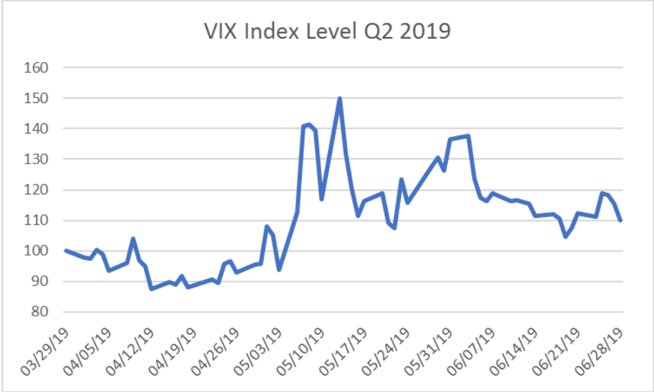
Q2 2019 U.S. Large Cap Growth Commentary

Highlights

- *The portfolio generated attractive absolute and relative returns in Q2 amid rising uncertainty over the future pace of global growth, but more dovish comments by the Fed*
- *Stock selection was the primary driver of the portfolio's outperformance; sector allocations also contributed positively to results*
- *Selection in the Communication Services and Materials sectors was strongest while selection in the Health Care and Consumer Discretionary sectors was weakest*
- *The portfolio's remaining position in Ulta Beauty was liquidated following a strong rise in its stock price and a new position in Danaher was initiated*
- *Positions in Disney, Ecolab, Equinix, Estee Lauder, and FleetCor were trimmed on strength and we added to positions in Alphabet, Intuit, Salesforce.com, TJX Companies and UnitedHealth on weakness; positions in Regeneron and Lowe's were reduced reflecting rising concerns*
- *We are pleased to announce that Jon Richter has joined our research team, and that Kishore Rao will join our U.S. equity portfolio management team effective December 31st 2019 given the strong contributions he has made in research and portfolio management since joining SGA in 2004 and co-managing our Emerging Market Growth portfolio since its inception in 2014*

Performance

After participating strongly in the market rebound in Q1, the portfolio outperformed in Q2 as rising global growth concerns and greater uncertainty over the impact of trade disagreements among key world economies contributed to rising volatility in the equity and fixed income markets. Indeed, the S&P 500 Index hit successive new highs during the quarter, but also experienced significant declines due to the trade related uncertainty. The CBOE VIX rose 43% in May to 18.7, peaking above 20 before declining to 16 in June.



Source: FactSet.

The portfolio posted attractive absolute returns for the second quarter while outperforming its Russell 1000 Growth Index benchmark. Underscoring the higher volatility regime we have entered, relative performance varied within each month of the quarter. The portfolio trailed its benchmark in April amid strong gains on rising optimism regarding a trade agreement, but then protected capital in May during the market's steep decline due to rising fears over slowing global economic growth, and then generated attractive absolute returns, albeit behind those of the benchmark, in June as the market climbed a wall of worry. Specifically, the portfolio returned 5.4% (gross) and 5.2% (net) for the period, while its benchmark returned 4.6%, and the S&P 500 Index returned 4.3%. Amid the increase in volatility, the portfolio protected capital on down days while participating well on strong days in the market.

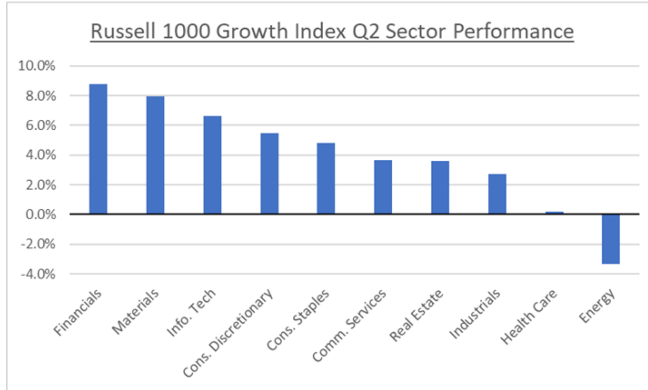
Rising Global Growth Concerns

Increasing signs of slowing global economic growth compounded by rising trade tensions between the U.S. and China negatively impacted expectations for corporate profit growth in Q2. While U.S. Q1 GDP growth topped expectations with 3.2% annualized growth, ironically boosted by trade and inventories, the World Bank reduced its forecast for global economic growth in 2019 from 2.9% in January to 2.6% due to rising trade tensions, declining business confidence and more signs of slowing global growth. Cyclical stocks performed best in April as hopes for a settlement to the U.S. – China trade war rose, but then gave gains back in May as differences thought to have been settled reemerged and negotiations ended, sending stocks lower. June saw new gains as hopes that a trade deal could be worked out at a meeting between Presidents Trump and Xi at the G-20 summit, and indications that the U.S. Federal Reserve and European Central Bank (ECB) were contemplating interest rate cuts if economic data weakened further pushed global stocks higher for the month.

Manufacturing continued its weakening trend in the U.S. and globally, with the Purchasing Managers Index for U.S. Manufacturing activity declining to 50.1 in June, its lowest level in nearly a decade while other economic indicators such as the U.S. Composite Output Index and the U.S. Manufacturing Output Index also continued to deteriorate in June. Similarly, manufacturing activity in Europe and Japan contracted further resulting in the weakest quarter for production in both economies in several years. Europe faced headwinds tied to Brexit uncertainties as well as weakening in China, one of its largest trade partners. While manufacturing weakness in the U.S. and other key global economies raised concerns for central banks, and consumer confidence posted another decline, the service side of the U.S. economy, which is much larger than the manufacturing side, continued to grow at an attractive pace, benefiting from historically low unemployment, improving wages and strong consumption.

Rising Expectations for New Monetary Accommodation

At the same time, more dovish comments from the U.S. Federal Reserve and indications of more accommodative monetary policy by the ECB benefited equities as investors reacted to the potential for new stimulus to counter further slowing. While growing signs of weakening global economic growth pushed bond yields in the U.S. lower (with the 10-year Treasury yielding below 2% for the first time since 2016), the broad equity market hit successive new highs. Market leadership varied over the course of the quarter, but for the full period, more defensive areas of the market performed best as investors balanced growth fears with the potential for a trade deal between the U.S. and China and an increased likelihood of greater monetary accommodation. Several sectors within the Russell 1000 Growth Index generated strong returns during the quarter, with the primary exceptions being the Energy and Health Care sectors which returned -3.3% and 0.2% respectively due to sliding oil prices resulting from rising supplies, and growing political rhetoric from both sides of the aisle in the U.S. regarding rising health care and prescription drug costs, in advance of the 2020 presidential election.



Source: FactSet.

Portfolio Attribution

The portfolio's performance benefited from the outperformance of businesses with higher quality characteristics during the quarter as investors rewarded companies with more sustainable growth runways given rising uncertainty over slowing global growth. Larger-cap companies with higher returns on equity, lower betas, lower levels of debt and earnings performed best, and U.S. markets outperformed non-U.S. markets. Portfolio performance benefited due to attractive stock selection across most sectors, with selection in the Communication Services sector contributing most due to a position in Walt Disney which was one of the largest detractors from performance last quarter, but one of the largest contributors this quarter. Selection in the Health Care and Consumer Discretionary sectors detracted most due primarily to positions in Regeneron, Novo Nordisk, Lowe's and TJX Companies. Sector allocations also contributed modestly to performance with an underweight in Industrials and an overweight in Materials contributing positively, and a lack of exposure to the Financials sector and an overweight in the underperforming Health Care sector detracting.

Largest Contributors

After being among the portfolio's largest detractors to performance in Q1, **Walt Disney** was the largest contributor to portfolio performance in Q2 following its investor day and a strong quarter in which it reported adjusted earnings per share that exceeded the average analyst estimate as well as ours. At the investor day, Disney announced its upcoming Disney+ streaming service with a price point of $6.99 per user. It also provided a global subscriber target by FY 2024, including 60-90 million for Disney+, 8-12 million for ESPN+, and 40-50 million for Hulu, and a financial outlook guiding the investment spending and path to profitability towards FY 2024. The compelling pricing point, greater than expected content availability from day one, as well as the subscriber and financial targets provided by the company boosted investor confidence on Disney's direct to consumer strategy. During the quarter, Disney Studio's business faced a strong headwind against the success from Black Panther and Last Jedi in 2018, but benefited from the strength of Marvel's Avengers: Endgame which exceeded the company's expectations. Its Parks business generated strong results, showing attractive margin improvement, and we expect further gains given the recent opening of Star Wars Land at the California and Orlando Disney Land and Disney World properties. During the quarter, Disney also benefited from the announcement that it would assume full operational control of Hulu effective immediately. We see the deal benefiting Disney in a few ways as it moves to enhance content for it's direct to consumer Disney+, and as they begin to roll out Hulu internationally. We trimmed our position in Disney on strength during the quarter but maintained an above-average weight in the company given our positive long-term outlook.

Microsoft reported strong results in its Fiscal Q3 report, with operating income rising 25% and revenue growth exceeding the highest Street estimates as well as ours. Strength in the company's Cloud business Azure was particularly strong with revenues rising 41% year-over-year, while its Productivity and Business, and Personal Computing segments also posted attractive results. Building upon their major enterprise software relationships, we see attractive future growth opportunities in Microsoft's burgeoning cloud business, and see the Intelligent Cloud market offering plenty of room for them to co-exist with current leader Amazon Web Services. We increased the target weight of the position during the quarter, maintaining an above-average weight in the company.

Yum! Brands was the third largest contributor to overall portfolio performance. The company reported solid quarterly results with total system sales up 7%, new unit growth up 4% and core operating profit up 14% driven by strong results at KFC which posted strong comparable sales gains, handily beating expectations. Offsetting this strength to an extent were weaker results at Taco Bell and Pizza Hut which were hurt by international sales. Also, Yum's management signaled that company capex spending would likely be higher than expected for the next few years driven by expansion of company owned stores and investments in technology which will ultimately be recouped from franchisees over time. Yum's franchise model continues to insulate its profitability from deceleration in China, and the company's attractive recurring revenues supported by attractive price points, menu innovation, customer loyalty programs and prime locations, benefits it as investors search for more predictable, stable growth. We maintained an above-average weight position relative to other companies in the portfolio.

Ecolab and **Equinix** were the fourth and fifth largest contributors to portfolio returns.

Largest Detractors

Regeneron was the largest detractor from performance in Q2, primarily due to concerns around the pace of future growth of its key product Eylea because of potential changes to Medicare reimbursement as well as impending competition. Eylea currently comprises a majority of the company's sales and profits. It is a drug that treats multiple forms of degenerative eye diseases, and is reimbursed under Medicare part B, along with other drugs that are administered in physician offices.

A recent draft proposal by the Trump Administration aimed at lowering drug costs calls for lowering the reimbursement for part B drugs to the international pricing index over 5 years. Implementation of the proposal, as initially proposed, would result in a growth headwind for Regeneron in the near-term given the company's still heavy reliance on Eylea. Regeneron has made good progress developing other drugs such as Dupixent for the treatment of atopic dermatitis, Kevzara for the treatment of rheumatoid arthritis, Libtayo for the treatment of the second most common form of skin cancer, and Praluent for the treatment of hyper-cholesterolemia. However, the company is still incurring losses on the new drugs, as they ramp up their sales efforts. In the case of Praluent, sales have also been disappointing. The company's most recent earnings report illustrated the high start-up expenses the firm is currently still incurring.

The Trump administration is expected to publish its final proposal on Medicare Part B reimbursement soon. While we think it is likely that the proposal gets toned down to some extent, we would not be surprised to see a reform enacted in some form. Our analysis indicates that the enactment of the proposal is likely already largely reflected in the current valuation of the stock. The impending competition from Novartis also has been well tracked and while it will impact Eylea sales, we do expect Eylea to remain competitive in the marketplace. Given the company's progress in building a multi-drug platform, its proven ability to bring new drugs to the market which address key needs, and the likelihood that the start-up expenses currently being incurred will help them successfully launch some of their new products, we maintained a below average weight position in the company pending further clarity regarding the treatment of Medicare part B reimbursements and while evaluating other possible opportunities on our Qualified Company List.

Alphabet was the second largest detractor from portfolio performance in Q2 after posting lighter than expected revenue growth compared to consensus expectations. Speculation around a possible U.S. Department of Justice (DOJ) anti-trust inquiry also contributed to the underperformance. Paid clicks dropped from +60% in Q4 to +39% in Q1, which the company partially attributed to changes in YouTube monetization last year that created a difficult comparison this year. Investor concerns that part of the deceleration came from advertising dollars being redirected from Google to Amazon also weighed on the stock. We have expected revenue growth to moderate for some time. However, the sheer volume of advertising and trade promotion dollars shifting away from more traditional off-line venues to on-line is sufficiently large that we continue to expect both Amazon and Google to benefit with the latter's growth rate moderation to be gradual and manageable over time given its key growth drivers including YouTube, mobile maps and increased efforts in the online travel category. Google Cloud, while in its early stages, offers attractive longer-term opportunities as does expansion of the company's machine learning ventures among others. While top-line deceleration received focus by the market, Alphabet's core operating profit grew at a 10% rate, as it had in the prior two quarters. We continue to see Alphabet as one of the more attractively valued big technology companies with tremendous potential opportunity via advertising, cloud, machine learning and other businesses. We also believe the company has the potential to increase its cash return and disclosure profiles over time.

While a DOJ inquiry is certainly a possibility, we consider fines to be the most likely outcome, and given the company's $100 billion net cash position, the impact would be manageable. Forced material changes in business practices or outright divestments could result, but we see the probability of such actions as being lower and potentially less problematic than the markets currently do. We would note that, historically, US antitrust investigations have focused on the matter of consumer harm and price effects. As most of Google's products are priced freely to the consumer and widely used, the current framework does not easily lend itself to findings of consumer harm. While politicians could seek to modify the 'consumer harm' framework, definitive outcomes will nonetheless take years to unfold and will require the US judicial system to dismiss the inevitable legal challenges and appeals that arise not only from the target company but also the broader business lobby. We purchased additional shares in the company on weakness during the quarter, maintaining an above average weight.

Lowe's was the third largest detractor from performance for the period. The company reported mixed results for Q1 with same-store sales growth above our estimates despite unfavorable weather trends and deflation in lumber prices, but with gross margins coming in lighter than expected due to cost pressures from poor inventory purchases as well as issues with legacy pricing practices left over from previous management. This led the company to reduce its full year EPS guidance, and created uncertainty in the market over new management's credibility just five months after its inaugural analyst meeting. We were encouraged by the company's strong top line growth despite headwinds, and expect that the cost pressures driving the Q1 margin surprise will be short-term in nature. Given the rise in uncertainty, we reduced our target weight in the company, but remain constructive on management's ability to successfully drive improved earnings growth at the company, particularly given macro-economic tailwinds in the form of continued strong employment data, rising incomes, and stable to declining mortgage rates.

Salesforce.com and **Novo Nordisk** were the fourth and fifth largest detractors from performance for the quarter.

Portfolio Activity

Turnover in the portfolio was somewhat below its long-term average, with the sale of the remainder of our position in beauty retailer Ulta Beauty and the purchase of specialty manufacturer Danaher. We also took advantage of the significant strength in stock prices during the quarter to trim positions in Disney, Ecolab, Equinix, Estee Lauder and FleetCor on strength and adding to positions in Alphabet, Intuit, Salesforce.com, TJX and UnitedHealth on weakness. Positions in Regeneron and Lowe's were reduced reflecting rising concerns.

Sales

We sold the remainder of our position in **Ulta Beauty** following a strong rise in its stock price in order to redeploy the capital to Danaher which we see as having more attractive earnings growth and appreciation potential from current levels.

Purchases

Scientific instrumentation company **Danaher**, a manufacturer and seller of scientific instruments and consumables across multiple industries, was added to the portfolio during the quarter. The company utilizes a razor-razor blade business model wherein it has a large installed base of equipment or systems to which it sells captive consumables, generating reliable, recurring revenues. Its portfolio of products is more science and technology oriented, and benefits from a strong market share and a clientele which extends across the globe. This and the fact that Danaher's consumables tend to be more difficult to switch out given that they are parts of routine processes for testing or manufacturing, as well as the company's scale advantages, enhance its pricing power. As a producer of captive consumables with mission critical applications, approximately 70% of the company's revenues are recurring in nature. Danaher's expected long-term growth benefits from a diverse geographic sales base with 40% of its sales in North America, 30% in non-U.S. Developed markets and 30% in Emerging Markets, as well as secular trends including more testing of foods, drugs, municipal water quality, and people (for diagnosis), in addition to rising requirements for more detailed information on packaging for a wide variety of products across the spectrum. Recent changes in their portfolio of products such as the acquisition of GE biosciences, and the impending IPO of the dental business have enhanced the growth profile of the company.

While we view Danaher as providing an attractive and stable growth opportunity, the company faces risk given its ongoing focus on making acquisitions and enhancing the productivity and growth opportunity for these businesses. Likewise, it is critical that Danaher retain key talent and not impede innovation at faster growing businesses. Given its history with such acquisitions, we are comfortable that its management understands the need for stability and innovation. While the Company's exposure to industrial markets, which comprise approximately 35% of its sales, makes it somewhat more susceptible to cyclical trends than other companies in the portfolio, the consumable nature and breadth of its products, are expected to enhance the resiliency of its results amid any future economic weakness. We established a below-average weight position in the stock initially and expect to build the position opportunistically moving forward.

Outlook

Rising volatility has traditionally been positive for SGA's portfolios, and Q2 2019 continued the historical trend, as the portfolio generated strong absolute returns in months when investors were more optimistic and less focused on risks, and protected capital in periods when greater uncertainty reigned and investors refocused on higher quality and sustainable growth. We continue to see ample reason for volatility in the markets to remain high given that, even after recent increases, rolling 3-year trends show volatility below long-term averages. The opportunity to buy unique high-quality businesses that reliably generate above average levels of revenue and earnings growth, and significant free cash flow, at attractive valuations excites us. Periods like May of this year give us the chance to do more of this, while periods like April and June allow us to reallocate capital away from great businesses that are valued a little less attractively, and toward other businesses on our Qualified Company List that offer more attractive long-term investment opportunities.

Organization Update

We are pleased to let you know that Jon Richter joined our research team on June 25th, after completing an internship with SGA. Jon will be a generalist like every other member of our team, and will add to our third generation of analysts. Jon is a well-thought-out investor with a background in emerging markets and computer software research, as well as an MBA from the Stanford Graduate School of Business, experience as a Fulbright Fellow at Peking University, and an undergraduate degree in International Business from the University of Pennsylvania. We are excited to have him on the team and look forward to the perspective he will provide and the opportunities he will research. We expect to continue to gradually build out the third generation of our firm over time as we identify candidates through our internship program and opportunistic hiring who can contribute successfully to our clients.

We are also pleased to announce that Kishore Rao who joined SGA in 2004 will be joining the Portfolio Management Team for our U.S. portfolios effective December 31, 2019. Kishore has distinguished himself over the 15 years he has spent with SGA through the outstanding contributions he has made to client portfolios with his company research, as well as the contributions he has made as a co-portfolio manager for our Emerging Markets portfolio since its inception in 2014. To protect our successful decision-making process, built on three-person portfolio management teams, Kishore will replace co-founder George Fraise on the U.S. portfolio management team. George will continue to serve as a portfolio manager for our Global Growth portfolio and as an analyst, while continuing to oversee the firm's business development and client service efforts. As a result of the stability that our team-based process and culture has provided us, we have had the luxury of being able to look far down the road in our planning, and we can be very methodical in how we manage the organization to ensure multi-generational sustainability. This step is consistent with our long-term plan to gradually promote second generation analysts to the flagship portfolios in a way that allows them to work alongside the other two co-founders and portfolio managers and ensure continuity. Consistent with our long-term plan, we will also make a similar adjustment for the Global Growth portfolio over the course of 2020, and promote another second-generation analyst and portfolio manager who has thoroughly distinguished himself. We will keep you posted on that adjustment as we move closer to its implementation next year.

We look forward to discussing recent performance in more detail directly in the weeks to come and are grateful for your continued trust.

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Results are presented gross and net of management fees and include the reinvestment of all income. The Net Returns are calculated based upon the highest published fees. The net performance has been reduced by the amount of the highest published fee that may be charged to SGA clients, 0.75%, employing the U.S. Large Cap Growth equity strategy during the period under consideration. Actual fees charged to clients may vary depending on, among other things, the applicable fees schedule and portfolio size. SGA's fees are available upon request and also may be found in Part 2A of its Form ADV. The performance record presented for periods prior to July 1, 2003 occurred before to the inception of SGA and represents the portable performance record established by two of SGA's founders (and investment committee members) Gordon Marchand and George Fraise while affiliated with a prior firm. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. Upon request, free of charge, SGA can provide a list of all portfolio holdings held in SGA's U.S. Large Cap Growth portfolio for the past year. SGA's earnings growth forecast data is based upon portfolio companies' non-GAAP operating earnings.