U.S. Focused Growth Commentary

1Q 2021

SGA
Sustainable Growth Advisers

Performance

SGA's U.S. Focused Growth portfolio returned 1.2% (gross) and 1.0% (net) in Q1 versus 0.9% for the Russell 1000 Growth Index.

Strength of U.S. Economy Boosting Economically Sensitive Stocks

The U.S. economy is now expected to grow by almost 10% in Q1, up from 4.1% in Q4. U.S. vaccination rates are ramping up significantly, manufacturing is at its highest level since 2018, and employment improving. There is nearly $5 trillion in consumer savings on the sideline together with massive new fiscal stimulus and continued monetary accommodation. All these favorable factors led investors to more economically sensitive companies that had suffered the worst during the pandemic. With the level of growth expected in Q1, much of the downturn in the economy experienced during the pandemic will have been eliminated, setting the foundation for attractive economic growth over the remainder of 2021 and into 2022. While investor expectations for corporate profit growth in 2022 is understandable given the recovering economy and massive stimulus, we would caution that estimates do not generally include the impact of tax increases, which we believe are likely and could possibly reduce growth to single digits in 2022, thus reducing some of the momentum in stocks. Given the likelihood of tax increases, we have already factored in estimates for a higher corporate tax rate into our company modeling and resulting valuations.

Highlights

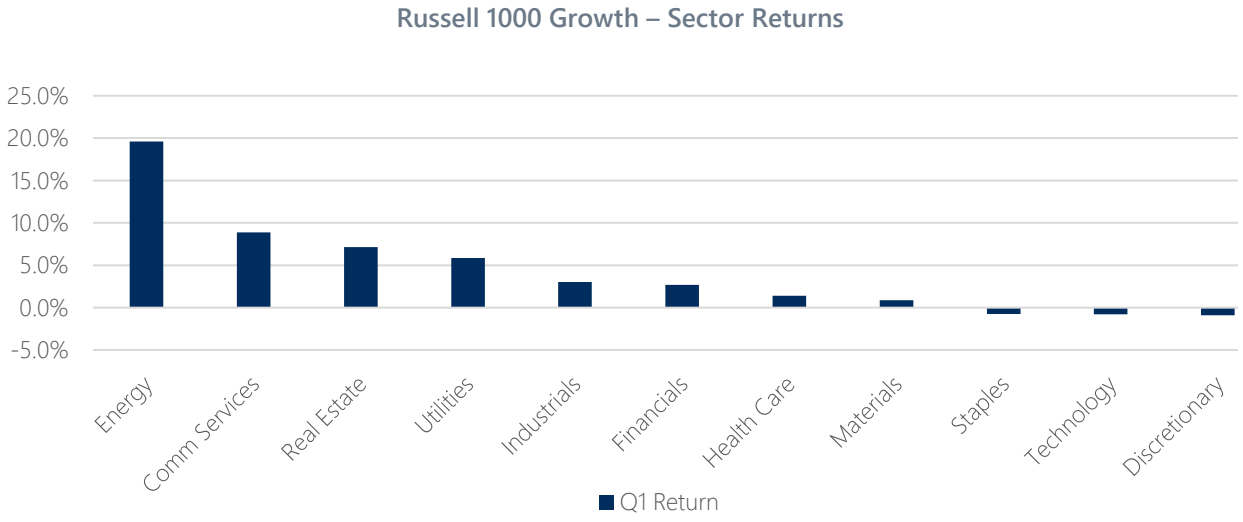
- Our approach faced a headwind as smaller cap, lesser quality more economically sensitive stocks outperformed on rising expectations for a strong economic recovery
- The portfolio marginally beat the Russell 1000 Growth Index in Q1 with sector weights contributing positively to relative returns and stock selection detracting
- Overweights in the Real Estate and Communication Services sectors along with stock selection in the Health Care and Communication Services sector benefited results; selection in the Real Estate, Materials, and Consumer Discretionary sectors detracted
- No new positions were added to the portfolio during the quarter but we trimmed positions in Autodesk and PayPal which had appreciated substantially in the market rebound

With a light at the end of the pandemic tunnel and massive fiscal and monetary stimulus being applied, concerns that inflation may heat up pushed the 10-year Treasury yield past 1.7% in March, marking a new 14-month high. The increase in borrowing costs led to widespread selling of growth stocks, particularly those that had outperformed so strongly over the past year in the Information Technology and Consumer Discretionary sectors. The increase in rates meanwhile boosted investor interest in Financials and particularly bank stocks. While investor concern over higher inflation, and a quicker than expected end to the Fed's highly accommodative policy stance penalized growth stocks, actual inflation rates remained well under control and the Fed reiterated its willingness to allow inflation rates to exceed 2% as the economy continues to heal and unemployment subsides. The rise in yields off the historically low levels seen in the depths of the pandemic was not surprising to us. In fact, in the course of our valuation work at the end of 2020, we had adjusted the discount rates we apply to company cash flows on the expectation that interest rates would rise from unsustainably low levels.

Source: FactSet

Market and Portfolio Attribution

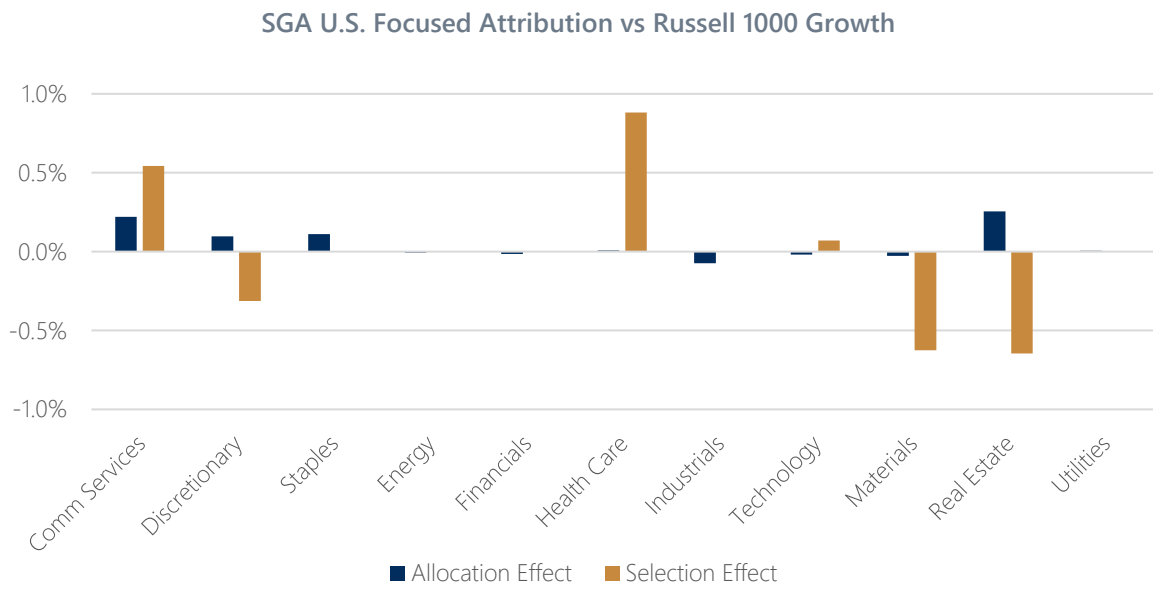
Market leadership varied over the course of the quarter with more economically sensitive companies outperforming strongly, particularly in the first half of the quarter. Rising bond yields together with a fourth COVID-19 wave in Europe and rising cases in the U.S. served to moderate optimism. Higher interest rates put pressure particularly on high growth stocks in the Information Technology and Consumer Discretionary sectors in the second half of the period. Given the outperformance of more economically sensitive companies for the overall period, however, value outperformed growth, higher beta stocks beat lower beta stocks, and small caps outperformed. With the bounce in the reward to quality in the second half of the quarter, companies with earnings or higher returns on equity outperformed, however companies with higher debt levels continued to outperform as well.



Source: Russell

Leadership in the Russell 1000 Growth Index was eclectic for the quarter with the Energy sector performing best, returning +19.6% as energy prices rose reflecting the potential for higher demand in a stronger global economy. Communication Services and Real Estate were the next best performing sectors. In a reversal from 2020, the index was dragged down by weak returns in the Information Technology sector (-0.8%) which comprised about 45% of the index as well as the Consumer Discretionary sector (-0.9%) which comprised about 17% of the Index. Likewise, large specific contributors to market returns last quarter and in 2020 such as Apple and Tesla underperformed in Q1 as investors sought more economically sensitive companies more likely to see pronounced near-term improvements in their results.

At the portfolio level, sector allocations contributed positively to relative returns while stock selection detracted. Overweights in the strongly performing Real Estate and Communication Services sectors benefited performance most while the absence of exposure in the Industrials sector hurt results.



Source: FactSet, Russell

Strong stock selection in the Health Care and Communication Services sectors driven by positions in Abbott, Alphabet, and Facebook was mitigated by weak selection in the Real Estate, Materials, and Consumer Discretionary sectors where positions in Equinix, Ball Corp, and Yum! Brands were not rewarded.

Largest Contributors

Internet search leader **Alphabet** was the portfolio's largest contributor in Q1 after reporting impressive revenue growth led by an unexpectedly strong rebound in Search, despite travel related headwinds, as well as strong margins. Strong controls over operating expenditures led to more than a 60% rise in operating profits. The stock also benefited from a strong increase in the company's cloud backlog which increased from $19 billion in Q3 to $30 billion in Q4. The company cautioned that operating expenditures and capital spending would reaccelerate in 2021, but we remain comfortable with its ability to temper spending as needed to protect earnings and cash flow in periods of economic weakness.

Diversified global health care company **Abbott** was the second largest contributor to portfolio returns for the quarter. The company reported strong Q4 results, influenced heavily by use of its COVID-19 testing kits. Revenues rose 29% while earnings per share jumped 53%+. Other segments of the business posted much smaller gains with Nutrition sales up 4.4%, Established Pharmaceuticals up 3.4% and Medtech flat as medical procedures continued to be negatively impacted by virus concerns. We continue to see the company as being well-positioned as we emerge from the pandemic given pent up demand for procedures and core testing. While COVID-19 testing will inevitably decline, the global nature of their business will help offset weakness and more importantly, we think the company will be able to drive double-digit growth as it executes on its numerous Medtech pipeline opportunities including multiple versions of Libre, devices for heart valve and heart failure, as well as continuing the rollout of the Alinity diagnostic system globally.

Social media leader **Facebook** was the third largest contributor to portfolio performance. The company reported a strong Q4 exceeding the most bullish views with solid engagement and attractive advertising revenue growth while issuing cautious guidance for the second half of the year as consumers begin shifting back from e-commerce to on-site retail. The company also authorized the repurchase of $25 billion worth of stock. We continue to see Facebook and its strong stable of businesses as being a prime beneficiary of the ongoing shift of advertising dollars from traditional to internet venues, but given ongoing and potentially increasing regulatory pressures, we maintained an average weight position.

UnitedHealth and **Microsoft** were the fourth and fifth largest contributors to portfolio performance for the quarter.

Largest Detractors

Aluminum packaging producer **Ball Corp.** was the largest detractor from performance in the quarter despite delivering solid quarterly results and attractive guidance for 2021. The weakness was primarily due to concerns by shorter-term investors who focused on some initial start-up costs the company was facing as it worked to add capacity to meet the strong demand for its containers. We are confident that the capacity being added will be met with increased demand as consumers, beverage brands and regulators are all embracing the sustainability benefits and SKU innovations in cans. Ball's revenues grew 14% in Q4 while its earnings were up 15%, exceeding our expectations and those of the market. The company's global beverage volumes grew 12% with strength across each of its segments as demand continued to outstrip supply across all regions. Its aerospace backlog grew 30% year-over-year. In 2021, the company expects double-digit growth in global beverage volumes and earnings growth exceeding its long-term target of 10-15%.

Leading computer assisted design company **Autodesk** was the second largest detractor from performance during the quarter despite a solid Q4 report with revenues exceeding expectations and strong bottom-line growth. Billings for the year declined by only 1% which, given the issues associated with the pandemic, was quite strong and better than the company's guidance. Their guidance called for softness in the first half of 2021 which is not abnormal given the seasonality in their business. This, coupled with very strong performance by the stock in Q4 last year, led to its underperformance this quarter. We used the weakness to add to our position after we had trimmed it on strength earlier.

Software-as-a-service leader **Salesforce.com** was the third largest detractor from performance during the period. Salesforce's shares were negatively impacted by weakness in technology stocks despite the company reporting a solid Q4 earnings report. Revenues and operating profits grew 20% and 37% respectively, both better than expectations. Operating cash flow growth of 33% missed guidance for the quarter, while the company's current backlog grew 18%. While sentiment remains depressed given the recent announcement of an agreement to acquire Slack, our conviction in Salesforce's 3-5-year growth opportunity remains high given its strong position in the enterprise software-as-a-service category and its suite of front-office applications which address functions of companies of all sizes.

Amazon and **Visa** were the fourth and fifth largest detractors from portfolio performance for the quarter.

Portfolio Activity

There were no new positions added to the portfolio or positions fully liquidated during the quarter. However, we took advantage of strength in Autodesk and PayPal early in the quarter, reallocating the capital to more attractively valued positions in Facebook and Workday. Later in the quarter, we took profits in Facebook, which was one of the portfolio's best contributors, and reallocated it to Autodesk which experienced some relative weakness after our earlier trimming of the position.

Summary

The portfolio's return pattern over the quarter was consistent with our expectations and history as it lost some relative ground in the early part of the quarter amid high optimism over the potential for life to get back to normal as vaccination programs gained traction. Similarly, the portfolio gained ground relative to the market as the flourish of optimism was tempered a bit by hiccups in the rollout of vaccines, variants spread in Europe, Brazil and the U.S., and bond yields climbing precipitously on new inflation worries. With more states allowing businesses and schools to reopen, manufacturing humming and massive monetary and fiscal stimulus being piled on, we are not surprised by the optimism or the market's willingness to embrace cyclicals. Q1, however, illustrates the basis for our continuing focus on businesses and the key quality characteristics we demand. Likewise, it underlines our expectation that the path out of the pandemic is likely to be volatile and marked by periodic reversals and fluctuations in sentiment.

The businesses we invest in are expected to grow at well above average rates, despite the volatility and variations in investor sentiment, compounding over our longer time horizon. Over the next three years, the portfolio is expected to generate 13.6% revenue growth and 21.0% earnings growth while the Russell 1000 Growth Index is expected to generate 10.5% and 14.6% revenue and earnings growth respectively. This predictability and sustainability of growth should provide a much smoother ride for our clients over time, generating strong risk-adjusted and absolute returns. We've seen headwinds from

the bounce in cyclicals before and have confidence that our approach to growth investing will generate attractive performance for our clients over the long-term.

Please let us know if you have any questions regarding the quarter or the portfolio's positioning, and thank you for your continued confidence in our team.