SGA
Sustainable Growth Advisers

Q3 2020 U.S. Focused Commentary

Highlights

- *The portfolio generated strong absolute returns trailing the Russell 1000 Growth Index and outperforming the S&P 500 Index as markets continued their rebound led by e-commerce, technology and more economically sensitive companies*
- *Stock selection was the primary detractor from returns during the quarter, along with residual sector allocations*
- *Stock selection in the Information Technology and Consumer Discretionary sectors accounted for the vast majority of relative underperformance due in part to companies not owned; in contrast selection in the Real Estate and Health Care sectors contributed to returns*
- *The portfolio's position in PayPal was trimmed due to valuation while its position in Visa was raised on weakness*
- *The portfolio is expected to generate revenue and earnings growth higher than that of the Russell 1000 Growth Index benchmark over the coming three years with greater predictability and sustainability*

Performance

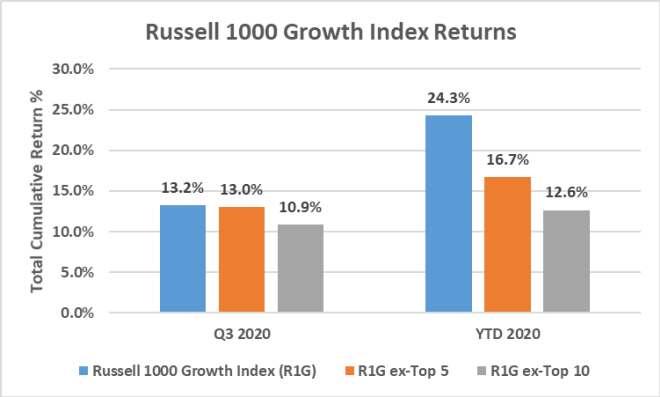
Equity markets posted strong absolute returns for the quarter. SGA's U.S. Focused portfolio returned 9.2% (gross) and 8.9% (net) in Q3 versus 13.2% for the Russell 1000 Growth Index and 8.9% for the S&P 500 Index, as equities continued to rebound on improving economic growth and corporate profitability. Year-to-date thru 9/30/20, the portfolio returned 24.5% (gross) and 23.7% (net) versus 24.3% for the Russell 1000 Growth Index and 5.6% for the S&P 500 Index.

More Optimism for Recovery

Despite an ugly Q2 U.S. GDP report in August indicating that the U.S. economy shrank by -31.7% (annualized) during the period, equity markets continued to rally in July and August, rising 18.8%, on the back of Q2's advance of almost 28% (for the Russell 1000 Growth Index) as investors reacted to gains in PMI's, durable goods orders and employment, and anticipated continued economic recovery. Concern over advancing COVID-19 caseloads in the Midwestern and Western sections of the U.S., as well as increased uncertainty over additional government assistance, put downward pressure on markets in September. The OECD (Organization for Economic Co-operation and Development) updated its 2020 forecast for U.S. economic growth from -7.3% at the end of June to -3.8%, as rising durable goods orders buoyed manufacturing, but the service side of the U.S. economy remained weak. At the same time, Eurozone growth declined -11.8% in Q2, slightly better than expected, boosted by better than expected recovery in Germany which helped offset further weakness in the UK, Spain and France. Growth in China was strongest of all with its economy growing 3.2% year-over-year in Q2, as it benefited from a strong recovery driven by government stimulus and continued containment of the COVID-19 virus.

Market and Portfolio Attribution

Sectors most heavily levered to e-commerce and improving global economic growth performed best during the quarter while more defensive sectors performed the worst. A surge in options trading centered on large technology stocks by big and small global investors magnified volatility. The Consumer Discretionary sector was the strongest performer, but over two-thirds of its return was due to strong performances by Amazon and Tesla. Materials, Information Technology and Industrials also outperformed the Index for the period with returns of 15.0%, 14.9% and 13.4% respectively. While market leadership broadened during the quarter, a narrow band of e-commerce and technology related stocks accounted for a significant portion of the Russell 1000 Growth Index's returns. The portfolio's lack of exposure to Apple and Tesla negatively impacted relative performance by -2.3% in Q3 and -4.2% year-to-date. While we have owned Apple in the past, we have not owned it since 2017 due to concerns over the iPhone's secular growth. Additionally, Apple's services segment and wearables business, still do not have the scale or profitability to effectively move the earnings needle at the company. In the case of Tesla, the company's lack of recurring revenues, inherent cyclicality and the uncertainty over its ability to sustainably and predictably generate profit growth over our investment horizon, has led us to not include the stock on our Qualified Company List. Strong performances by Amazon, NVIDIA, Facebook, Microsoft, and Salesforce.com also contributed meaningfully to the Index's return.



Source: FactSet, Russell. Companies excluded based on largest index weights at 9/30/20.

More traditionally defensive sectors such as Utilities and Real Estate performed poorly amid the cyclical relief rally, and Energy which continued to be negatively impacted by low oil prices and possibly some growing concerns about increased regulation should a new administration enter the White House, performed worst.

Both stock selection and residual sector allocations detracted from the portfolio's relative performance in Q3. Stock selection in the Information Technology sector accounted for a vast majority of the portfolio's underperformance for the period with the decision to not own Apple detracting about -1.4% from the portfolio's relative return. Selection in the Consumer Discretionary sector was the second largest detractor, driven by a position we did not own, as Tesla's shares continued to soar, detracting about 0.9% from relative returns. Stock selection in the Real Estate and Health Care sectors contributed positively due to positions in Equinix and Abbott. The portfolio's overweight in Real Estate, one of the weaker performing sectors, and underweight in Information Technology, one of the stronger performing sectors, detracted from relative performance.

Largest Contributors

Salesforce.com was the largest contributor to portfolio performance during the quarter. The company posted a strong Q2 and subsequently addressed key shorter-term and longer-term controversies having to do with revenue and backlog outperformance, and evidence of acquisition synergy in the form of Tableau growth acceleration. They also reported record margins and raised their guidance for both their top and bottom lines while reiterating that they are committed to integrating the company's recent acquisitions rather than initiating new M&A. This was well received by the market. Salesforce.com continues to be well positioned with a broad suite of market leading "front office" software-as-a-service applications which generate attractive recurring revenue streams and have ample room to grow in the global salesforce management, customer service and marketing automation areas. In addition, we continue to expect further revenue synergies from the Tableau acquisition.

Nike was the second largest contributor to portfolio performance this quarter. The company reported an excellent quarter with both revenue and earnings significantly above our forecasts as the company continued to recover from pandemic-related weakness at a faster rate and with a sharp acceleration in North American and EMEA operations. We were pleased to see significant progress in Nike's key digital transformation where it is increasing its engagement with consumers and deepening their connection to the company's brands. We were also pleased to see accelerating penetration and growth in women's shoes and athletic leisurewear. Each of these initiatives portends longer-term benefits for the company and when combined with its impressive scale and ability to provide customers with a seamless shopping experience, should enhance competitive barriers further making it more difficult for competitors to duplicate.

Abbott was the third largest contributor to portfolio performance as the stock benefited from investor enthusiasm over the company's announcement that it had secured regulatory clearance for a $5 COVID-19 antigen test which might allow the U.S. to move a bit closer to "normalcy". This announcement accelerated the trend toward more possible testing at physician offices and clinics in 2021 and beyond. The company also benefited from a solid Q3 report where it exceeded estimates in its nutrition, diabetes and device segments. Abbott's diversified business model has proven to be resilient during the pandemic. While procedure-driven revenues were negatively impacted in medical devices and routine testing, the company has executed extremely well in launching its COVID-19 testing product across multiple platforms, offsetting the headwinds in the other businesses. While we expect a fade in COVID-19 testing revenues at some point, we expect the other businesses that were negatively impacted to come back as elective procedures and routine testing return post the pandemic.

The fourth and fifth largest contributors to performance were **Amazon** and **Facebook**.

Largest Detractors

Payments solutions provider **FleetCor** was the largest detractor from results during the quarter as the company reported

earnings results which disappointed some shorter-term focused investors. Revenues were in-line with our expectations with -17% organic revenue growth, however the recovery in their Fuel Card is a little slower than our expectations. Retention levels remained steady at 91%, which should bode well for future growth as volumes recover. FleetCor's Corporate Payments segment declined 17% organically, but showed positive recovery trends through the quarter, although within this segment a recovery in T&E products remains challenged. Its Brazilian Toll business surprised positively, growing 3% organically with an increase of 5% in average monthly tags. The announcement of CFO Eric Dey's retirement was a surprise and may have weighed on the stock as well. We came away impressed with Charles Freund, his successor, following a subsequent conversation with him during the month. Our longer-term thesis remains intact and we continue to have high conviction in FleetCor's growth opportunity moving forward.

Autodesk was the second largest detractor from results during the quarter as investor concerns around future billings weighed on the stock given a cautious outlook from management driven by continued macro-economic uncertainty. While Autodesk's guide for the balance of the year was cautious, the company delivered solid Q2 results with revenue and billings above expectations while net retention rates remained over 100%. Usage trends remained positive, especially among customers in Asia Pacific given a quicker recovery in those markets, while trends have been slightly slower to rebound in the U.S. and U.K. We remain positive on the longer-term growth opportunity for Autodesk as the resiliency and predictability of the business model has improved considerably following its transition to a subscription-based model from a traditional license-based model. Autodesk is well-positioned to benefit from continued penetration and adoption of computer-aided-design software solutions, which enhance productivity and efficiencies for companies in the manufacturing, construction, architecture and media sectors.

Ecolab was the third largest detractor from performance with results affected by the company's recent sale of their energy unit and guidance for the second half of the year being cautious as a result of the uncertain outlook for its restaurant and lodging businesses due to the effects of the COVID-19 pandemic. Excluding one-time effects, Ecolab's sales declined 13% for the quarter led by their Institutional business which has been impacted the most by the dislocations caused by the pandemic. While Ecolab has been impacted in the near term by fewer restaurants, offices and hotels being open, it is expected to benefit over the longer term as the pandemic has accelerated client adoptions of its products, and allowed it to take market share from smaller, less efficient companies in its markets. Consumers prefer their products which are considered "hospital grade" relative to those of their competitors, in addition to their greater service coverage and digital capabilities to make the cleaning processes more efficient.

No other positions detracted from returns, however the smallest contributors to performance were **Becton Dickinson** and **Visa**.

Portfolio Activity

We continued to take advantage of significant market movements to actively reallocate capital from positions which were becoming less attractively valued to those growth businesses where valuation continued to appear attractive. The portfolio's position in PayPal was trimmed on strength following a positive report while the portfolio's position in Visa was added to on weakness. There were no full positions liquidated or new positions added during the period.

Summary

As noted in previous letters, we expect the process 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 the U.S. and global economies serves as a 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 and the U.S. elections 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 steady 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 continue to attract investor attention 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 hired another member of our client service team who started recently. We truly appreciate the confidence our clients are placing in SGA and we will continue to do our utmost to continue 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.

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