International Growth Commentary

1Q 2021

SGA
Sustainable Growth Advisers

Performance

SGA's International Growth portfolio returned 0.9% (gross) and 0.7% (net) in Q1 versus 3.5% for the MSCI ACWI ex USA Index.

A Global Economic Recovery Underway

As vaccination rates around the world rose, forecasts for economic growth continued to improve and buoy further stock market gains as investors focused on the prospects for improving corporate earnings. Chinese economic growth continued to benefit from the country's fewer COVID-19 cases while vaccination programs in Europe and much of the emerging world were slow to roll out, causing new surges in the virus and its variants. Despite the weak vaccine rollout and new surges in Europe, India, and Brazil among other places, investors focused on the light at the end of the tunnel believing that vaccines and massive fiscal and monetary stimulus would cause growth in 2021 and 2022 to surge off the weakness seen in 2020. Preliminary promising signs of improvement in employment, manufacturing, rising consumer purchases, and signs that personal travel plans were heating up encouraged investors to focus on a return to normalcy.

The unpredictable nature of the global pandemic and the varied national government responses to it continue to negatively impact economic recovery. The Biden administration's plan to significantly increase tax rates combined with higher regulatory costs also pose a threat to U.S., and therefore global, growth as well. Rising geopolitical tensions between the U.S. and China, Russia's military build-up on the border of Ukraine, China's heavy-handed approach to removing democracy from Hong Kong, and its stepped up threats to Taiwan pose additional key risks to the global economy over the coming year. Given the tremendous amount of optimism already discounted in world stock prices despite these risks, we believe ample ingredients exist to generate higher levels of volatility in the coming year as investors look beyond the current bounce in world economic activity.

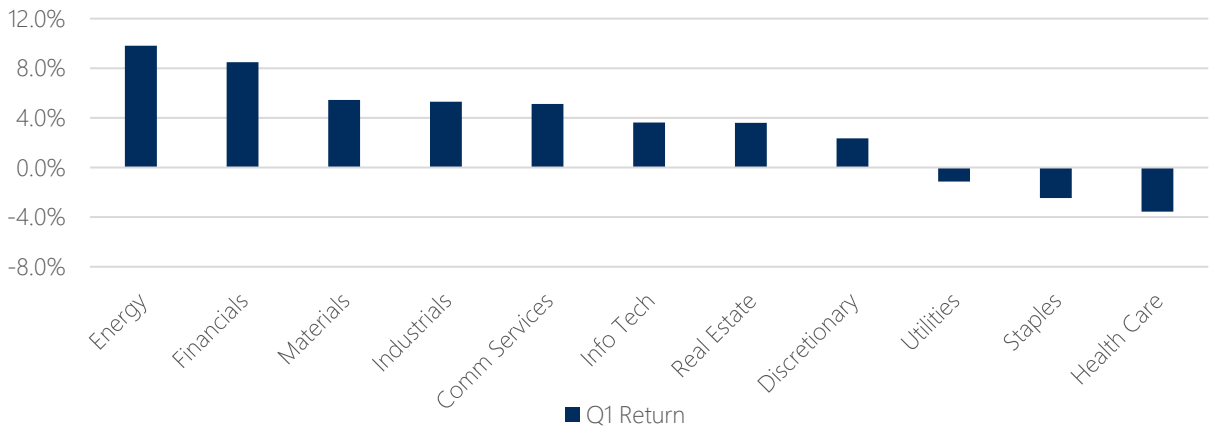
Highlights

- Our approach faced a headwind as smaller cap, lesser quality and more economically sensitive stocks outperformed on rising expectations for a strong economic recovery
- The portfolio trailed the MSCI ACWI ex USA Index with residual sector weights and stock selection detracting from relative returns
- The portfolio's overweights in the weakly performing Consumer Staples and Health Care sectors presented a headwind for performance, as did the lack of any exposure to the strongly performing Energy sector; stock selection in the Consumer Discretionary and Financial sectors hurt relative returns offsetting strong selection in the Consumer Staples and Health Care sectors
- A new position in Recruit was initiated during the quarter, no positions were liquidated
- We added to positions in CP All, New Oriental Education and Novo Nordisk among others while trimming positions in Linde, Adyen, Fast Retailing and others on strength

Market Attribution

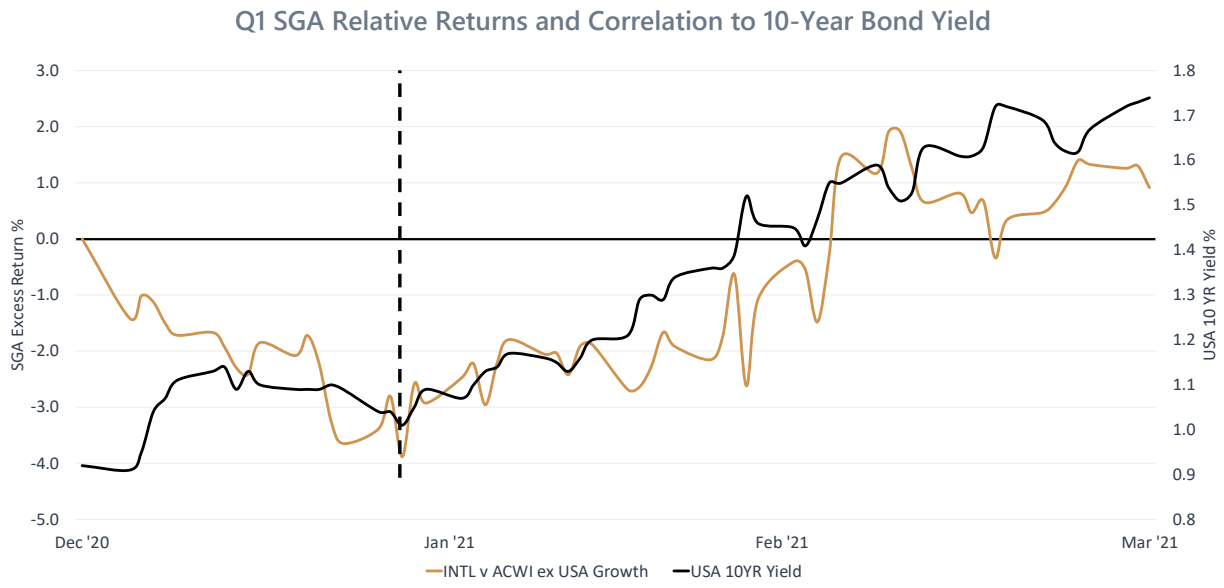
Market leadership varied over the course of the quarter with more economically sensitive companies outperforming strongly, particularly during January. Quickly rising U.S. bond yields together with a fourth COVID-19 wave in Europe and Brazil and rising cases in the U.S. served to moderate optimism. Higher 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 and small caps outperformed. Higher quality business metrics went largely unrewarded with companies with low returns on equity or high debt levels 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.

MSCI All Country World ex USA Index - Sector Returns



Source: FactSet, MSCI

From a sector standpoint, the Energy and Financials sectors performed best, returning +9.8% and +8.5% respectively, as both sectors benefited from rising expectations for stronger growth. The Materials 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 Health Care, Consumer Staples, and Utilities performed the worst. Information Technology, which comprised about 13% of the ACWI ex USA, performed in-line with the index.

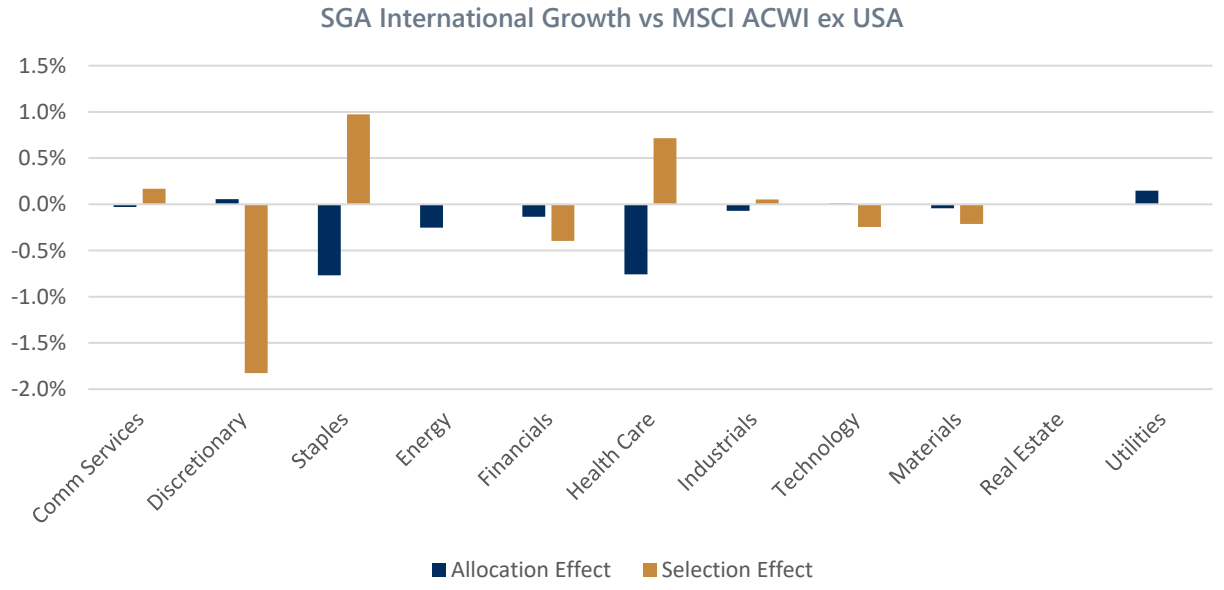


The performance figures shown are for the institutional share class of the Virtus SGA International Growth Fund, SCIZX, relative to the MSCI ACWI ex USA Index.

Source: FactSet, 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. Despite the quickly increasing number of people being vaccinated, there remained concern over the widening spread of COVID-19 variants and the potential impact this could have on re-openings. Sector allocations and stock selection each detracted from relative returns. Overweights in the poorly performing Consumer Staples and Health Care sectors hurt most. Stock selection within the Consumer Discretionary sector was the largest detractor overall due largely to positions in New Oriental Education and Adidas.



Source: FactSet, MSCI

Positive stock selection in the Consumer Staples and Health Care sectors due to positions in CP All, Wal-Mart de Mexico, and Sartorius helped mitigate some of the weakness.

Largest Contributors

Aon was the largest contributor to performance after reporting a solid Q4 with sales up 2% and earnings per share up 4%. Despite pandemic related pressures, Aon delivered 1% growth in revenues and 7%+ growth in earnings per share during 2020, demonstrating the underlying resiliency of its business model. Looking ahead, we expect continued execution of topline growth and operating margin expansion, as the company capitalizes on its scale and investments into data and analytics, and faster growing areas of insurance such as cyber and intellectual property. There remains some uncertainty regarding the closing of the acquisition of Willis Towers Watson, and whether there will be significant divestitures. However, we view Aon as well positioned as a standalone or with Willis Towers Watson and, given attractive valuation, and maintained an above-average weight position.

HDFC Bank was the second largest contributor to portfolio performance in Q1 as it posted a strong earnings report and benefited from improving economic activity in India. Its results benefited from reduced provisioning for bad loans as their balance sheet is in solid shape and has sufficient floating provisions to account for any future issues. The company reported strong deposit growth on a year-over-year basis along with strong loan growth and well-controlled costs which all led to attractive profit growth of about 18%. We maintained an above-average weight position.

Sartorius was the third largest contributor to portfolio performance in Q1 after it reported strong sales and earnings growth while raising its long term 2025 forecast. Growth across each of its business segments and regions was strong with order growth up 74% in Q4 and 49% for 2020. Bioprocessing sales (related to the manufacturing of biologic drugs) were up 34% and lab product sales (related to life sciences research) were up 30% buoyed by strength in all geographies. While results benefited from COVID-19 related strength in bioprocessing, we see a basis for continued strength in the segment albeit at a somewhat slower pace than experienced in 2020. The growth drivers behind its businesses are secular in nature, as we expect continued global manufacturing of biologic drugs, and continued investments in life sciences research. Given the strength in the company, we trimmed our position slightly and maintained a below-average weight position during the quarter.

CP All and **Wal-Mart de Mexico** 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 pronouncements by government regulators led to increased concerns about how EDU and other private education companies may be impacted by new regulations and whether they would slow the company's expected growth. Following a review of the issue and further discussion, 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 company on weakness through the quarter.

Adidas was the second largest detractor from performance in Q1. The company reported an in-line Q4 with constant currency revenues and operating income growth both showing improvement above our expectations on a concurrent basis over Q2 and Q3 of 2020. 2021 guidance was in-line with our expectations with low to mid-teens constant currency sales growth expected together with meaningful improvements in gross margins. E-commerce sales growth was up 43% in Q4 and we see strong prospects for continued growth in this key segment looking forward over our 3-5-year investment horizon. The company expects to launch its Adidas Sportswear in 2022 to address the growing athleisure segment. Concerns the company expressed over the possible use of forced labor in the production of cotton from the Xinjiang region of China and subsequent reports of Chinese social media driven boycotts put some pressure on the company later in the quarter. It is important to note that company does not source any input materials from the region, and we believe any near-term pressure on the brand resulting from its public stand on the issue will pass. We maintained an average weight position during the quarter.

Shandong Weigao was the third largest detractor from portfolio performance in Q1. Weakness in China's equity markets put pressure on the company, but there were also concerns early in the quarter on whether the Chinese government's central procurement of medical consumables would negatively impact the company, as pricing on tendered products would be pressured. When the company reported their 2H20 results, Weigao reported that while there were some pricing pressures, they were able to take significant market share as a scaled player, overcoming the pricing pressure from the central procurement process. The company also returned to growth in the 2H20 as medical visits and procedures started returning, rebounding significantly from 1H20. Not all of the higher margin categories returned to growth, as biopsies and elective procedures remain below pre-COVID-19 levels. We expect demand for these procedures will return, and see significant potential opportunity for the company as it continues to build its portfolio of higher margin products, participates in the growth of health care services within China and begins to grow its business outside of China. We maintained an average weight in the company.

Heineken and **Fast Retailing** were the fourth and fifth largest detractors from portfolio performance for the quarter.

Portfolio Activity

Turnover during the quarter was in-line with our long-term average. A new position was initiated in Recruit while no positions were liquidated. However, many trims and adds took place during the period as we sought to take advantage of significant price appreciation in some holdings while adding to other positions where valuations had become more attractive. Specifically, we added to positions in New Oriental Education, Novo Nordisk, SAP, and CP All while trimming positions in Tencent, Fast Retailing, Alibaba, Adyen, HDFC Bank, Aon, and Linde.

New Positions

Japanese human resources and media company **Recruit** was added to the portfolio in Q1. Recruit owns the job search engine Indeed.com as well as a variety of online media and staffing businesses. The company receives 250 million+ monthly visitors in 60+ countries. With strong pricing power driven by a 66% market share of U.S. hires, strong user traffic, difficult to replicate back-end services, an attractive history of customer retention, and strong U.S. fee-based services as well as international growth opportunities, we see the company meeting our key business quality requirements well.

Among the risks we are monitoring are the competition within the human resources technology market. To date, Indeed has not been significantly impacted by LinkedIn or Google in obtaining job listings, but Indeed's user base also uses these other services. In addition, the staffing, classifieds and online job advertising businesses all have a degree of cyclical risk. To the extent that ad volume on Indeed slowed for a prolonged period, this could lead to lower bidding prices.

We initiated a below-average weight position in the company at what we consider a very attractive entry point and expect to build the position opportunistically moving forward.

Sold Positions

No portfolio positions were fully liquidated during the quarter.

Summary

The portfolio's return pattern over the quarter was consistent with our expectations and history as it underperformed early in the quarter amid high optimism for renewed global growth. While the market's preference for cyclicals continued through the quarter, the strength of the advance moderated as the quarter went on as concerns over the slow rollout of vaccines and the spread of virus variants in Europe, Brazil, India and much of the world increased. With vaccine supplies gradually building, global manufacturing rebounding, and massive monetary and fiscal stimulus being applied, we were not surprised by the market's optimism or willingness to embrace more economically sensitive companies. However, much good news has already been reflected in stock prices and we expect the road out of the pandemic to remain volatile with the pace of global vaccination programs varying widely by country and region, and the impact of new variants of the virus being an ongoing threat. Additionally, rising geopolitical tensions, rising debt levels and higher interest rates pose additional concerns. The

attractive pricing power, recurring revenues and strong cash flow generation of the businesses we invest in help insulate them from some of these concerns. They are expected to grow at above-average rates on a secular basis, despite volatility and variations in investor sentiment, compounding over our longer time horizon. Over the next three years, the portfolio is expected to generate 11.0% revenue growth and 20.8% earnings growth while the MSCI ACWI ex USA is expected to generate 4.8% and 17.9% revenue and earnings growth respectively, after having had -2.2% earnings growth versus -37.2% for the index during 2020. The predictability and sustainability of this growth should provide a much smoother ride for our clients over time, generating attractive 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

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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.