SGA
Sustainable Growth Advisers

Q2 2020 International Growth Commentary

Highlights

- *The portfolio generated strong absolute and relative returns as global equity markets rebounded in response to hopes for 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 e-commerce related consumer and technology stocks as well as rare metals; 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 was the primary contributor to portfolio outperformance; selection was strongest in Consumer Discretionary and Information Technology sectors where positions in MercadoLibre and Adyen contributed most*

- *New positions were initiated in New Oriental Education and Steris while the portfolio's position in TAL Education was sold; positions in Adyen, MercadoLibre, and Shandong Weigao were trimmed on strength while positions in AIA Group, Alibaba, Linde, Novo Nordisk and Tencent were increased*

- *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 ex-USA Index over the coming three years despite significant uncertainties over the pandemic, weak global economic growth, and myriad 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, CFA was promoted to Client Portfolio Manager effective July 1st*

Performance

Global markets posted strong absolute returns for the quarter with Developed Markets (led by the U.S.) outperforming Emerging Markets. SGA's portfolio returned 20.3% (gross) and 20.0% (net) in Q2 versus 16.1% for the MSCI All Country World ex-USA Index (ACWI ex-USA).

	SGA - Gross	*SGA - Net*	*MSCI ACWI ex-USA*	*MSCI ACWI Growth ex-USA*
QTD	20.3%	20.0%	16.1%	19.1%
YTD	1.3%	0.8%	-11.0%	-2.6%
1-Year	6.3%	5.2%	-4.8%	5.8%
3-Year	9.8%	8.7%	1.1%	6.1%
5-Year	8.8%	7.7%	2.3%	5.6%
Inception	8.4%	7.3%	1.9%	5.2%

Source: MSCI, FactSet. Data as of 6/30/20. SGA International Growth composite inception 3/1/15. MSCI indices are Net TR.

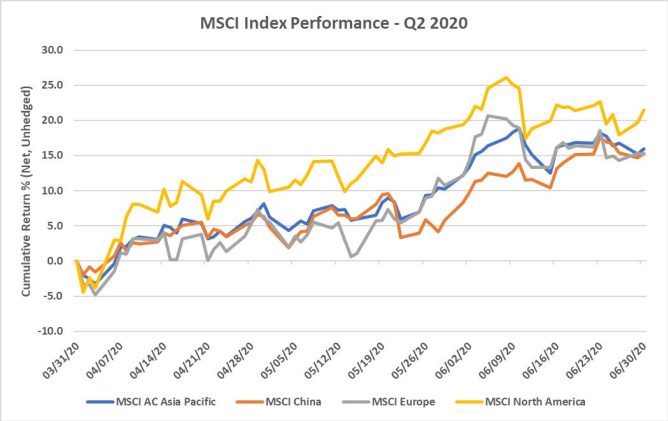
Continued Uncertainty but Hope

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. Similarly, the UK, European Union, Japan, India, Latin America and South Africa all saw their respective GDP's decline meaningfully in Q1, and expect 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.

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. Given continued sporadic regional virus outbreaks, fluctuating re-opening plans and persistent fears over a second wave, we continue to expect elevated volatility in global equity markets to persist. 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. Developed Markets led by the U.S., 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 ex-USA Index.



Source: MSCI.

Leadership in the market was relatively narrow with the Materials and Information Technology sectors performing best in the rebound led by rare metals and companies more 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 Real Estate, Energy and Consumer Staples performed the worst.

Within the portfolio, strong stock selection contributed most to the portfolio's outperformance. Residual sector weightings also contributed positively. Selection in the Consumer Discretionary, Information Technology and Health Care sectors was the strongest contributor driven by positions in MercadoLibre, Adyen and Shandong Weigao. Selection in the Financials, Industrials and Communications Services sectors also contributed positively to results due largely to positions in IHS Market, Sanlam and Tencent. In contrast, selection in Materials and Consumer Staples detracted from results due mainly to positions in Asian Paints, Wal-Mart de Mexico, and FEMSA. From a regional perspective selection was strong across both developed and emerging markets.

Largest Contributors

Global payment services company **Adyen** was the largest contributor to portfolio performance in Q2 as the market increasingly recognized the company's favorable position relative to the challenges and opportunities created by the COVID-19 pandemic. With roughly 90% of volumes coming from e-commerce and modest exposure to travel and cross-border related revenue, the company should be a beneficiary of the acceleration in the shift from physical to digital commerce catalyzed by the pandemic while facing minimal headwinds from depressed global travel activity. Adyen's Q1 results reinforced this notion, as payment volumes grew nearly 40% despite the onslaught of COVID-19 towards the end of the period. Margins during Q1 were weaker than some in the market expected due to expenses tied to headcount increases and marketing, but we think the spending represents prudent investments by management to maximize the considerable long term growth opportunities still ahead for the company. We trimmed the position on strength to an average weight in the company during the quarter.

Chinese medical device company **Shandong Weigao** was the second largest contributor to performance during the quarter. The stock benefited from continued improvement in execution at the company, expectations that China's new government tendering process will benefit scaled companies such as Shandong Weigao, and a greater likelihood that the company will benefit from an increasing share of China's rising health care expenditures at the expense of foreign firms. In addition, the company's strong research and development pipeline and improving governance as management and shareholder interests become more aligned due to the listing of the company's previously unlisted H shares should benefit the stock over our 3-5-year investment horizon. We maintained an average weight position in the company, trimming on recent strength.

Latin American e-commerce and Fintech company **MercadoLibre** was the third 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 one-third 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 point 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.

The fourth and fifth largest contributors to portfolio performance in Q2 were **IHS Markit** and **Fast Retailing**.

Largest Detractors (i.e. Smallest Contributors)

Leading Chinese K-12 after school tutoring services provider **TAL Education** was the largest detractor from performance during the period after employee wrongdoing was discovered in an accounting audit which pressured the company's stock as investors expected slower enrollment and revenue growth in the future. The stock was subsequently sold due to forced attrition given an opportunity to reallocate the capital to a higher confidence candidate with similar growth expectations but a more attractive valuation.

India's leading decorative paint brand and manufacturer, **Asian Paints**, was the second largest detractor to portfolio performance. The company reported mixed Q1 results, experienced strong volume gains early in the quarter followed by significant weakening in March due to the COVID19 pandemic. Weakness was further exacerbated by continued negative price mix due to strategic initiatives to grow the company's rural and exterior paint volumes and market share. Reductions in oil prices, and input costs in general, helped temper this weakness. As Q2 progressed, statements by the company indicating that business in May had improved from levels seen in April buoyed the stock, along with the generally more optimistic tone of the market as investors looked beyond current virus related weakness. We continue to admire the company's market position, management execution and see attractive long runways of growth for the business as India's middle class continues to grow and incomes rise commensurately. We maintained a below-average weight position in the stock.

Steris was the smallest contributor to portfolio returns in Q2 after it was added to the portfolio mid-quarter and provided only a small contribution to results for the period. An explanation of our thesis for the company is provided below in the Purchases section.

The second and third smallest contributors in the quarter were **Wal-Mart de Mexico** and **FEMSA**.

Portfolio Changes

Turnover increased in Q2 relative to Q1 as we took advantage of market volatility to improve the portfolio's growth, valuation and visibility moving forward. We liquidated the portfolio's position in leading Chinese K-12 after-school tutoring services provider TAL Education, while reinstating our position in Chinese private educational company New Oriental Education. We also initiated a new position in health care service provider Steris. We trimmed positions in positions in Adyen, MercadoLibre and Shandong Weigao, and reallocated capital to AIA Group, Alibaba, Linde, Novo Nordisk and Tencent.

New Positions

New Oriental Education is the largest private educational company in China based on the number of program offerings, total student enrollments and geographic presence. The company offers a range of programs including English test preparation courses for students taking language and entrance exams in the U.S., U.K. or other commonwealth countries, K-12 after-school tutoring for elementary through high school students, overseas school application consulting services, as well as general adult language training courses. Its revenue growth in recent years has been driven mainly by K-12 after school tutoring services, due to Chinese millennial parents' strong willingness to spend on education for their next generation. A strong brand reputation combined with its scale advantages and technology capabilities enhance the company's pricing power. The resulting attractive profit margins allow EDU to attract better teachers and pay them more which, in turn, attracts more students, enhances the brand further and leads to stronger pricing in a virtuous network effect. With competition to enter good schools rising within China, and parents increasingly aware of the benefit EDU's programs can offer, the company's revenue stream is more predictable and recurring. Further contributing to EDU's expected growth is the decision by Chinese authorities to replace individual state-created exams with a national-standardized test that should benefit nationally oriented providers who have the ability to expand across more regions. With industry leaders EDU and TAL accounting for less than 5% of market share, the

current educational provider market is quite fragmented allowing stronger providers ample opportunity to gain share from smaller, local providers.

Among the key risks we see for EDU are the consolidation taking place within the market and the potential for the company to pay too much or expand too quickly, negatively impacting their teaching quality and their brand, and the potential for advances in online technology. Other risks include policies which create obstacles for students to obtain overseas study visas, and the ongoing risk of the pandemic in China worsening again which would likely damage the company's revenue stream and lead EDU to lose market share to online-focused educational providers.

We initiated a new position in **Steris**, a provider of services, consumables and equipment used to sterilize healthcare products across multiple settings. The company provides essential products and services to healthcare providers (65% of sales), medical device manufacturers (21% of sales), and to biopharmaceutical manufacturers (14% of sales).

The company offers business quality characteristics which are consistent with those we seek. Its pricing power is derived from the fact that it provides a very critical service which is not a high proportion of the customer's costs. Additionally, Steris provides efficiency advantages and reputational comforts as a leading supplier. The barriers to entry are high due to strict regulatory oversight by government entities such as the FDA and EPA in the U.S. Approximately 80% of the company's revenues come from the sale of consumables and services which are repeatable as long as there are recurring operations and medical procedures, and consumption of medical devices and pharmaceutical products such as vaccines and biologics, which must be delivered in sterile formulations. We see the company as having long runways of growth as it grows with healthcare consumption around the world, and as a leader in a very fragmented industry. The company generates attractive cash flow with a cash flow to earnings ratio of about 90%.

Among the key risks we are monitoring for Steris are the disruption of surgical procedures and its impact on the company in the near term, the economic consequences of COVID-19 and the slowing macroeconomic environment on capex equipment sales which are about 20% of total sales. Regulatory oversight from the FDA also poses a risk to companies such as Steris involved in medical equipment production and sales, while EPA oversight related to the chemicals and procedures used to sterilize equipment is also an ongoing risk.

Sold Positions

We liquidated the portfolio's position in **TAL Education** and reinstituted a position in its peer, **New Oriental Education (EDU)**, which offered similarly attractive revenue and earnings growth at a more attractive valuation. EDU also faces less uncertainty relative to its accounting. This is illustrated by a better correlation between the company's revenue and free cash flow growth over time.

Summary

Given the Global COVID-19 pandemic, widespread economic dislocations impacting consumers, and uncertainty over a second wave and the development of treatments and vaccines, we expect the path forward to be filled with wide variations of optimism and disappointment, as well as continued market volatility. The recovery process is likely to be staggered and long as different countries take different paths to managing the crisis, and as testing and contact tracing continue to gradually expand.

Given this backdrop, and with monetary authorities around the world indicating continued accommodation over the next few years, we see attractive opportunities for the stocks of companies with predictable earnings and cash flow streams, and long runways of growth – exactly the types of companies in which we invest. As such, we believe the portfolio is well positioned to continue its strong performance with the companies in the portfolio expected to generate 11.4% revenue and 14.6% earnings growth over the coming three years while the MSCI ACWI ex-USA is expected to generate 1.0% and 4.0% revenue and earnings growth respectively. Although absolute valuations are elevated versus the beginning of the year, the spread between the risk free rate for the U.S. 10-year Treasury 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 six 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 three-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 three-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, CFA 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 of even more 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.

The opinions expressed herein reflect the opinions of Sustainable Growth Advisers, LP and are subject to change without notice. Past performance is no guarantee for future results. This information is supplemental and complements a full disclosure presentation that can be found with composite performance. The securities referenced in the article are not a solicitation or recommendation to buy, sell or hold securities. This commentary is provided only for qualified and sophisticated institutional investors.

SGA earnings growth forecasts are based upon portfolio companies' non-GAAP operating earnings. 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, 1.0%, employing the International 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. 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 International portfolio for the past twelve months. Past performance is not indicative of future results.

SGA
Sustainable Growth Advisers

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.

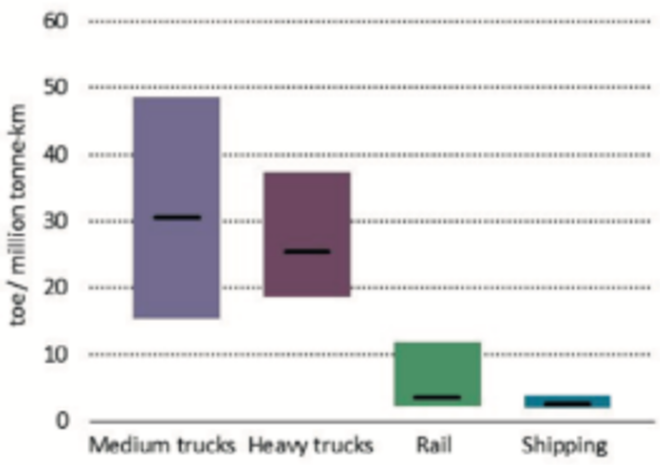
Rails – an ESG friend or foe?

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.

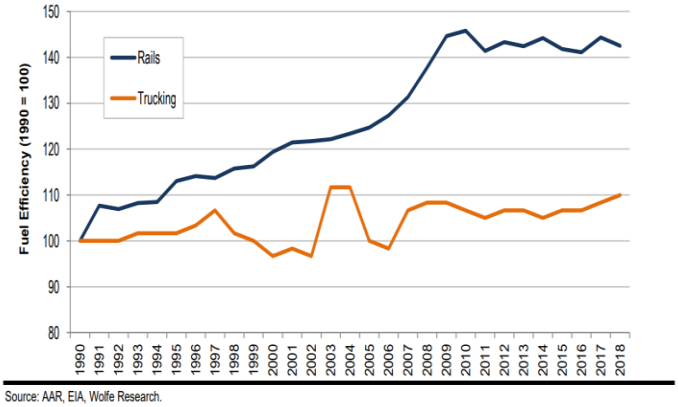
Upon our assessment of the environmental impact of these companies, we learned that rails are among the most carbon efficient modes of transport. According to Wolfe Research, rails are around 3-4x more fuel efficient than trucks and 100x more fuel efficient than aircraft. Furthermore, rail fuel efficiency 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.
