SGA
Sustainable Growth Advisers

Q2 2018 Global Growth Commentary

Highlights

- *SGA's Global Growth portfolio returned 3.4% (gross) and 3.1% (net) in Q2 2018 compared to 0.5% for its primary benchmark the MSCI All Country World Index (ACWI), and 2.3% for the ACWI Growth Index; On the year-to-date the portfolio has returned 6.6% (gross) and 6.1% (net) compared to -0.4% for the MSCI ACWI and 3.0% for the MSCI ACWI Growth Index*

- *Higher U.S. interest rates and significant repatriation of funds by corporations due to tax law changes continued to push the U.S. dollar higher and emerging market currencies fell; volatility subsided in May and early June before rebounding late in the quarter; we continue to expect increases in market volatility over the course of 2018-19*

- *U.S. markets outperformed most developed and emerging markets despite Q1 U.S. GDP growth being revised downward; China's Shanghai Index plunged over prospects of a trade war with the U.S.; European economic growth showed signs of decelerating while nationalists assumed power in Italy and markets particularly in Europe and Latin America faced selling pressure*

- *As in Q1, smaller-cap growth companies performed best; the return to business quality was mixed and varied significantly over the course of the quarter; higher beta low return on equity companies and those with no earnings performed best, but those with low debt also outperformed*

- *The Energy, Technology and Consumer Discretionary sectors performed best with Energy leading by a wide margin as oil prices rose on potential supply concerns; Financials, Telecommunications, Industrials and Consumer Staples all generated negative returns*

- *The portfolio's position in Core Labs was sold with the proceeds in part going to fund an increase to the target weight in the portfolio's other investment in the oil services industry, Schlumberger; other positions were trimmed or added to consistent with our valuation discipline and focus on reallocating capital from strongly performing stocks to those with more attractive 3-5 year opportunities*

Performance

SGA's Global Growth portfolio returned 3.4% (gross) and 3.1% (net) in the second quarter of 2018 while its benchmark, the MSCI ACWI, returned 0.5%, and the ACWI Growth Index returned 2.3%. On a year-to-date basis, the portfolio has returned 6.6% (gross) and 6.1% (net) compared to -0.4% for the MSCI ACWI and 3.0% for the MSCI ACWI Growth Index, in line with how it has performed in previous periods where there has been more volatility like in 2011 and 2015.

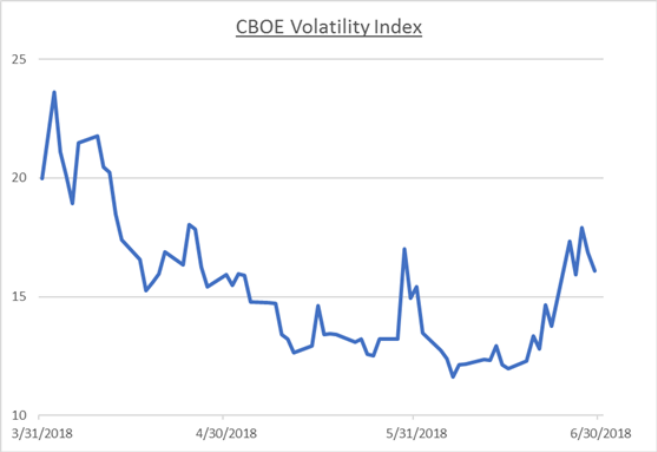
The portfolio's Q2 relative performance was influenced by two key factors:

1. Volatility in the U.S. market declined from Q1 highs before rebounding late in the quarter

2. U.S. dollar strength boosted U.S. markets at the expense of emerging markets and Europe

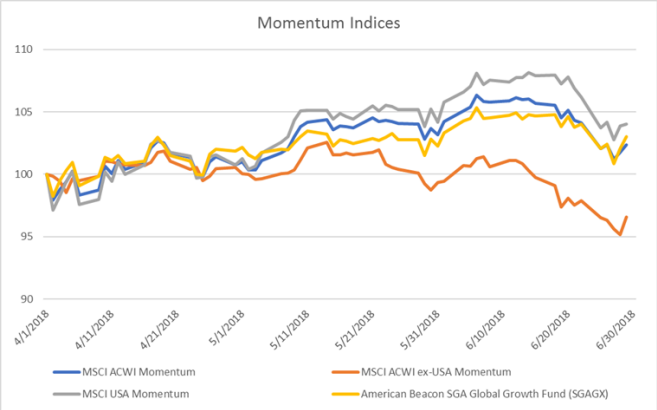
U.S. Market Volatility Declined from Q1 Highs

Following an 81% rise in the U.S. CBOE Volatility (VIX) Index off historical lows in the second half of Q1, volatility declined by over 50% from April highs through early June as investors judged the likelihood of a NAFTA deal and agreement between the U.S. and Chinese to be higher. However, volatility again picked up in late June on renewed market weakness tied to concerns over trade policy and the likelihood of further trade actions against China. Investors largely ignored rising interest rates as concerns of an overheating economy declined with Q1 U.S. GDP growth being revised down to 2.0%, its weakest reading in a year. Signs of more benign core inflation added to speculation over whether the Federal Reserve would limit its interest rate hikes to three during 2018. However, with later reports showing core inflation hitting the Fed's long elusive 2% target, along with the G-7 Summit ending in disarray, expectations for a NAFTA agreement declining and the application of $50 billion of trade tariffs on Chinese products, and the threat of $200 billion more, investors again became increasingly uneasy later in the quarter.



Source: FactSet.

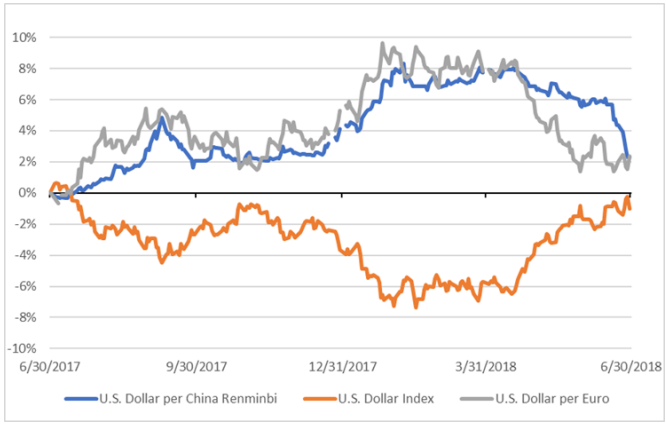
High momentum stocks led the U.S. market for most of Q2 before coming under pressure later in the quarter. Momentum played less of a role in non-U.S. markets. The continued strong performance of high price momentum stocks, particularly the FAANG's in the Technology and Consumer Discretionary sectors, remained a headwind for our process (as in Q4 and Q1) for much of the quarter before becoming less onerous in June. Our adherence to our valuation discipline and our decisions to continue reallocating capital to more attractively valued growth opportunities impacted short-term results to some degree. We have seen this effect in other high momentum periods such as 1999, 2007 and 2013 and are confident in the long-term benefit of taking a contrary position relative to the market when our research shows strong long-term opportunity despite short-term headwinds.



Source: FactSet, MSCI. SGAGX is the Institutional share class of the American Beacon SGA Global Growth Fund for which SGA serves as sole sub-advisor.

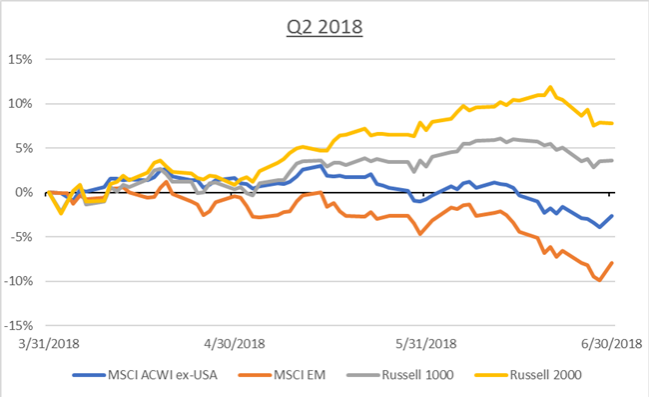
Rising U.S. Dollar and Trade Tensions Negatively Impacted Emerging Markets

The U.S. dollar appreciated back to levels last seen in 2017 on continued strength in the U.S. economy, higher interest rates and strong demand for the currency as corporations began to repatriate some of the $3.5 trillion in profits estimated to be held overseas.



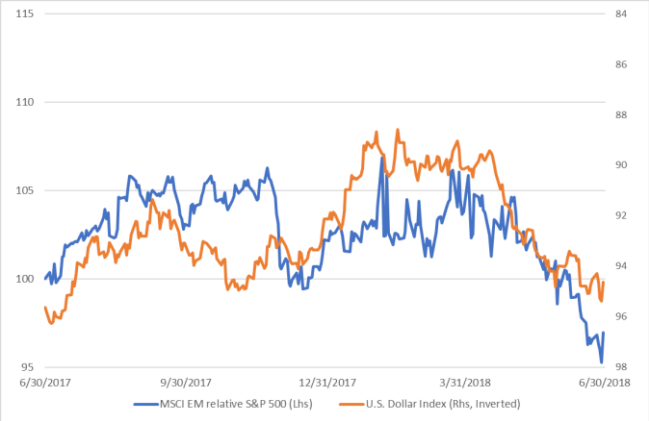
Source: FactSet.

U.S. markets outperformed non-U.S. markets, both developed and emerging. The strong dollar, rising trade tensions, signs of weaker growth in Europe and currency weakness in emerging markets led investors to seek the perceived safety of the U.S. market where they rewarded smaller cap businesses with less international sales and currency exposure. China's Shanghai Composite Index fell 14.7% during the quarter on rising fears over the impact of a trade war with the U.S., as Chinese authorities took steps to loosen monetary policy to stem losses. This weakness negatively impacted returns in other regions where any material weakening in China's growth would have an effect. South Africa's economy reported its worst quarterly GDP figures in nearly a decade as the economy shrank by 2.2% in Q1, amid broad-based weakness across its economy which pressured South African equities. In Brazil (-26.4%) and Turkey (-25.9%), the two worst performing emerging markets in Q2, stocks weakened on slowing economic growth and rising political concerns. In Brazil, an economic recovery that appeared to be occurring in Q4, 2017 lost traction as uncertainty over the results of the country's presidential election in October arose and as GDP growth for Q1 slid. The country's industrial production plunged in May, dropping at the fastest pace since December of 2008. Turkey's market experienced weakness on further signs of faltering economic growth and increased political concerns as President Erdogan extended his 15-year reign in a highly controversial election.



Source: FactSet, MSCI, Russell.

The chart below illustrates the close relationship between movements in the dollar and emerging markets relative performance over the past year.



Source: FactSet, MSCI.

Key Performance Drivers

The portfolio's overweight in Emerging Markets detracted from returns as they trailed U.S. and non-U.S. Developed Markets, but stock selection within the Emerging Markets and non-U.S. Developed Markets contributed very positively. Smaller sectors within the ACWI Index performed best during the quarter with Energy (+10.2%) providing the highest return. The Technology (+3.9%), Consumer Discretionary (+3.0%), and Health Care (+2.5%) sectors performed next best, while the Financials (-5.6%), Telecommunications (-4.2%), Industrials (-2.7%) and Consumer Staples (-1.3%) performed the worst generating negative returns. Sector weightings and stock selection both contributed positively to relative returns as the portfolio benefited from its overweights in the Technology and Consumer Discretionary sectors and its underweights in the weakly performing Financials and Industrials sectors. Stock selection in the Consumer Discretionary sector accounted for most of the strength due to positions in Nike, TJX and Fast Retailing while selection in Financials benefited most from its position in Indian bank HDFC. Stock selection in Consumer Staples and Health Care detracted most due mainly to positions in South African based retailer Shoprite and global diabetes treatment leader Novo Nordisk. The reward to business quality during the quarter was mixed, with smaller cap companies with low ROE's, low debt, no earnings and high betas being rewarded most.

Largest Contributors

Amazon reported an impressive first quarter with AWS revenue growth accelerating to 49% and revenues from advertising growing 75% on a normalized basis. In response to questions about the United States Postal Service, the company highlighted its progress with Amazon Logistics, which in some countries accounts for as much as 50% of fulfillment. Our research continues to indicate a strong growth opportunity for the company, however we remain cognizant of recent stock price appreciation and an above-average cash-flow based valuation. Hence, we trimmed the position during the quarter.

Nike's shares rose to a record high after the company reported sales which exceeded most analysts' estimates and noted a return of growth (albeit modest at this point) in the U.S. market which had slowed in recent quarters due to difficult conditions for many retailers and excess inventories which needed to be worked off. Strong international sales, particularly in China, as well as attractive digital sales and successful new product launches buoyed results. The company's new strategy of selling more directly to consumers (and thereby improving gross margins) and use of online wholesale partners such as Zalando, Asos, Tencent and Amazon benefited results as did their greater focus on women's footwear and apparel. We continue to see attractive opportunities for Nike as it continues to build its direct to consumer sales and capitalize on the trend toward more athletic-leisurewear in the Emerging Markets. We trimmed the position on strength during the quarter and held an average weight position at quarter end.

Off-price retailer **TJX Companies** reported Q1 sales that beat the highest analyst estimates as well as our own. Comparable store sales guidance was in line with expectations, while margins remained steady at about 29%. The company continues to benefit from attractive inventory situations from vendors who have overproduced due to excessive optimism, as well as the proliferation of e-commerce brands who often misgauge demand creating additional inventory for TJX. The company also continues to take advantage of real estate

opportunities resulting from the weakness of traditional retailers, adding attractive new locations as they come up. Increased wage costs in Canada and some U.S. states, and higher freight costs pose headwinds, but the company continues to work toward improving its efficiency, including moving its IT from legacy to outsourced and cloud solutions to offset cost headwinds. TJX has also been investing in capex to improve its supply chain and distribution system for HomeGoods. We expect these short-term expenses to enhance the company's competitive position over the long-term and contribute to future growth. We continued to maintain an average weight position.

The fourth and fifth largest contributors to portfolio performance were **Salesforce.com** and **Visa**.

Largest Detractors

South African equities underperformed materially during the quarter due to three identifiable reasons. The South African Rand depreciated significantly, negatively impacting returns measured in U.S. dollars. In addition, poor sentiment across emerging markets resulted in weakness across the space. Leading up to this, South African equities had materially outperformed in reaction to the election of the new president in Q4, 2017 and hopes for political stability and economic reforms. With the weakness in Q2, South African equities retrenched, giving back some of what they had gained earlier in the year. Given the election driven strength in Q1, we had trimmed our South African related positions.

South African retailer **Shoprite** was the largest detractor from portfolio performance. The company's business in South Africa continues to gain market share and do well operationally but, due to deflation in over 6200 product lines, revenue growth does not have the benefit of inflation it has had previously. The Shoprite story for SGA, however, has always been about its ability to grow outside the mature South African market. While business conditions in many markets outside South Africa remain challenging, they are making progress in Angola, Zambia and Kenya, and they continue to look at other opportunities in Africa to expand. Given the company's strong distribution capabilities and scale, it has been able to maintain attractive operating margins despite the weakness, and its multi-store format which serves customers across all income segments, continues to generate attractive repeat traffic, ensuring strong recurring revenues. We view the current deflationary issue as being short-term in nature and remain positive on Shoprite's growth opportunity in sub-Saharan Africa and expect it to be able to double its revenues in Africa over our 3-5 year time horizon.

South African financial services conglomerate **Sanlam** was the second largest detractor from performance this quarter. Slower economic growth in the South African market and concern on the part of the market over the third and final phase of the company's acquisition of Saham Finances (a Morocco-based insurer) negatively affected the stock. Saham provides Sanlam with an attractive footprint in the sub-Saharan Africa market which has attractive long-term growth potential and little penetration at the moment. The equity raise to fund the purchase dilutes the shareholders, but it does meet their hurdle rate requirements. They expect to build a life insurance presence in Saham's markets leveraging Sanlam's expertise in the area while also building Specialist and Reinsurance businesses. We expect gradual improvement in the South African macro-economic situation as reforms are instituted, but our thesis is not dependent upon material improvement as Sanlam is well positioned to succeed despite ongoing volatility in the country and region's economic growth. We maintained a below average weight in the stock, but bought it back to its target on weakness.

MercadoLibre's stock declined during the quarter after its Q1 results missed optimistic analyst estimates due largely to a hike in its shipping costs in Brazil and the perceived headwind that presents to the company's margin structure as it offers free shipping across its markets. The rising U.S. dollar and decline in the Brazilian real negatively impacted it and other emerging market currencies. Concerns about weakening macro-economic environments in Brazil and Argentina also contributed as MercadoLibre generates a majority of its sales from Brazil and is sensitive to fluctuations in its currency and market. We remain positive on MercadoLibre's long-term growth opportunity and see the recent price drop as an opportunity given the company's moves over the last few years to reduce its dependence upon the Brazilian post service (Correios) and enhance its own delivery logistics. As the company faces increased competition from B2W and others, we expect a greater tradeoff between profitability and growth, but see the company as being attractively positioned to capitalize on the region's continued move toward greater e-commerce penetration given its first mover advantage, and improving fulfillment and logistics capabilities. Opportunities to build its Financial Technology offerings to better serve its MercadoPago user base through rapidly scalable, highly profitable but less costly merchant financing and payment processing offer another attractive growth avenue over our 3-5 year time horizon. After trimming the position on strength earlier in the year, we took advantage of the weakness during the quarter to buy additional shares.

The fourth and fifth largest detractors from portfolio performance during the quarter were **Red Hat** and **Yum! Brands**.

Portfolio Activity

Turnover in the portfolio was below our long-term average, with the sale of specialty oil service provider Core Labs being the sole full liquidation. In addition to this, positions in AIA, Amazon, Nike, Red Hat, Salesforce.com, and Ulta Beauty were trimmed on strength while additional shares in Equinix, MercadoLibre, Red Hat, Schlumberger and Sanlam were purchased on weakness.

Sales

We sold our position in specialty oil field services provider **Core Labs** as it rallied, and consolidated our position in the energy sector by adding to larger global oil services leader Schlumberger, which we expect to benefit more as international capital expenditures increase with rising exploration and drilling. Core Labs reported strong Q1 results as their business benefited from improved operating leverage, rising margins and attractive gains in free cash flow generation. Strength at Core Lab's Production Enhancement business boosted results. North American well completions continued to grow quickly as Core Labs helped customers get more from their existing wells. We continue to expect the company to capitalize on its growing strength in the North American market, but believe Schlumberger offers better long-term risk/reward at these price levels due to of its greater exposure to increased international oilfield capex investment.

Outlook

Over the last year the portfolio has continued to perform well, and its long-term record continues to be very strong. While our clients are pleased with the performance, every now and then we get the question: "Can the portfolio continue to outperform as strongly?" While we have a lot of confidence in the companies we own and in our positioning, we, of course, can't answer the question with absolute certainty because there are so many factors that come into play in determining how the portfolio will perform over a period of years. As the regulators require all investment managers to include with their performance: past performance is not a guarantee of future performance. Within the context of that caution, however, we firmly believe that the portfolio is positioned to perform very well as the market transitions from the low volatility, high correlation type environment of the post financial crisis period where sub-par companies have been bailed out by cheap borrowing and many investors have become complacent in their benchmark hugging or passive strategies.

By its nature, this portfolio is built stock-by-stock based solely on the bottom-up opportunities our research process identifies. While our key focus is always on the business quality and growth opportunity a company possesses, the third consideration of weighing the value of the growth streams relative to other candidates we could own from our Qualified Company List is critical. As such, we continuously upgrade the portfolio by taking advantage of valuation opportunities in great businesses. While growth as a broad factor has led the markets over the past several years, given the slow GDP growth over much of the post Great Financial Crisis period, returns have been concentrated in pockets of high growth such as Technology and Consumer Discretionary stocks, particularly in recent years. Our ongoing focus on valuation and the resulting reallocation of capital from less attractive high momentum stocks to businesses with more attractively valued 3-5 year opportunities has driven the positioning of the portfolio since its inception and continues to guide it today. Accordingly, the portfolio continues to offer an attractive 3.2% enterprise yield, while forecasting 13.2% revenue growth and 19.6% earnings growth over the next three years; well above that of the ACWI, while invested in businesses with superior quality characteristics. Given our view that earnings and cash flow growth ultimately drive stock prices, we remain confident that superior levels of each should be increasingly rewarded as less accommodative monetary policies around the world encourage investors to differentiate more between truly successful businesses and those that have been buoyed by liquidity provided by global central banks that are now retracting these highly accommodative policies. Finally, as volatility increases with rising interest rates, trade tensions and an aging bull market, if history is any precedent, this should further benefit our approach. We are very excited by the portfolio's prospects looking forward given the changes occurring in the world today, and continue to consider it an attractive time to be investing in the type of businesses that satisfy our required quality and growth characteristics.

We thank you for your confidence in our team and look forward to speaking with you about the businesses we own and the positioning of the portfolio.

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recommendation to buy, sell or hold securities. This commentary is provided only for qualified and sophisticated institutional investors.

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, 0.90%, employing the Global 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. Upon request, free of charge, SGA can provide a list of all portfolio holdings held in SGA's Global Growth portfolio for the year. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. SGA's earnings growth forecast data is based upon portfolio companies' Non-GAAP operating earnings.