SGA
Sustainable Growth Advisers

Q3 2019 Global Growth Commentary

Highlights

- *The portfolio outperformed amid trade and macro-economic driven market weakness in August, but trailed the MSCI ACWI index in July and particularly in September as cyclicals rebounded sharply on hopes for a trade war truce and new global monetary accommodation*

- *Stock selection was the primary detractor from relative performance, with selection in the Financials, Information Technology and Consumer Staples sectors being weakest due primarily to positions in SAP, AIA Group and Shoprite*

- *Stock selection in the Consumer Discretionary and Real Estate sectors contributed the most positively to relative returns due to New Oriental Education and Equinix*

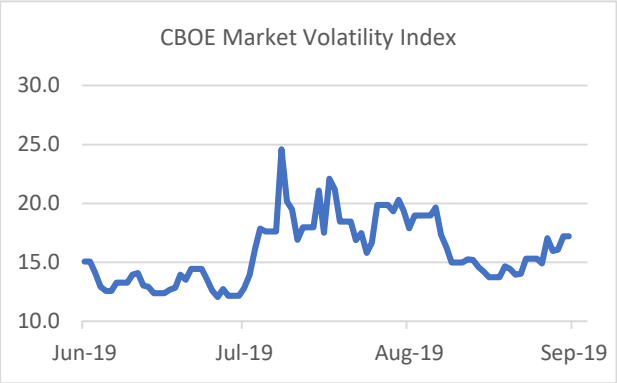
- *New positions in Heineken and Illumina were initiated while positions in Ctrip, FEMSA and Shoprite were sold*

- *Positions in Equinix, MercadoLibre, and New Oriental Education were trimmed on strength while positions in Amazon, Salesforce.com, and Tencent were added to on weakness*

Performance

The portfolio trailed the MSCI All Country World Index (ACWI) in Q3 as global markets swung from periods of relative optimism to periods of fear as some investors predicted global recession. The volatility was driven by weaker global economic data, a ratcheting up of the U.S.–China trade dispute, and expectations for more accommodative global monetary policies, particularly in the U.S., European Union, and China.

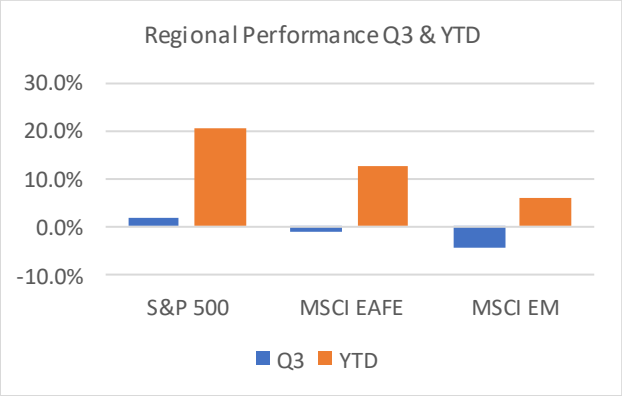
Between a relief rally in July, new escalation of trade tensions in August and another rebound in September, the CBOE VIX varied significantly, ranging from 12.1 at its low in July 24th to 24.6 at its high on August 5th. The portfolio returned -0.8% (gross) and -1.0% (net) for the quarter, while its benchmark, the MSCI All Country World Index (ACWI), returned 0.0%, and the ACWI Growth Index returned 0.3%.



Source: FactSet.

Macro Events Played a Major Role - Slowing Global Economic Growth and Rising Stimulus

Slowing global growth ranging from Europe to the Pacific together with a strong U.S. dollar negatively impacted U.S. economic growth. Initial Q2 U.S. GDP growth was recorded at 2.1%, down from 3.1% in Q1, as manufacturing weakened further with the Purchasing Manager Index (PMI) sinking to 47.8 in September, its lowest level since June of 2009 due to slowing new orders from overseas and rising trade tensions. In line with this, factory output in the U.S. fell for the first time in three years. Temporary issues including Boeing's continuing problems with the 737 Max and the United Autoworker's strike against General Motors also impacted the readings. In response to the weakness, the U.S. Federal Reserve cut interest rates twice and signaled a willingness to support economic growth further as data required. Central monetary authorities from key economies around the world likewise cut interest rates to boost economic growth. Business confidence in the U.S. declined as companies reacted to the Trump administration's more aggressive trade policy and tariffs, slowing capital spending plans. However, the U.S. consumer, which has been the engine of global growth continued to spend remained resilient given gains in income, continued strong employment and low inflation. The Health Care sector in particular faced growing pressure from Democrats and Republicans as most Democratic presidential hopefuls called for Medicare for all, and both parties expressed interest in forms of drug price controls, negatively impacting U.S. health care stocks during the period.



Source: FactSet, MSCI.

Economic growth in the Eurozone continued to show weakness with GDP expanding by only 0.8% in Q2, due to weakness particularly in Germany which until recently had been the engine driving European growth. Given the Eurozone's significant trading relationship with China, slowing in that country has meaningfully reduced exports from Germany where the PMI has now shown eight consecutive months of contraction and business confidence hit levels last seen during the financial crisis in 2009. Uncertainty over Brexit (which currently faces an October 31st deadline unless it gets extended again) also negatively impacted European growth. British manufacturing activity fell to a seven-year low as companies remained uncertain over what their new operating environments would look like and put off significant capex spending. The economic weakness caused bond yields in the region to decline with German Bund yields turning negative across all durations, and the ECB cutting its main rate to -0.5% and announcing it would restart its quantitative easing bond buying program. Yields on 10-year government bonds in other parts of Europe including Austria, Denmark, France, the Netherlands, Sweden and Switzerland also went negative given economic weakness. Meanwhile, Australia reported its slowest economic growth since the financial crisis as consumers reigned in their spending and China's slowing impacted another major trading partner. Also in the Pacific, trade tensions between South Korea and Japan rose due to a decision by South Korean courts ordering Japanese firms to pay retribution for forced labor which took place during WWII. This inflamed the relationship between the two countries further, with Japan subsequently limiting the export of rare materials that are crucial to Korea's electronics industry on national security concerns.

Slowing growth and uncertainty plagued many of the emerging markets during the quarter as well. Chinese Q2 GDP growth was officially reported at 6.2%, the slowest rate in three decades, with independent analyses indicating an even slower growth rate. Manufacturing in the country has been particularly hard hit by higher tariffs, on the back of already slowing global demand for Chinese products. In response to the ongoing weakness, and the additional strains resulting from the U.S.–China trade dispute, the Chinese government continued to apply significant monetary and fiscal stimulus to temper the slide in economic growth. The Indian economy grew 5% on a year-over year basis in Q2, its slowest in the last six years as unemployment hit its highest level in decades. Tax cuts proposed by the government to buoy growth pushed Indian stocks higher in September. Later in the quarter, global markets were strained by an attack on Saudi Arabia's oil infrastructure which led to a reduction of 5.7 million barrels per day in output and a spike in Brent crude prices. While the production outage was expected to be temporary in nature, it further inflamed geopolitical risks in the region and further strained oil dependent economies globally.

Portfolio Attribution

Returns to style, capitalization and business quality varied widely over the course of the quarter with September standing out as a period that strongly favored value and lesser quality business factors. For the quarter, larger-cap companies with higher returns on equity performed best, but the reward to quality factors was quite mixed. While there were large fluctuations in the relative returns of growth and value during the period, at the end of the quarter, there was little differentiation in the return. U.S. stocks outperformed non-U.S. stocks and developed markets outperformed emerging markets.

Portfolio stock selection detracted from performance for the full period, but contributed positively in the market weakness in August. Sector allocations contributed positively for the quarter due to the portfolio's lack of exposure to Energy, overweight in more defensive Consumer Staples, and overweight in the Information Technology sector. Selection in the Information Technology sector was the primary detractor from returns for the period, with positions in SAP and Autodesk detracting most. Selection in the Financials sector was also weak due to underperforming positions in Hong Kong-based insurer AIA Group, Indian financial services company HDFC Bank and South African insurer Sanlam. Mitigating some of the weakness, selection in the Consumer Discretionary sector contributed positively due primarily to positions in Chinese education company New Oriental Education and U.S. sportswear company Nike.

Largest Contributors

Equinix reported solid Q2 results beating expectations and raising guidance for the full year due to strength in bookings and margins. During the quarter, the stock has benefited from strong operational performance as well as the market's defensive focus and lower interest rates. As two of the three rating agencies have now upgraded the company's credit rating, their cost to borrow will also decrease, providing a further boost to cash flow. In parallel, their wholesale joint venture has progressed well and helped alleviate some prior investor concerns. As we look forward, the integration of Verizon assets should progress further, helping to normalize customer churn levels, while interconnection revenues are also expected to face less of a headwind from their migration towards 100GB. We trimmed the portfolio's position on strength during the quarter. Due to valuation, we reduced the position target to an average weight, but continue to view Equinix's opportunity as being attractive.

New Oriental Education (EDU) was the second largest contributor to portfolio performance in Q3 as it reported its FY Q4 results which benefited from classroom expansion and strong increases in student enrollment. The company's revenues increased about 28% in RMB (20% in USD) with both its K-12 and Overseas Testing segments posting strong growth. In the case of Testing, growth was above expectations due to reforms management has made in their offering to cater more to younger students. Margins improved due to lower sales & marketing outlays, as well as improved classroom utilization. Management guided to 20% capacity expansion moving forward, as well as 30% top line revenue growth (in RMB) and continued margin expansion, which was at the high end of expectations. The stock recovered quickly from weakness later in the quarter due to rumors about possible changes in government policies with regard to permitted business structures for private K-12 schools, which would not apply to EDU. We trimmed our position in the stock as its valuation increased but maintained an average target given our positive 3-5-year outlook.

Alphabet posted attractive Q2 results with strong revenue and profit growth exceeding our estimates. The reacceleration in revenue growth was broad based geographically with the key contributions to growth coming from mobile search, YouTube and Google Cloud. The company disclosed that Google Cloud achieved an $8 billion annualized run rate in Q2 versus their last disclosure of a $4B run rate in Q4'17 which implies ~60% annualized growth rate. Management also disclosed plans to triple the size of their sales force for Cloud. While Google may have an inferior position and delayed entry relative to Amazon Web Services (AWS) and Microsoft Azure, it is experiencing impressive growth (albeit off a smaller base), and has assembled a commercially-oriented leadership team with the former head of Oracle R&D, SAP's Global Sales Head and Red Hat's North American sales head to guide their growth in this key area.

While antitrust issues in Europe and the U.S. remain risks, we are comforted to a degree by the way in which Google has demonstrated in the EU that it could effectively manage any alterations to its search algorithms to avoid favoring owned services. The ongoing headlines, investigations and speculation are likely to affect the stock in the short-to-medium term but we expect the ultimate outcome to likely involve fines and be manageable. In the highly unlikely event of a forced corporate breakup, we see the potential for the conglomerate discount that has been applied to the business to disappear, and disclosure to improve, possibly leading to an enhanced overall valuation. We maintained an above-average weight in the stock during the quarter.

Nike and **Nestle** were the fourth and fifth largest contributors to portfolio performance during the quarter.

Largest Detractors

South African retailer **Shoprite** was the largest detractor from portfolio performance for the period. Their most recent report highlighted improvement in South African (RSA) operations, but showed weaker results in the non-RSA businesses which are critical to our growth thesis for the company. We are concerned that the non-RSA operations continue to remain a contagion to the more favorable parts of the business, thereby possibly pushing out our growth thesis for the business further. With the complexity of the non-RSA business rising, lower cash productivity and higher debt, our expectation for growth in the future has declined. At this stage, the valuation does seem compelling and thus we will not be a surprised by a short-term recovery. However, based on our analysis, the company's growth opportunity for the long term has changed and we therefore reallocated the capital to other higher confidence growth opportunities.

Hong Kong-based insurer **AIA Group** reported solid operating results with continued attractive growth in the value of new business led by China and Hong Kong. Its operating profits rose 12% while recurring premiums were up 22%. While operating results continued to be strong, investor concerns over the impact of continued social unrest in Hong Kong as democracy protests spread negatively impacted the stock. Together with lower interest rates, this has provided a short-term headwind.

While we certainly acknowledge the impact of these factors in the short-term, we continue to see the key drivers of our investment thesis, namely the expanded sale of insurance products in mainland China due to ongoing economic development, as being intact. In particular, AIA is a key beneficiary of China opening up its insurance markets given its unique position of owning 100% of its life insurance operations in China. We continued to maintain an above-average weight in the company during the quarter.

Indian financial services company **HDFC Bank** was the third largest detractor from performance during the quarter after it reported earnings growth generally in line with expectations after raising provisions for non-performing loans, but otherwise controlling other expenses well. Given the weakness in the Indian economy, the size of their provisioning is consistent with their conservative nature. We continue to see HDFC as an attractive beneficiary of ongoing growth in the Indian middle class and their demands for more efficient services than the country's national banks are able to provide. The conservative nature of the bank's loan portfolio and its low cost of capital put it in an attractive position to capitalize on this long-term trend. We continued to maintain an above average weight position in the company during the quarter.

SAP and **Amazon** were the fourth and fifth largest detractors from portfolio performance during the quarter.

Portfolio Activity

Turnover in the portfolio was slightly higher than average during the quarter given the additional volatility in the markets. We sold the remainder of our positions in Chinese travel company Ctrip.com and Latin American consumer company FEMSA, and liquidated our position in South African retailer Shoprite given rising concerns relative to our investment thesis. We reallocated the capital to initiate new positions in DNA sequencing and genetic analysis leader Ilumina and global brewer Heineken. We also took advantage of the strength to trim positions in Equinix, MercadoLibre and New Oriental Education & Technology. We purchased additional shares in existing holdings Amazon, Salesforce.com and Tencent.

New Positions

Heineken, the second largest global beer brewer by revenue, with the number one international premium beer brand, was added to the portfolio on weakness after the company reported solid top line results with organic sales growing in line with expectations but profits that were flat due to temporary hedging costs and IT investments, which we do not expect to be recurring. The company operates more than 160 breweries across 70 countries, with Heineken being its primary brand in addition to 250+ other brands including Amstel, Sol, Dos Equis and others. Heineken's strong pricing power is supported by the company's premium beer line up which is ranked #1 or #2 in 5 of the top 10 premium beer markets. The beer industry benefits from relatively stable, recurring consumption patterns across the world, and Heineken's business is geographically diversified with no region accounting for more than one-quarter of its profits and no country accounting for more than 15% of sales. This geographic diversity and consumption pattern have enabled the firm to generate strong recurring revenues, and we see no reason for this to change based on our research. Heineken also benefits from long runways of growth driven by two key secular trends – the increasing demand for premium brands and the ongoing development of middle class consumers in emerging markets. With about 40% of its profits derived from the premium segment of the market and profits from developing markets making up about 60% of the firm's total profits, we see plenty of room to grow from current levels. Additionally, plans to capitalize on the growing cider, craft beer and non-alcoholic markets offer further opportunities.

Key risks we see for Heineken include increased competition from AB InBev (ABI), the loss of exclusivity at a key retail partner in Mexico, and the transition of the company's distribution system in Brazil. Regarding ABI, now that their period of growth via transformational M&A (e.g, acquisitions of SAB Miller and Grupo Modelo) has passed, there is a risk that ABI will become more aggressive in their commercial tactics to sustain business momentum. However, we believe ABI will remain disciplined in the marketplace because its top priority is cash flow to pay down its considerable debt from these acquisitions. Regarding Mexico, Heineken's loss of exclusivity at convenience store operator OXXO is noteworthy considering the retailer represents 25% of the volume in Heineken's most important market, but the risk is mitigated by a number of factors including OXXO's intention to expand total beer shelf space in its stores to accommodate new brands while preserving Heineken sales, as well as Heineken's increased freedom to pursue other more profitable commercial opportunities with new retailers. Finally, regarding Brazil, the company's transition from Coca-Cola FEMSA-led distribution to recently acquired Kirin's distribution force will likely lead to modest disruption in the near term, but we expect this to be significantly exceeded by benefits including revenue synergies from their new directly controlled and aligned sales/distribution force as well as cost savings from scale advantages and vertical integration.

DNA sequencing and genetic analysis leader **Illumina** was added to the portfolio during the quarter. The company develops, manufactures, and markets integrated systems and consumables used in the analysis of genetic variations. Its products range from high through-put sequencers used for large scale whole genome sequencing, to mid-range systems that work well for small and medium sized labs, and low through-put benchtop sequencers used for handling more targeted genome sequencing as well as microbial/virus sequencing needs. Over time, the company's fit with SGA's business quality characteristics has improved. Today, revenues are less driven by instrument sales than they were historically, with high margin subscriptions comprising about 85% of total revenues. Additionally, as clinical applications for such testing continue to grow, visibility for Illumina's long-term growth has continued to improve. Increases in the willingness of insurance companies to reimburse the cost of genome testing in more situations enhances the likelihood that testing will play a larger role in future diagnostics. Finally, the company's dominant position in the market continues to strengthen given their patented DNA read technology, unique manufacturing capabilities, comprehensive service network, and time tested, strong relationships with research institutions, pharmaceutical and biotech companies.

With this evolution and the company gaining an 80% share of the DNA sequencing market, Illumina's pricing power has strengthened. While eventually the company will need to manage its pricing to enable sales volumes to continue to increase, we see it as something that the company is well aware of and able to carefully manage. With 70% of its revenue stream recurring due to its consumable sales and services, the company's business model fits our criteria well, but we remain cognizant that the remaining 30% of revenues is derived from instrument sales, the DTC market (i.e. 23and me), and population sequencing which are not recurring streams. Cell functions and their relation to cancer and various other infectious diseases remains in its early stages, and provides Illumina with a long runway of growth as its technology is used to better understand how changes in genes lead to diseases, what can trigger the changes, and how doctors can more easily, and with greater comfort to the patient, identify such issues moving forward. All of these are driving growth in fundamental research and clinical analysis where DNA sequencing is involved, and serving to extend the likely duration of the company's growth opportunity. With over $1.1 billion in net cash, a cash flow/earnings ratio of near 100% and a business that no longer requires a lot of capital spending, we see Illumina's financial position as being quite strong. While periodic acquisitions are expected, and a $1.2 billion acquisition of Pacific Biosciences is currently pending regulatory approval, our research indicates that they have traditionally been positive contributors to long-term growth. Finally, based on our analysis of management and conversations with them we have developed a favorable impression of Illumina's governance.

Among the main risks we are monitoring with regard to Illumina are the degree to which the company can manage its product cycle appropriately, being able to launch new products at the right times and right price for the market. Additionally, as with any technology driven firm, we also need to be focused on the emerging technology in the space and its ability to disrupt Illumina's current dominant position. The pace of end market demand development and expansion of insurance reimbursement depends on the success the company's products have in leveraging DNA sequencing to improve health care outcomes.

Positions Sold

Chinese travel company **Ctrip.com** was sold due to rising concern over the businesses' ability to generate the sustainable and recurring revenue stream we had expected given weakening macro-economic conditions in China, greater uncertainty over Hong Kong due to the ongoing protests and their impact on Chinese travel, and the government's ban on solo travel by Chinese citizens to Hong Kong and Taiwan. While we continue to view Ctrip's long-term opportunity as being attractive, without the confidence to build the size of the position further at this time given market weakness, we liquidated the position and reallocated the capital to other higher confidence opportunities from our Qualified Company List.

FEMSA remains a very high quality business, with both its Coca-Cola bottling and OXXO convenience store businesses defined by strong market share and world class execution. However, on the margin, we believe that the growth prospects for the company will begin to moderate due to limited upside in per capita consumption in the case of soft drinks and store saturation in the case of OXXO. In addition, recent deceleration in the Mexican macroeconomic environment is likely to persist, leading to a more difficult operating environment for the company. Although FEMSA does have several new retail initiatives in place, including drugstores and gas stations, to help drive the next chapter of its growth, it will be a while before these initiatives gain the critical mass to have a meaningful impact on the consolidated results of the company, and we expect there to be an interim period of lower growth during the transition. Ultimately, we saw FEMSA as a candidate for attrition, identified other more attractive growth businesses on our Qualified Company List that would enhance the overall

growth of the portfolio, and liquidated our position to reallocate the capital.

As noted above, we liquidated the portfolio's position in **Shoprite** as our growth expectations for the company's non-South African operations declined and our confidence in management decreased. Given the reduction in our confidence in key aspects of the thesis, we reallocated the capital to other higher confidence businesses.

Summary

There were numerous signs of slowing global economic growth that heightened uncertainty and raised investor fears during the quarter. At the same time, significant steps by central banks around the world to reduce interest rates spiked investor risk appetites and supported the prices of risk assets, contributing to volatility with the rebound in stock prices in September. As we have noted in prior quarters, we continue to see many key economic issues which we expect to contribute to rising volatility in global equity markets. Add to those the current impeachment controversy and the beginning of the U.S. presidential race with its accompanying rhetoric and debate over topics including tax and trade policy, health care, the environment, and regulatory policy with greater scrutiny of U.S. technology leaders likely. Given this ongoing uncertainty, we expect the more predictable, sustainable growth provided by our portfolio companies to resonate with investors. During this time, there will inevitably be brief periods of renewed hope benefiting lesser quality and more cyclical businesses during which we may trail indices on a relative performance basis, but in our view these are likely to be short-term phenomenon until the stage is set for a strong global recovery in economic growth. In the meantime, with an attractive cash flow based enterprise yield valuation of 3.3%, higher margins, less debt, greater cash generation and more stable growth, we are excited by the prospects for the portfolio in coming years.

We thank you for your continued confidence in our investment approach and our team, and look forward to speaking with you in more detail about the quarter should you have any questions.

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