SGA
Sustainable Growth Advisers

Q3 2017 Emerging Markets Growth Commentary

Highlights

- *SGA's Emerging Markets portfolio returned 4.4% (gross) and 4.1% (net) in Q3 2017 compared to 7.9% for its primary benchmark the MSCI Emerging Markets Index; during the same period the MSCI Emerging Markets Growth Index returned 10.2% and the MSCI ACWI with EM Exposure Index returned 8.0%*

- *Emerging markets outperformed developed markets; Latin America was the best performing region*

- *Large cap growth leadership continued; business quality factors were generally rewarded as companies with higher returns on equity and less debt performed better, but higher beta stocks and companies with no earnings also outperformed*

- *Energy performed best followed by the Technology, and Materials sectors; Industrials were weakest followed by Consumer Staples and Telecommunications*

- *Stock selection and sector weights detracted from portfolio performance; selection in the Consumer Discretionary sector detracted most from SGA's performance accounting for more than half of the portfolio's underperformance*

- *Positions in Kansas City Southern, Ping An Insurance, JD.com and Shoprite were trimmed on strength and positions in Fast Retailing, MercadoLibre, and Mondelez were added to on weakness. A new position in New Oriental Education and Technology Group was initiated and the remainder of our position in Kansas City Southern was sold*

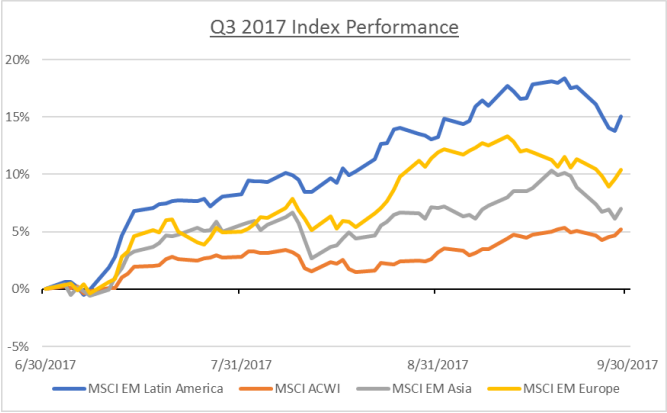
Performance

SGA's Emerging Market portfolio returned 4.4% (gross) and 4.1% (net) in the third quarter of 2017 while its benchmark, the MSCI Emerging Market Index, returned 7.9%, the MSCI Emerging Market Growth Index returned 10.2% and the MSCI ACWI with EM Exposure Index returned 8.0%.

	QTD	YTD	1-Year	3-Year	Inception
SGA Emerging Markets Growth (Gross)	4.4%	25.4%	15.3%	7.8%	6.6%
SGA Emerging Markets Growth (Net)	4.1%	24.4%	14.0%	6.6%	5.4%
MSCI EM	7.9%	27.8%	22.5%	4.9%	2.8%
MSCI EM Growth	10.2%	36.0%	26.3%	8.1%	6.1%
MSCI ACWI with EM Exposure	8.0%	26.4%	22.5%	5.5%	3.7%

Emerging Markets Outperformed

The continued outperformance of emerging markets during the quarter reflected greater comfort by world market participants in the stability of the global economy and its ability to accelerate growth without igniting inflationary concerns. Improved economic data in Europe, a pickup in U.S. growth, and continued attractive growth in China mitigated fears over structural impediments to improved emerging market growth. The commodity producing economies of Brazil (+22.9%), Norway (+19.2%), Russia (+17.6%) and Chile (+16.9%) were the best performing markets in Q3 driven by rising oil and metal prices. Over the course of the quarter, oil prices rose 20% (Brent) after a rebound in expectations for improved global economic growth and continued controlled output from OPEC producers. Likewise, Aluminum and Copper prices rose roughly 10% during the quarter, reaching their highest prices since 2014, while Zinc prices reached their highest levels in over a decade, up nearly 17% in the quarter. The rally in metals was supported by expectations for stronger global demand and tighter supplies. From a regional standpoint, Latin America performed best, driven by Brazil, Chile and Peru while Emerging Europe was the second best performing region due to strong returns by Russia, Czech Republic (+10.0%), Hungary (+9.6%) and Poland (+9.3%). The weakest markets during the quarter included Israel (-12.7%) as it dealt with continued political uncertainty, Greece (-12.2%), and Qatar (-6.9%) which continues to be embroiled in a dispute with its Arab neighbors over charges of funding for terrorism.



Source: FactSet

In Latin America, in addition to a firming in global commodity prices, Brazil's markets benefited from progress by the government on economic reforms and reduced prospects for a return of the leftist Workers Party in the upcoming 2018 presidential elections. With inflation declining, easing by the country's central bank was also a tailwind. In Chile, in addition to the boost from higher commodity prices, investor sentiment

benefited from improved prospects for the center-right pro-business candidate in the country's upcoming presidential election in November.

In China, GDP growth in Q2 was reported at 6.9% year-over-year, indicating little impact from the government's moves to selectively tighten monetary conditions. The strength in growth was supported by significant government infrastructure spending which began in 2016 as President Xi sought to strengthen his position going into the October Communist Party Congress. Despite the upbeat quarter, however, we continue to be cautious with regard to such future strength in GDP, and believe selectivity is particularly important.

Key Performance Drivers

Emerging markets generated strong absolute returns during the quarter driven by rising expectations for continued improvement in global economic growth. This benefited more economically sensitive, and higher beta areas of the market including Energy, which returned over 13% for the period and Materials (+10%), while Technology (+11%) was the second best performing sector. Despite, more confidence on the part of investors, larger cap growth stocks again outperformed smaller cap stocks. The reward to higher business quality was mixed with higher returns on equity and lower debt outperforming, but cyclicals and companies with no earnings also outperforming. Sector allocations and stock selection detracted from relative portfolio performance for the quarter, with selection in the weakly performing Consumer Discretionary sector being responsible for the vast majority of the portfolio's weak stock selection and contributing to over half of the overall portfolio's underperformance. The portfolio's overweight to the weakly performing Consumer Staples sector cost over 1% in relative return for the quarter as more economically sensitive areas of the market performed best. Stock selection in the Energy and Industrials sector detracted to a lesser degree and the impact was mostly offset by strong selection in the Technology sector.

Largest Contributors

Chinese internet search provider **Baidu** reported a good second quarter with revenues growing 14% year-over-year and earnings up by 47%. Earnings growth was driven by an attractive improvement in margins after it significantly reduced investment spending on its Nuomi and Baidu Food Delivery ventures. These segments were aimed at creating a Yelp/Groupon/Grubhub combination, and had gained good traction but were falling behind competitors after the merger of two top players in the industry. Top line revenues improved as the number of online marketing customers increased by 16,000 over the last quarter, and the number of daily active users of the Newsfeed product surpassed 100 million. Meanwhile, the online video app iQiyi maintained its industry leadership, with a 28% market share, improving its share relative to last quarter and relative to competitor Tencent Video. The company continues to invest in artificial intelligence and improving the personalization of its customers' search experiences. With less of an anticipated drag from Nuomi and Food Delivery services moving forward, the company posted a strong Q3 outlook. We see Baidu's knowledge search business continuing to be attractive as it leverages its leadership position.

Chinese video game and e-commerce firm **Tencent** reported strong results with revenues increasing 59% and gross profits up 38%. Videogame revenues grew 39% due to strength in online and mobile games while advertising revenues grew 55% as ad loads continued to gradually increase. Revenues from the cloud and payments grew quickly, rising 177%, and combined WeChat/QQ users grew 19% up to 963 million users. With the company's popular game "Honor of Kings", Tencent's user base experienced gains in non-traditional demographic groups, and in the PC game segment, while its user base stayed relatively constant, a larger proportion of its players elected to spend more on in-game product offerings. While Tencent's stock has appreciated considerably over the last year, we have maintained our position size, trimming on strength due to its higher valuation, and continue to see the company as offering attractive secular growth as it begins to target its advertising capabilities more and benefit from continued growth in its successful game and social media businesses but also in its burgeoning cloud, payments and international opportunities outside China.

Chinese e-commerce leader **Alibaba** posted strong quarterly results with overall revenues up 56% and earnings per share up 62% driven primarily by continued strength in its e-commerce business. Alibaba's mobile monthly active users (MAU) now exceed 529 million, and revenue per mobile MAU continues to inflect upward as the company continues to refine and enhance its mobile targeting capabilities for merchants. Meanwhile, Alibaba's other businesses continue to grow nicely, with its cloud computing business growing its user base by almost 75% and nearing profitability, and other businesses in its Media & Entertainment and Innovation segments gaining traction. Alibaba has also embarked on international expansion, most notably with its increased stake in Lazada, a leader in e-commerce in Southeast Asia. While the stock has appreciated substantially, we have maintained our position as we continue to expect Alibaba to leverage its formidable advantages to gradually create a seamless shopping experience

for Chinese consumers similar to what Amazon is doing in the U.S. and other countries.

Magnit and **Ping An Insurance** were the fourth and fifth largest contributors to portfolio performance during the quarter.

Largest Detractors

Despite a good report in June, **Nike's** stock came under pressure this quarter as data points from its retail channel in North America continued to be weak and concerns about competitive pressure from Adidas persisted. Our research indicates that Nike will overcome its dependence on the third-party retail channel soon by investing in the Direct-to-Consumer channel. In fact, it is likely that its units sold may have still increased on a year-over-year basis this quarter. With better control over the end customer experience, Nike will be able to stem the year-over-year erosion in its average selling price (ASP) as well. In parallel, the company continues to innovate and is working to reignite the "Air" franchise across its shoe platform. This should also help with the unit growth and ASP erosion. Early signs suggest that the gain in market share by Adidas across North America may also be stabilizing now. All said, Nike posted a good Q3 report towards the end of the quarter. North American sales were down, but better than expected, and inventories were down about 2% indicating the inventory overhang which had plagued the stock last year is gradually being corrected. EMEA results were weaker than expected versus strong comparisons last year and considering the impact from a cyber-attack on one of the company's logistics providers. However, the overall report was not enough to change investor sentiment yet. While the level of competition from Adidas and others will vary over time, we believe it is Nike's superior ability to read the market and bring its product to market more quickly, without relying on one hit wonders related to endorsements, which will help it increasingly stand out relative to its peers as the athletic-leisure market continues to grow, particularly outside of North America. Given our positive view of Nike's opportunity and our 3-5 year time horizon, we added to our position in the stock on weakness.

Amorepacific reported weak Q2 results with the company's sales declining 16% and operating profit down 60% as key travel trends from China continued to be disappointing due to ongoing tensions over South Korea's deployment of the THAAD anti-missile defense system in response to the North Korean nuclear threat. Its business within mainland China decelerated during the quarter as well, but Amore reported improving trends there later in the period and expects better results by Q4. The company had halted all of its advertising and promotional activity in China to avoid being targeted by the government, but gradually restarted such activity later in Q3. Meanwhile, Amore's domestic business also experienced weakness due to poor tourist traffic in key commercial areas and increased competition from local businesses. Expectations for the quarter were low given the geopolitical issues impacting its sales, and the fact that it continued to invest during the quarter in additional salespeople, improved digital capabilities, remodeled stores and innovation which contributed to lower margins. While additional weakness in the short-term is certainly possible given the high degree of uncertainty associated with the North Korean nuclear threat and geopolitical tensions, we expect the company to continue to manage through these issues with continued global expansion in China, Southeast Asia and the U.S. In domestic markets, the company continues to invest in digital capabilities to strengthen its ecommerce capabilities amidst changing customer shopping patterns. However, given the unpredictable nature of the geopolitical issues impacting Amore's business, we reduced our target weight for the stock in favor of other higher confidence opportunities.

Fast Retailing reported attractive results with revenue growth of 17% and profit growth of 50% year-over-year. The report pointed to good improvement in their international markets segment with profitability improving in all of the geographies it serves, with the exception of Europe where results were impacted by expenses associated with new store openings. While its report was viewed positively by the market, the company also noted that it will be investing in its supply chain to its local markets in Japan in order to shorten lead times and better manage its inventories. These investments are expected to weigh on the company's margins in its domestic market negatively impacting its profit growth in the short-term, and this caused an adverse reaction for some investors. In SGA's case, we believe these investments make sense in the long-term and should help the company reduce the level of its discounting in the future by helping it to better control its inventories, and thereby improving margins. Consistent with our 3-5 year time horizon when investing in companies, we used the opportunity to add to our position.

Universal Robina and **Mondelez** were the fourth and fifth largest detractors from portfolio performance during the quarter.

Portfolio Changes

Turnover in the portfolio was less than average for the quarter. The remainder of the portfolio's position in railroad Kansas City Southern was sold to fund a new position in Chinese provider of

private educational services New Oriental Education and Technology Group. Positions in JD.com, Ping An Insurance Group and Shoprite were trimmed on strength, while positions in Fast Retailing, MercadoLibre and Mondelez were added to on weakness.

Purchases

An initial position in **New Oriental Education and Technology Group (EDU)** was established during the quarter. EDU is the largest private educational company in China, based on the number of programs it offers, the number of students it serves and its geographic presence. The company offers English language test preparation courses to students taking various language and entrance exams used by schools in the U.S., U.K. and other commonwealth countries. It also provides K-12 after-school tutoring services, overseas school application consulting services, and adult language training courses. The company's well regarded reputation, large scale and ability to develop more advanced products via superior technology provide it with a competitive advantage and strong pricing power. It generates recurring revenues through strong and weak economic times as education services are non-discretionary and EDU's comprehensive product portfolio meets the demand present at all learning stages, enabling it to cross sell and encourage recurring enrollments. In weak economic times, parents tend to view education as even more important leading to steady increases in enrollment. With increasing divergences in income and high competition for good jobs, it is increasingly important for students to be able to enter the best universities. Our research indicates that the company should possess long runways of growth as China reforms its testing format, replacing state-created exams with a national-standardized test where EDU should be able to expand across more regions and reduce the fragmentation which now exists in the K-12 private education industry in the country. With all tuitions paid up-front before classes begin EDU's Cash/Earnings ratio is very attractive at over 150% and the company continues to return cash to shareholders via special dividends.

Key risks we are monitoring with EDU include the possibility that it faces more pricing pressure as it moves into new regions within China as existing players try to defend their market share. The company's technology spending and M&A raises the likelihood that it will go through periods where operating margins come under pressure, however we would view this as something that would likely contribute to the company's long-term competitive edge. We are also cognizant of the large cash balances the company has invested in bank trust products making it more sensitive to interest rate and default risk.

Sales

Kansas City Southern was sold from the portfolio after experiencing significant appreciation due to a lessening of negative trade rhetoric following the recent U.S. presidential election and posting impressive volume growth due to increased shipments of coal, sand for fracking, and Canadian crude oil. We continue to view the company positively, and it remains on our Qualified Company List, however given its increased valuation and the upcoming Mexican presidential election in 2018, which has the potential to create meaningful "headline" risk for U.S.-Mexican trade relations, we locked in attractive gains on the stock and redeployed the capital into other more attractively valued long-term growth opportunities.

Summary

Emerging markets again outperformed developed markets on preliminary signs of improving economic data in Europe and parts of Asia. While structural problems and geopolitical issues continue to pose a threat to many emerging economies, attractive valuations and the ability of these economies to grow at faster rates over the long-term have drawn investors as growth in the U.S. continues to be moderate at best. Like our U.S., Global and International portfolios, SGA's emerging markets portfolio continues to generate significantly greater sales and earnings growth than its index benchmark. As of the quarter end, the portfolio was forecast to generate revenue and earnings growth of 15.6% and 20.8% respectively, compared to 7.8% revenue growth and 16.2% earnings growth for the MSCI Emerging Markets Index over the next three years. With monetary policies in the U.S. and Europe gradually becoming less accommodative and the likelihood of some slowing in the Chinese economy, we expect attractive business quality, stronger pricing power, highly recurring revenue streams and long runways of growth to continue to be valued by investors in the emerging markets. In periods of optimism over future global growth, we would expect the portfolio to participate in strong market returns, but we would expect its best relative returns to continue to be seen as market volatility increases and investors again factor in the many risks which remain as a result of the extended global expansion we have enjoyed over the past eight years.

We thank you for your continued interest in our team and portfolio.

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are not a solicitation or recommendation to buy, sell or hold securities. This commentary is provided only for qualified and sophisticated institutional investors. SGA earnings growth forecasts are based upon portfolio companies' non-GAAP operating earnings. SGA Emerging Markets Growth Composite inception is 8/1/2014. 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, 1.1%, employing the Emerging Markets 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. 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 Emerging Markets portfolio for the past year. Past performance is not indicative of future results.