SGA
Sustainable Growth Advisers

Q4 2018 Global Growth Commentary

Highlights

- *SGA's Global Growth portfolio returned -10.5% (gross) and -10.7% (net) in Q4 compared to -12.8% for its primary benchmark the MSCI All Country World Index (ACWI), and -14.7% for the ACWI Growth Index*

- *Trade tensions between the U.S. and China overshadowed the signing of the new NAFTA agreement, and led to a marked rise in market volatility as investors'risk aversion increased*

- *Global markets took on a decidely defensive tone with stocks deemed to be most sensitive to slowing global economic growth most negatively impacted; emerging markets held up relatively well despite significant weakness in Chinese stocks*

- *Larger-cap companies performed best; the reward to business quality was mixed with value, high debt, companies with earnings and lower betas outperforming*

- *Utilities and Real Estate performed best while more economically sensitive sectors such as Energy and Technology performed worst; Health Care and Utilities were the only sectors to generate positive retuns for 2018*

- *A new position in Abbott was initiated and existing high confidence holdings were supplemented as positions in Amorepacific, MYOB, Red Hat and Schlumberger were liquidated; other positions were adjusted as we took advantage of the increase in market volatility*

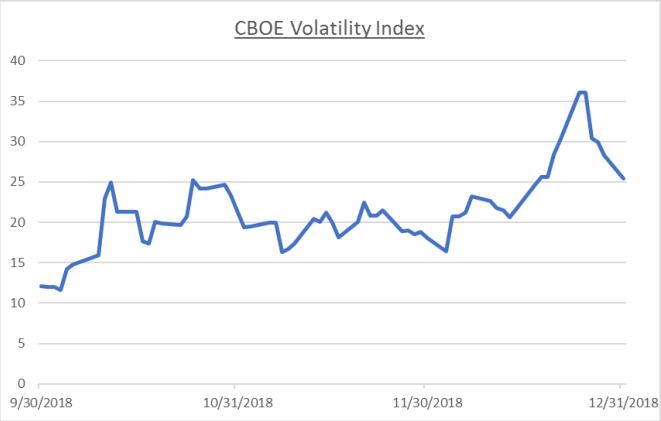
Performance

SGA's Global Growth Equity portfolio returned -10.5% (gross) and -10.7% (net) in the fourth quarter of 2018 while its benchmark, the MSCI All Country World Index (ACWI), returned -12.8%, and the MSCI ACWI Growth Index returned -14.7%. For 2018, the portfolio returned -0.9% (gross) and -1.8% (net) relative to -9.4% and -8.1% for the MSCI ACWI and MSCI ACWI Growth respectively.

The portfolio performed as we would have expected given the rise in market volatility in 2018, and consistent with how it has performed in other periods of higher volatility and weakness in the ACWI since 2010 (2011, 2015 and now 2018) generating sizable excess returns.

Slowing Global Economic Growth and Rising Volatility

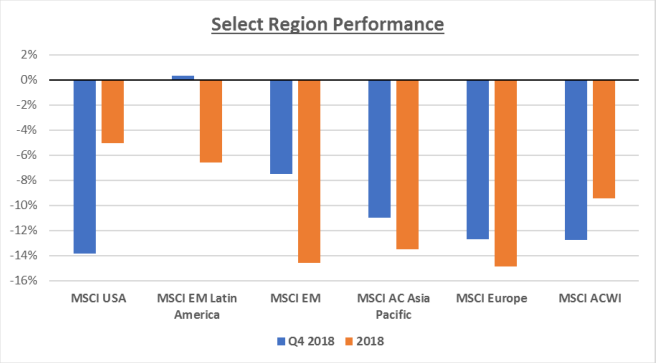
Fears over slowing global growth, rising trade tensions between the world's two largest economies, slumping commodity prices and indications from the fixed income markets that higher interest rates are likely to slow economic activity in the U.S. and negatively impact corporate profits, led to sharply higher volatility and declining global equity markets. The CBOE Volatility Index (VIX) or "Fear Index" rose from 12.1 at the beginning of Q4 to a high of 36.1 during December as U.S. markets were on track to experience their worst Q4 since 2008.



Source: FactSet

Emerging markets performed better in Q4 as several of the markets which have been under the most pressure in recent quarters rebounded. Brazil was the best performing market in the ACWI and one of only seven countries in the index to generate a positive return for the period. Others, including South Africa, which has seen significant weakness for the year, held up quite well, showing only marginal declines. While the economy in the U.S. remained relatively strong, growing at an annualized pace of 3.5% in Q3 (second estimate), supported by strong consumer spending, the U.S. equity market weakened significantly in Q4. It underperformed other developed as well as emerging markets as investors became increasingly concerned that the current pace of U.S. growth was not sustainable given weakening overseas, higher interest rates and signs that trade tariffs were beginning to impact domestic businesses. Signs of weakening in autos, lower homebuilder confidence and, most importantly, reduced consumer confidence contributed to the weakness. This is reflected in the declining earnings estimates for the U.S. market. While consensus earnings expectations for the broad market (S&P 500 Index) are for 8% growth in 2019 according to Factset, this is down from 10% at the end of September and down from the estimated 22% earnings growth rate in 2018 when corporate

profits benefited from tax changes and the effect of regulatory rollbacks.



Source: FactSet

In contrast to the U.S. economy, the GDP growth in the Eurozone slowed to 0.6% in Q3, its slowest since 2013 and in stark contrast to 2017 when the region benefited from a synchronized pickup in growth and strong manufacturing activity. With the ECB ending its four-year Quantitative Easing program in December, and inflation coming down, growth remained sluggish, hurt by weakening in its major trade partner China.

In Asia, the Japanese economy contacted by 1.2% in Q3 due largely to the lingering effects of recent natural disasters impacting the nation. In China, economic growth slowed and we expect it will likely continue to do so on a secular basis to a more sustainable mid-single digit growth rate given the economy's tremendous size, its transition to a more domestically consumer driven economy from an investment and export driven economy, and friction from trade conflicts. Massive stimulus applied by the government in 2018 ranging from interest rate cuts and auto tax reductions to lower mortgage rates and increases in government spending will likely counter the slowing in their economy and that of their larger trade partners to a degree, however we continue to expect secular slowing in China.

Indian stocks finished the quarter in positive territory due to a significant market recovery in stock prices in November following October's broad-based selloff in emerging market equities. Concerns over the impact of rising oil prices and currency fluctuations had pressured equities earlier in the year, given the economy's reliance on oil imports. With oil prices tumbling Indian equities found relief to finish the year stronger, benefiting our holding in HDFC Bank.

Mexican equities were among the worst performing within the ACWI as investor's lost confidence in president-elect "AMLO" following his announcement that he was considering scrapping Mexico City's $13B airport project. Specifically, investors increasingly worried about his administration's willingness to honor current business contracts and take further populistic actions which could hurt investors and growth in the country. In contrast, the Brazilian market was the best performing in the ACWI for the quarter, rallying as far-right candidate Jair Bolsonaro won the country's presidential election vowing to restore social order and safety, generating greater confidence in a more pro-business, pro-growth free market agenda which investors expect to turn around the troubled Brazilian economy.

Key Performance Drivers

The portfolio's superior business quality profile combined with our attention to valuation helped protect client capital from suffering the full extent of the market's Q4 downturn and enabled the portfolio to outperform for the period. Stock selection, particularly in the non-U.S. developed and U.S. markets, was strong during the period and drove the portfolio's positive relative returns. The Information Technology sector was notably weak, and the portfolio's overweight to it detracted from relative returns but strong selection in the sector more than compensated for it. Likewise, an underweight in the Financials sector hurt relative returns but strong stock selection more than offset the impact. An overweight in the more defensive Consumer Staples sector contributed positively to excess returns, however stock selection in the sector detracted. Overall, sector allocations detracted from performance, but positive stock selection resulted in strong relative returns for the quarter.

Largest Contributors

Open source software leader **Red Hat** was the largest contributor to portfolio performance in Q4 after agreeing to be purchased by IBM in a $33 billion deal, IBM''s largest acquisition ever. The stock rose as much as 50% after the announcement of the offer, its largest jump since 1999. Red Hat is expected to boost IBM's cloud computing business, which is central to management's plan to revitalize the company and return it to growth. With the relatively rich valuation offered by IBM, we deemed that a secondary offer was unlikely and eliminated our exposure to Red Hat shortly thereafter.

Indian financial services company **HDFC Bank** benefited from the better performance of the Indian stock market relative to other emerging markets. HDFC continues to capitalize on an improving Indian economy and a desire on the part of the country's growing middle class for more efficient banking services relative to what is available through India's traditional

national banks. With its funding largely supported by lower cost retail deposits and expenses related to corporate overhead growing at a slower pace than revenues, we continue to see an attractive opportunity for an improving return on equity. Despite the volatility in global markets, Indian consumers are less levered traditionally and remain relatively insulated thus far, and the bank's results during the quarter were steady on all metrics as anticipated. Accordingly, we increased the portfolio's position in the stock in Q4 to an above average weight.

Cloud based business management and accounting solutions provider **MYOB** received an offer to take the company private from KKR & Co, as well as a subsequent increase in the offer once MYOB's Board of Directors granted approval for KKY to complete additional due diligence. Given the company's history operating as a private company, we expect MYOB's management to be comfortable with a transaction, and reallocated capital from our position as the stock's valuation became less attractive compared to other opportunities on our Qualified Company List.

The fourth and fifth largest contributors to portfolio performance in Q4 were **Abbott** and **Yum! Brands**.

Largest Detractors

Over the last quarter we determined that our investment thesis for oil service leader **Schlumberger** had materially changed due to an unforeseen lack of revenue and earnings predictability from the company's recent expansion into more capital-intensive and more commoditized areas of oil services. This lack of visibility was highlighted during the recent pullback in oil prices brought about by the oversupply in the oil markets caused mainly by Saudi Arabia and Russia in anticipation of stricter Iranian sanctions that did not happen, requiring a production cut later and further delaying expected increases in capex spending by U.S. and international producers. Schlumberger had forecasted tighter service capacity, which should have led to increased pricing power in the near term, but with less activity, its expanded under-utilized fixed cost base (especially more recently in North America) meant larger earnings misses. Given the significant increase in market volatility and the improved opportunities to invest the capital in Schlumberger in higher confidence, higher secular growth businesses which had become more attractively valued, we sold Schlumberger and redeployed the proceeds.

Investors reacted negatively to news of German enterprise software leader **SAP** acquiring "experience management" software company Qualtrics for $8 billion in cash. While we were surprised by the acquisition and its size and valuation, previous acquisitions have made strategic sense and worked out well for the company. While we do have some reservations about the Qualtrics acquisition price, we continue to view SAP's growth prospects favorably. In Q3, the company beat consensus earnings estimates, with earnings increasing 13% and revenues up by 10% driven by strong growth in cloud revenues (+41%) and new cloud bookings (+37%). The company raised its guidance again for 2018, after having increased it substantially in the prior quarter. Concern on the part of some investors about a decline in licensing revenues (-8%) and margin also contributed to the short-term weakness in the stock. With the company emphasizing cloud growth over licensing growth, we are not surprised to see licensing revenues or margins weaken. We continue to see the transition from the firm's traditional licensing model to a cloud model as positive, enabling SAP to improve its revenue predictability and overall business quality, as the cloud business continues to scale rapidly enhancing margins and profitability.

E-commerce leader **Amazon** reported strong profitability across its businesses with higher margins in its key Amazon Web Services (AWS) business, as well as lower than expected losses in its burgeoning international businesses. However, the stock declined on the report as sales were a little lower than the street consensus due solely to weakness in international sales and what some considered to be cautious guidance. We were pleased to note that sales in all of Amazon's other business segments were in line with rather high expectations. Likewise, we were pleased with the company's advertising growth and indications that operating margins in its AWS unit may have been an all-time high despite continued price cuts. While we have been disciplined in managing our position size in Amazon given its extraordinary strength over the past few years, we took advantage of the recent weakness to add to our position, increasing the target given its more attractive valuation. We fully realize that Amazon will not beat expectations and raise guidance every quarter, however we remain highly optimistic over the company's future growth opportunities.

The fourth and fifth largest detractors from portfolio performance in Q4 were **New Oriental Education** and **Equinix**.

Portfolio Activity

Turnover in the portfolio was in line with our long-term average, with the sale of open source software leader Red Hat and business management and accounting solutions provider MYOB, each of which received takeover bids from businesses attracted to the sustainable growth these companies offer. Oil field service leader Schlumberger and Korean cosmetics company Amorepacific were sold after we determined that their

respective theses had weakened and better opportunities were presented to us by the rise in market volatility during the quarter. Proceeds were reallocated to the purchase of Abbott and supplementing several other positions on weakness during the period including Alibaba, Tencent, HDFC Bank, Amazon, and Autodesk among others. Other positions were reduced on strength including Fast Retailing and Autodesk (earlier in the quarter).

Sales

Amorepacific was sold after we became increasingly concerned that its earnings growth recovery would be slower than we had expected. While we expect the business to continue its recovery as the THAAD missile defense related geopolitical headwinds with China abate, the company is investing heavily to launch into new markets such as North America, the Middle East, and Southeast Asia, likely tempering the recovery in profits. Slowing Chinese growth and less confident consumers are also likely to impact the resurgence in the company's growth. While we expect that Amorepacific will eventually succeed in their globalization efforts, considering other opportunities which evolved amid the market volatility during the quarter, we redeployed the capital to other higher confidence secular growth candidates.

MYOB was sold following its agreement to an offer by KKR to take the company private. After further analysis, we determined that the likelihood of a higher offer was low and began gradually liquidating our position in the stock and redeploying the capital to other higher expected return opportunities.

Open source software leader **Red Hat** was sold from the portfolio following the announcement of IBM's offer to purchase the company, after which we concluded that the likelihood of a higher counter offer was low. Proceeds from the sale were reallocated to a new position in Abbott.

As noted earlier, **Schlumberger** was sold from the portfolio during the quarter to reallocate the capital to higher confidence, higher secular growth businesses on our Qualified Company List that had become more attractively valued.

Purchases

Abbott is a diversified global healthcare company which has 4 major operating segments: nutritionals (23% of sales), branded generics in emerging markets (15% of sales), diagnostics (25% of sales), and medical devices (37% of sales). Abbott currently operates in 150+ countries, with 40% of its sales coming from emerging markets, 35% from the U.S., and 25% from other developed markets.

Abbott has gone through a portfolio transformation over the years and has positioned itself as a leader in a number of sustainable high growth franchises within its diversified global portfolio of healthcare businesses. The portfolio transformation was achieved from internal innovation as well as M&A and divestitures. In particular, we believe that Abbott will benefit from the recurring revenue growth in the continuous glucose monitoring franchise of Libre, diagnostics platform Alinity, and emerging market pharmaceuticals. Abbott also has some near-term growth drivers in structural heart such as mitral valve repair devices, which are underpenetrated and have room to grow. Approximately 30% Abbott's businesses are mature, lower growth franchises such as its U.S. nutrition, vascular (stents), and cardiac rhythm management (pacemakers) businesses, however, they provide steady cash flow generation.

While we do not expect pricing pressure in health care to abate over our investment time horizon, we are impressed by Abbott's sustainable growth opportunities and their room for margin expansion as the company benefits from cost savings from recent acquisitions of St. Jude Medical and Alere. We expect management to continue to reposition the company to higher growth markets within healthcare, with a rising emphasis on emerging markets and innovation driven growth.

We initiated a below-average weight position in the stock and increased it to an average weight later in the quarter.

Outlook

As volatility rose in Q4 in response to higher interest rates, trade tensions, fragile global economic conditions and other factors it was encouraging to see the portfolio protect shareholder capital while continuing to deliver strong cash flow and earnings growth. The careful attention paid to valuation and the benefit our companies have in generating strong repeatable cash flows also contributed to this protection, as investors moved away from the high momentum stocks that had led market indices in recent years. We were pleased with the ability of the portfolio to protect capital on the downside, as it has historically. Equally important, we were pleased with the opportunity to take advantage of widespread share price reductions in high quality secular growth businesses which previously looked less attractive due to valuation, and we took advantage of the chance to supplement existing positions in strong businesses we already owned. The discipline to carefully manage position sizes in strong growth businesses as investor

optimism and momentum driven allocation algorithms drove them higher, together with the willingness to capitalize on volatility and step up to leverage our 3-5-year time horizon to increase positions in attractive secular growers that are temporarily under pressure allows us to generate attractive absolute and relative long-term results for our clients.

After a decade of unprecedented monetary accommodation and high levels of stock correlations, we strongly believe that we are in the early innings of what will be a higher volatility environment as investors react to greater uncertainty over U.S. monetary and trade policy, the dollar, the debt ceiling, divided government, and continued slow global growth. With an enterprise yield of 3.6% at year end, meaningfully higher than the 3.2% seen at the beginning of 2018, and three-year forecasts of revenue and earnings growth of 12.9% and 19.1% respectively, well above that of the MSCI ACWI, together with higher cash flow generation, less debt and stronger margins, we are highly optimistic over the opportunity in the portfolio looking forward.

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