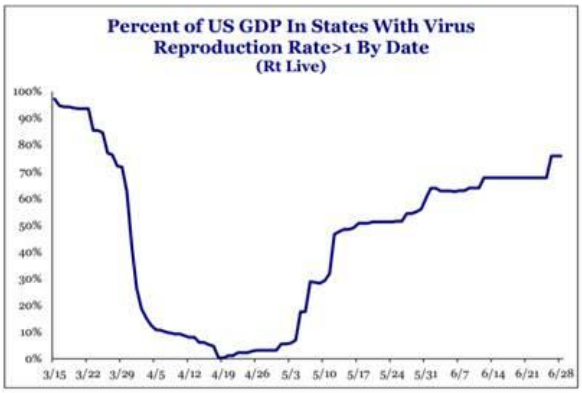
As noted above, we liquidated the portfolio's position in **Nestle** given its defensive nature and relative valuation after having held up better in Q1 market weakness, and the attractive investment alternatives available in Q2.

The portfolio's position in **TJX Companies** was sold due to forced attrition as we determined that there were other more attractive growth opportunities with greater near to mid-term certainty that would benefit the portfolio more. TJX remains one of the best "non-essential" retail franchises we have identified, but our thesis had largely played out. With the COVID-19 pandemic and its massive disruptions, TJX's business was also affected and we see this pressure likely continuing through 2020 and into 2021. Additionally, the company is one of the more mature growth businesses in the portfolio and its long-term growth rate did not compare favorably to other opportunities, particularly given the likely uncertainties still ahead. With the stock's significant rebound in the market's upward spike in Q2, we liquidated the position on strength.

**Summary**

Given the Global COVID-19 pandemic, upcoming U.S. elections, widespread economic dislocations impacting consumers across the world, and uncertainty over a second wave, treatments and vaccines, we expect the path forward to be filled with wide variations of optimism and disappointment, market strength and weakness. In particular, in the U.S. the recovery process at the national level is likely to be staggered and long as states take different paths to managing the crisis, and as testing and contact tracing continue to gradually expand. The chart below illustrates the difficulty facing the U.S. economy with over 75% of U.S. GDP currently coming from states with COVID-19 reproduction rates greater than one.

**75% OF US GDP HAS A COVID-19 REPRODUCTION RATE GREATER THAN 1**




*Source: Strategas*

At the same time, massive monetary stimulus is being applied to the U.S. and global economies while governments are applying significant fiscal stimulus to place a floor under economic activity and encourage growth. With monetary authorities from around the world indicating continued accommodation over the next few years, keeping interest rates near zero or below, and significant excess capacity in the economy, we see attractive opportunities for companies with long duration growth streams that also provide investors with predictability and sustainability. The portfolio is well positioned to provide such predictability in cash flows and earnings over the coming years with superior profit margins, and management teams that are incented to perform. Specifically, the companies in the portfolio are expected to generate 12.7% revenue and 16.9% earnings growth over the coming three years while the MSCI ACWI is expected to generate 1.9% and 4.5% revenue and earnings growth respectively. While absolute valuations are not as attractive as seen at the beginning of the year, the spread between the U.S. 10-year Treasury rate and the portfolio's Enterprise yield has actually widened, thereby keeping valuations quite attractive on a relative basis. In addition to this still attractive relative valuation, we continue to see tremendous opportunity for our portfolio businesses as they provide the growth and safety that investors are likely to seek in these uncertain times.

## Organizational Update

We are pleased to announce that HK Gupta who joined SGA in 2014 will be joining the Portfolio Management Team for our Global portfolios effective January 1st, 2021. HK has distinguished himself over the 6 years he has spent with SGA through the outstanding contributions he has made to client portfolios with his company research, as well as the contributions he has made as a co-portfolio manager for our Emerging Market and our Mid-Cap portfolios. To protect our successful decision-making process, built on 3-person portfolio management teams, HK will replace co-founder George Fraise on the Global portfolio management team. George will see no other change to his role at SGA. He will remain with Rob Rohn and Gordon Marchand, as a member of the 3-person Executive Committee that runs the firm and approves all companies that go onto our Qualified Company List from which all SGA portfolios are built. George will also be able to devote more time to client facing efforts which he is passionate about, supporting our new offices in Sydney and London, our partnerships with important consultants, and absorbing some of the marketing burden from other Investment Committee members.

We are also pleased to announce that Peter Knudsen was promoted to Client Portfolio Manager effective July 1st, and will also become a non-voting member of the Investment Committee. Pete joined our client service team in 2014 as an analyst and since then has made enormous contributions to our client service efforts. He has developed a deep understanding of our investment process at SGA and looks forward to being even more of assistance to clients moving forward.

We thank you for your continued trust in our team and look forward to answering any questions you may have.

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SGA
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# June 2020 Sustainability Report

## Firm Update

With society increasingly recognizing and addressing the issue of racial injustice in the US and across the globe, we thought it important to publish our SGA Core Value Statement and reiterate our longstanding commitment to actively cultivating a diverse workforce and contributing to a fair and better world. From the beginning, our mission was "to add value for our clients, employees and the communities we operate in", and we recognize that that we must continuously try to better understand the issues facing our world to be effective agents for positive change. The full text of our statement is available on our website.

During the quarter we finalized our new engagement with MSCI, including a subscription to the company's ESG Research, portfolio benchmarking and greenhouse gas analysis services. We expect MSCI to enhance several key components of our investment process, including improved identification and analysis of ESG-related risks and opportunities for companies on our Qualified Company List. We also expect MSCI to assist with identifying prospective new ideas, the benchmarking of client portfolios through an improved ESG lens, and the enhanced analysis of the performance of companies across key environmental considerations such as GHG emissions.

Also during the quarter, we updated our proprietary Portfolio Opportunity Scoring system to better rate the net ESG-related risks and opportunities to each company on our Qualified Company List and prospective new ideas. The updated system leverages our multi-year historical record of proprietary ESG scores and commentary while adding a more detailed scoring mechanism. The system follows our "Identify", "Assess", "Model" and "Engage" framework and factors in not only the raw ESG risks and opportunities to a business, but also management's ability to mitigate the identified risks and/or capture the opportunities.

While there are many third party ESG research services, including MSCI, that offer their own ESG scoring systems, none are completely compatible with our bottom-up, sector-indifferent approach to analyzing investment opportunities. In addition, as with all other aspects of our investment process, while we seek input from various respected sources, we ultimately apply our own judgement. Our proprietary ESG score serves several important purposes in our investment process, including, 1) representing an important reference point to check our theses and agendas regarding management engagements and our financial models, 2) providing an important input into the determination of risk category designations and therefore discount rates applied in our valuation system, and 3) providing an important input into our proprietary Portfolio Opportunity Scoring system which serves as a check on our portfolio management-decision making.

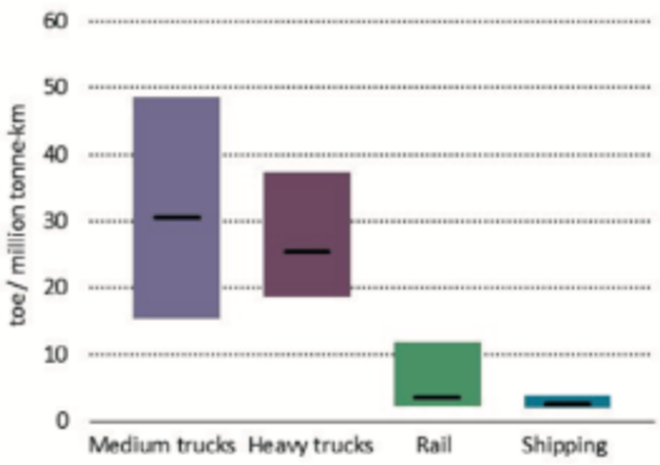
## Rails – an ESG friend or foe?

We recently made an investment in two freight-hauling railroad companies, Union Pacific and Kansas City Southern, across select client portfolios. Given the heavy emissions of the transport industry and nature of the goods transported, we identified the risk of regulatory change (namely carbon taxes) to the sustainability of long-term earnings growth of these companies.

The transport sector – cars, trucks, planes, trains & ships – is one of the largest sources of GHG emissions across the globe. It is estimated the sector contributes to roughly 30% of total emissions. As such, decarbonizing the sector is a key objective of global policymakers.

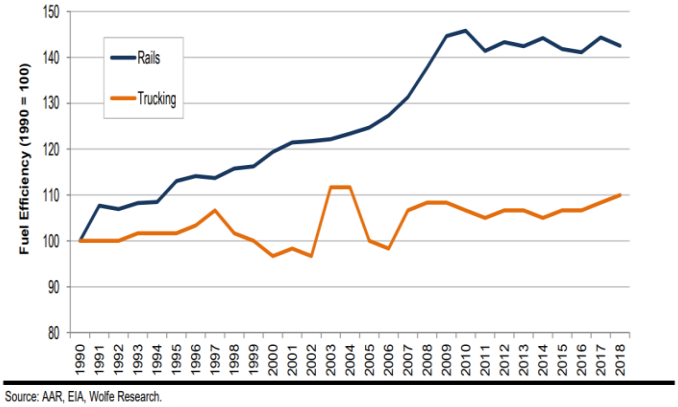
Upon our assessment of the environmental impact of these companies, we learned that rails are among the most carbon efficient modes of transport. According to Wolfe Research, rails are around 3-4x more fuel efficient than trucks and 100x more fuel efficient than aircraft. Furthermore, rail fuel efficiency has increased dramatically since the early 1990's with opportunities for further gains as fleets move from diesel to electric power.

Chart 1. Energy intensity of freight transport (2017), in tonnes of oil equivalent (toe) per million tonne km transported.




*Source: IEA 2019*

Chart 2. Rail vs Truck Fuel Efficiency over Time




*Source: AAR, EIA, Wolfe Research.*

We believe the rail sector plays a vital role in containing the GHG emissions of the transport industry into the future and herein lies the premise for a powerful secular growth opportunity. Should shippers increasingly prioritize ESG considerations, in conjunction with greater advocacy of rails by global policy makers, demand for rails could increase markedly as freight is moved off the roads and onto the tracks.

## Engagement with MercadoLibre

MercadoLibre is a leading e-commerce and digital payments provider servicing Latin America, namely Brazil, Argentina and Mexico. On a recent call with management we discussed some of the company's strategic ESG initiatives and shared our feedback. Decarbonizing operations is a clear area of focus; management is working on a number of projects including a transition towards an increasingly electric fleet, greater use of recyclable packaging and carbon offset initiatives such as reforestation. On human labor risks, the company's online marketplace – where a large number of third-party merchants retail their goods – presents challenges. While the company has addressed the issue of supply chain sustainability throughout their first-party and private label markets, we believe the process of monitoring third-party merchants is lacking and have encouraged management to take more ownership and accountability across all levels of their supply chain. We continue to engage with the company on this matter and consider this to be a long-term dialogue.

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