SGA
Sustainable Growth Advisers

Q3 2020 International Growth Commentary

Highlights

- *The portfolio generated strong absolute returns and outperformed the MSCI All Country World ex-USA Index (ACWI ex-USA) as world markets continued their rebound led by e-commerce, technology and more economically sensitive companies*
- *Relative portfolio performance in Q3 was positively impacted by stock selection and residual sector allocations*
- *Stock selection in the Financials, Consumer Discretionary and Health Care sectors was strongest; selection in the Consumer Staples and Industrials sectors detracted*
- *MercadoLibre was sold due to valuation and the portfolio's position in Sanlam was liquidated to fund other higher confidence growth opportunities*
- *The portfolio is expected to generate revenue and earnings growth higher than ACWI ex-USA Index over the coming three years with greater predictability and sustainability*

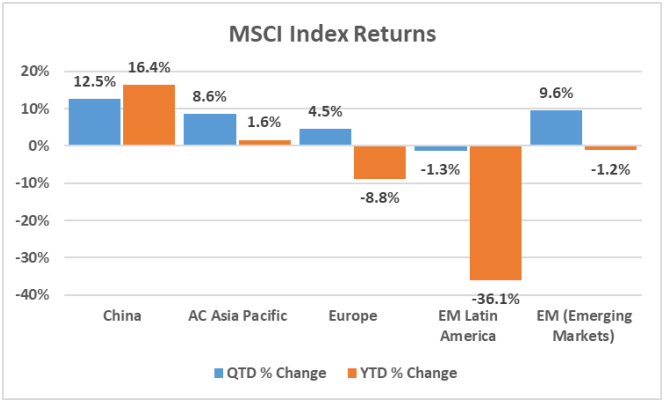
Performance

World equity markets posted strong absolute returns for the quarter. SGA's portfolio returned 8.7% (gross) and 8.4% (net) in Q3 versus 6.3% for the ACWI ex-USA as equities continued to rebound on improving economic growth and corporate profitability. Year-to-date thru 9/30/20, the portfolio returned 10.1% (gross) and 9.3% (net) versus -5.4% for the ACWI ex-USA.

More Optimism for Recovery

While dismal Q2 GDP figures resulting from government imposed lockdowns to stem the COVID-19 pandemic were widely reported in Q3, global equity markets continued their rebound benefiting from massive economic stimulus, improving economic data, a lull in the growth in infection rates during the summer and progress on therapeutics and vaccines. Absolute returns continued to be attractive, although not at the level seen in the initial global market rebound experienced in Q2.

Asian markets performed best while European markets generally performed the worst. Emerging markets, led by Taiwan, India, Korea, and China outperformed developed markets as investors reacted positively to recovering economic growth in China and the Pacific region. China's economy grew 3.2% year-over-year in Q2, benefitting from a recovery in manufacturing and consumption driven by significant government stimulus and continued containment of the virus. In contrast, Japan's GDP contracted -7.8% in Q2 on a quarter-over-quarter basis as its economy was already in recession prior to the pandemic which caused consumption to plunge and exports to weaken further.



Source: FactSet, MSCI.

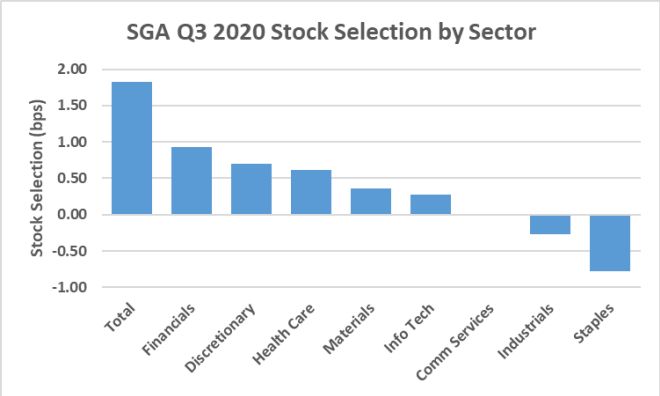
Indian GDP shrank -23.9% in Q2 due to strict government imposed lockdowns to control the spread of the virus. Despite government debt approaching a 40-year high and the economy already experiencing difficulty prior to the pandemic, highlighted by GDP growth falling from 9% in 2016 to 4.9% in 2019, India's equity markets benefited from the wave of optimism that drove the quarter and led their market to be the second best performing in the ACWI for the period.

Eurozone growth declined -11.8% in Q2, slightly better than expected, boosted by a better than expected recovery in Germany which helped offset further weakness in the UK, Spain and France. Scandinavian markets posted strong returns, but fears over a developing second wave of COVID-19 infections swept markets in Spain, France the UK and other parts of the continent as the quarter progressed.

Brazil's GDP contracted by -9.7% quarter over quarter in Q2 with the country being amongst the hardest hit by the COVID-19 pandemic (with recorded deaths 2nd only to the U.S.). With unemployment above 13% and Brazilian consumers still wary, the country's equity markets were among the worst performers during the quarter.

Market and Portfolio Attribution

Given the continued investor optimism over the potential for recovery, the Consumer Discretionary sector, led by e-commerce, Information Technology, and more economically sensitive sectors heavily levered to improving global economic growth performed the best during the quarter. The Energy, Financials, Utilities, Real Estate, and Health Care sectors performed the worst. Emerging market stocks outperformed developed market stocks given their greater leverage to improving economic data and rising chances for global recovery.



Source: FactSet, MSCI, SGA.

The portfolio's strong relative performance was driven primarily by stock selection as well as by residual sector allocations. Stock selection was strongest in the Financials, Consumer Discretionary and Health Care sectors, driven largely by the portfolio's positions in HDFC Bank, Alibaba, Adidas, and Steris. In contrast, selection detracted from relative performance in only two sectors, Consumer Staples and Industrials, where positions in FEMSA, Heineken, and IHS Markit detracted most. The portfolio's overweight in the strongly performing Information Technology sector benefited relative performance while overweights in the weakly performing Health Care and Consumer Staples sectors detracted from returns. An underweight to the more economically sensitive Industrials sector which was in favor during the quarter also detracted, while the portfolio's lack of exposure to Energy contributed to returns. From a regional perspective, stock selection in developed markets drove returns, and the portfolio's overweight in emerging markets also benefited.

Largest Contributors

Chinese e-commerce leader **Alibaba** was the largest contributor to returns in Q3 after delivering a reassuring quarter with revenues, free cash flow and profits up by 30% or more during the quarter. New retail, cloud computing, Cainiao Logistics (a platform similar to Amazon's fulfillment arm used mostly by third party logistic assets), and e-commerce advertising led the gains. While Alibaba posted strong results, we remain cognizant of the competition the firm faces across its core e-commerce, cloud, digital payment, merchant services and delivery businesses as well as difficulty in reaping the full benefits of its acquisitions historically. Given the company's still dominant position in the critical e-commerce and cloud businesses, confidence in management's ability to compete effectively versus peers and the stock's still attractive valuation which falls roughly within the top quartile of businesses on our Qualified Company List, we maintained the portfolio's above-average weight position.

Indian consulting firm **Infosys** was the second largest contributor to portfolio performance this quarter after reporting solid operational as well as financial results with good cash flows and collections. We were pleased to see the company signing $1.7 billion in new deals during the quarter as well as a new $700 million arrangement with Vanguard which will be included in Q4 reports. We were also pleased to see their manufacturing and retail segments, which had been under pressure earlier in the pandemic showing no further material decline. The company also seems to be managing immigration headwinds successfully with 60% of its employees now visa independent, and a staff of 30,000 U.S. nationals now, up considerably from levels three years ago. While we continue to see Infosys benefiting from its scale and reputational advantages in the quickly growing IT outsourcing space, we trimmed the position to fund other more attractively growing opportunities, maintaining a below-average weight.

Global payment services company **Adyen** was the third largest contributor to performance after it posted a solid quarter, benefitting from the acceleration of global ecommerce and its strong competitive positioning. Revenues were up 27% year-over-year due to strong growth in processed volumes and a small increase in the company's take rate. Earnings only grew about 10% for the period due to increased headcount, but we support management's decision to invest aggressively to support long term growth. We were pleased to see the company's total processed volume level (which included airlines) recover back to pre-COVID-19 levels. Likewise, physical retail has also recovered to pre-pandemic levels while online retail growth continued to grow very quickly in the 50-60% range, suggesting that Adyen is seeing solid market share gains. We trimmed the position on strength, maintaining below-average weight due to valuation.

The fourth and fifth largest contributors to portfolio performance were **Adidas** and **Linde**.

Largest Detractors

Leading Latin American consumer company **Fomento Economico Mexicano (FEMSA)** was the largest detractor from portfolio performance for the quarter, as the company faces several headwinds at the moment from COVID-related pressures on convenience store traffic, a deteriorating Mexican economy, significant depreciation in the Mexican Peso and a string of small acquisitions outside of its core bottling and convenience store businesses. The company reported Q2 results that were weak, but generally in line with our expectations, with revenues down 14% and earnings off 40%. OXXO stores had about 35% of their stores operating under restrictions, down from 50% earlier in the quarter. COVID-19 has raised questions regarding the trajectory of unit growth moving forward, with peak growth now possibly behind them should consumer behavior brought on by the pandemic persist longer-term. The company's Coca-Cola bottling operations also faced difficulty but showed improving volumes as the quarter progressed. We see most of these issues gradually receding as COVID-related issues abate and new growth initiatives in Latin America offset decelerating growth in its core OXXO business in Mexico. We continue to view FEMSA's business position as fundamentally strong, but are in conversation with management regarding its capital allocation strategy. Given continued conviction in the growth thesis for the business over the coming 3-5 years and the stock's attractive valuation, we purchased additional shares and maintained an average weight during the quarter.

Leading financial services software provider **Temenos** was the second largest detractor from performance. Temenos' business has been negatively impacted by COVID, as it was difficult to close new license sales during the pandemic. While subscription and license renewals were more resilient, we expect the company to see further weakness as the pandemic continues. Importantly, Temenos' products enable bank operations to become more efficient and reduce their ongoing operating costs, thereby enhancing long-term profitability. The pandemic is driving increased demand for investments in digital capabilities at financial institutions, and we expect Temenos to benefit in the medium term as lockdowns ease and banks turn to investing to enhance their efficiency and capabilities. Accordingly, the company reported that none of its pending deals had been cancelled, and that there was actually a build-up in the top of the sales funnel indicating demand could well accelerate as the pandemic gradually abates. We purchased additional shares on weakness during the quarter maintaining a below-average weight position.

Chinese medical device company **Shandong Weigao** was the third largest detractor from performance. It reported mixed 1H results with Q1 sales down 12%, but 2Q sales growing 16%. The company's results were negatively impacted early in the year due to the COVID-19 pandemic and price cuts from government purchasing. Hospital visits and procedures were delayed, impacting their medical consumables business, however hospital activity had returned to 70-80% of pre-COVID levels by the time of their report in August. While they are negatively impacted by government price cuts, centralized buying is enabling them to take market share from smaller less efficient producers. We expect 2H growth to improve from current levels and see the company as well positioned to benefit from increased medical spending in China as well as market share gains resulting from value-based purchasing where they are having success and expanding their penetration to smaller hospitals as well. We maintained an above-average weight position in the company during the quarter, adding on recent weakness.

The fourth and fifth largest detractors from portfolio performance were **Heineken** and **Sanlam**.

Portfolio Changes

Turnover in the portfolio was average during the quarter as we continued to take advantage of significant market movements to actively reallocate capital from positions which were becoming less attractively valued to growth businesses where valuation continued to appear attractive. As detailed below, we sold the portfolio's positions in MercadoLibre and Sanlam. In addition, positions in Adyen, Infosys, Sysmex, and SAP among others were trimmed with their proceeds flowing to more attractively valued stocks including AIA Group, FEMSA, Nestle, Diageo and others.

Sold Positions

We sold the balance of our position in Latin American e-commerce leader **MercadoLibre** after the stock appreciated significantly for the year through the date of our sale and its valuation became less attractive relative to other long-term growth opportunities on our Qualified Company List. We continue to find MercadoLibre's growth thesis to be highly attractive and the company remains on our Qualified Company List.

The portfolio's position in **Sanlam** was liquidated following recent management changes which we felt added uncertainty and increased execution risk at the company. We reallocated the capital to existing positions which offered higher confidence long-term growth opportunities.

Summary

As noted in previous letters, we expect the progress of the global recovery from the pandemic to be a gradual and non-linear process with alternating periods of optimism and fear driven by economic hardships, changing data, virus resurgences and successes in developing therapeutics and vaccines. The massive global stimulus aimed at buoying global economies serves as a positive backstop during this process, but is not likely to eliminate these swings in investor emotions or the ensuing market volatility. Increased geopolitical conflicts, slow growth around the globe, ongoing trade tensions, rising debt levels as well as uncertain progress against COVID are likely to continue to enhance this volatility. In periods when optimism reigns and those stocks most levered to an improvement in economic activity outperform, the consistent and predictable revenue and earnings growth generated by our portfolio isn't likely to be fully rewarded relative to the market. As we have seen in previous periods, we should generate strong absolute returns during these times and protect capital and generate strong relative returns when cyclical rebounds are replaced by moderate single digit growth or economic weakness. Given the opportunities we see today in a wide array of truly unique and attractively valued growth businesses (based on our proprietary cash flow based valuation metrics), we are confident in the ability of our portfolio to compound mid-teens earnings growth over the next 3-5 years, and believe that this will be highly valued by the market and benefit our clients over the long term.

Separately, we want to take this opportunity to say thank you to our clients who have partnered with us over the years as well as to our newer clients who have joined us over the course of 2020. We have experienced strong growth through the pandemic, and our team has remained healthy, stable and productive. We continue to focus on providing our clients superior returns and the best service and support possible, and to that end we are in the process of hiring another member of our client service team. We truly appreciate the confidence our clients are placing in SGA and we will continue to do our utmost to earn your trust. We will manage our firm responsibly, factoring in our regular liquidity analysis to ascertain firm capacity which remains at about $30 billion. Thank you again for your continued support and we wish you all the best for the upcoming holiday season.

We thank you for your confidence in our team and look forward to speaking to you about the attractive growth opportunities in our portfolio today.

SGA
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September 2020 Sustainability Report

Firm Update

We believe comprehensive disclosure of material climate-related risks and opportunities facing companies enhances our objective of generating optimal risk-adjusted long-term portfolio returns for our clients. Increased disclosure improves awareness of climate-related risks and opportunities within companies resulting in better risk management and more informed strategic planning, while also enhancing our ability to integrate the consideration of ESG factors in our investment process via our Identify, Assess, Model and Engage framework. As a result of this belief, and consistent with our obligations as a PRI signatory, we actively support movements to improve climate-related financial disclosure. To this end, we are pleased to announce that during the third quarter we initiated affiliations with two leading organizations in the promotion of climate-related financial disclosure, TCFD and CDP.

The Task Force on Climate-related Financial Disclosures (TCFD) is an industry-led initiative to develop consistent disclosure of material climate-related financial risks and opportunities for companies. TCFD's recommendations represent a practical approach to material disclosure for companies focused on four key considerations: metrics and targets, governance, strategy and risk management. By becoming an official supporter of TCFD, we are signaling to the world that we believe in the importance of transparency around climate-related risks and opportunities within financial markets.

CDP, formerly the Carbon Disclosure Project, is a not-for-profit organization that runs a global environmental disclosure system to help thousands of companies and other entities measure and manage their risks and opportunities on climate change, water security and deforestation based on standardized, uniform and comparable data. CDP engages over 2,500 companies every year via comprehensive questionnaires aligned with TCFD's recommendations, yielding over 2.1 million data points. As a signatory, SGA is signaling our public support for requesting that companies disclose through CDP. We also gain access to datasets on company responses and CDP scores, as well as the opportunity to participate in important industry campaigns, such as those on science-based targets and non-disclosure.

Engagement with Visa

During the quarter we engaged with Visa's recently appointed Chief Sustainability Officer and team to discuss several potentially material risks and opportunities for the company which we identified related to ESG-factors including data security and employee retention.

Regarding data security, we probed criticism by MSCI in their recent ESG research report regarding Visa's data privacy and security. After engaging with management and careful consideration, we believe MSCI's conclusions are misplaced. MSCI penalizes Visa for lack of disclosure regarding its data policies and protocols. However, for obvious reasons, Visa is very reluctant to publicize details regarding its security strategy and operations given the magnitude of sensitive data it controls stemming from its 3+ billion cards in use worldwide. While MSCI relies solely on publicly available information to support its research conclusions, in instances where other research organizations agree to confidentiality agreements and have access to greater details regarding Visa's data security efforts, the company ranks at the top of its peer group.

Consistent with our recently published white paper "ESG Scoring in an Imperfect World", this engagement highlights the importance of relying on proprietary fundamental analysis as a basis to capture material opportunities and risks associated with a company rather than blindly accepting the conclusions of one third party service.

Separately, while our engagement with Visa management did address our questions regarding data security, our engagement regarding employee retention left us less satisfied. Given its enormous size and significant secular growth opportunities, the global financial payments industry is brimming with new fintech startups eager to recruit experienced talent. We identified employee retention as a key risk for Visa given the quality of its personnel. We spoke with the company on this topic and asked for data on retention across the company, hoping to analyze trends by region, function and seniority, to make sure the company is not suffering from a drain of talent. Unfortunately, Visa does not provide such data at the moment, so we noted this issue as a key agenda item on which to follow up with management during future engagements.

Engagement with Linde

During the quarter we spoke with management of industrial gas company Linde following the recent publication of their 2019 Sustainable Development Report and 10-year Climate Change targets. Linde's applications allow their customers and end-users to avoid more than twice the GHG emissions of all Linde

operations, enabling 2.7x carbon productivity. Despite this, the carbon intensity of Linde's primary operations is relatively high and pose a risk to the sustainability of the company's long-term profits.

The company is targeting a 35% reduction in GHG emissions intensity by 2028 and aims to achieve this through investments in decarbonization and hydrogen projects, doubling the amount of low-carbon power used in operations, development of new technologies and driving operational efficiencies. On review, we felt this to be on the conservative side given the target is framed as emissions per EBITDA (we expect EBITDA to dramatically increase as the merger synergies with Praxair are realized) and the target base year is 2018, prior to the combination of the merging entities' financials. We discussed our views with management to which they acknowledged the targets could be more ambitious, however they do expect to exceed these goals.

One area of opportunity for Linde is the potential to further increase the carbon efficiency of their customers' operations by leading the transition to clean hydrogen. Hydrogen is a versatile and clean energy carrier and has zero emissions at point of use. The company plans to significantly increase investments into hydrogen projects which, if successful, will enable the company to capitalize on ESG opportunities as their customers increasingly prioritize ESG considerations.

In summation, we believe the company's carbon intensity will remain a risk if they cannot reduce GHG emissions more significantly than the 35% target. Furthermore, the likelihood of Linde reaching the Paris goal of net zero emissions by 2050 seems at risk to management today. We will continue to engage with management on these issues as advocates for a faster pace of change. Given the stock's recent appreciation and less attractive valuation combined with our longer-term concerns over risks due to the company's carbon intensity, we reduced the size of our position in the company.
