SGA
Sustainable Growth Advisers

Q3 2019 U.S. Large Cap Growth Commentary

Highlights

- *The portfolio protected capital amid trade and macro-economic driven weakness in late July and August, but trailed its benchmark in September as cyclicals rebounded sharply on hopes for a trade war truce and new monetary accommodation*

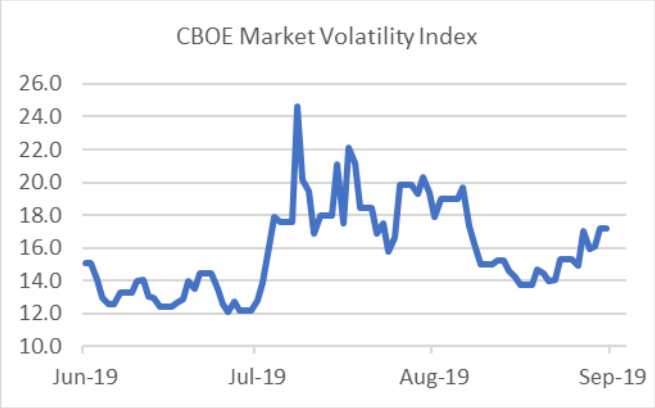
- *Stock selection was the primary detractor from relative performance, with selection in the Information Technology sector detracting most due to weakness in Autodesk and PayPal. Stock selection in the Consumer Discretionary sector was the largest positive contributor to returns given strength in Nike, TJX Companies and Lowe's*

- *New positions in IHS Markit, Illumina and Workday were initiated at below average weights while the remainder of our position in Walt Disney was sold*

- *Positions in Estee Lauder, Equinix, FleetCor, Intuit, TJX Companies, Visa, and Yum! Brands were trimmed on strength. Positions in Amazon, Autodesk, Nike, Salesforce.com, and UnitedHealth were added to on weakness*

Performance

After participating strongly in the market rebounds in Q1 and Q2, the portfolio trailed the Russell 1000 Growth Index in Q3. The quarter encapsulated two very distinctly different market environments. July and September were driven by growing anticipation of additional global monetary accommodation, a reduction in interest rates in the U.S., and new hopes for a cessation in tariff hikes and potentially an interim trade deal between the U.S. and China. In contrast, markets declined in August as investors became more concerned over slowing global economic growth and possible recession as U.S. factory output continued to struggle, and fell for the first time in three years. Between the relief rally in July, new escalation of trade tensions in August and another rebound in September, the CBOE VIX varied significantly, ranging from 24.6 at its high on August 5th to 12.1 at its low in July 24th.



Source: FactSet.

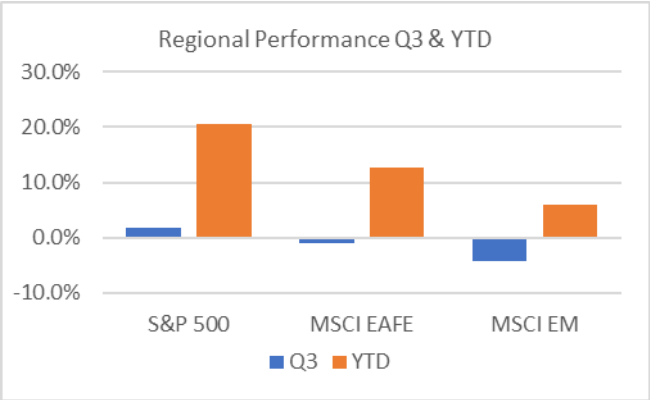
For the overall quarter, the portfolio returned 0.9% (gross) and 0.7% (net), while the Russell 1000 Growth Index returned 1.5%, and the S&P 500 Index returned 1.7%. The portfolio trailed the Index in July and again in September as more value oriented, cyclical stocks outperformed and indexes rebounded due to the anticipation of additional global monetary easing and expectations that China-U.S. trade tensions would abate. The portfolio protected capital in August as markets declined with more defensive stocks including Real Estate and Consumer Staples performing best.

Macro Events Drove Market Movements to a Large Degree

U.S. economic growth continued to compare favorably to growth across most non-U.S. developed markets, but cracks began to appear in the relative strength of the U.S. economy. Growth was negatively impacted by weakness in overseas economies and the safe haven U.S. dollar which continued to strengthen.

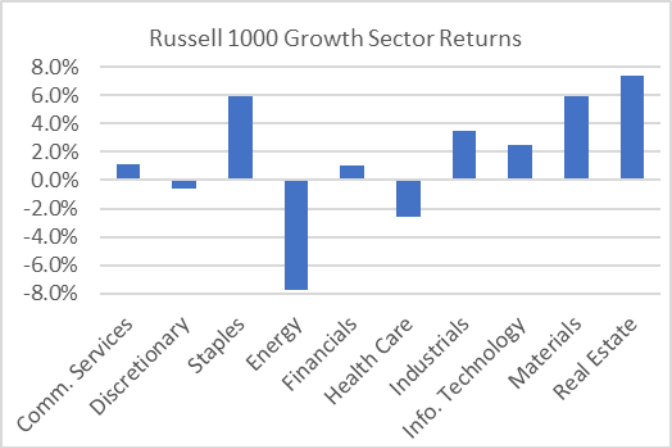
Initial Q2 U.S. GDP growth was recorded at 2.1%, down from 3.1% in Q1, as manufacturing weakened further and the Purchasing Manager Index (PMI) fell to 47.8 in September, its lowest level since June of 2009. Slowing in new orders from overseas due to trade tensions and as the strong U.S. dollar led factory output in the U.S. to fall 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 negatively impacted the readings. Although manufacturing accounts for only about 8.5% of total employment in the U.S. today (down from 16% in 1990), indirectly it continues to have a meaningful impact on overall economic growth with U.S. – made goods accounting for about 30% of U.S. GDP. 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, and the U.S.

consumer, which has been the engine of global growth in recent years continued to spend given gains in income, historically low unemployment and continued low inflation. These countering forces created the fluctuations in the markets and leadership over the course of the quarter.



Source: FactSet.

Returns to style, capitalization and business quality varied widely over the course of the quarter with July and particularly August having a more defensive tone and September standing out as a period that strongly favored value and lesser quality business factors. For the quarter, U.S. markets outperformed non-U.S. markets, larger-cap value companies with higher returns on equity, lower betas, higher levels of debt and earnings performed best.



Source: FactSet.

Significant variations in leadership occurred over the course of the quarter. For the overall period, more defensive sectors such as Real Estate and consumer Staples performed best but more cyclical sectors including Materials and Industrials were close behind. Energy performed the worst by a wide margin as investors focused on supply outstripping demand given the weakening global economy. Health Care also performed weakly due to political rhetoric over reducing health care costs. The poor performance of the Consumer Discretionary sector was negatively impacted by weakness in retail stocks.

Portfolio Attribution

Stock selection detracted from portfolio performance while the contribution from sector allocations was marginally positive. Selection in the Information Technology sector was the primary detractor from returns for the period, with Autodesk and PayPal detracting most. Selection in the Materials sector also detracted from returns, due mainly to the portfolio's position in industrial gas provider Linde. Mitigating some of the weakness, selection in the Consumer Discretionary and Real Estate sectors was strong with positions in Nike, TJX Companies, and Equinix contributing nicely. While sector weights are purely a residual of our stock selection, the portfolio's overweight to Health Care and underweight to Industrials negatively impacted performance, while its overweight in Materials was helpful.

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 to investment grade, 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.

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 was the third largest contributor to portfolio performance after it reported strong Q2 results with revenue growth of 7% on a reported basis in line with our expectations and slightly above the market consensus, and earnings growth of 23%. Margins expanded more than expected. We were pleased with the strength of results from China and EMEA, while U.S. results were actually a bit lighter than anticipated. We continue to expect mid-teens earnings growth over our 3-5-year investment horizon as the company continues to benefit from its ability to marry innovation with strong execution in marketing and supply chain management to better serve the growing demand for their product line. We had refilled our position prior to the report and maintained an above-average weight position.

The fourth and fifth largest contributors to performance for the quarter were **Estee Lauder** and **TJX Companies**.

Largest Detractors

UnitedHealth was the largest detractor from portfolio performance during the quarter despite reporting solid results with revenue growing approximately 8% and earnings per share up 15%, exceeding most analyst estimates and in line with our own. The company also increased their full year earnings guidance. The quarter was not perfect, however, as enrollment figures were weaker than expected and multiple participants across the industry have noted rising medical loss ratios as a concern. We view these issues as being temporary in nature. Over the next year, we see the larger concern for the stock being the high level of political rhetoric from both sides of the aisle which is likely. While the stock will continue to face headwinds over the course of the upcoming 2020 election cycle, we see the company as part of the solution to the healthcare reform versus part of the problem. We purchased additional shares in the company on weakness during the quarter, maintaining our above-average weight position in the stock.

Amazon was the second largest detractor from portfolio performance in Q3 despite reporting solid Q2 results. Over the period, unit growth improved after the company introduced one-day shipping on some of its inventory in North America. We expect this trend to gain momentum in Q3, further boosting revenues, as one-day shipping is extended to more locales and outside the U.S. Amazon Web Services grew 37%+ year-over-year mostly in line with expectations. While Amazon continues to extend one-day shipping, we are highly cognizant of the additional costs it will be incurring and have included them in our analyses. In the near term, as the company bears these incremental costs they will weigh on earnings. However, as the company grows more efficient in its shipping, and also starts to lap the increase on a year-over-year basis, we expect the incremental revenue growth to gain the spotlight with investors. We also expect the company's margins to gradually recover. Over our 3-5-year investment horizon, we expect the investments to spur additional growth and be lucrative. While temporarily a headwind, we see the investment as an additional edge they are developing which their competitors will find difficult to keep up with. We purchased additional shares of the company on weakness and are maintaining an above-average weight position.

Computer Assisted Design leader **Autodesk** reported solid results for the quarter with all key metrics including revenues, billings, earnings and cash flow growth exceeding expectations. However, the stock was pressured by management's guidance to expect annual recurring revenues for the full year of 2019 to be down marginally relative to prior guidance. This reflected management caution tied to minor signs of weakness in the UK due to Brexit, in Germany tied to manufacturing, and in China due to the U.S. – China trade dispute. This led to a weakness in the stock price, as investors began to price in concerns that the company could be more adversely affected by an economic downturn than previously thought. While we acknowledge that the company's book of business includes some clients who operate in more economically sensitive segments of the economy, and that the company has exposure to Europe which is experiencing economic slowing, we continue to see Autodesk possessing a more resilient business model now after the transition, and should grow its sales and profits at attractive rates over our 3-5 year time horizon despite macro-economic

slowing. Given our positive outlook, we purchased additional shares in the company on weakness.

The fourth and fifth largest detractors from portfolio performance during the quarter were **PayPal** and **Regeneron**.

Portfolio Activity

Turnover in the portfolio was generally consistent with its long-term average during the quarter, with the sale of our position in media giant Walt Disney, and new positions in DNA sequencing and genetic analysis leader Ilumina, global information services leader IHS Markit, and human capital management software leader Workday. We also took advantage of the strength in a number of stocks to trim positions. These included Ecolab, Equinix, Estee Lauder, FleetCor, Intuit, Visa, and Yum! Brands. We purchased additional shares in a number of existing holdings taking advantage of price weakness. These included Amazon, Autodesk, Nike, PayPal, Salesforce.com, and UnitedHealth.

Sales

The portfolio's position in **Walt Disney** was sold due to forced attrition after being an attractive contributor to portfolio performance over our latest holding period. While we remain excited by the direct-to-consumer Disney+ opportunity moving forward, success in the venture is already partially reflected in the stock's valuation, and we took advantage of this in Q2 and early Q3 as we trimmed our position in the company. Given additional costs and uncertainties associated with the transitioning of the Fox assets, developing additional content and launching Disney+, as well as accelerating revenue and profit loss at its cable and broadcasting businesses, we anticipate reduced earnings visibility over the next couple years, and remain cognizant of the ever present cyclicality that exists with the company's theme park business. Given the reduced earnings visibility, likely margin pressures and cash burn associated with the Fox integration, new content development, and Disney+ launch, we determined that other more attractive opportunities existed on our Qualified Company List.

Purchases

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 test, 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.

IHS Markit is a global information services business that provides critical information and analytical insights to companies in the Energy, Financials, Automotive, Aerospace & Defense, Chemicals and Technology industries. The company was formed by the merger of IHS and Markit completed in mid-2016. It is a high quality business we expect to generate high-single-digit revenue growth and mid-teens earnings growth over our 3-5-year investment horizon. The company's pricing power is supported by the critical nature of the data and insights it provides, which are typically unique and deeply embedded in client workflows. It continues to leverage its vast data sources to offer increasingly interconnected and comprehensive views of the global economy. The majority of its revenues are recurring with approximately 71% tied to fixed long-term subscription contracts, with 90%+ renewal rates. The remaining 29% is comprised of transaction-based revenues, and consulting, research and conference sales. Exposure to upstream oil focused clients has been reduced to less than 14% of its sales. The company enjoys attractive runways of growth driven by its steadily expanding coverage into new industry verticals and their ability to increase wallet share among existing clients, and further increase their penetration of global clients outside the U.S. and Europe, which today only comprise about 10% of sales. IHS also has a good track record of making successful acquisitions as they focus on businesses that complement their existing offerings, offer proprietary data primarily through subscription relationships and can benefit the company's global distribution capabilities while offering cost synergies and enhancing cross selling opportunities. The company continues to offer attractive top line and earnings growth, and an Enterprise Yield (SGA's proprietary cash flow derived measure of valuation) of approximately 3.5% in a world where such revenue and earnings growth have become scarce.

Among the key risks we will monitor for IHS are its ability to continue to successfully identify and execute material advantageous acquisitions, and the company's exposure to the more cyclical Energy sector. While its exposure to Energy and its accompanying volatility has been reduced, this remains the most cyclical element of IHS's business.

A new position in leading human capital management software-as-a-service provider **Workday** was initiated during the quarter. Workday's products are widely recognized among human resource specialists for their superior ease of use, ease of installation and upgrading, their ongoing innovation and overall customer satisfaction. The resulting edge in referenceability, relative to peers, allows Workday to charge a premium price, which is further supported by the high switching costs and risks businesses often face in making changes in the enterprise software applications they utilize. Underlying the company's success is a single code base that can easily be updated and deployed to all customers on a frequent and regular basis. Consistent with our focus on businesses that generate strong repeat revenues, approximately 85% of the company's sales are subscription based with a customer churn rate below 5% annually. The remaining 15% of revenues are tied to professional services they provide, mainly new client installations. Workday offers attractive long-term growth runways as it continues to take advantage of the opportunity to migrate new clients' existing on premise solutions to their cloud based software-as-a-service products, and see the use of their new Financial Management, Planning and Analytics products grow and expand globally. The integration of these newer products with Human Capital Management, and the ability to enhance cross selling between them should help the company maintain its attractive growth rate over our 3-5-year time horizon. Likewise, as the company scales its operations, we expect to see further improvement in its operating margins and free cash flow generation. With a strong net cash position of over $1.5 billion, a cash flow/earnings ratio of over 100%, and a proven senior management team, the company meets our key financial strength and management quality criteria.

Among the key risks we are monitoring with the company are its ability to reduce its implementation costs, its ability to continue to take mid-market share gains, its ability to continue to innovate and gain traction with its new products, and the competitive responses from the incumbent providers. With the stock's enterprise yield in the lower end of the range of our portfolio businesses, we initiated a below-average size position in the company, and plan to build the position opportunistically moving forward.

Summary

U.S. economic growth continues to be solid, but not immune to the slow growth plaguing many of the economies in Europe and Asia. The current U.S.–China trade dispute exacerbated the weakness, sending the safe haven U.S. dollar higher. With U.S. GDP growth slowing from 3.1% in Q1 to 2.1% in Q3, investors sought more defensive exposures until September, when hopes

for more aggressive monetary easing and a truce in the trade dispute sent more cyclical and value shares higher. We continue to expect higher levels of market volatility as investors wrestle with the tradeoff between weak economic growth and the hope for more aggressive monetary and fiscal stimulus around the world, complicated by trade issues and rising political rhetoric. With the myriad issues facing the U.S and non-U.S. economies, we think it's unlikely that global economic growth quickly improves to provide the necessary foundation for a sustained recovery in cyclical stocks. Until then, we expect our portfolio's focus on high quality businesses with recurring revenue streams and above average long-term sustainable growth rates, to be rewarded by investors seeking greater certainty. Regardless of the macroeconomic events buffeting the markets, our focus remains on identifying the best long-term growth businesses we can find, and building concentrated portfolios of those ideas free of constraints over benchmark composition and backward looking tracking error statistics.

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

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