SGA
Sustainable Growth Advisers

Q3 2017 Global Growth Commentary

Highlights

- *SGA's Global Growth portfolio returned 3.2% (gross) and 3.0% (net) in Q3 2017 compared to 5.2% for its primary benchmark the MSCI All Country World Index (ACWI); year-to-date, the portfolio has returned 23.1% (gross) and 22.3% (net) compared to 17.3% for the MSCI ACWI*

- *Emerging markets outperformed developed markets again with Latin America performing best*

- *Higher beta smaller-cap growth stocks outperformed; the reward to quality metrics was mixed with low return on equity companies and those with no earnings outperforming, but also those with low debt being rewarded*

- *Energy (+9.4%), Materials (+9.1%), and Technology (+8.9%) performed best; Consumer Staples (-0.2%) and Health Care (+2.4%) were weakest*

- *Relative performance was negatively impacted by the outperformance of stocks not owned (and in many cases not on our Qualified Company List), decisions to trim strongly performing positions which had become less attractive from a valuation standpoint, and our reallocation of capital to other holdings which presented more attractively valued growth opportunities over our 3-5 year investment outlook*

- *Stock selection in the Consumer Discretionary sector detracted most from performance; selection in Consumer Staples and Energy detracted to a lesser degree; sector allocations had only a minor impact*

- *Holdings in Ping An Insurance, Kansas City Southern and Whole Foods Market were sold on strength to fund new positions in TJX Companies and Ulta Beauty. Positions in Amazon and Tencent were reduced on strength while positions in Fast Retailing, Infosys, MercadoLibre, and MYOB were added to on weakness*

Performance

SGA's Global Growth portfolio returned 3.2% (gross) and 3.0% (net) in the third quarter while its benchmark, the MSCI All Country World Index (ACWI), returned 5.2%. After a strong rebound in Q1 and Q2 of this year, where higher quality growth stocks regained leadership from deep cyclicals and financials, a less favorable market environment in Q3 and short-term company specific issues detracted from portfolio performance. Consistent with our focus on high business quality, superior long-term growth and attractive cash flow based valuation, we continued to reduce our exposure to stocks which have become less attractively valued due to significant price momentum while taking new positions in, and adding to existing businesses where our analysis of their 3-5 year opportunities indicate highly attractive share appreciation potential. Accordingly, we trimmed positions on strength in Amazon and Tencent, and added to existing positions in Fast Retailing, Infosys, MercadoLibre, and MYOB where we could take advantage of short-term investor concerns and leverage our time horizon.

A Synchronized Uptick in Global Growth Expectations but Headwinds Remain

Emerging markets outperformed developed markets for the period thanks to strength in Latin America where Brazil (+22.9%) and Chile (+16.9%) performed best. Year-to-date, emerging markets have outperformed developed markets by approximately 8% (27.8% versus 20.0% respectively). Given an improved outlook for global economic growth, commodity rich economies such as Brazil, Canada, Norway and Russia performed best, benefiting from rising expectations for growth in the U.S., Europe, China and Japan. This synchronized improvement in the outlook for growth across several of the world's key economies benefited value as a style, and stocks with lower business quality particularly later in the quarter.

In the U.S., improving economic data and growing investor confidence that pro-growth tax and regulatory policies by the new administration stood a better chance of being enacted and positively affecting future growth drove the market advance. Second quarter GDP growth was revised upward to 3.1% and the unemployment rate declined to a 16-year low while household incomes rose, marking the largest increase in the metric since the 1960's. U.S. consumer confidence remained strong and reached a new high even though retail sales growth continued to slow. At the same time, however, vehicle sales, which have been a major driver in the economy's post financial crisis expansion, showed increasing signs of weakness as lenders tightened loan requirements in response to rising default rates among subprime loans. A decreased savings rate and rising consumer credit card debt also pointed to a stretched consumer. Meanwhile, the Federal Reserve announced that it was poised to begin normalizing its balance sheet after the massive monetary stimulus and quantitative easing it had applied in the aftermath of the financial crisis over the past nine years, despite the fact that inflation remains low and has actually declined in 2017. With reduced inflationary concerns, and intense geopolitical uncertainty driving investors to U.S. Treasury bonds as a safe haven, interest rates in the U.S.

declined during the period unlike in Canada, the U.K and Germany where interest rates rose. The decline in interest rates in the U.S. year-to-date and the likelihood for restraint in upcoming monetary policy decisions, together with an outlook for continued moderate growth, leads us to believe there may be further room for equity multiple expansion for companies with the high quality characteristics we seek. Regardless, however, we are highly confident in the attractiveness of our portfolio's overall multiple and those of our businesses based on the current enterprise yields they offer relative to history.

Eurozone markets benefited as consumer confidence continued to move higher and unemployment declined to 9.1%, its lowest level since February of 2009. GDP growth for the second quarter showed further improvement as the region grew at an annualized rate of 2.2% from the first quarter, its fastest growth since the first quarter of 2011. While many pointed to the election of Emmanuel Macron as President of France as a rebuke of populism in the region, the narrow election victory of Chancellor Merkel in Germany and new separatist pressures in Catalonia highlighted that such forces remain a threat to stability in Europe.

China's economy showed unexpected strength with second quarter GDP growth being reported at a better than expected 6.9% helped by heavy government spending as President Xi worked to further consolidate his position ahead of the country's Communist Party Congress. While positive sentiment boosted returns for Europe and China during the quarter, we believe it is important to point out the benefit the Eurozone economy had gained from favorable currency movements in 2016 in contrast to the strength of the Euro relative to the U.S. Dollar this year, and the potential headwind this may create for European exports and manufacturing moving forward. Likewise, China's unexpected strength certainly benefited European economies which export to the country. To the extent stimulus is reduced from current levels following China's pending Communist Party Congress, this will pose a headwind to European and global growth. While excessive debt loads, manufacturing overcapacity and negative long-term demographic trends are likely to moderate the pace of China's economic growth in coming years we continue to identify unique businesses which our research indicates should generate highly attractive revenue and earnings growth over the next 3-5 years.

Japan's economy likewise showed signs of improvement as its exporters benefited from the Yen's decline relative to other major currencies, and continued fiscal and monetary stimulus. Japan has benefited from "Abenomics" as seen in the significant tax cuts over the past four years which has improved profitability and in turn business spending and capex, while enhancing productivity and increasing employment. Second quarter GDP growth of 4% surprised to the upside as consumer spending grew at its fastest pace since the government's imposition of a sales tax increase in 2014. While growth has improved as a result of government policies the progress remains fragile, as Japan's inflation picture remains below expectations and longer-term headwinds including difficult demographic trends, high debt levels and new geopolitical threats make sustained improvement more difficult.

Key Performance Drivers

After strong stock selection in the portfolio in Q1 and Q2, selection was the primary detractor from performance in Q3. Selection was weakest in the Consumer Discretionary sector, accounting for about 70% of the overall portfolio's underperformance in the period. Selection in the Consumer Staples, Energy and Industrials sectors also detracted from returns albeit to a lesser degree. Holdings in athletic footwear and apparel leader Nike, South Korean cosmetics company Amorepacific, and Japanese retailer Fast Retailing detracted most from results. In contrast, selection contributed positively to performance in the Financials, Technology, Real Estate and Health Care sectors. Holdings in Chinese videogame producer and e-commerce leader Tencent, credit card processor Visa, and Chinese insurance company Ping An Insurance contributed the most to performance.

Largest Contributors

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, and we have reduced our position size due to its higher valuation, we 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.

Visa reported a strong quarter, beating analyst estimates and raising both their earnings per share and revenue growth targets beyond analyst forecasts. The company reported revenue growth and earnings per share growth of 26% as it benefited from strong volume, lower incentive fees and a lower than expected tax rate. U.S. volumes increased by 12% while Europe and Asia ex-China also posted strong gains. The Visa Europe integration was reported to be proceeding well, with accretion actually running ahead of schedule thanks to stronger than expected European markets and weaker local currencies. We remain excited about the potential benefits the Visa Europe acquisition can provide and have confidence in Visa's opportunity to continue to benefit from the secular shift from cash and check to electronic forms of payment in both consumer and business applications around the world. We maintained an above average weight in the stock, but trimmed our position on strength to help fund other growth opportunities.

Ping An Insurance Group (Ping An) was added to the portfolio in Q2 to take advantage of its million plus professional agents selling Ping An's proprietary products, their enviable position in the quickly growing Chinese auto insurance market where they were a first mover, and growth in their bank which has taken significant steps over the past three years to establish substantial loan loss reserves to address any future weakening in credit quality associated with their legacy institutional loan portfolio. Prior to our purchase, concern over slowing in China's economic growth and the potential for material loan losses in the future, had caused the stock to decline, reaching an attractive valuation based on our projection for 8%+ earnings growth over the coming three years. Given their improved loan loss provisioning, the underserved markets they participate in, new opportunities offered by emerging businesses, and an attractive valuation, we purchased the shares. With China's GDP growth surprising investors to the upside and global earnings growth showing some signs of improvement, the stock appreciated significantly since our purchase in April of this year, and with valuation becoming less attractive relative to other opportunities on our Qualified company List, we sold the shares and reallocated the capital.

Global pharmaceutical company **Novo Nordisk** and open source software provider **Red Hat** were the fourth and fifth largest contributors respectively.

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 pressure from local competitors. 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 e-commerce 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 conviction opportunities.

Fast Retailing reported attractive results with revenue growth of 17% and profit growth of 50% year-over-year. The report pointed to 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, we used the opportunity to add to our position.

Biopharmaceutical firm **Regeneron** and American specialty beauty retailer **Ulta Beauty** were the fourth and fifth largest detractors respectively.

Portfolio Changes
Purchases

Ulta Beauty (Ulta) is the largest specialty beauty retailer in the U.S. and has been on our Qualified Company List for some time. We took advantage of a valuation opportunity to initiate a below average weight position in the stock while many companies in the retail sector declined on fears that Amazon may derail their growth. While Ulta's stock continued to decline after our initial purchase, we view the Amazon fears as short term and manageable within the context of our 3-5 year investment horizon. The company provides a differentiated value proposition to beauty enthusiasts by offering a wide assortment of classic and emerging cosmetics, fragrances, skin and hair care brands across many price points in 1,010 stores and through its e-commerce portal. With only 5% market share, Ulta has a long runway of growth, solid pricing power, an attractive stream of repeat revenues from a passionate customer base and a strong management team led by CEO Mary Dillon. The company is a beneficiary of the disintermediation of the department store distribution channel resulting from the growth in e-commerce and is viewed as a preferred distribution partner by beauty brands. It has an impressive loyalty program with over 24 million members which provides both data and the ability to enhance the value proposition of its customers both online and in stores through targeted offers, gifts and opportunities to trial new products before they are widely available.

Ulta's differentiated merchandising strategy across prestige and mass market beauty products results in broad appeal across ages, demographics and lifestyles. The company also benefits from a robust customer relationship management system, where it can tap its database to ensure optimal replenishment of its stocks on Ulta.com. Its position in the market is protected by high barriers to entry resulting from its strong relationships with over 300 vendors across products (some of which are exclusive), which make it more difficult for other retailers to enter the space.

Among the risks to our investment thesis is the possibility that Amazon gains the confidence of key beauty brands by changing the shopping experience to more closely mirror the experiential nature of a trip to an Ulta store or to its e-commerce portal. Also, comparative store sales growth will continue to slow from the unsustainable double-digit rates of the past couple of years.

TJX Companies is an off-price apparel and home furnishings retailer which serves the U.S. and international markets. The company benefits from strong financials and has been highly disciplined in allocating capital between reinvesting for long-term growth and returning cash to shareholders via share buy-backs and dividend increases. Unlike many traditional retailers, we view TJX's business model as being less susceptible to threats from Amazon, with the company offering its customers a treasure hunting experience and an attractive pricing advantage at 20-60% off retail, while Amazon cannot track or predict their inventory, thereby making it impossible for them to price-match against TJX. The company has a 40% market share in the off-price retail category in the U.S. with its T.J. Maxx brand, and operates Winners in Canada, TK Maxx in Europe, as well as HomeSense and Marshalls in Canada and the U.S. Its largest competitor, Ross Stores, has total sales and a number of stores less than half the size of TJX. The company's large store base, specialized supply chain and distribution system provide significant barriers to entry in their market and ensure strong pricing power. Its off-price business model enables the company to generate attractive recurring revenues

in both good and bad economic times, as customers become more value conscious in difficult environments and spend more freely in better times benefiting all retailers. Likewise, in leaner economic times, TJX benefits from higher quality inventory from other retailers and wholesalers becoming available at attractive prices. In up cycles, other retailers become less promotional raising the overall price level for everyone, and increasing the value proposition TJX can offer. We expect TJX's business model to be successfully replicated across the globe in coming years, enhancing the company's attractive runways of long-term growth and guided by an experienced management team where most of its executive committee is made up of company veterans who joined the firm early in their respective careers.

Among the potential risks facing TJX are wage pressures due to both state regulations and the limited supply of workers currently available given today's low unemployment rate, the ability of the company to continue to inventory the right kind of merchandise to attract their targeted clients in the U.S. and globally, as well as currency and weather risks. In the midst of this quarter's weakness in the retail segment as investors worried that Amazon would make brick and mortar retailers obsolete, we used the decline in TJX shares to establish a below average weight position, with the expectation of continuing to build the position opportunistically moving forward.

Sales

Kansas City Southern was sold from the portfolio after experiencing significant price appreciation due to a lessening of negative trade rhetoric following last year's 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.

Leading natural and organic food retailer **Whole Foods Market** received an offer from Amazon to purchase the company for $42 per share in cash in Q2. We cut our position in the stock significantly immediately following the offer, believing that it was fair and offered Whole Foods compelling benefits from both a strategic and financial point of view, as it would enable the company to leverage Amazon's technology and distribution expertise to accelerate strategic initiatives such as category management, supply chain and customer affinity programs, while enabling management to truly focus on running the company for the longer term away from the spotlight of public shareholders. After no competing bids were received, we sold the remainder of our position this quarter to reallocate the capital to other new opportunities.

As noted above, we also sold **Ping An Insurance** during the quarter as its valuation became less attractive relative to other opportunities on our Qualified Company List.

Summary

After strong absolute and relative performance in Q1 and Q2 of this year, the portfolio delivered good absolute returns but trailed its benchmark in Q3. Decisions consistent with our discipline to reallocate capital from more highly valued outperformers to out-of-favor companies where our research indicates there is more attractive long-term growth and return potential hurt our short-term relative performance. In periods of rising optimism, the sustainable growth characteristics of our business aren't always fully or immediately rewarded, particularly when market returns are very strong and likely unsustainable. However, in such periods we typically participate well in the market's strength, albeit to a lesser extent than the index itself. On a year-to-date basis, your portfolio has generated an absolute return of 23.1% (gross) and 22.3% (net) compared to 17.3% for the MSCI ACWI. This is consistent with the sustainable mid-teens earnings growth we expect from our portfolio businesses in general over time. This quarter, as noted earlier in our comments, a few of our portfolio companies posted results that fell short of our expectations while others reported solid results but were penalized for cautious short-term guidance or because they didn't beat expectations by enough. Our longer-term outlook allows us to take advantage of such short-term movements, and add value for our clients. When looking in aggregate at the overall growth characteristics of our portfolio businesses, we can confidently say that they are growing their earnings meaningfully faster than the average company in the Index with 19.1% earnings per share growth expected over the coming three years versus 11.7% expected for the Index, which we view as highly optimistic. We continue to believe that such growth, when priced attractively based on the cash flows the businesses are generating, should be rewarded in the long-term. Just as we have invested in out-of-favor long-term secular growth businesses that are generating significant free cash flow in the past, we continue to do it today, reallocating capital from less attractively valued outperformers to future opportunities which offer better upside potential. This has always been the focus of our approach to growth investing, and it continues to be the case today. For long-term investors seeking to capitalize on

high levels of compounding free cash flow and above average earnings growth we know of no better way. We thank you for your continued confidence in our team and approach, and look forward to answering any questions you may have.

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