Global Growth Commentary

1Q 2021

SGA
Sustainable Growth Advisers

Performance

SGA's Global Growth portfolio returned 2.2% (gross) and 2.0% (net) in Q1 versus 4.6% for the MSCI All Country World (ACWI) Index and 0.3% for the ACWI Growth Index.

A Global Economic Recovery Underway

As vaccination rates around the world rose, forecasts for economic growth continued to improve with growth in the U.S. now expected to reach almost 10% in Q1, up from 4.1% in Q4. Employment continued to improve with the unemployment rate dipping down to 6.0% versus 14.8% at the height of the pandemic. With a massive amount of new fiscal stimulus being applied, in addition to the trillions of dollars already spent, and almost $5 trillion in U.S. consumer savings on the sidelines, 2021 and 2022 are likely to witness rates of growth well in excess of anything seen in recent years. At the same time, China reiterated that its GDP would grow 6% in 2021 up from 2.5% in 2020. Chinese equities trailed during the period given concerns about fiscal and monetary tightening by Chinese authorities to rein in risky lending and curtail financial asset bubbles. Additionally, concerns about regulation of China's internet and technology companies weighed on sentiment.

With harsh lockdowns coming to an end after an aggressive vaccination program, the UK looked to see a strong rebound in growth as well. At the same time, the rest of Europe remained mired in pandemic-related weakness with extensive new lockdowns announced in France and Italy and other parts of the continent. In the Emerging Markets, quickly rising COVID-19 caseloads in Brazil, which surpassed the U.S. in terms of virus related deaths, and India negatively impacted growth forecasts. Rising geopolitical tensions between the U.S. and China posed an additional risk. Additionally, while economic growth in the U.S. is rebounding strongly at the moment, proposed significant changes in tax policy and rates could pose a headwind to U.S. growth and corporate profits in 2022. With this in mind, we have adjusted the assumed tax rates we use in modeling companies on our Qualified Company List.

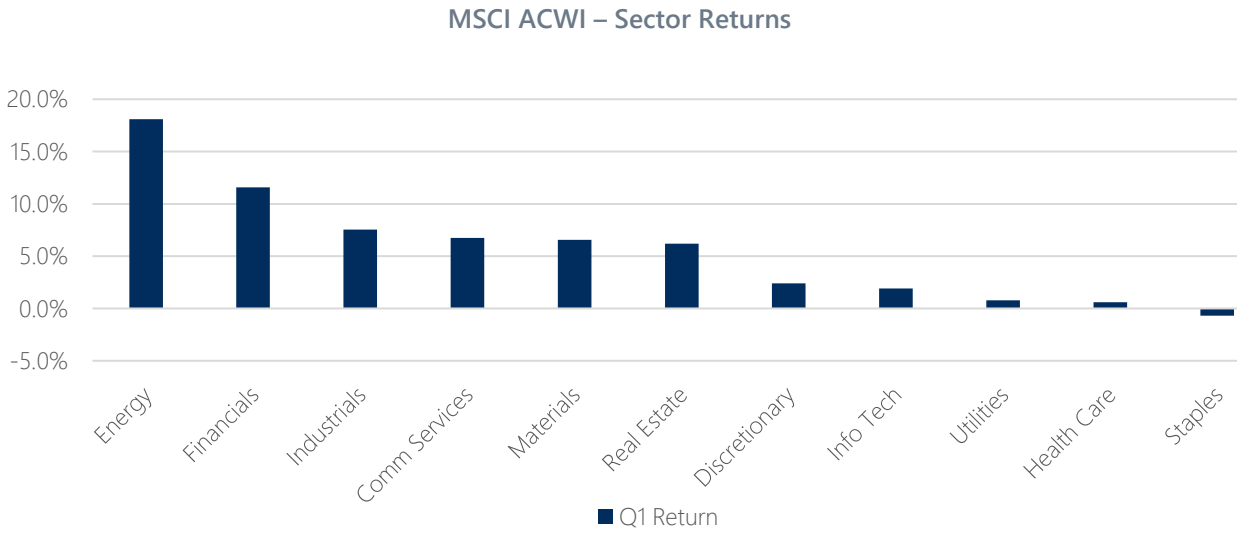
Highlights

- 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 trailed the MSCI ACWI with residual sector weights and stock selection detracting from relative returns
- The portfolio's underweight in the strongly performing Financials sector and lack of exposure to Energy stocks presented a headwind for performance, while stock selection in the Consumer Discretionary also hurt relative returns; strong selection in the Industrials and Communication services sectors boosted relative returns
- The portfolio's position in Fast Retailing was sold due to valuation and the proceeds reinvested in media leader Walt Disney
- We continued to trim positions that had appreciated substantially such as Alibaba, HDFC Bank and Kansas City Southern, while buying additional shares of other stocks that remained attractively valued such as Dassault, Equinix, and Workday among others

Source: FactSet

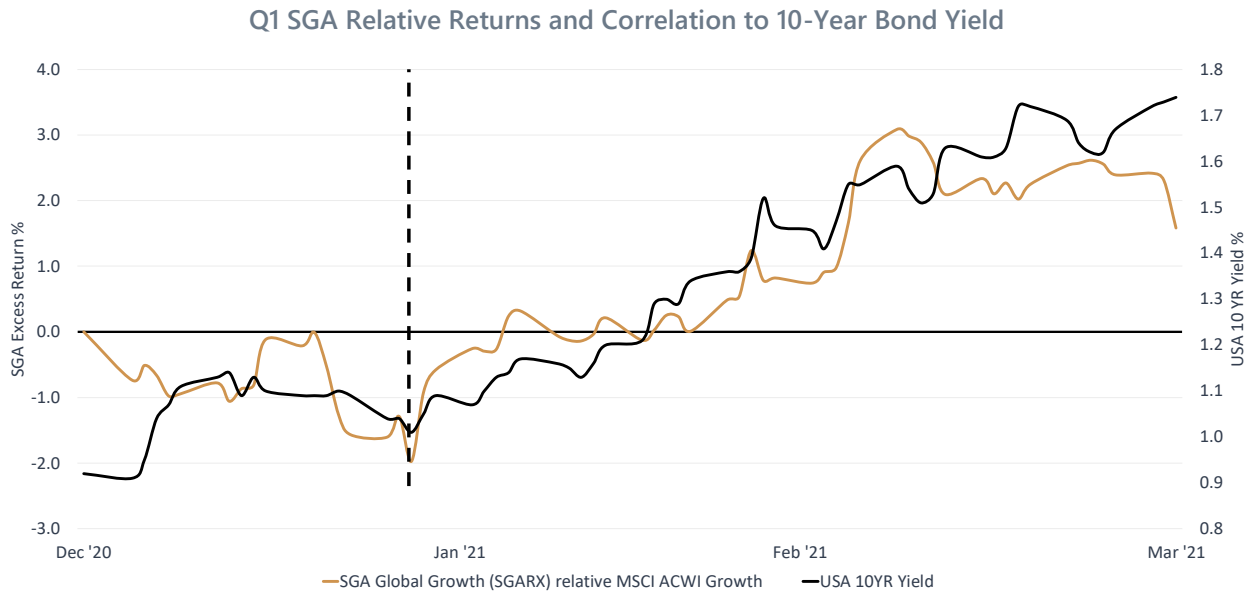
Market Attribution

Market leadership varied over the course of the quarter with more economically sensitive companies outperforming strongly, particularly during January. Quickly rising U.S. bond yields together with a fourth COVID-19 wave in Europe and Brazil and rising cases in the U.S. served to moderate optimism. Higher interest rates put pressure on longer duration high growth stocks particularly in the Information Technology and Consumer Discretionary sectors in February and March. For the overall period, value outperformed growth, higher beta stocks beat lower beta stocks, and small caps outperformed. Higher quality business metrics went unrewarded with firms generating low returns on equity, high debt levels, or no earnings performing best. The willingness of investors to take on higher levels of risk and earnings variability posed a headwind to our approach which is focused on owning the most predictable and sustainable growth businesses we can identify around the world.



Source: MSCI

From a sector standpoint, the Energy and Financials sectors performed best, returning +18.1% and 11.6% respectively, as both sectors benefited from rising expectations for stronger global growth. The Industrials sector also benefited from the desire by investors to buy cheap exposure to the economic cycle. Not surprisingly, more defensive areas of the market such as the Consumer Staples, Health Care, and Utilities performed the worst. Information Technology, which comprised about 22% of the ACWI Index, also underperformed by a wide margin as longer duration growth stocks in that area were negatively impacted by quickly rising bond yields. Large contributors to market returns from last quarter and 2020 such as Apple and Tesla underperformed in Q1 providing some benefit to our portfolio on a relative performance basis.

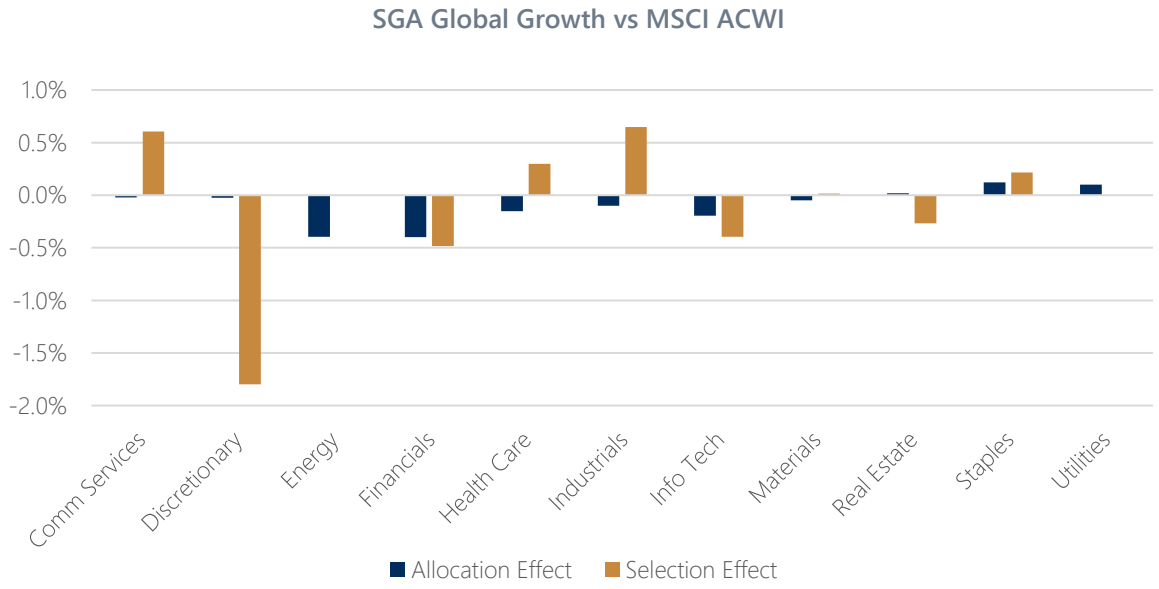


The performance figures shown are for the institutional share class of the Virtus SGA Global Growth Fund, SGARX, relative to the MSCI ACWI Growth Index.

Source: MSCI

Portfolio Attribution

The portfolio underperformed on a relative basis in the first half of the quarter as cyclical stock headwinds were most intense but saw a turn in relative results beginning in late January as interest rates rose quickly and negatively impacted higher growth companies, particularly in the Information Technology and Consumer Discretionary sectors. Concern over the widening spread of COVID-19 variants and the potential impact this could have on U.S. reopening's despite the quickly increasing number of people being vaccinated also moderated investor optimism as the quarter went on. Sector allocations and stock selection each detracted from relative returns. An underweight in the strongly performing Financials sector and no exposure in the strongly performing Energy hurt most. Stock selection within the Consumer Discretionary sector was the largest detractor overall due largely to positions in New Oriental Education and Nike.



Source: FactSet, MSCI

Selection in the Consumer Discretionary and Financials sectors also had a negative impact due to positions in New Oriental Education, Nike, Yum! Brands, and AIA Group. Strong stock selection in the Industrials and Communication Services sectors due to positions in Kansas City Southern, IHS Markit, and Alphabet helped mitigate some of the weakness.

Largest Contributors

Kansas City Southern received a $25 billion merger offer from Canadian Pacific Railroad which would form a company that would create the first freight railway network linking the U.S., Canadian, and Mexican borders. The deal faces scrutiny from U.S. regulators but, with little geographic overlap between the respective rail networks of the two companies, both parties committed to it. With the ability for the new entity to help expedite and enhance service for customers, we consider the chances of approval to be high. This is further supported by the fact that a similar deal was approved in the late 1990's where it was determined that there was little negative impact on competition. Along with the chance to enhance service for shippers and thereby strengthen the new company's value proposition, we see the potential for meaningful synergies on both the top and bottom line for the company over our 3-5-year investment horizon. Given the increase in KSU's share price with the announcement of the deal, and the potential risk that it may not be approved, we took profits in the position but maintained an average weight at quarter-end.

Internet search leader **Alphabet** was the portfolio's second 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. We maintained an average weight position in the company during the quarter.

Thai Convenience store operator **CP All** was the third largest contributor to performance. The company posted an in-line Q4 report with comparable store sales impacted by more transient issues including lockdowns due to COVID-19, poor weather, and temporary government-provided subsidies which could only be redeemed in traditional stores. Looking forward, the company expects to be able to grow comparable store sales in-line with GDP which should be in the 3-4% range. They also plan to open 700 more stores in 2021 as space becomes available while focusing on controlling staff levels. Additionally, we see benefits from the company's continued expansion of 7-eleven and Makro stores as well as O2O delivery initiatives and synergies from their acquisition of Tesco assets which closed in December of 2020. We maintained an average weight position in the company.

HDFC and **Facebook** were the fourth and fifth largest contributors to portfolio performance for the quarter.

Largest Detractors

Chinese private education company **New Oriental Education** was the largest detractor from portfolio performance in Q1 after announcements by government regulators led to increased concerns about how EDU and other private education companies may be impacted by new regulations. Following a review of the issue, we determined that the main tenets of our original thesis for EDU remained intact and that we expect the company to potentially benefit from the change in regulations which may lead to a further consolidated industry. We continue to see EDU as being well-positioned to benefit from demand for higher quality education in China and purchased additional shares of the stock on weakness through the quarter.

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 on strength earlier.

Premium brand brewer **Heineken** was the third largest detractor from performance in Q1 as the company continued to be negatively impacted by the closure of restaurants, bars, and pubs due to COVID-19 restrictions in many of its key markets.

We see these issues being temporary in nature and continue to focus on the company's strong brand presence in the premium brand markets, its geographically diverse and normally stable consumption patterns and exposure to the key secular growth drivers (premium brands and participation in the developing markets) in the global beer business. We maintained an average weight position in the company during the quarter.

Intuitive Surgical and **Nike** were the fourth and fifth largest detractors from performance during the quarter.

Portfolio Activity

Turnover during the quarter was in-line with long-term averages. A new position was initiated in Walt Disney while the portfolio's position in Fast Retailing was liquidated given its valuation and the better forward-looking opportunity in Disney. We were also active in trimming back positions in select positions on strength, consistent with our valuation discipline. Positions in Autodesk, AIA Group, Alcon, Alibaba, New Oriental Education, Facebook, HDFC Bank, Illumina, Kansas City Southern, PayPal and Tencent were trimmed. Given volatility during the quarter, we reallocated more capital to other growth businesses where valuations had become more attractive. Those included Autodesk, Dassault, New Oriental Education, Equinix, Facebook, IHS Markit, Novo Nordisk, PayPal and Workday. You will note that some positions were both added to and trimmed during the quarter given large swings in stock prices over the period.

New Positions

Global media leader **Walt Disney** was reintroduced to the portfolio in February as the company posted impressive user growth for its Disney+ streaming service. While its theme parks and studios have been negatively impacted by the COVID-19 pandemic given state-mandated closures to parks, movie theaters, and the reduction in travel, we see attractive opportunity for the business in the rebound expected in 2021 and 2022. We also see continued investments in content for the company's key direct-to-consumer media offerings. However, given wide acceptance by consumers and a strategy that emphasizes quality over quantity, we see it becoming profitable over our 3-5-year time horizon with attractive long-term margin and cash flow potential. As consumers increasingly embrace streaming services, which are still priced at a significant discount to traditional cable subscription rates, we see ample room ahead for Disney to lift pricing and gain share of the consumer's wallet. This business will increasingly be a key driver of Disney's growth helping the company monetize its premium content in more effective ways.

Disney continues to meet the key business quality criteria we focus on, offering attractive pricing power due to the unique value of their branded content. The company's ESPN, Pixar, Lucas Films, Marvel brands and Fox assets provide it with strong content relative to peer media businesses. The company enjoys a high level of recurring revenues despite the somewhat cyclical nature of their theme parks given their emphasis on longer-term contracts and distribution, and the unique and ongoing demand for their content. Finally, our research indicates that Disney's direct-to-consumer distribution network offers significant long-term growth opportunities albeit in conjunction with increased content expenses. Meanwhile, a successful direct-to-consumer relationship will lead to flywheel effects among the Park, Consumer Products, and Studio businesses, which we see as advantages that are unique to Disney.

While we see enhanced growth opportunities for Disney looking forward, we remain cognizant that the streaming industry has become highly competitive and Disney's growth will be affected by how it continues to build its offering and differentiate itself from peers. We also understand that its theme park business, while expected to rebound strongly as the pandemic recedes, may face difficulty growing its margins significantly further. However, we do see opportunity for improved efficiencies in this business, some of which have become more apparent as a result of the pandemic. While the Fox acquisition turned out to be less attractive to Disney's business in the short-term, we do see that it has brought meaningful benefits to the company's content library and expect that it will be accretive. While cord-cutting has been a threat to ESPN in the past, we see the impact mitigated by Disney's direct-to-consumer steps. We initiated a below-average weight position in the company and expect to build it opportunistically moving forward.

Sold Positions

The portfolio's position in **Fast Retailing** was sold due to valuation following significant appreciation and the identification of other more attractive growth opportunities over our 3-5-year investment horizon.

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. While the cyclical advance continued through the quarter, its strength moderated as the quarter went on as a result of hiccups in the rollout of vaccines, virus variants spread in Europe, Brazil, and the U.S., and U.S. bond yields rose. With vaccine supplies gradually building, global 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 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 12.9% revenue growth and 23.0% earnings growth while the MSCI ACWI is expected to generate 5.8% and 16.5% 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.

Sustainability Report

1Q 2021

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Nike: Sustainable Cotton

China is the world's largest cotton producer with 84% of its cotton sourced from the Xinjiang region. Following concerns over the prevalence of labor abuses in the region, many major brands have been associated with forced labor resulting in consumers calling for an end to the sourcing of cotton and yarn from the region. The situation complicates global supply chains; presenting challenges to transparency, access and auditing, while inflaming already fragile geopolitical relations. One of our portfolio companies, Nike, has found itself targeted by the Western media with accusations of profiting from the forced labor of the Uyghur people in the Xinjiang region, which we believe inaccurate.

Nike began to improve labor standards in contract factories over 20 years ago with a focus today on traceability at the raw material level. The company works closely with its suppliers, industry associations, brands and other stakeholders to map supply sources so it can have confidence materials are responsibly produced. With regard to cotton sourcing, 2020 marked the first year 100% of cotton used across Nike's product line was certified organic, recycled or Better Cotton (sourced through the Better Cotton Initiative). This represents approximately a 4x uplift in the amount of sustainable cotton used since 2015.

In response to the recent headlines, Nike has expressed concerns over reports of forced labor in the Xinjiang region and reaffirmed their previous statement (from over one year ago) that neither Nike nor its suppliers source products from the region. Furthermore, Nike has moved to dispel inaccurate reporting of its cotton supplier relationships and lobbying efforts. Nike does not have supply relationships with suppliers in China linked to forced labor in the region, including (i) Haoyuanpeng Garment Group, (ii) Qingdao Jifa Huajin Group, and (ii) Changji Esquel Textile, as has been inaccurately reported in the press. Its supplier Qindao Taekwang Group stopped hiring new employees from the region in 2019 and no longer has any employees there (verified by independent third-party audit). Additionally, Nike has not lobbied against the proposed Uyghur Forced Labor Prevention Act, or any other proposed forced labor legislation, as was inaccurately reported by the New York Times in December 2020.

In 2020, Nike strengthened its audit protocols related to the identification of risks related to potential labor transfer programs (including more frequent reviews and self-assessment requirements for supply chain participants) and continues to conduct ongoing due diligence with its suppliers in China to identify and assess potential risks relating to the employment of Uyghurs, or members of other ethnic minorities in China. China remains an important market for Nike, in terms of growth and profitability, and we will be closely monitoring the situation for any impact to sales from boycotts by Chinese consumers as a result of nationalistic support for Xinjiang cotton.

Know Your Supply Chain – Yum! Brands

The complexity of global supply chains today present increasing risks to global businesses given changing consumer attitudes, concerns over the sustainability of our environment and increasing geopolitical tensions. The path to supply chain transparency is fraught with obstacles, costs and requires a methodical transition. Any 'quick fixes' are likely to displace small farmers & producers and cause disruption to local economies. Corporates must work to continually improve the transparency of supply chains with careful consideration of the first-, second- and third-order effects.

Food companies are seeing heightened interest in their supply chains as discerning consumers demand to know where their ingredients come from, how they are sourced and the conditions and welfare of workers and animals. We recently spoke with the management of Yum! Brands, operator of the KFC, Taco Bell and Pizza Hut global franchises, as to how they are addressing their customers' concerns.

Yum! works with thousands of suppliers across food, beverages, packaging and equipment through the company's Office of Sustainability created in 2009. In recent years, the Office has increased its focus on several areas including the sourcing of animal proteins and forest stewardship with hand-picked ingredients including tomatoes and palm oil a key area of risk. In efforts to conduct supply chain sustainability risk assessments, in 2019 Yum! partnered with SEDEX – a leading ethical trade organization that works to ensure ethical standards are monitored and measured across global supply chains. SEDEX collects

data on suppliers across the globe and shares this information with members of its association to encourage collaboration amongst businesses to improve working conditions in global supply chains. Yum! utilizes the SEDEX data to form risk assessments of its suppliers and identify those that need to make improvements to their workers' rights and conditions. Yum! audits its suppliers over 15-month periods with third-party audits utilized to provide an objective report of suppliers. Transparency into the company's audit results is an area where we will continue to advocate for improvement; the company does not share statistics on the number of suppliers that fail an audit or are cited for significant infractions, although they implied the number of incidents is low.

Yum's journey towards sustainable sourcing will be gradual, with progress dependent upon contributions from not only the company itself, but other stakeholders such as government agencies, NGOs and peer collaborations as well. We believe the company is on the right path with its policies, but we will be closely monitoring future developments and continue our engagement with management.

Other Noteworthy Items

Heineken is considering a 'Say on Climate' vote at future annual general meetings. Say on Climate is a new initiative to encourage companies to disclose emissions and produce reports on interim environment targets (5-10 years) that bridge the gap between shorter and long-term targets (e.g. 2050 carbon neutral). These reports would be subject to non-binding shareholder votes similar to Say on Pay - a very successful shareholder campaign.

Industrial gas provider **Linde** announced plans to build the world's largest PEM (Proton Exchange Membrane) electrolyser to supply green hydrogen throughout Europe. PEM electrolysers are currently one of the most cost-efficient ways to produce green hydrogen however the world is still some years away from producing large-scale, cost-efficient green hydrogen. As the costs of renewable energy and electrolysers decline over time, we expect green hydrogen to play a pivotal role in the transition towards a net-zero economy with applications across many industries, particularly refining and transportation. Linde is making strategic investments in the area today with the potential to serve a multi-billion-dollar market in the future. We have factored in a conservative assumption of this market to our long-term growth estimates for Linde however we will be watching this space closely.