SGA
Sustainable Growth Advisers

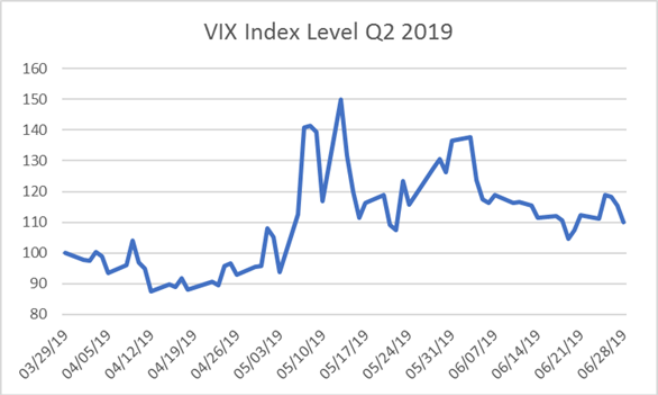
# Q2 2019 Global Growth Commentary

## Highlights

- *The portfolio generated attractive absolute and relative returns in Q2 amid rising uncertainty over the future pace of global economic growth*
- *Stock selection was strong across most sectors and was the main driver of the portfolio's outperformance; sector allocations also contributed positively to results*
- *Selection in the Consumer Staples and Information Technology sectors contributed most while selection in the Health Care and Communication Services sectors detracted*
- *Regionally, stock selection in the Non-U.S. Developed Markets contributed the most to the portfolio's outperformance, with stocks from the United Kingdom, Japan and Germany having the largest impact*
- *Positions in Fast Retailing, FleetCor and Equinix were trimmed on strength and we added to positions in Abbott, Alibaba, Booking Holdings, Alphabet and Novo Nordisk on weakness; the portfolio's position in Regeneron was 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 Markets Growth portfolio since its inception in 2014*

## Performance

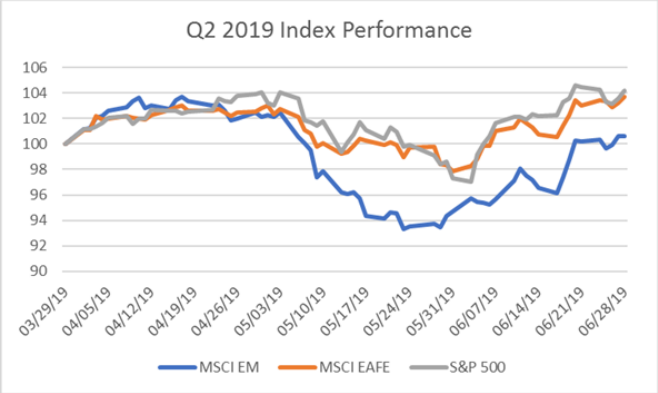
After participating strongly in the market rebound in Q1, the portfolio outperformed again in Q2 as rising global growth concerns and greater uncertainty over the impact of trade disagreements among the world's key economic blocks contributed to rising volatility in the equity and fixed income markets. In the U.S., the broad market S&P 500 Index hit successive new highs during the quarter, but also experienced significant declines due to the trade related uncertainty causing the CBOE VIX to rise 43% in May before declining in June. The portfolio returned 6.1% (gross) and 5.9% (net) in the second quarter of 2019, while its benchmark, the MSCI All Country World Index (ACWI), returned 3.6%, and the ACWI Growth Index returned 4.9%.




*Source: FactSet.*

## 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 earnings growth in Q2. 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. U.S. and Non-U.S. Developed Markets outperformed Emerging Markets.




*Source: FactSet, MSCI.*

Russia, Greece and Thailand were the best performing markets for the period while China and South Korea were among the weakest. 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 at the end of the month. This together with indications that the U.S. Federal Reserve and European Central Bank (ECB) were contemplating interest rate cuts if economic data

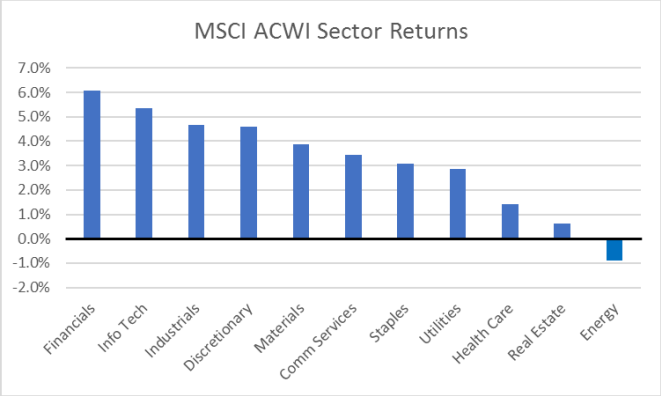
weakened further pushed the ACWI Index up over 6% for the month.

U.S. Q1 GDP topped expectations with 3.2% annualized growth, boosted by contributions from trade and inventories, while consumer spending disappointed, growing just 1.2% after having grown by 2.5% in the previous quarter. European Q1 GDP grew at a 1.5% rate in Q1, better than feared, while Indian Q1 GDP growth slowed to 5.8% year-over-year, the slowest pace since Prime Minster Modi took office in 2014. South Korea's economy contracted by 0.3% in Q1 as Korean exports fell sharply. In contrast, China's economy grew at a 6.4% rate according to government supplied figures, indicating that its recent massive stimulus efforts may be helping the economy navigate the current slowdown.

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 (according to an IHS/Markit survey). 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, 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, indications of more accommodative monetary policy by the ECB and the Bank of Japan, and multiple interest rate cuts by central banks in India, China and elsewhere benefited equities as investors reacted to the potential for new stimulus to counter further economic slowing. Indeed, U.S. 10-year Treasury yields briefly sank below 2% while yields on German 10-year Bunds declined to negative levels reaching all-time lows. Despite growing signs of weakening global growth, the broad market hit successive new highs during the quarter with volatility rising in May. While market leadership varied significantly over the course of the quarter, reflecting an increase in expectations for interest rates to decline, beneficiaries of lower borrowing costs performed best. Financials performed best followed by Information Technology, Industrials and Consumer Discretionary stocks. In contrast, Energy stocks generated a negative return for the period, as oil prices declined on increased supply before rebounding near quarter end due to rising tensions between the U.S. and Iran. Real Estate and Health Care stocks also underperformed, with the U.S. Health Care sector coming under growing pressure as the 2020 U.S. presidential election season began with candidates from both major parties focusing on rising health care costs and prescription drug pricing.




*Source: FactSet, MSCI.*

### Portfolio Attribution

The portfolio performed well in very different market environments over the course of the quarter, outperforming its benchmark in April as markets reacted to positive economic news out of the U.S., Europe and China. In May, it protected capital and outperformed as global markets declined due to resurfacing trade tensions, weaker economic data in China and rising geopolitical tensions. In June, the portfolio rebounded strongly, outperforming on the upside as global markets rallied on more dovish comments from world monetary authorities. Not surprisingly, the reward to higher business quality characteristics during the quarter was mixed. For the overall period, investors rewarded larger-cap growth businesses, but the reward for business quality was mixed with lower levels of debt, lower returns on equity, no earnings and lower betas performing best.

The portfolio's performance benefited from strong stock selection across most sectors. Selection in the Consumer Staples and Information Technology sectors contributed most due to positions in Danone and Nestle, and SAP and FleetCor respectively. In contrast, selection in the Health Care and Communication Services sectors detracted most due primarily to positions in Regeneron and Novo Nordisk, and Alphabet and Tencent respectively. Sector allocations also contributed positively primarily due to a lack of exposure to the underperforming Energy sector and an overweight in the Consumer Discretionary sector, one of the strongest

performing sectors this quarter, while an underweight in the Financials sector detracted most.

**Largest Contributors**

**Fast Retailing** was the largest contributor to the portfolio's performance this quarter after the company reported Q2 profits which exceeded expectations driven by significant improvement in results from its GU and Global Brands as well as strong results at Uniqlo International. We continue to see opportunity for Fast Retailing as the company expands in Europe and works to improve its business operations in the United States. Given the stock's valuation, we trimmed the position on strength and reallocated the capital to other more attractively valued growth opportunities.

**SAP** was the second largest contributor to portfolio performance. The company reported sales and profit growth that exceeded consensus and our expectations, with attractive software license growth and strong results in its cloud division including a 26% rise in new bookings. With added pressure from activist investors, management raised its 2019 operating profit target and focus on long-term margin improvement. Our research continues to point to an attractive growth runway for SAP's business, albeit somewhat slower growth than most stocks in the portfolio, as it continues to transition its business from the traditional software licensing model to higher margin cloud based offerings. We maintained an average weight position in the company during the quarter.

**HDFC Bank** was the third largest contributor to performance after they reported a solid quarter, delivering on management's 20% earnings per share goal. The stock also benefited from strength in the Indian equity market following Prime Minster Narendra Modi's reelection in a landslide victory. The company continued to increase provisions for non-performing agricultural loans during the quarter, but actual non-performing loans remained flat for the period. Loan growth remained healthy, rising +19% year-over-year, but slightly below expectations. We continue to see attractive growth opportunities for HDFC as it capitalizes on the increasing banking needs of India's growing middle class. Given its strong retail base and inexpensive funding source, we see the bank as being in a strong position relative to its competition to serve those growing needs effectively. We maintained an above-average weight in the company.

**IHS Markit** and **Yum! Brands** were the fourth and fifth largest contributors to performance during the quarter.

**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 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. We view 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 as positive, but we lowered our target to a below-average weight position in the company pending further clarity regarding the treatment of Medicare part B reimbursements and continued to evaluate other possible opportunities on our Qualified Company List.

Given weakness in the Chinese equity market during the quarter, **Ctrip** was the second largest detractor from portfolio performance despite delivering solid Q1 results. The company's revenues grew 21%, while operating profit grew by 42%

year-over-year driven by significant improvement in operating margins in Q1. Ctrip's weakness reflects broader softness in China ADRs as a resulting of escalating trade tensions and the challenging macroeconomic outlook of China. However, despite the short-term overhang from trade and macro-economic factors, the longer-term outlook for China travel growth remains intact, underpinned by China's rising middle class, and the country's shift to a more consumption-driven economy. In addition, the fundamental picture of the company is improving: margin improvement was well ahead of expectations as a result of stabilizing competition; and the company is gaining market share at an accelerated pace with solid execution. We maintained a below-average weight in the company given its improving business fundamentals but greater sensitivity to China's domestic economic slowdown.

**Alphabet** was the third 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.

**Alibaba** and **Salesforce.com** were the fourth and fifth largest detractors from performance during the quarter.

### Portfolio Activity

While turnover in the portfolio was below average for the period, with no positions eliminated or new positions initiated, several positions were trimmed on strength. Among those were Equinix, Fast Retailing, FleetCor, and MercadoLibre. We also added to positions in Abbott, Alibaba, Alphabet, Booking Holdings, and Novo Nordisk on weakness as we took advantage of rising volatility during the quarter.

### 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 opportunity to take advantage of weakness in shares of high-quality businesses, while periods like April and June allow us to reallocate capital away from great businesses that are valued a little less attractively.

## Organizational 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 this 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, 0.90%, employing the Global 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. Upon request, free of charge, SGA can provide a list of all portfolio holdings held in SGA's Global Growth portfolio for the year. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. SGA's earnings growth forecast data is based upon portfolio companies' Non-GAAP operating earnings.*