SGA
Sustainable Growth Advisers

Q1 2018 Global Growth Commentary

Highlights

- *SGA's Global Growth portfolio returned 3.1% (gross) and 2.9% (net) in Q1 2018 compared to -1.0% for its primary benchmark the MSCI All-Country World Index (ACWI) and 0.7% for the MSCI ACWI Growth Index*

- *Rising inflationary expectations and interest rates together with concerns over U.S. trade policy and the potential for a trade war with China led to a spike in market volatility off historic lows*

- *Smaller-cap growth companies with higher betas performed best; the reward to business quality was generally supportive with higher return on equity companies and those with earnings outperforming*

- *Technology and Consumer Discretionary sectors performed best while Telecom, Consumer Staples and Energy performed the worst*

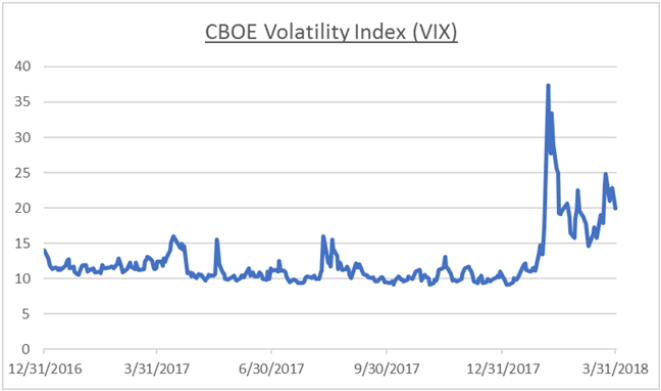
- *Turnover was average with positions in Nielsen and Lowe's being sold to fund new positions in Praxair and Yum! Brands; weights in MercadoLibre, Tencent, and Fast Retailing among others were reduced on strength and positions in Regeneron, TJX and HDFC Bank among others were added to on weakness*

Performance

SGA's Global Growth portfolio returned 3.1% (gross) and 2.9% (net) in the first quarter of 2018 while its benchmark, the MSCI ACWI, returned -1.0% and the MSCI ACWI Growth Index returned 0.7%. Technology continued to lead global markets by a wide margin for most of the quarter, while Consumer Discretionary stocks also performed strongly due largely to significant appreciation in Amazon and Netflix. In contrast, Telecom, Consumer Staples and Energy stocks performed the worst as the market penalized higher dividend paying "bond proxies" as inflationary expectations rekindled and interest rates rose. Like in 2017, stocks with the strongest price momentum led the market's performance in Q1 as the MSCI ACWI Momentum Index returned 2.4%. Emerging markets outperformed U.S. equities given their greater leverage to improved global economic growth. Non-U.S. developed market returns were dragged down by weakness in European equities.

Strong Global Economic and Corporate Profit Growth

Strong corporate earnings growth continued to drive the stock rally in Q1 as analysts boosted their forecasts for earnings growth for the ACWI for the full year up to about 14% versus 11% at the beginning of the year. U.S. GDP growth increased to +2.3% in 2017 from +1.5% in 2016 while GDP growth for the European Union came in at +2.5% versus +1.8% in 2016. Japan recorded its 8th straight quarter of growth, the longest run in improving economic growth since 1989. China's economy grew 6.8% in Q4 and 6.9% in 2017, beating expectations. While growth in traditional heavy industries continued to ebb, other parts of China's new economy focused on services and technology showed strength.



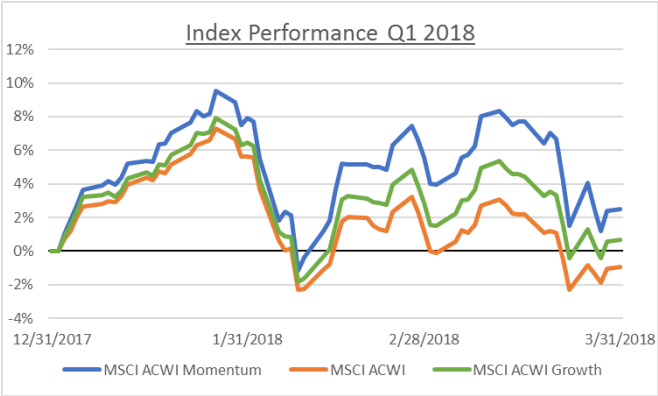
Source: FactSet.

Market Volatility Increased

Following an extended period of very low levels of volatility, the VIX nearly doubled in the quarter from historic lows and experienced the largest one-day percentage increase in its history when the index jumped 116% on February 5th to close at 37.3. (The level remains low compared to the index' all-time high of 80.9 reached in November of 2008.) Global markets experienced their first major drop since the beginning of 2016 when the possibility of a global recession was a major concern; the ACWI dropped 9.0% from its high on January 26th, before recouping some of its losses as investors again refocused on improving earnings. While the Index experienced only 3 daily moves of 1% or more in all of 2017, it experienced 14 such days in Q1 alone. We view the increase in volatility positively, as historically our investment approach has benefited in such periods when we have been able to take advantage of shorter-term market overreactions, buying high quality growth businesses that are temporarily priced more attractively.

Beyond interest rates, growing concerns over trade, including the future of NAFTA, new trade tariffs on steel and aluminum imports, and broader tariffs aimed at China contributed to the rise in market volatility. Pressure on U.S. Technology shares later in the quarter as companies such as Facebook and Amazon faced the potential for greater regulatory oversight

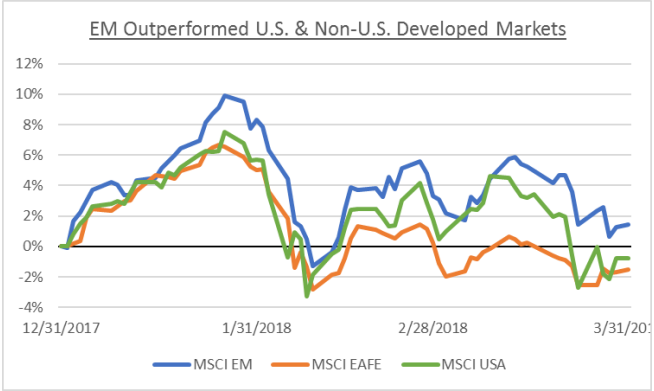
caused additional uncertainty. A cooling of tensions on the Korean peninsula and continued strong global economic growth mitigated these fears to a degree. European shares were negatively impacted by difficult Brexit negotiations, the formation of a weak coalition government in Germany and populist favoring election results in Italy, Europe's 4th largest economy, which renewed concerns over the future viability of the Eurozone.



Source: FactSet.

Momentum Stocks Outperformed

Like Q4 and indeed all of 2017, stocks with the strongest price momentum led the market's performance in Q1 as the MSCI ACWI Momentum Index benefited from continued strength in Technology stocks, considered by many to be the main growth engine of global markets. However, U.S. FAANG stocks came under pressure later in the quarter after Facebook encountered scrutiny over their user data privacy policies and Amazon's tax status was questioned, raising concerns that regulatory intervention in their and other technology related businesses may increase. Our decision to reduce our weightings in higher price momentum stocks including Tencent, Red Hat, and others, and not to own higher valuation technology stocks that do not satisfy our fundamental criteria such as Netflix, Tesla, and NVIDIA that had previously driven strong index performance benefited the portfolio's relative performance significantly later in the quarter.



Source: FactSet.

Key Performance Drivers

Emerging markets performed best in the quarter as Brazil, Egypt, Peru and Russia provided the strongest returns in the ACWI Index. The U.S. market outperformed non-U.S. developed markets due largely to weakness in European shares. Within the ACWI, market leadership was narrow with only the Technology and Consumer Discretionary sectors outperforming and providing positive returns. Health Care generated a negative return but also performed roughly in line with the Index. The Telecom, Consumer Staples and Energy sectors performed worst as investors penalized higher dividend yields. Market factors were generally supportive of our process with the reward to business quality positive for the most part. However, the strong performance of small caps and price momentum stocks, particularly in the U.S., presented a headwind for much of the quarter (as it did in Q4 2017) as we continued to reallocate capital to more attractively valued growth opportunities.

Stock selection was the primary driver of the portfolio's outperformance, while sector allocations also contributed positively. Selection in the Technology, Consumer Staples and Consumer Discretionary sectors was strongest, benefiting most from positions in open source software provider Red Hat, e-commerce and web services leader Amazon, and South African retailer Shoprite. We continued to manage our position size in Amazon, trimmed our position in Shoprite back on strength and used weakness in Autodesk in the fourth quarter to rebuild the position based on our positive long-term outlook for the stock. Stock selection in the Health Care sector was the main detractor from performance due to weakness in biopharmaceutical Regeneron and pharmaceutical Novo Nordisk. The portfolio's overweights in the strongly performing Technology and Consumer Discretionary sectors also contributed positively to the portfolio's outperformance.

Largest Contributors

Leading open source software solutions provider **Red Hat** reported attractive revenue growth in Q4, up 23% year-over-year as subscription revenue for the quarter grew 22% and billings growth rose 25%. The company raised its Q1 and FY 2019 guidance more than expectations. The company's backlog grew to a record $2.7 billion, up 28% from year earlier levels. It is clear companies have become increasingly more comfortable with the benefits of Red Hat's hybrid cloud infrastructure and other open source software technologies. Subscription revenues comprised 89% of total revenues. We remain encouraged by the increasing interest being shown in the company's Open Shift technology platform which allows developers to easily build apps that can run on any infrastructure, whether on a private cloud or any of the public clouds, that use OpenShift. With it, continued vibrant growth in its hybrid cloud model, continued growth in OpenStack and improving operating leverage as the company digests recent acquisitions, we expect Red Hat to generate high-teens revenue growth and approximately 20% earnings growth over the next three years while generating increasingly attractive levels of free cash flow. Given the stock's recent strength and the expectation for fluctuations in short-term billings growth over the coming year we have trimmed its weight back to an average size position.

Amazon reported another strong quarter with its Web Services business sales growing 45% year-over-year (slightly better than in Q3) as margins improved and advertising growth continued to improve. The company's retail segment reported strong results, in line with aggressive expectations in the market. Overall, company sales increased 38% in Q4. Our research continues to support holding an above-average position in Amazon given its dominant position in the evolving Web Services business, its highly disruptive strategy across many facets of retailing and the tremendous range of opportunities for its businesses across the globe. While we have high expectations for Amazon, we continue to be cognizant of the fact that it encompasses rapidly growing businesses with a need for investment, and a management team that, to their credit, focuses on the long-term opportunity, which isn't always consistent with the short-term focus of Wall Street expectations. Accordingly, we continue to manage our position in the stock taking advantage of shorter-term volatility to adjust our position.

South African retailer **Shoprite** was the third largest contributor to portfolio performance. Shoprite continued to benefit from its strong distribution capabilities and scale. In a tough economic and low inflationary environment, the company delivered extraordinary results, gaining market share while maintaining margins in South Africa. With greater political certainty in South Africa following the election of Cyril Ramaphosa to lead the ruling African National Congress (ANC) in the upcoming presidential election, the Rand appreciated and investors took a somewhat more positive view of the country's economic opportunities. We trimmed our exposure to the stock on strength during the quarter given its valuation and maintained a smaller than average weight.

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

Largest Detractors

Australian accounting software provider **MYOB** was the largest detractor from performance after it reported revenue growth of 12% year-over-year with recurring revenues up 13%. Earnings grew approximately 11% as the number of small-mid size enterprises (SME's) using MYOB's accounting software rose 6% to 618,000 subscribers. Consistent with the company's business plan, approximately 94% of new customers coming to MYOB took an online subscription. Of concern to the market, however, was new evidence of a change which has been occurring over the last six months whereby Intuit has transformed MYOB's market from a rational duopoly (with Xero) to one where a new entrant is aggressively marketing low priced subscriptions forcing MYOB to respond in kind with new price investments and increasing marketing expenses. In conjunction with this, the company reiterated plans to continue to invest in upgrades to its product for the accountancy channel which plays an increasingly influential role in product adoption by businesses in the small to medium size market where MYOB is focused.

Our thesis for MYOB continues to be based on the company's ability to convert non-paying desktop users of its systems to paying cloud subscribers. This transition should be aided by their competitive strength in the important accountancy channel and the high switching costs which customers face in moving from one software provider to another. Given the increasing costs it now faces related to more intense competition and the likelihood of continued meaningful capital investments by the company, we maintained a below-average weight in the stock during the quarter and are actively evaluating its long-term growth opportunity relative to other stocks on the Qualified Company List.

Enterprise application software leader **SAP** was the second largest detractor from performance in Q1 after the company's stock price was negatively impacted by currency issues in its

quarterly report and relative weakness in European shares during the quarter. The company continues to execute well on its transition from the sale of on-premise licenses to cloud subscription products with license sales growing in the mid-single digits and cloud sales growing at around 30% per year. With capex expenses leveling off in 2018 and declining in 2019 and beyond, good traction in the company's transition to more predictable cloud subscription-based business, improved macroeconomic conditions in some of its important markets (Russia and Brazil), and improving cash flow available to shareholders (CFATS) we continue to view SAP's opportunity positively although it remains one of the portfolio's more moderate growers. We added to the position on weakness during the quarter and maintained an above-average target weight.

Similar to last quarter, biopharmaceutical **Regeneron** reported solid results, which beat analyst estimates, however the stock underperformed as concerns persisted over competition to their key product Eylea. The company guided to continued major investments in new product research and development and product launches. Earnings per share grew 72% while revenues rose 29% during the period with Eylea sales in the U.S. growing 11%, and sales of Dupixent, the company's treatment for atopic dermatitis, showing good strength on its launch. Additionally, early in March, the company announced that its hypocholesteremia drug Praluent cut the risk of cardiovascular death in a high-risk patient population in a long-term trial, setting the stage for improved growth for the drug. While we acknowledge the likelihood that Eylea, which treats patients with different forms of elderly eye diseases, will face increased competition, we remain confident based on indications from the likely competing drugs, that it will remain a front-line therapy for patients, and that the reduction in sales will be manageable given Regeneron's evolving pipeline of new drugs. Accordingly, we used weakness in the stock price to buy shares and maintain our position size.

The fourth and fifth largest detractors from portfolio performance during the quarter were **Novo Nordisk** and **Equinix**.

Portfolio Activity

Turnover in the portfolio was in line with our long-term average during the quarter, with sales of media measurement provider Nielsen and home improvement retailer Lowe's helping to fund new positions in specialty gas provider Praxair and restaurant franchiser Yum! Brands. In addition to these changes, positions in MercadoLibre, Tencent, Fast Retailing, Shoprite and Salesforce.com, were trimmed on strength and positions in HDFC Bank, Regeneron and TJX, where our research continues to show attractive 3-5 year opportunities, were added to on weakness.

Sales

It became increasingly clear to us that media measurement firm **Nielsen's** Buy segment, which measures consumer purchase and market share data primarily for consumer-packaged goods companies spanning over 104 countries, was going to continue to face stiff headwinds as consumer goods companies continued to experience generally weak pricing power. Also, the company's pending transition to its new Connected Buy system involves significant execution risks for our thesis which were underestimated. The stock continues to be on our Qualified Company List as we believe Nielsen is likely to remain the leader in the evolving Watch business with its alternative digital viewing platform, however we sold the stock in Q1 in order to reallocate the capital to other higher confidence opportunities which we expect to offer better earnings growth and returns over our 3-5 year time horizon.

Home improvement retailer **Lowe's** was removed from the portfolio to make room for more attractive growth opportunities. We purchased the stock in the portfolio in 2013 after our research indicated significant room for the company to improve its execution in several different areas relative to Home Depot and significantly accelerate earnings and cash flow growth, supported by continued improvement in the (then) still depressed housing cycle and positive demographic trends. The stock performed well over our holding period and still looks relatively attractive from a valuation standpoint, but its growth potential relative to other Qualified Company List businesses, particularly outside the U.S., made it less attractive. The company is a major beneficiary of the recent tax law changes, and continues to benefit from solid macro-economic and demographic forces, however we expect major new investments by the company in the years ahead as they continue to seek to close the execution and productivity gaps which exist relative to Home Depot. This, combined with weaker than expected margins given spending and the specter of higher interest rates gradually impacting the maturing housing cycle led us to reallocate to other holdings.

Purchases

Praxair is a specialty industrial gas company with sales across North America, Europe, South America and Asia that serves both cyclical and non-cyclical businesses (i.e. food and beverage). With approximately 90% of its businesses generating recurring revenue streams, the oligopolistic nature

of its market, and pricing power that benefits from its favorable logistics infrastructure and willingness to co-locate its operations close to its customers, the company provides more predictable and sustainable growth than most of the industrial businesses we research. With only three global players remaining after the completion of the Praxair/Linde merger, we expect to see improving operating leverage and backlogs as the business benefits from consolidation and continues to recover from the global industrial recession which began in 2013. Efficiency programs instituted by the company to control costs and enhance cash flow are expected to increasingly pay off. In addition, we expect the company's combination with German based Linde AG, a global manufacturer of industrial gases, to generate significant revenue and cost synergies, enhance cash productivity and pave the way for meaningful cross-selling opportunities and large share buybacks. With Linde's greater exposure to emerging markets, we expect the growth rate of the combined firm to be enhanced. The European Union has extended its anti-trust review of the deal to August 9, 2018, but we expect it to ultimately be approved with the stipulation that the merged company will need to divest a few of its businesses to ensure sufficient pricing competition in their markets. We initiated a below-average weight position in the stock with the expectation that we would build it opportunistically moving forward.

Among the risks we continue to monitor are the potential that the company's Linde transaction runs into trouble, or regulators impose requirements for asset sales which may reduce the synergies we expect. Being one of the more economically sensitive businesses we are invested in, we are cognizant that fluctuations in expectations for global growth will affect the stock's performance.

Yum! Brands is one of the world's largest restaurant companies with overall sales of more than $45 billion, and 45,000 stores in over 135 countries. The company's brands include Kentucky Fried Chicken (KFC), Pizza Hut and Taco Bell. Over 97% of its stores are franchised, providing the company with a strong stream of recurring revenues. This is enhanced by the company's affordable price points, geographic and brand diversity, and ongoing menu innovation. Yum's pricing power is enhanced by the company's operating excellence driven by strong franchise partners committed to superior service and positive customer experiences. The company's asset-lite franchise model significantly reduces the level of operating volatility expected from the business. The ability to triple the number of stores in Yum's system combined with compelling new-unit economics and attractive opportunity to further penetrate emerging markets (which today comprise about 40% of franchise fees), provides attractive long runways for future growth.

As in any restaurant-oriented business, food safety is a primary risk associated with this investment. However, the franchised nature of the business reduces the potential impact from such risk, with approximately 80% of profits coming from franchise fees and the balance from company owned stores. Likewise, the global nature of the company's sales will create additional currency risk which must be taken into account. We have held the company in the portfolio in the past and our research indicates the combination of strong fundamentals and attractive valuation warrants Yum's inclusion in the portfolio today.

Outlook

Expectations for global economic growth and corporate profits have increased significantly over the last year as U.S. fiscal policy has become more supportive, Japanese growth has surprised on the upside and China experienced attractive growth. Nascent signs of inflation in the U.S. have begun to generate higher inflationary expectations and cause interest rates to rise. The reduction in U.S. monetary accommodation combined with high debt levels in Japan, questions over the longevity of monetary easing in Europe and structural issues in China present hurdles to faster economic growth. The imposition of new trade tariffs, and growing concern over a trade war between the U.S. and China, along with continued uncertainty over the fate of NAFTA negotiations pose additional threats to the improving economic growth being discounted by global equity markets. At the very least, a transition away from the "free money", low inflation, "goldilocks" economy of the last decade along with its high stock correlations and low dispersion, is underway. This fundamental change in the market backdrop leads us to expect greater volatility as market participants adjust to a new economic environment and reprice risk accordingly. While we expect U.S. and global growth to improve over the balance of 2018, we remain mindful of the high expectations which exist in the market and potential headwinds present. This potential mismatch between expectations and realities, and the strong returns of recent years have increased the risk inherent in the market and will likely lead to more volatility. Our portfolio's higher business quality in terms of greater predictability of revenue and profit growth, attractive cash flow generation and enterprise yield valuation continue to compare favorably to the Index. Over the next three years, the portfolio is forecast to generate 19.7% earnings growth versus 11.4% for the ACWI and 13.3% revenue growth compared to 4.7% for the Index. Given the increased potential for disappointment relative to the market's optimistic

forecasts for earnings and revenue growth, we expect that these characteristics will be increasingly rewarded as volatility rises.

We appreciate your confidence in our team and investment process and look forward to answering any questions you may have about the quarter.

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