Q3 2018 Global Growth Commentary

Highlights

- *SGA's Global Growth portfolio returned 3.9% (gross) and 3.6% (net) in Q3 2018 compared to 4.3% for its primary benchmark the MSCI All Country World Index (ACWI), and 4.6% for the ACWI Growth Index*
- *U.S. stocks outperformed non-U.S. Developed and Emerging Market stocks by a wide margin as investors rewarded the certainty and strength being exhibited by the U.S. economy; concerns over escalating trade tensions were offset by positive economic data and high levels of consumer and business confidence in the U.S.*
- *U.S. GDP growth in Q2 posted its strongest gain since 2014 as benefits from recent tax cuts, regulatory reform and repatriation of funds from overseas kicked in*
- *Larger-cap U.S. companies performed best; the return to business quality was mixed with high return on equity companies outperforming, but also those with high debt; the return differential between growth and value, and companies with and without earnings was minimal*
- *Health Care outperformed by a wide margin, followed by Technology and Industrials; other sectors performed roughly in line or trailed the ACWI benchmark*
- *New positions were initiated in Alibaba and Nestle while our position in Ulta Beauty was sold on strength; guided by our valuation discipline, we continued to trim positions where valuations were less attractive and add to positions where we saw more opportunity*

Performance

SGA's Global Growth Equity portfolio returned 3.9% (gross) and 3.6% (net) in the third quarter of 2018 while its benchmark, the MSCI All Country World Index (ACWI), returned 4.3%, and the MSCI ACWI Growth Index returned 4.6%. On a year-to-date basis, the portfolio returned 10.0% (net) relative to 3.8% and 7.6% for the MSCI ACWI and MSCI ACWI Growth respectively.

U.S. Stocks Responded to Strong Domestic Economic Data

Among the major global economies, the U.S. market performed best as Q2 GDP growth improved to 4.2% supported by high consumer and business confidence, lower taxes, a reduced regulatory burden and the repatriation of billions of dollars in funds previously held overseas. The U.S. market was rewarded by investors seeking perceived safety and stability given a significantly less certain global economic environment. All other G-7 markets underperformed the MSCI ACWI for the quarter. Concerns over slowing growth, the impact of trade issues on future growth, and nationalist gains in recent European elections caused investors to move away from European equities. In fact, according to the Wall Street Journal, in 28 of the last 29 weeks, investors withdrew funds from European stocks. Tremendous uncertainty over the U.K.'s future relationship with the European Union (EU) with the Brexit deadline quickly approaching also pressured European markets. With approximately 19% of the revenues from companies listed in the Stoxx Europe 600 coming from Emerging Markets, as compared to about 14% for the S&P 500 Index, the region was also more sensitive to the weakening in developing markets. The region's close trading ties to China and the fact that European manufacturing export orders failed to grow for the first time in five years added to investor concerns as a protracted trade war between the U.S. and China appeared more likely creating more uncertainty for EU exporters.

Emerging Markets Trailed

Rising interest rates, ongoing trade tensions, the strong U.S. dollar, rising oil prices and weakening global economic growth combined to negatively impact emerging markets again in Q3. The MSCI Emerging Markets Index declined -1.1% for the quarter and -7.7% year-to-date as stocks most reliant upon a continuing global economic expansion underperformed. The Turkish and Greek markets declined double-digits (in USD terms) for the quarter while markets in China and South Africa also performed poorly. The table below notes the best and worst performing markets in Q3 and year-to-date:

Quarter-to-date Best & Worst Country Returns

Top 10	Return	Bottom 10	Return
Thailand	13.6%	Turkey	-20.5%
Qatar	12.8%	Greece	-17.6%
Poland	10.6%	China	-7.5%
USA	7.4%	South Africa	-7.4%
Switzerland	7.3%	Egypt	-6.8%
Sweden	7.0%	Ireland	-5.4%
Mexico	6.9%	Belgium	-5.2%
Norway	6.6%	Pakistan	-4.9%
Taiwan	6.5%	Italy	-4.5%
Russia	6.2%	Colombia	-2.5%

Source: FactSet.

Year-to-date Best & Worst Country Returns

Top 10	Return	Bottom 10	Return
Qatar	19.7%	Turkey	-44.1%
Finland	13.1%	Greece	-24.8%
Norway	11.6%	South Africa	-21.8%
Israel	10.4%	Philippines	-20.7%
USA	10.2%	Indonesia	-17.2%
Colombia	9.2%	Pakistan	-16.0%
Russia	9.1%	Brazil	-12.3%
Taiwan	5.5%	Chile	-12.0%
Thailand	5.2%	Hungary	-11.3%
Czech Republic	4.7%	Belgium	-10.4%

Source: FactSet.

China officially reported 6.7% Q2 GDP growth, slightly lower than Q1's 6.8%, but it is likely that trade related weakness tied to tariffs recently imposed will have a greater impact on growth over the remainder of the year and into 2019 unless some agreement with the U.S. is reached. Weakness in Chinese manufacturing worsened in Q3 with producers of cars, machinery and other products ceasing expansion in September and exports falling to their lowest levels in two years. Output from large state-owned manufacturers continued to weaken as well. While the manufacturing, or older, side of the Chinese economy faces increasing difficulty, the newer service side of its economy continues to generate more attractive growth. The indirect impact of tariffs on the services economy remains less clear. However, we continue to see selective areas where we expect domestically driven secular growth to remain steadier. The Chinese government's ability to reverse course on more restrictive monetary policies and add stimulus to the system through easier credit and increased government spending will likely support growth in the near term, however already high debt levels pose a longer-term threat.

Within the MSCI ACWI, stocks in the Health Care, Technology and Industrials sectors performed best in Q3. Health Care led by a wide margin generating an 10.9% return while Technology and Industrials gained a more modest 6.0% each. Stocks in the Real Estate, Materials, and Utilities sectors provided the weakest returns. Growth led value during the quarter by a small margin, but the end result obscured large variations in relative returns due largely to the strength in Industrials. Larger cap companies outperformed smaller cap companies, in a reversal from Q2. Similar to Q2, the reward to business quality was mixed as investors rewarded companies with earnings, higher returns on equity, higher betas, and higher levels of debt.

Key Performance Drivers

The portfolio underperformed in Q3 due largely to its overweight to and stock selection within Emerging Markets. This was due mainly to poorly performing Chinese stocks which declined on concern over the impact of rising tariffs on future economic growth in China. The portfolio's overweight to and stock selection in non-U.S. Developed Markets contributed positively to relative performance as did stock selection in U.S. markets. Weakness in the Chinese and South African markets was broad and negatively impacted businesses across the quality spectrum. Our longer-term time horizon and deep fundamental research on companies led us to selectively take advantage of the higher level of volatility in emerging markets. This opportunistic approach has traditionally been a source of value added for our portfolios over time.

Stock selection in the Energy, Consumer Staples and Financials sectors detracted from relative performance most. The portfolio's sector weights contributed positively to relative returns due to an overweight to the strongly performing Technology sector and underweight to the lagging Financials and new Communications Services sectors. This was partially offset by the portfolio's underweights in the strongly performing Health Care and Industrials sectors, and overweight in the Consumer Discretionary sector.

Largest Contributors

Computer assisted designed software leader **Autodesk** posted a solid Q2 earnings report and boosted their forecast amid attractive cloud subscriber growth as the company's digital transition gained strength. Its annualized recurring revenues were slightly higher than what the consensus, and we, expected based on higher average revenue per user. While the transition to a software as a service model will result in some added volatility to revenue and earnings growth metrics in the short-term, our expectation is that it will lead to higher quality, more predictable revenue and earnings growth over our 3-5 year investment horizon.

Regeneron posted solid Q2 results showing Eylea growth of 8% in the U.S. and 13% globally. Earnings per share grew by 31%, benefiting from a lower tax rate. The pace of growth at Regeneron has improved with the launch of new drugs, although profit growth has been limited by costs tied to launching the new products and the company's commitment to further developing its stable of new products. Accordingly, sales of its new drug Dupixent, for atopic dermatitis, were strong followed by sales of Praluent for hypercholesterolemia and Kevzara for rheumatoid arthritis. New launches for drugs focused on asthma and cancer are also underway, and we expect them to be on track to move 4-6 new drugs into the clinical phase before the end of 2018. We maintained an average weight position in the stock having added to the position on weakness earlier in the year.

TJX Companies advanced after posting a strong Q2 report with its net sales beating the highest analyst estimate. Same store sales were strong across its business segments, driven mostly by improving traffic and new customers. The company continued to see good inventory flow as it benefited from higher production levels as brands responded to the more optimistic macro environment by producing more. Its e-commerce channel also contributed. Marmaxx saw continued improvement in its average ticket, while international sales were strong as well. Increased freight costs negatively impacted results and will likely continue to be an issue in the second half the year. We continue to see opportunity for TJX as the company continues to expand its store base, gain market share, and improve international sales and maintained an average weight in the portfolio.

The fourth and fifth largest contributors to portfolio performance in Q3 were **Visa** and **Amazon**.

Largest Detractors

A common denominator among the key detractors this quarter was their exposure to China. The Chinese stock market declined -7.5% amid rising trade tensions with the U.S. and fears over how long the impasse would last and its likely effect on the Chinese economy and businesses who derive a significant amount of their sales from exports. Despite near-term uncertainty over trade issues, we continue to see select unique long-term growth opportunities in China which are being painted with a broad brush amid the current fears.

New Oriental Education (EDU) shares were negatively impacted by the general weakness of the Chinese stock market resulting from rising concerns over the likelihood of a trade war between the U.S. and China and the impact it could have on the growth of the Chinese economy and businesses. Further, 15% of EDU's business is catering toward students who take English language tests such as the GRE and GMAT for pursuing a degree in the U.S., therefore further deterioration in the relationship between the two countries could suppress such demand. In addition, concerns over new government regulations aimed at tightening licensing requirements for K-12 tutoring providers to discourage less qualified teachers and banning subject competitions negatively impacted private education stocks in China. News of stricter licensing requirements and a lowering of the burden on Chinese students is not new, and the change in focus appears to us to be a more strict enforcement of existing regulations as opposed to setting tougher requirements for tutorials. We consider concerns related to stricter regulation to be unwarranted and actually helpful to EDU as it accelerates industry consolidation and removes many smaller inferior quality providers.

Likewise, EDU is not involved in subject competitions. One of its main competitors, TAL, is primarily focused on such things and weakness in its stock spread to EDU despite the very different nature of EDU's business. In fact, EDU is not likely to be impacted by a change in subject competition rules, but investors did not differentiate. Accordingly, we purchased additional shares in EDU on weakness.

As in the case of EDU, **Tencent** shares were negatively impacted by the general weakness in the Chinese stock market in Q3. The stock also faced pressure following news that Chinese regulators delayed approval of new games due to a review of content, as well as concerns that the government is growing increasingly concerned regarding the amount of time minors spend playing videogames. Online games account for approximately 47% of the company's revenues. We expect the approvals to be forthcoming in relatively short order, and see the risk of new regulations on games to be limited for Tencent given the longer lifecycle of their existing game franchises and the game time restrictions they already have in place. Our research for the company indicates an attractive long-term growth opportunity remains, driven by increased monetization from advertising which is still in its infancy, the company's ability to emulate Alibaba's Ant unit by offering financial services (such as money market funds, insurance and FinTech) to its extensive user base, and the attractive potential its cloud business offers. We expect robust top-line and incremental margin growth and see greater monetization and harvesting of recent company investments driving results in 2019. We purchased additional shares on weakness, after having trimmed our position in the stock earlier in the year.

Ctrip.com reported a better than expected quarter amid fears over reduced outbound travel from China due to currency impacts and trade tensions, as well as increased competition from (Alibaba's) Fliggy unit and Meituan (which recently became public). Travel volumes remained healthy with attractive hotel, airline ticketing and packaged tour revenue growth. Customer-centric initiatives put in place by management (i.e. refunding travel expenses in cases where visa applications had been denied and an expanded hotel rewards loyalty program) are expected to differentiate the company from more purely transactional travel platforms and lead to stronger customer retention and loyalty. Management guidance was stronger than expected with margins expected to improve and easier comparable sales now that it has been a year since the government mandated changes to the bundling of insurance and other value-added services to air tickets. We remain cautious on the Chinese macro-economic backdrop given trade issues and regional slowing, as well as due to increasing competition to Ctrip from Alibaba and others. Given significant opportunity to further penetrate lower tier cities, continued improvement in domestic and outbound travel infrastructure (such as high-speed rail and more flights), growing numbers of travelers with higher disposable incomes and travel visas, we see Ctrip being able to build on its strong reputation and economics. We maintained a below average weight in the stock.

The fourth and fifth largest detractors from portfolio performance were **Amorepacific** and **Schlumberger**.

Portfolio Activity

Turnover in the portfolio was slightly below our long-term average, with the sale of beauty retailer Ulta Beauty and the purchases of Chinese e-commerce leader Alibaba and Swiss food and drink company Nestle. In addition to these sales and purchases, several other positions were trimmed or added to during the quarter. Specifically, positions in Autodesk, Fast Retailing, Infosys, MercadoLibre and TJX Companies were trimmed on strength while shares in HDFC Bank, Ctrip, New Oriental Education, Shoprite and Tencent were purchased on weakness.

Sales

Ulta Beauty was sold in order to reallocate client capital invested in the company to a higher confidence opportunity after the stock's valuation became less attractive relative to other companies on our qualified company list.

Purchases

We reinitiated a less than average weight position in **Alibaba** on weakness tied to concern over escalating trade tensions and the potential for further slowing in Chinese economic growth. In addition to e-commerce, Alibaba is a leader in cloud computing, internet infrastructure, and online financial products and payments. The company stands to benefit from the tremendous breadth of its unified user data set given the dominance of its e-commerce platforms and significant stakes and affiliations with major parts of the Chinese internet ecosystem via online video (Youku), social media (Weibo) and payments (Ant). China's strict internet controls and the company's existing cloud infrastructure leadership position provide key advantages to Alibaba, and serve as a barrier to other domestic and foreign cloud competitors. While top line revenue growth continues to grow impressively and the key Chinese commerce segment of the business grew 47% according to its most recent report, profits grew about 13% due to spending for ongoing innovation, product development and marketing. Similar to Amazon in many respects, our research points to attractive long-term revenue and profit growth but we are cognizant that the company will continue to invest heavily limiting profit growth in the short-term as it works to enhance the breadth and depth of its "New Retail", cloud and payments offerings. We see these investments deepening Alibaba's relationships with merchants and promoting the ubiquity of its services, giving it a major advantage over primarily online focused e-commerce players. We expect to continue to build the position opportunistically moving forward.

We reinitiated a position in **Nestle** given changes in management and positive restructuring steps which we expect to improve the long-term earnings and cash flow growth of the company over our 3-5 year investment horizon. CEO Mark Schneider moved into his position in late 2016 and took steps to enhance the operating performance of Nestle, replacing leaders of underperforming businesses, cutting headcount where needed and consolidating cost centers. With improvements in operating profit margins already occurring and enhanced revenue growth expected by 2020, our research points to a gradual transformation taking place at Nestle which could allow the company to generate double-digit earnings and cash flow growth. While about 5% of the company's slower growing revenues have been replaced with more strategically consistent and faster growing businesses, much work remains as they take steps to optimize their business mix. Acquisitions such as the recent Starbucks packaged food purchase offer additional incremental growth. Global leadership positions in pet care, nutrition and bottled water, which comprise about 80% of profits, provide a strong mid-single-digit growth base as they cull slower growth, poorer fitting business units. With the stock underperforming by a wide margin in 2017 and early 2018, Nestle offered a cash yield of 5% plus a dividend yield of 3%. Accordingly, we took advantage of the underperformance and attractive valuation given the positive changes occurring at the company, and leveraged our longer time horizon to initiate an underweight position. We expect to build the position opportunistically moving forward.

Among the key risks we will be focused on are the ability of CEO Mark Schneider to continue to affect positive change in Nestle's established company culture. Continued steps toward rationalizing underperforming businesses and replacing them with higher growth opportunities which build on Nestle's core operating strengths will be important. With a diverse multi-product, international business such as Nestle, currency and commodity cost fluctuations will affect short-term results and need to be evaluated in a longer-term context.

Outlook

Much of the strength in the U.S. and weakness in European and Emerging Markets this quarter was macro driven, with the U.S. appearing, at least for now, to be positioned well for continued solid economic growth, Europe struggling with myriad political headwinds and the emerging markets seen as the losers in a prolonged U.S. – Chinese trade war. While broad geo-political and macro-economic forces dominated the headlines in Q3, our emphasis remains on deep, long-term focused bottom-up company research. If we identify high quality sustainable growth businesses with strong pricing power, truly recurring revenue streams and long-term growth runways, and buy them opportunistically, our portfolios should, if history is any precedent, provide the long-term capital appreciation our clients expect, regardless of the short-term swings in sentiment and macro fluctuations. Such broad trends often paint swaths of companies the same regardless of their underlying fundamental characteristics or long-term growth opportunities. The downward price pressure seen across emerging markets this year provides us with the chance to leverage our deep research and longer time horizon to invest in attractive long-term secular growers at attractive prices. Historically, stocks we have been able to purchase under such circumstances have often ended up being amongst the better contributors to portfolio returns over time. We are confident that our opportunistic approach to building concentrated portfolios of the highest quality long-term growth businesses we can find, is the best approach to building less volatile growth streams and attractive absolute and relative returns over time.

Today, the portfolio is forecast to generate 19.6% earnings growth over the coming three years versus 11.4% for the ACWI, with significantly higher cash flow generation, better profitability, less debt, and a more attractive cash flow-based valuation. While high momentum stocks, such as the FAANG's and BAT's, have driven market performance over the last few years, our approach has continued to take profits in those more expensive holdings we owned and reallocate the capital to other more attractively priced high growth opportunities. The diversity of our secular growth businesses coupled with their superior business quality and attractive valuations makes us highly confident in the portfolio's outlook and we look forward to speaking with you in more detail about it.

Thank you for your continued confidence in our team and approach.
