SGA
Sustainable Growth Advisers

Q1 2017 Global Growth Commentary

Highlights

- SGA's Global Growth portfolio returned 9.6% (gross) and 9.4% (net) in Q1 2017 compared to 6.9% for its primary benchmark the MSCI All Country World Index (ACWI) and 9.1% for the MSCI ACWI Growth Index
- Emerging markets performed best followed by developed markets outside the U.S.; Emerging Asia, Latin America and Asia Pacific ex-Japan were the best performing regions
- Stock indexes generated strong absolute returns on investor optimism that global economic growth would strengthen, improved economic data in Europe and signs that recent populist movements may have peaked
- Strong pro-cyclical headwinds from Q4 2016 were replaced by broader large cap growth leadership; business quality factors were generally positive as companies with higher ROE's, low debt and earnings performed better
- Sector leadership was relatively narrow with the Technology, Health Care and Consumer Discretionary sectors outperforming while Energy stocks declined on concerns over building inventories and whether OPEC would respect previously announced production cuts
- SGA's performance benefited from both sector allocation and stock selection in Technology, and selection in Financials and Consumer Discretionary; stock selection in the Consumer Staples sector detracted most
- Amgen was sold to fund other more attractive growth opportunities while positions in Mondelez, MYOB, Fast Retailing, FEMSA, and others were added to and positions in Apple, Colgate-Palmolive, Lowe's and MercadoLibre were trimmed on strength

Performance

SGA's Global Growth portfolio returned 9.6% (gross) and 9.4% (net) in the first quarter of 2017 while its benchmark, the MSCI ACWI, returned 6.9% and the MSCI ACWI Growth Index returned 9.1%. Strong absolute returns in the market resulted from investor expectations that global economic growth would improve driven by an acceleration in growth in the U.S. In contrast to Q4, which was led by a rally in lower quality, more cyclical value stocks, the market advance in Q1 was led by larger cap, growth businesses with earnings, higher ROE's, and lower debt.

Emerging Market Stocks Take the Lead

The top five performing markets in Q1 were emerging markets geographically located across different continents around the world. Poland led the pack with a return of almost 18%, followed by India, South Korea, Mexico, and Chile. In contrast, the U.S., Japan, Italy, the United Kingdom and Canada, among others, underperformed the MSCI All Country World Index. Emerging Asia, Latin America and Asia Pacific were the strongest performing regions followed by Europe. Russia and Greece performed the worst during the quarter, with both economies under pressure.

Source: FactSet

Notwithstanding the broader expectations for improving global economic growth, investor confidence in the Trump administration's ability to deliver promised tax reform and a major new infrastructure spending bill in the U.S. moderated, resulting in pullbacks in many of the Industrials, Energy and Financial stocks that drove the rally in Q4. Doubt over the extent of the administration's ability to deliver on promises to revise America's trade policies also likely benefited emerging markets as U.S. interest rates and the U.S. dollar weakened. Foreign stocks took the lead from U.S. stocks in March as political concerns shifted away from Europe where the focus had been on key elections in the Netherlands, France and Germany. Dutch Prime Minister Rutte's victory over nationalist candidate Geert Wilders, polls showing French populist candidate Marine Le Pen's chances of winning the upcoming French presidential election declining, and victory by Angela Merkel's conservative party in German regional elections moderated investor concerns of a nationalist wave sweeping Europe and threatening the Eurozone. Great Britain's triggering of Article 50 of the Lisbon Treaty to initiate its separation from the European Union was met with little trepidation in the markets. A weak Euro and a steeper yield curve prompting an

acceleration in bank loans within the region, as well as signs of stronger economic activity in Europe buoyed investors. The March IHS Markit Purchasing Managers Index (PMI) for the Eurozone showed the strongest economic conditions in six years, while the U.S. Composite PMI, fell to a six-month low.

In Asia, geopolitical concerns continued and the reversal of massive stimulus implemented by Chinese authorities in late 2015 and 2016 which spurred a cyclical upswing in the Chinese economy, as well as in Europe's, which is a major trading partner, raised concerns over the sustainability of the recent advance. Weaker economic data and moves by the government to reign in stimulus by raising short-term borrowing rates, tightening home mortgage and lending standards and increasing the auto sales tax gave investors pause. Chinese retail sales growth in January and February slowed to 9.5% year-over-year, which is a healthy figure by most standards but masked a 3-month average which fell to its lowest level in 13 years. Chinese personal income growth slowed to half the 13% year-over-year growth experienced between 2004 and 2012.

Key Performance Drivers

The market backdrop in Q1 differed significantly from the cyclical and financials driven rally in Q4 2016, with larger cap growth stocks and emerging market stocks performing best. This change in market preference helped the portfolio. In contrast to last quarter, positive stock selection in the Technology, Financials and Consumer Discretionary sectors contributed most to the portfolio's outperformance. An overweight in Technology also benefited performance, while selection in the Consumer Staples and Industrials sectors detracted from performance.

Top Contributors

Apple reported record iPhone shipments of 78.3 million units during the 4th quarter, exceeding consensus expectations. At the same time, stabilization in mainland China sales on a constant currency basis has also helped the investor sentiment. Similarly, Mac unit sales growth stabilized, while the decline in iPad sales continued. Overall, the company reported revenues and earnings per share slightly ahead of expectations. We continue to see Apple generating high single digit earnings growth on low single digit sales growth over the next three years. While valuation based on current earnings is by no means excessive, the stock's recent movement discounts a fair amount of positive future developments tied to capitalizing on their large installed base of iOS users, and excitement about their next iPhone 8 Anniversary launch later in the year. We have trimmed the position to reflect recent share price strength and are measured in our expectations for the upcoming iPhone 8 product cycle.

Leading Chinese internet, media and mobile application company **Tencent** continued to execute its business plan well in its core video game business, while also benefiting from its quickly growing advertising and emerging pipeline businesses in payments and cloud computing. The company reported solid 4th quarter revenue gains of 44% with gross profit growth of 33%. Margin compression due to significant investments in video content and its emerging operations in the quickly growing, but lower margin, payments business tempered results. While Tencent is entering an investment cycle in its video game and payments businesses, we continue to see it as the best positioned company to capitalize on growth in Chinese mobile internet usage. Given the law of large numbers in its tremendous user base and expected margin pressures, our research assumes a slowing in the company's revenue and earnings growth over the next three years from the 30%+ earnings growth delivered over the last three years we have owned the stock, to the mid-high teens on 20% revenue growth.

Leading online travel company **Priceline** benefited from a solid Q4 report, which demonstrated continued strong bookings growth and positive business momentum. Another positive, according to management, were signs that marketing return on investment (ROI) was starting to stabilize. In the past couple of years Priceline's online marketing expenses have grown faster than revenues, which have led to declines in ROI, but still resulted in highly profitable bookings. This trend now seems to be easing due to increased bookings from mobile application (less reliance on Google search), fewer competitors and Priceline's improving online marketing capabilities. Despite worries over slowing growth in gross bookings and room night bookings from high levels achieved in 2014 and 2015, the company delivered +28% and 31% growth respectively. Gross profits grew 21%, surpassing management guidance, and EPS growth of 24% beat consensus expectations. Guidance for Q1 was a bit light, however this was due mainly to seasonal timing and a shift in Easter from Q1 to Q2. Business fundamentals remain strong for Priceline as it benefits from positive trends in advertising, continued strong organic growth in hotel and vacation rental supply, and a healthy travel market.

Salesforce.com and **Red Hat** were the fourth and fifth largest contributors to portfolio performance for the quarter.

Largest Detractors

At the beginning of the quarter, **Fast Retailing** reported somewhat disappointing monthly comps in Japan, mostly

affected by weather. After the company reported the quarter, investors began to realize that there would likely be continued FX headwinds in the reported numbers for the remainder of the year due to mark down on foreign assets due to the stronger yen. These factors have made it more difficult for the stock to recover from its initial weakness at the beginning of the quarter. Despite the stock's volatility, the business' underlying fundamentals are quite strong. In fact, the company reported a significant improvement in the margins of its international operations, growing to 15% now compared to 10% last year. Given the strength of the company's underlying operations, we increased our position size in the stock and continue to feel confident in the opportunity.

Oil service companies such as **Schlumberger** continued to face headwinds in Q4 of last year amid reduced activity by producers. Sentiment changed following the November election as investors anticipated reduced regulation in the energy industry. This optimism was enhanced as OPEC announced that it would cut output levels. In Q1 of this year, however, oil prices declined as doubts surfaced over the impact of OPEC's production cuts given continued high inventory levels in the U.S., and questions over compliance by OPEC and non-OPEC members. Our research indicates that U.S. oil inventory levels are high due primarily to seasonal factors (such as refinery maintenance), as well as excess oil production by OPEC members in the period after the announcement but prior to the cuts being implemented at the beginning of the year. As such, we remain of the view that the backdrop will improve for the companies we are invested in as we move further into 2017.

Due largely to these pressures on the Energy sector as a whole, Schlumberger was the second largest detractor from performance in the quarter. The company however, reported a quarter that was broadly in line with expectations and provided a more positive outlook relative to prior quarters. Revenues increased modestly, marking a change from the declines experienced in previous quarters. We expect Q1 to show the first year-over-year increase in the last two years, and expect further improvements in free cash flow generation. Following the completion of its latest round of cost reductions, Schlumberger is more efficient and likely to benefit as oil prices stabilize and companies move ahead with increased capital spending. With contributions to earnings from international projects declining by over 70% since Q4 2014, we see the company being well positioned to benefit significantly from new non-U.S. opportunities which arise. Schlumberger has also added to its North American presence with a recent joint venture with Weatherford, matching the size and scale of Halliburton in the U.S. While we remain positive on Schlumberger's outlook, we are also very cognizant that the improvement will not be linear and that international markets may take longer to recover.

South Korean cosmetic company **Amorepacific** was the third largest detractor from returns in Q1. The company reported weaker than expected Q4 results with sales up about 7% amid political turmoil leading up to the recent impeachment of the country's President Park Geun-hye, as well as tension with China related to Korea's decision to allow the deployment of the THAAD anti-missile system, which resulted in China's decision to limit tourist travel to Korea. Domestic sales (32% of total sales) decreased 5% due to a sluggish South Korean economy and increased competition. Duty free sales, which account for 28% of total sales, grew a respectable 7%, and Asian exports (33% of total sales) grew 27%. While the Korean market is likely to stay weak in the near-term, the company has already begun its transition away from domestic markets given that 60% of sales are coming from duty free and exports. The company considers the U.S. market a large opportunity for growth as well and plans to enter it in 2017. While duty free sales to Chinese tourists will suffer in the short-term, we look for the incident to pass and the impact to dissipate as other similar situations have in the past. We have maintained a below average weight in the stock.

Novo Nordisk and **Whole Foods** were the fourth and fifth largest detractors from portfolio performance for the quarter.

Portfolio Changes

No new positions were initiated in the portfolio during the quarter, however we sold our position in Amgen. We actively trimmed positions where valuation had become less attractive, and added to positions where we sought to take advantage of price weakness and increased volatility. We trimmed positions in strong performers including Apple, Colgate-Palmolive, Lowe's and MercadoLibre, and added to positions in Core Labs, Fast Retailing, Kansas City Southern, Mondelez and MYOB on weakness.

Sales

While leading biotech company **Amgen** continues to meet our business quality criteria, we sold our position in the stock in order to redeploy the proceeds to other portfolio companies offering more attractive growth opportunities. The company has an attractive pipeline of innovative and biosimilar drugs that should reach the market over the next 2-3 years, but continues to face erosion within its base businesses due to patent expirations. With pressure on drug pricing in general likely to persist, Amgen's growth is expected to remain limited

as the company gradually transitions from its current suite of products into new therapies in various levels of clinical trials to treat osteoporosis, migraines and cancer as well as Repatha, their new drug to treat patients with hypercholesterolemia.

Summary

The market rally of Q4 continued through the first part of this quarter although the drivers of performance were different. In March the global market rally moderated, as investors began to question the ability of the new U.S. administration to enact the tax overhaul, infrastructure spending and regulatory reduction programs which had caused stocks to rally so strongly beginning last November. While we are of the view that the global economy will improve modestly in 2017 we also believe that the euphoria following the U.S. election will continue to be tempered by the reality of governance. As such, periods of renewed optimism will be followed by disappointment amid harsh rhetoric. Volatility, which has traditionally been positive for the portfolio, is likely to pick up. We will continue to take advantage of opportunities to enhance the business quality, growth and valuation of the portfolio. With global economic growth likely to remain modest over the next few years, the superior predictability and sustainability of the growth of portfolio companies' earnings and cash flows should be rewarded. As of March 31st, the portfolio is forecasted to generate 11.5% and 19.1% revenue and earnings growth respectively over the next three years, while companies comprising the ACWI are expected to generate 4.5% and 11.4% revenue and earnings growth over the same period. At the same time, the portfolio remains attractively valued based on our enterprise and discounted cash flow valuation metrics.

We thank you for your continued confidence in our team and process at SGA, and look forward to answering any questions you may have.

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