SGA
Sustainable Growth Advisers

Q2 2020 U.S. Large Cap Growth Commentary

Highlights

- *The portfolio generated strong absolute returns and outperformed the Russell 1000 Growth Index as markets rebounded in response to hopes for a faster than expected economic recovery and continued massive monetary and fiscal accommodation*

- *The market advance was driven by a narrow group of e-commerce and technology stocks more highly leveraged to the quicker pace of business re-openings; we took advantage of volatility to lock in gains where valuations had risen and trade up in terms of growth and cash flow visibility*

- *Stock selection was the driver of portfolio outperformance with the selection strongest in the Information Technology and Communication Services sectors; selection in the Consumer Discretionary sector was the primary detractor; sector weights detracted moderately from relative returns*

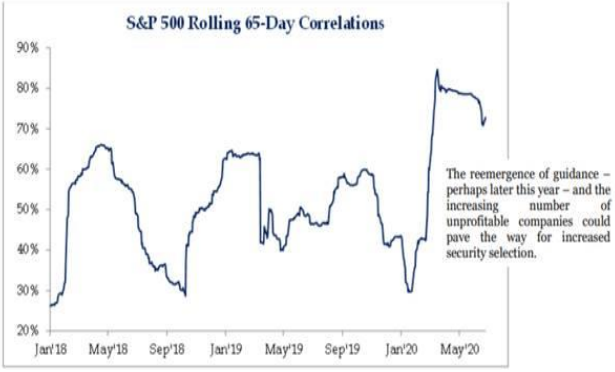
- *New positions in Ball Corp and Union Pacific were initiated while holdings in Ulta Beauty, Booking Holdings and TJX Companies were sold*

- *Given the superior business quality and predictability of our companies, the portfolio is expected to generate significantly greater revenue and earnings growth than the Russell 1000 Growth Index benchmark over the coming three years despite significant uncertainties over economic growth, as well as tax and regulatory policies*

- *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

Markets posted tremendous absolute returns for the quarter. SGA's portfolio returned 28.8% (gross) and 28.6% (net) in Q2 versus 27.8% for the Russell 1000 Growth Index and 20.5% for the S&P 500 Index, in the market's continued rebound off the lows hit in Q1. The market advance was relatively narrow with Consumer Discretionary stocks, particularly retailers and those businesses most levered to the re-opening of the economy, as well as Information Technology leading the advance. Not owning Apple (due to our concerns over the maturity of its markets, lengthening phone replacement cycles and expected slow growth) cost the portfolio about -1.1% of relative return for the quarter, while strength in other market favorites which also do not meet our business quality criteria such as Tesla and Nvidia detracted from relative returns as well. Stock correlations remained high in Q2 after spiking in Q1 (Mid-March), but trended somewhat lower.



Source: Strategas.

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 were all expected to see their respective GDP's decline meaningfully, while China's GDP was forecast to grow by only 1%. This global weakness poses a headwind to U.S. manufacturing and trade while the service sector continued to be impacted by varying levels of business closures and wary consumers. 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. In a sign of gradual progress in re-opening the economy later in the quarter, U.S. unemployment unexpectedly dropped from 14.7% to 13.3% in May as 2.5 million people were added to payrolls as lockdowns began to ease.

Following Q1's market weakness, U.S. equity markets staged a historic rebound in Q2 as investors reacted to faster than expected business re-openings and additional monetary and fiscal stimulus. 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 the likelihood of continued sporadic virus outbreaks across the country, fluctuating re-opening plans and persistent fears over a second wave, we continue to see the ingredients for elevated volatility in U.S. and global equity markets. This is further underlined by the current U.S. Presidential and Congressional races 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 due to the coronavirus lockdowns, growth stocks outperformed value stocks as investors sought businesses that could generate attractive earnings growth despite widespread economic weakness. Within the Russell 1000 Growth Index, consistent with investors' more positive outlook, higher beta stocks, companies with lower returns on equity, lower levels of debt and no earnings performed best during the quarter. The Consumer Discretionary sector was the best performer (after Energy which rose 41% but comprised only 0.2% of the benchmark). The next best performing sectors were Information Technology and Communication Services. In contrast, more defensive sectors such as Consumer Staples performed the worst followed by Real Estate.

Stock selection was the primary driver of excess returns while sector allocations detracted from results. Selection in the Information Technology sector was the strongest contributor driven by positions in PayPal, Autodesk and Workday. Selection in the Communication Services, Health Care and Materials sectors also contributed positively to results due largely to positions in Match Group, Illumina and Ecolab. In contrast, selection was weakest in the Consumer Discretionary sector due largely to a position in Nike which had been a key contributor to performance in Q1, but also given the strong rebound in more economically-sensitive stocks.

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, along with 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 of users on its platform, is favorably positioned to capture these trends. We trimmed the position on strength during the period but continue to see PayPal as well positioned to capitalize on the shift toward more digital payments globally.

E-commerce and cloud computing leader **Amazon** was the second 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 our position in the company on strength during the quarter, but maintained an above-average weight in the portfolio.

Computer-aided design software provider **Autodesk** was the third largest contributor to performance during the quarter. Despite the difficult macro-economic environment, the company reported results which were in line to better than expected. Underlying business metrics continued to be positive and consistent with our longer-term thesis. Business activity appeared to be rebounding from trough levels with the design side of its business, which encompasses its core products, not seeing material weakness while cloud product adoption was strong. Client churn remained in line. The company reaffirmed its guidance for FY23/CY22, driven by a higher proportion of cloud business in its mix, increasing adoption of its products, and steps being introduced to increase compliance among

users and reduce piracy. We trimmed the position on strength during the period, and lowered the position target to an average weight given heightened valuation.

Microsoft and **Facebook** were the fourth and fifth largest contributors to performance during the quarter.

Largest Detractors (i.e. Smallest Contributors)

Ball Corp was the only detractor from portfolio performance during the quarter. With no significant news from the company during the period since it was purchased, Ball's long-term growth thesis remains unchanged with expected EPS growth in the 10-15% range over the next 3-5 years, driven by increased utilization of aluminum cans for packaging as concerns over the environmental impact of single use plastic increases.

Union Pacific provided no contribution to portfolio performance during the quarter, given the timing of market movements and its limited time with the portfolio. The stock returned -1.2% from the time of its initial purchase in June 2020.

Becton Dickinson had the smallest impact on performance as it reported results which were slightly better than expected and provided guidance in line with previous comments. An unexpected announcement of a stock offering in May and minor dilution posed a headwind to the stock. Likewise, while receiving a tailwind related to the COVID-19 pandemic due to the use of more swabs, infusion pumps etc., with fewer elective surgeries taking place, this benefit is being mitigated to some degree. Concern over a COVID-19 driven delay in the company's 510k submission to the FDA to re-approve the Alaris infusion pump also raised concerns with investors negatively affecting the stock. We continue to view the issue as a temporary headwind for the stock which will be successfully addressed, and expect Becton to benefit from broad growth opportunities across the emerging markets and key scale advantages. We maintained an average weight in the company.

The second and third smallest contributors to performance in Q2 were **TJX Companies** and **Equinix**.

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 29% on a year-to-date basis (58% annualized), reflected the more volatile nature of the markets and the opportunity we continued to take advantage of in Q2. We liquidated three companies, Booking Holdings, TJX Companies and Ulta Beauty, and initiated new positions in Ball Corp and Union Pacific where we saw superior long-term growth potential at more attractive cash flow based valuations. In addition, we trimmed positions in Amazon, Autodesk, Illumina, Intuit, Nike, and PayPal, on strength while adding to companies with attractive long-term growth opportunities including Abbott, Alphabet, Becton Dickinson, Equinix, FleetCor, Linde, and Visa on weakness. Through our purchases and sales, we sought to use increased volatility to improve both earnings and cash flow visibility in the portfolio while keeping valuation attractive in a strong market.

New Positions

Ball Corp, a global leader in aluminum packaging products for the beverage, consumer goods, personal care and household products industries was added to the portfolio given our expectation for continued secular and sustainable growth in the use of cans given their environmental and economic benefits. The company benefits from dominant scale advantages relative to peers as well as its global footprint and unmatched specialty can capability. We see these factors enhancing the company's pricing power and contributing to more repeatable revenue generation as the company capitalizes on a trend that is likely in its early innings with years of above-average growth to go as consumers increasingly realize the damage caused by single use plastic bottles and containers. The company also has a successful aerospace and defense segment which produces advanced sensors and parts for spacecraft integral to the NASA, NOAA and Department of Defense programs, which continues to grow at a rate three times that of the rest of the company. With the stock's valuation negatively impacted by concerns over weaker than expected global beverage consumption caused by the COVID-19 pandemic, we initiated a below-average position in the company in May and added to the position later in the quarter.

Among the key risks we are monitoring relative to Ball are the potential for slower or negative growth in the consumer soft drink and U.S. domestic beer markets, and the potential for new competition in the specialty can market.

Union Pacific (UNP) is one of North America's premier rail companies with over 32,000 miles of routes touching most U.S. west coast and Gulf coast ports as well as several Mexican interchange locations. UNP's railroad system is the second largest in the United States, and has a duopoly on transcontinental freight rail lines in the western U.S.

UNP is considered an "essential service" and possesses structural cost advantages relative to the trucking industry which is their primary competition. Truckers continue to

experience secular cost inflation due to driver shortages, higher insurance costs, increased regulation and deteriorating highway systems while rails have been able to effectively improve their operating efficiency. Specifically, UNP has successfully adopted the Precision Scheduled Railroading (PSR) model which has allowed them to enhance the productivity of their equipment, increasing the fluidity of their service networks and providing their customers with more reliable service. Its success in implementing PSR has led to improved margins and higher returns on invested capital, and we expect it will also lead to accelerating revenue growth as their services compete more effectively with truckers. The company's contractual relationships with a broad set of shippers ranging from basic agricultural and energy commodities to industrial products and intermodal shipments that are essential to the ongoing functioning of the U.S. economy enhance the recurring revenues generated by their business.

Among the key risks we are monitoring with UNP are its competition from BNSF as well as trucking, and from a longer-term standpoint, the potential adoption of autonomous trucking which would impact UNP's long-term pricing power. 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 is deemed an "essential service", and the products it transports 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 weight position in the company and added to it over the balance of the quarter.

Sold Positions

The portfolio's position in online 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 as a strong competitor in a long-term growth market, but also acknowledged rising concerns over increasing competition from Google and the potential for increased direct to hotel booking trends. Considering the stock's valuation and limited upside to our price target given the highly uncertain outlook for global travel demand over the next couple of years, we took advantage of strength in the stock to liquidate the position and reallocate the capital.

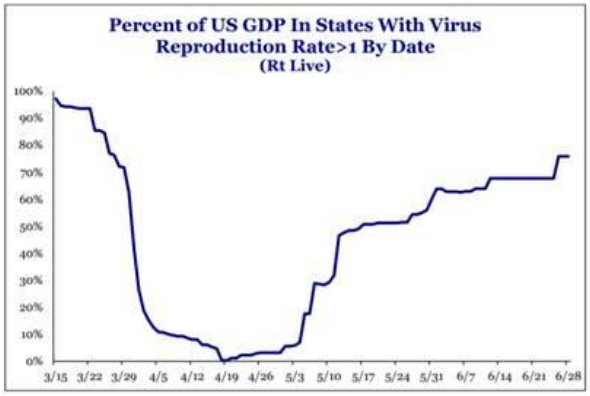
The portfolio's position in **TJX Companies** was sold due to forced attrition as we determined that there were other more attractive growth opportunities with greater near to mid-term certainty that would benefit the portfolio more. TJX remains one of the best "non-essential" retail franchises we have 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.

We liquidated the portfolio's position in **Ulta Beauty** in order to purchase Union Pacific (UNP). We viewed UNP as offering a similar valuation, but a more certain growth profile. The COVID-19 outbreak raised the possibility that Ulta's mix of stores may change to include a larger percent of sales coming from e-commerce, and a lower margin for the business. In contrast, our research indicated fewer uncertainties impacting UNP.

Summary

Given the COVID-19 pandemic, upcoming U.S. elections, widespread economic dislocations impacting consumers across the country, 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. We continue to expect that with the impact from the virus across the U.S. being very differentiated, the recovery process at the national level will be staggered and long. 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 the U.S. Federal Reserve indicating continued accommodation over the next few years, keeping interest rates near zero, 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 in 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 11.0% revenue and 15.7% earnings growth over the coming three years while the Russell 1000 Growth Index is expected to generate 5.0% and 7.0% revenue and earnings growth respectively. While absolute valuations are not as attractive as seen at the beginning of the year, the spread between the 10-year Treasury rate and the portfolio's Enterprise yield has actually widened, thereby remaining 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 Markets and 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.

Thank you for your confidence in our team. We look forward to answering any questions you may have.

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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, 0.75%, employing the U.S. Large Cap 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. The performance record presented for periods prior to July 1, 2003 occurred before to the inception of SGA and represents the portable performance record established by two of SGA's founders (and investment committee members) Gordon Marchand and George Fraise while affiliated with a prior firm. 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 U.S. Large Cap Growth portfolio for the past year. SGA's earnings growth forecast data is based upon portfolio companies' non-GAAP operating earnings.

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.

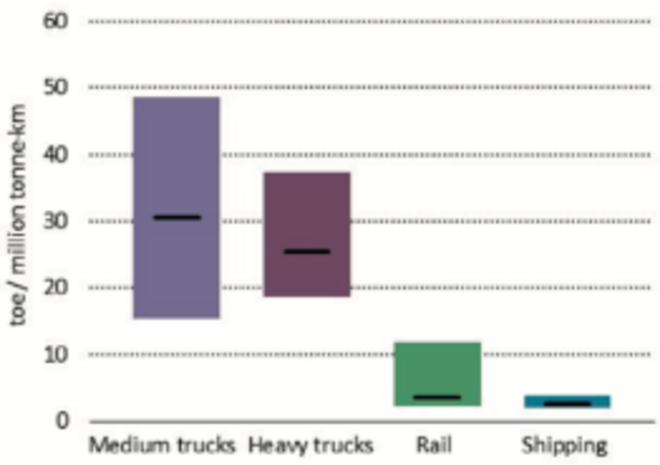
Rails – an ESG friend or foe?

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.

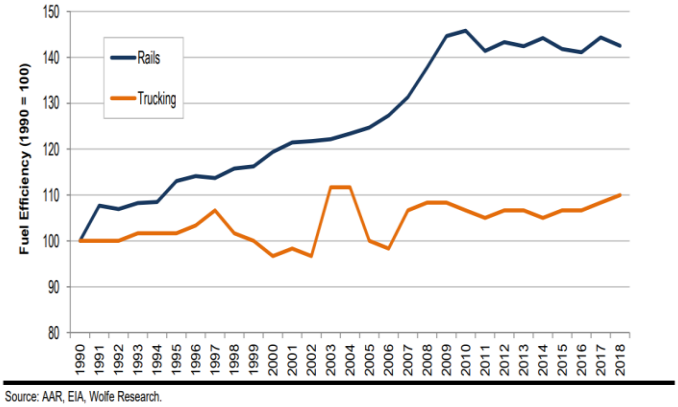
Upon our assessment of the environmental impact of these companies, we learned that rails are among the most carbon efficient modes of transport. According to Wolfe Research, rails are around 3-4x more fuel efficient than trucks and 100x more fuel efficient than aircraft. Furthermore, rail fuel efficiency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