SGA
Sustainable Growth Advisers

Q2 2017 Global Growth Commentary

Highlights

- *SGA's Global Growth portfolio returned 8.8% (gross) and 8.5% (net) in Q2 2017 compared to 4.3% for its primary benchmark the MSCI All-Country World Index (ACWI), and 5.7% for the MSCI ACWI Growth Index.*

- *Equities generated high absolute returns despite disappointing U.S. economic growth, weakness in the price of oil and related businesses, deceleration in China, continued recession in Russia, less monetary accommodation by the U.S. Federal Reserve and many geopolitical concerns.*

- *Large-cap growth stocks with higher quality business characteristics outperformed; European and Asian stocks outperformed U.S. markets while the MSCI Emerging Markets outperformed the MSCI ACWI ex-U.S.*

- *Energy stocks declined significantly on concerns over higher U.S. shale oil production, higher than expected output from Libya, Nigeria and Iraq and the potential for continued oversupply.*

- *Strong stock selection particularly in the Consumer Staples, Health Care and Financials sectors contributed most to the portfolio's outperformance while selection in the Energy and Consumer Discretionary sectors detracted; an overweight to the strongly performing Technology sector also contributed positively.*

- *Holdings in Apple and Colgate-Palmolive were sold to fund positions in Autodesk, Ping An Insurance and Sanlam; we added to positions in MYOB, Nike and Schlumberger on weakness and trimmed positions in Kansas City Southern, MercadoLibre, Tencent and Whole Foods on strength.*

Performance

SGA's Global Growth portfolio returned 8.8% (gross) and 8.5% (net) in the second quarter of 2017 while its benchmark, the MSCI ACWI, returned 4.3% and the MSCI ACWI Growth Index returned 5.7%. Attractive absolute returns in the market were driven by strong performance by European markets as well as emerging markets. U.S. markets trailed other ACWI markets as investors preferred areas where signs of new growth were budding versus the U.S. where growth has been superior, but where expectations for higher growth are moderating.

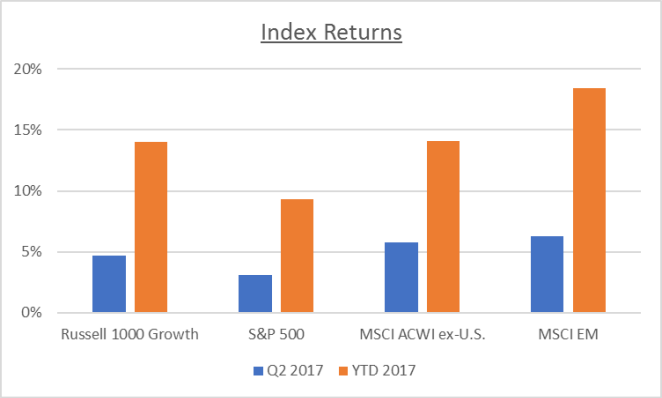
Emerging Markets and Non-U.S. Stocks Receiving the Handoff?

Emerging Markets outperformed U.S. the market on signs (at least temporarily) of improvement in some of the larger emerging economies. Chinese GDP growth in the first quarter came in at a better than expected 6.9% pace, its fastest growth since the third quarter of 2015. While growth undoubtedly benefited last quarter from significant government spending on infrastructure, other more forward looking metrics painted a less positive picture with retail sales, fixed asset investment and vehicle sales growth all slowing, money supply growth moderating, and steps taken by the government to deleverage and tighten lending standards. South Korea's market continued to be a top performer as earnings rebounded and political uncertainty declined with the inauguration of incoming President Moon. However, difficult questions over how to deal with North Korea and how to manage relations with China, North Koreas primary benefactor but also South Korea's largest trading partner create uncertainty for the country's economy moving forward.

Regionally, European markets led by Greece, Austria, Hungary and Turkey performed best in the quarter as they stood to benefit the most from continued accommodation by the European monetary authorities and from improving economic growth within the region. While European stocks performed best, they were followed closely by Asian stocks and emerging markets. Brazil finally broke out of an eight quarter long recession in the first quarter, growing 1% quarter-over-quarter boosted by agriculture which grew over 13% and was responsible for all of the growth. However, with new political turmoil led by corruption allegations against interim President Temer who replaced impeached President Rousseff, and the economy undoubtedly still weak, Brazil's stock market struggled for the quarter, outperforming only Russia which continues to face recession due to low oil prices and economic sanctions. Among world regions, Latin America performed worst, with Chile joining Brazil in generating negative returns for the quarter.

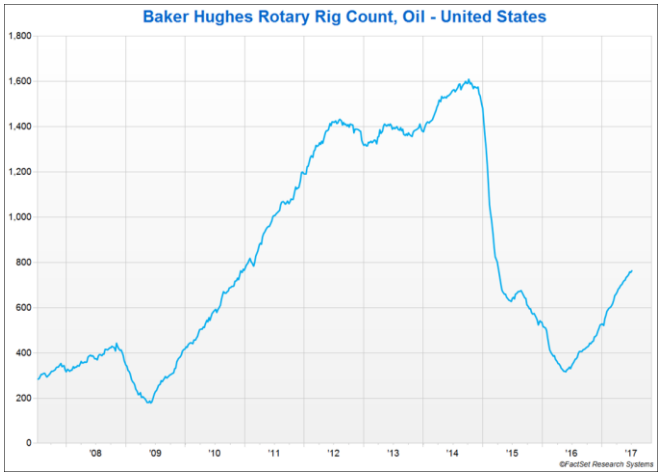
In the U.S., following a weak first quarter GDP report, a third interest rate hike in six months, little progress on the Trump administration's pro-growth agenda, the largest drop in U.S. retail sales in 16 months, plunging oil prices, lower than desired inflation, and little hard economic data pointing to an improvement in future growth, investors shied away from the higher risk, more cyclical stocks which had outperformed strongly following the November U.S. elections. Instead, larger capitalization growth businesses with higher quality characteristics such as high return on equity, lower debt levels, strong financial positions and positive earnings outperformed.

While Q2 earnings expectations in the U.S. (S&P 500 Index) continued to decline, falling from +11.3% at the beginning of the year to +6.9% expected now, expectations for earnings growth in non-U.S. developed and emerging markets have risen on signs of improvement in economic activity, supporting the higher stock market returns experienced in those markets this quarter. Since December 31, 2016, earnings growth expectations for the MSCI EAFE Index in 2017 have increased from +13.1% to +19.4%. Meanwhile, emerging market economies are now expected to expand at a faster rate of 4.7% this year, more than double the pace of U.S. and Europe according to some analysts. 10-year Treasury yields declined as U.S. growth expectations moderated, leading to a flattening of the yield curve, another potentially concerning indication of future U.S. growth, and less support for the strong U.S. dollar, which has declined about 5.6% year-to-date making it the worst-performing major currency.



Source: FactSet

The MSCI ACWI generated a strong absolute return of 4.3% during the quarter with the Health Care and Technology sectors outperforming by the widest margin, and the Industrials and Financials sectors generating strong relative returns. Energy was the weakest performing sector during the quarter, declining about 4.9%. With economic growth modest in the U.S. and other parts of the world, and China likely to slow again after intense infrastructure stimulus in 2016, investors focused on the growing supply of oil coming from U.S. shale producers who re-entered the market more quickly than many had anticipated. While U.S. oil stockpiles had declined in nearly every week of the quarter, investors focused on reports indicating that U.S. oil inventory drawdowns may have slowed at least temporarily, as well as concern that demand may not grow sufficiently to absorb excess supplies. This sent oil prices to levels last seen in the first quarter of 2016. U.S. rig count declined dramatically in 2015 (see the chart below) before bottoming in 2016, and has now regained about a quarter of its decline. With financing now drying up for many lesser quality producers, we expect this growth in rigs to slow. In addition, we see higher than expected output by OPEC members Libya and Nigeria which contributed to supply concerns as being temporary. However, with uncertainty over the pace of future shale production given lower prices, and the commitment of OPEC members to production restraints, we acknowledge that our thesis for greater equilibrium between global oil supplies and demand may take longer than originally expected. (We speak about our expectations for the specific oil service companies held in the portfolio below.)



Key Performance Drivers

Strong stock selection was the primary driver of the portfolio's outperformance contributing the vast majority of the 4.5% excess return in the quarter. Selection was strongest in the Consumer Staples, Health Care and Financials sectors while weakest in the Energy and Consumer Discretionary sectors. Selection in all other sectors contributed positively. Sector allocations also contributed positively to performance due mainly to the portfolio's overweight in the strongly performing Technology sector.

Largest Contributors

Leading natural and organic food retailer **Whole Foods** received an offer from Amazon to purchase the company for $42 per share in cash. The stock appreciated by 29% on the day of the offer and gradually traded above it given the highly disruptive nature of the combination and the potential for other competitors to make a competing higher offer.

A buyout by a strategic or financial buyer was never core to our investment thesis for Whole Foods, although the combination

of the recent involvement of JANA Partners and the attractive valuation of the stock (6% enterprise yield) made the announcement of Amazon's offer to purchase the company less of a surprise. Our thesis was based on the view that Whole Foods' management was taking appropriate, decisive action in critical areas such as pricing, sourcing, cost savings initiatives and customer engagement to more effectively respond to rising competition in the natural & organic food sector. For Whole Foods, the Amazon deal is compelling from both a strategic and financial point of view, as it will 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. While recent developments at Whole Foods, including their upgrade at the CFO position and the change in the composition of their Board of Directors as well as the further acceleration in their strategic and financial initiatives are undoubtedly positive, we believe Amazon's offer of $42 per share represents a fair price based on valuation metrics which exceed industry M&A precedents. We significantly reduced our exposure to Whole Foods following the offer, but maintained a small position in the stock at quarter end given the potential for other higher bids to emerge.

Leading Chinese internet, media and mobile application company **Tencent** reported a strong first quarter with revenues up 55% and profits growing 37%, up from +32% in Q4. The company's personal computer and mobile gaming businesses posted attractive growth, above our expectations. Deferred revenues in the PC business grew 58%, indicating that the group can likely maintain its strength for the balance of the year as the associated revenues should be recognized over the next few quarters. We expect higher revenues from the gaming segment to help cover incremental investments by the company in video content, and continuing to build their payments and cloud computing businesses, which each grew by over 100% in the latest report. Our positive view of the company's future prospects are also enhanced by the opportunity we see in their ability to build higher advertisement loads in their businesses, similar to what Alibaba, Facebook and Google have already done. This flexibility from being able to lever increasing advertising loads provides Tencent with the significant ability to continue to grow their revenues and earnings as they invest in future growth opportunities for the business. While we continue to be impressed by Tencent's management team and the financial control they have exhibited, we trimmed our position in the stock based on valuation, but it remains at an average weight position given its attractive long-term prospects.

Global pharmaceutical company **Novo Nordisk** reported slightly better Q1 results with 3% sales growth (4% sales growth normalizing for inventory/rebates adjustment) and 6% operating profit growth. Its diabetes business posted growth of 11% in constant currency (led by strong growth in sales of new generation insulins 163%+, Victoza 22%+). This, however, was offset by declines in growth in its hormone and hemophilia franchises. We expect Novo's hemophilia franchise to continue to decline in the near term as growth from new drugs (factor VIII, and factor IX) will likely not be able to offset the competition to its Novo-seven product at this point. In diabetes, while pricing pressure in the U.S. will continue, Novo is executing well on its new launches and we expect approval of the company's once weekly GLP-1 drug semaglutide, likely later in 2017, to help the company continue to grow its diabetes franchise despite competitive pressures. Valuation remains attractive, and while we wait for the approval of semaglutide, we maintained an average weight in the stock.

Positions in biopharmaceutical company **Regeneron** and Hong Kong insurance company **AIA Group** were the fourth and fifth largest contributors to the portfolio's performance.

Largest Detractors

Oilfield services provider **Schlumberger** was the largest detractor from portfolio performance during the quarter. The price of oil fell on continued concerns over excess oil supply and slower than expected U.S. oil inventory declines negatively impacting Schlumberger's stock price. While U.S. oil inventories continue to be the center of much focus given their greater transparency and frequency of data, oil inventories in most OECD countries have actually been declining while U.S. imports from OPEC nations have remained at historically high levels. Until more recently, U.S. oil inventories had declined at an accelerated pace year-to-date, virtually eliminating the oil inventory surplus over year ago levels. Continued excess supply and potentially weaker demand remain concerns in the market over the near term, but over the longer-term, several energy companies and consultancies are already warning of underinvestment and the potential for supply shortfalls, and the inability of shale alone to offset production declines.

Despite near term concerns, energy companies have begun to expand their capex spending by increasing efficiencies and lowering their project breakeven costs, both in North America and globally. For example, Exxon most recently approved a Final Investment Decision for a major offshore project off the coast of Guyana, while Statoil, the Norwegian oil company, has retooled almost all of their offshore oil projects to produce positive economic returns at prices below $30 per barrel of oil

(from prior levels of $70 per barrel in 2013) and are moving ahead with their capex plans. Both are large customers of Schlumberger, and year-to-date, there have already been twelve major projects that have been sanctioned (compared to approximately five for all of 2016). We took advantage of weakness in the stock during the quarter to add to our position.

Reservoir description, production enhancement and reservoir management provider **Core Labs** was the second largest detractor from returns in Q2. Its stock declined during the quarter due to the same macro and energy industry factors noted above. We remain positive on Core Labs' ability to help production companies maximize output from their existing wells and benefit from gradual improvement in oil exploration activity. The company has reduced its cost structure, as have many of their clients, and is well positioned to benefit from any increases in capex spending moving forward both from U.S. unconventional shale players and global energy companies. Energy companies are beginning to gradually expand their capex budgets but are increasingly seeking to improve returns on their spending, and service companies such as Core Labs are increasingly in the position to offer higher value-added services that meet those needs. While we believe our thesis for improving equilibrium between oil supply and demand remains on track today, and that oil companies will increasingly need to adopt technologies and practices that improve their returns, we acknowledge that markets are very fluid, and we continue to monitor events to ensure our expectations are being met.

Nielsen was the third largest detractor from portfolio returns. The company reported a quarter that disappointed many investors after its U.S. Buy business which measures consumer purchase and market share data for packaged goods companies fell short relative to difficult comparable sales and given a continued challenging pricing environment for many consumer goods companies. The Developed Market business continued to grow albeit at a lower level, while their Emerging Market Buy focused business saw accelerated attractive growth. Not surprisingly, multinationals continue to shift their spending toward markets that are growing at more attractive rates. We expect strength in Nielsen's Emerging Market Buy and Watch businesses to make up for the continued weakness in its Developed Market businesses, and note that these businesses will face easier growth comparisons as the year goes on. We expect this year to continue to be an investment year for the company as it works toward launching new services and streamlining its business model. We look for their new e-commerce directed efforts to gain strength, and are satisfied with the performance of their Watch focused business which measures media consumption and advertising effectiveness across television and radio, and increasingly for online.

Lowe's and **FleetCor** were the fourth and fifth largest detractors from portfolio performance.

Portfolio Changes

Turnover in the portfolio for the quarter was average with two new positions added and two liquidated. We also trimmed positions in Amazon, Amorepacific, Kansas City Southern, MercadoLibre, Tencent and Whole Foods on strength, and added to positions in FleetCor, Lowe's, MYOB, Nike and Schlumberger on weakness.

Purchases

South African financial services conglomerate **Sanlam** was added to the portfolio this quarter. The company operates in 47 countries with approximately three-quarters of its income being generated by its life insurance business, and the balance spread across general insurance, investment management, credit & structuring and other businesses. Sanlam has a history of maintaining capital at sound levels while being able to extract attractive dividends from its life business, and its management team has remained stable with its CEO and CFO both having grown with the group over the years. Sanlam generates a high level of repeat revenues due to the long-term nature of the life insurance they sell. 75-80% of their income is considered repeat business. The company also benefits from favorable demographics in most of the markets they serve, excluding South Africa. Insurance penetration is relatively low in most of their markets, allowing them to generate attractive growth given their dominant position. This strong position also provides them with better pricing power in many markets, and helps them attain improved economies of scale. South Africa's market is more mature, but the level of coverage is fairly low and insurance products have traditionally been used more as investment products. Accordingly, an attractive opportunity remains in terms of increasing coverage levels among those already insured, in addition to extending coverage to lower income segments of the population which may not currently have coverage. We also expect the company to benefit from regulatory changes which are expected to result in lower commissions being charged which should enhance its cash flows, as well as further consolidation in its markets as smaller players depart the otherwise saturated South African market.

We initiated a smaller than average position in the stock and expect to build it opportunistically moving forward. Among the risks facing the company, we remain focused on the political uncertainty, the possibility of lower interest rates in South Africa as inflation eases and the impact on the income generated on shareholder capital, as well as potential adverse

regulatory changes which could impact Sanlam's business. On the latter, we believe they are in a position to work with regulators and influence the nature of changes rather than simply being on the receiving end of regulatory change.

Autodesk is a leading provider of computer assisted design (CAD) software catering to the architecture, engineering and construction as well as the manufacturing and media industries. Over time, Autodesk has expanded its line-up of products to address more applications within these segments. Consistent with industry trends, the company is going through a major transition from its conventional license based revenue model to a software-as-a-service (SAAS) revenue based model, which will significantly increase the repeatability of revenues and thereby increase the quality of the business over the long-term. In the short-term, it will depress revenue generation as the company makes the transition. Autodesk offers attractive pricing power due to an industry structure where end customers are more attracted to relevant functionality and ease of use based on prior learning than to pricing discounts. The company prices entry-level products lower for those learning to use its products, and thereby builds its user base on an ongoing basis. The complex nature of the company's business, and the need for users to climb a steep learning curve, limit the amount of product switching which goes on. Today, about 75% of the company's revenue can be considered recurring, and we expect that level to increase each quarter moving forward. We are excited by the long runways of growth open to Autodesk given that the global market for its CAD software is considered to be about 10 times its revenues, and we expect this market to continue to grow as automation is pursued in more industries over time. Over the next 5 years, this company has a great opportunity ahead of itself to transform into a recurring business model and in parallel extract better price from its customer from providing more value. At the same time, long term valuation will also reflect the higher quality of the business model. Accordingly, we initiated a smaller than average weight position in the stock and expect to build it opportunistically as we continue to gain confidence that the company's transition to the SAAS model is progressing well.

Chinese insurance company **Ping An Insurance Group** (Ping An) was added to the portfolio this quarter at a below average weight. The stock has remained on our Qualified Company List since we sold it in April of 2015 on concerns over loan loss provisions and high valuation. The company was established in 1988 in China's Shenzhen Province and was the country's first insurance company to have a shareholder structure, and the first to allow foreign investors to participate in that structure. Today, the company is an integrated financial services conglomerate with core businesses in insurance, investment management and banking. In their life insurance business, Ping An benefits from over a million professional agents selling their products, making them much less reliant on traditional bank channels for generating new business. In the Property & Casualty side of their insurance business, they continue to benefit from a strong position in auto insurance where they were a first mover. As auto ownership continues to grow from still relatively low penetration levels, this offers continued attractive growth for Ping An. In addition to their insurance and investment businesses, Ping An Group holds a 50% stake in Ping An Bank. Over the last three years, Ping An Bank has established large loan loss reserves to mitigate any weakening in its loan portfolio. At the same time, due to concern over slowing in China's growth and the potential for loan losses in the future, the stock has declined, reaching a highly attractive valuation given our projection for 8%+ earnings growth over the coming three years. Given their improved loan loss provisioning, attractive valuation, the underserved markets they participate in, and new opportunities offered by emerging businesses they own that are beginning to achieve attractive scale (such as peer-to-peer lender Lufax and medical service app provider Ping An Good Doctor), we are excited about the prospects for Ping An and believe it offers an attractive investment opportunity over our 3-5 year time horizon.

Among the risks we are monitoring are the macroeconomic climate in China given its impact on potential growth in loan losses, the growth of Ping An Bank's role in Ping An Group's sales given that insurance companies in China typically trade at higher book values than banks, and the success of their emerging portfolio of new businesses.

Sales

Apple was sold during the quarter in order to fund other more attractive opportunities after the stock's strong performance since its reentry into the portfolio in May 2016. At the time we repurchased the stock, we cited the company's tremendous operating base of iOS users, and the all-encompassing ecosystem they had developed, reducing the likelihood that iPhone users would switch to alternative products in the future. While the stock appreciated significantly as investors realized that Apple still possessed growth potential and wasn't a declining business as had been speculated last year, our estimates of its earnings power did not change meaningfully, causing the stock's multiple to expand. Without significant changes in earnings power, we were well aware that multiple expansion would only carry the stock so far going forward and the stock's higher multiple already, to an extent, recognized the higher quality of the business. While not expensive by our measures, given higher expectations and its relatively slow

growth rate (compared to other opportunities on our Qualified Company List), we sold the stock to fund other more attractive opportunities.

Colgate-Palmolive was sold during the quarter as our forecast growth for the company continued to moderate and its valuation became less attractive following Kraft's bid for Unilever and speculation that Colgate could be a target as well. Accordingly, we reallocated the capital to other higher growth, more attractively valued opportunities where we expect better long-term returns. The company continues to have the business quality characteristics we seek, but its expected future growth rate was at the low end of the range we generally find attractive.

Summary

While future growth expectations continue to vary widely by quarter based on conflicting economic data releases, huge fluctuations in the price of oil, and geopolitical events, the expected sales and earnings growth for businesses owned in this portfolio remain less volatile. As a whole, the portfolio continues to generate significantly greater sales and earnings growth than the broad global market, and you should expect that to continue to be the case moving forward. In times such as these where there is great uncertainty over the global macroeconomic picture, and some companies are losing the benefit they have enjoyed over the last eight years from highly accommodative monetary policy, we expect business quality and the strong pricing power, highly recurring revenues and long runways of growth to continue to become more valued by investors. While standard earnings based valuation metrics may appear to be full for some of these businesses, in a market where the average rate of earnings growth is significantly less than theirs, we believe that the consistently superior earnings growth of our businesses should be worth more. In addition, when we value them using a conservative cash flow based metric, which we think is much more appropriate given that free cash flow is the life blood of successful businesses, they appear more attractive. As of quarter end, the portfolio is forecast to generate revenue and earnings growth of 12.8% and 20.1% respectively, compared to 4.8% revenue growth and 11.6% earnings growth for the MSCI ACWI over the next three years. With interest rates gradually rising, inflation modest at best, and few signs of rapidly accelerating growth in the U.S. or globally, we expect that this type of long-term secular growth portfolio should be amply rewarded, but remain cognizant of the fact that absolute returns in the market, and by this strategy have been strong and significant macroeconomic and geopolitical uncertainty exists which could negatively impact investor confidence and stock multiples. While there will inevitably be periods where our strategy will be out of favor due to fluctuating macroeconomic growth expectations, or a spike in fear over geopolitical issues, our approach will continue to identify what we see as superior long-term business quality and attractively valued, above average sales and earnings growth that is repeatable over time.

We thank you for your continued confidence in our team here at SGA and look forward to speaking with you about your portfolio.
