SGA
Sustainable Growth Advisers

Q1 2019 International Growth Commentary

Highlights

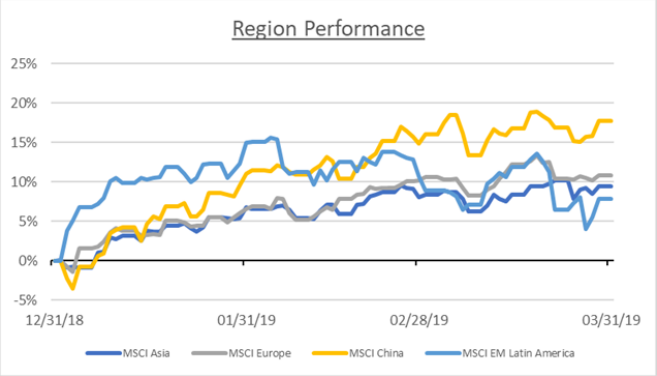
- *The portfolio generated attractive absolute and relative returns in the Q1 global market rebound*
- *Stock selection was additive across most sectors despite the strength in small cap and higher beta companies; sector allocations also contributed positively to results*
- *Selection in the Consumer Discretionary sector contributed most to the portfolio's outperformance while selection in the Technology sector detracted*
- *A new position in M3 was initiated and the portfolio's position in Core Labs liquidated*
- *Positions in Wal-Mart de Mexico, Novozymes and Nestle were added to on weakness, while positions in MercadoLibre and New Oriental Education were trimmed on strength*

Performance

SGA's International Growth portfolio returned 16.4% (gross) and 16.1% (net) in the first quarter of 2019, while its benchmark, the MSCI All Country World Index ex-U.S.A (ACWI ex-U.S.A), returned 10.3%.

A Rebound and Then a Reality Check

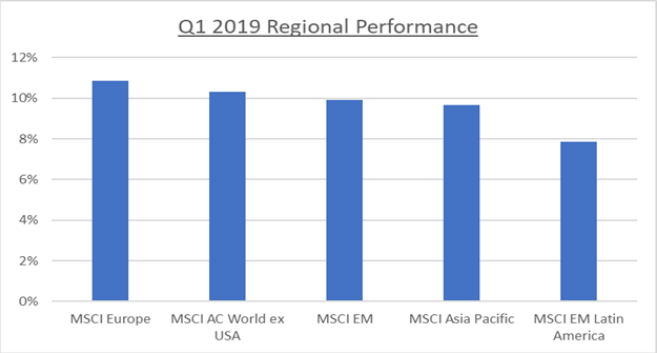
Global markets rebounded strongly in January following the widespread market weakness experienced in Q4. The rebound was initially driven by cyclical stocks, and those hardest hit in Q4, but the cyclical rebound gradually ran out of steam, as worries over slowing global economic growth re-emerged. Large cap growth stocks and those with higher quality characteristics regained their leadership. For the quarter, Technology stocks performed best, followed by Consumer Staples. Most other sectors performed either in line with the Index or behind it. Non-U.S. Developed Markets outperformed Emerging Markets by a small margin.



Source: FactSet

China reported its weakest economic growth in 2018 in nearly three decades, while its exports declined an estimated 21% in February, and imports were down 5.2% on a year-over-year basis. However, Chinese equities generated the second-best returns for the quarter, behind Colombia, given signs of possible movement toward a trade deal with the U.S., and more recent data points indicating that the significant stimulus being applied by the Chinese authorities including lower interest rates, increased lending and increased deficit spending over the last year, were beginning to have some positive effect.

The ECB's decision to push back any interest rate increases given the reduction in its growth forecast from 1.7% to 1.1%, and its decision to provide new cheaper loans to banks benefited many European markets. However, continued unrest in France likely delaying or blocking pro-growth initiatives weighed on stock prices there. The equity market in the United Kingdom only marginally trailed the Index despite the ongoing uncertainty relative to Brexit, and the growing chance that the country could exit the European Union without an agreement.



Source: FactSet

Emerging markets trailed the developed markets for the period, despite China's strong performance, as developing countries including Thailand, Mexico, South Africa and India generated

weaker returns. Ongoing uncertainty over the economic policies of Mexican President Andres Manuel Lopez Obrador, together with rising concerns over the likelihood of U.S. Congressional approval of the recently negotiated U.S. Mexico-Canada Agreement negatively impacted Mexican stocks for the quarter. Meanwhile, South Africa's economy continued to face uncertainty after slipping briefly into recession in late 2018 with unemployment remaining high, further depreciation in the Rand, and more corruption scandals within the ruling African National Congress party. With new national elections scheduled for May, and the country plagued by rolling blackouts which have negatively affected every sector of the economy, investor concern over future growth prospects and stability in the country hurt stock prices and negatively impacted the portfolio's holding in Sanlam. Similarly, uncertainty in India over upcoming elections, and whether current Prime Minister Modi will be re-elected given a united front by the opposition, weighed on Indian markets early in the quarter.

We consider the events and issues such as those discussed above important to understand in the context of the businesses and industries we consider investing client capital in over our 3-5 year time horizon. Such issues often lead to broad, sharp price movements in regional markets, creating opportunities for those who have done the detailed research on individual companies beforehand and are able to look beyond the near-term uncertainties. In this way, we use such volatility to take advantage of pricing anomalies, and the emotions that drive them, to build and manage concentrated portfolios from the bottom up. We continue to believe that we are in the early stages of an extended increase in market volatility due to peaking corporate profit margins, and slowing global economic growth. If correct, this should benefit the portfolio moving forward as more opportunities from wide price variations, and therefore attractive buying opportunities, develop globally.

Portfolio Attribution

The portfolio's outperformance was due to strong stock selection, particularly in the Consumer Discretionary sector where positions in MercadoLibre and strongly rebounding Chinese stocks New Oriental Education, Ctrip.com, and Alibaba boosted returns. We added to these positions in the fourth quarter of 2018 as their prices fell on near-term concerns. Selection was also strong in Financials and Consumer Staples due to positions in AIA Group and Aon, and Heineken and L'Oreal respectively. Selection in the Technology sector detracted due to the portfolio's position in Wirecard. Sector allocations also contributed positively due to the portfolio's significant overweight in Consumer Staples and underweight in Financials. From a regional standpoint, stock selection within the Emerging Markets contributed most to the portfolio's outperformance, while selection in the non-U.S. Developed markets also contributed positively.

Top Contributors

Latin American e-commerce leader **MercadoLibre** was the largest contributor to performance during the quarter. The company reported solid operating results for the quarter, beating consensus expectations. In particular, operating margins returned to break-even levels during the quarter and the company's burgeoning FinTech initiatives continued to post strong growth. While there was continued deceleration in its Brazil operating results tied to the ongoing impact of rising shipping costs associated with the Correios (Brazilian Postal Service) price hike implemented early last year, the company will be lapping those comparisons in short order. Furthermore, the company's effort to diversify away its reliance on Correios continues to make progress as 17% of shipments are now using MercadoLibre's logistics network, and delivery times continue to improve. Despite rising competition, we continue to see MercadoLibre's long-term growth opportunity as very attractive given the still low e-commerce and digital payments penetration still present in Latin America and the company's strengthening position in the market. We trimmed our position in the stock on strength given valuation and maintained an average weight position in the company.

China's largest private educational provider **New Oriental Education** reported better than expected Q2 FY 19 results with revenue up 34% (in RMB), along with better than expected margins due to lower sales, marketing and capital expenses. The company also increased its guidance for revenues and margins for the second half of fiscal 2019. With ongoing capacity expansion and investments in teaching content, continued positive momentum in its classroom business, heavier regulation leading to increased industry consolidation, and benefits from China's move toward national (as opposed to regional) standardized testing, we continue to see attractive long-term growth opportunities for the company. However, given its strong performance over the period and rising valuation, we trimmed the position during the quarter to reallocate some capital toward other attractive growth opportunities, harvesting gains from opportunistic purchases at the end of 2018.

Chinese e-commerce leader **Alibaba** reported a strong quarter with earnings exceeding the average analyst's estimate, as well as our own as the company benefited from continued strength in its core business and effective expense management.

Revenues grew 40% while profits grew 19% and profit margins remained strong at 45%. The company reported continued attractive growth in its active users with 23% more, for a total of 636 million active users on its platforms, and 70% of its new users coming from 3rd or lower tiered cities. With Alibaba's platform aimed at increasing consumption, it remains in a good position relative to other areas of the Chinese economy more focused on exports. We continue to expect Alibaba to benefit from the tremendous breadth of its unified user data set given the dominance of its e-commerce platforms and significant stakes and affiliations with major parts of the Chinese internet ecosystem via online video (Youku), social media (Weibo) and payments (Ant). The company's existing domestic cloud infrastructure leadership position and its ability to make large scale technology investments provides a key advantage to Alibaba, and serves as a barrier to other domestic and foreign cloud competitors. Our research continues to point to attractive long-term revenue and profit growth opportunities for Alibaba but we remain cognizant that the company will continue to invest heavily limiting profit growth in the short term as it takes steps to enhance the breadth and depth of its "New Retail", cloud and payments offerings, and expands its international footprint. We see these investments deepening Alibaba's relationships with merchants and consumers, expanding its total addressable market, and promoting the ubiquity of its services, giving it a major advantage over primarily online focused e-commerce players. We maintained an above-average weight position in the stock.

Ctrip.com and **AIA Group** were the fourth and fifth largest contributors to portfolio returns.

Largest Detractors

Wirecard was the largest detractor from portfolio performance in the quarter after its stock price declined amid allegations from a financial news agency of fraudulent accounting activity in the company's Singapore offices. As a result of the allegations, the company did disclose that compliance issues were raised to the internal compliance department during 2018, and that the company conducted an internal inquiry and had engaged a third party Singaporean law firm to investigate the matter further. So far, no material accounting violations have been found, although some employees are being investigated by local Singaporean authorities. We held onto the position during the quarter at a below-average weight as we awaited further clarity as the law firm's report was passed onto the company's auditors, in preparation of the company's annual results.

South African financial conglomerate **Sanlam** was the second largest detractor to performance. Sanlam's shares declined even though it reported six-month results which were generally in line with our expectations, indicating improving new business volumes and margins which were in line with management's guidance. Sanlam continues to face a difficult macroeconomic environment in South Africa. From an operational standpoint, however, the company's new partnership with Capitec, which sells funeral insurance among other things, benefited results, and its recently completed acquisition of Saham, should create attractive opportunities for Sanlam in the sub-Saharan region of Northern Africa. We maintained a below-average size weight in the stock during the quarter given the macro-economic influences in Africa currently, but remain positive on the long-term growth opportunity present for Sanlam.

Chinese pharmaceutical and medical device distributor **Sinopharm** was the third largest detractor from performance after a mixed Q4 report. Sinopharm reported 12% sales growth, and improving market share, but also reported continued invoice collection problems impacting cash conversion rates. Its pharmaceutical business and medical device segments posted faster sales growth than their underlying markets, and their retail pharmacy business is expected to post double-digit growth over our time horizon. While the company continues to perform better than its competition, and we continue to see an attractive secular growth opportunity in China's evolving health care needs, the company's collections and cash productivity have been disappointing and we are maintaining a below-average weight in the stock.

No other portfolio holding detracted from absolute results, however **M3** and **Novozymes** were the smallest contributors to portfolio returns.

Portfolio Changes

Turnover in the portfolio was below-average for the period, with a new position in Japanese medical services provider M3 being initiated and a position in specialty oil service provider Core Labs being eliminated. Positions in Wal-Mart de Mexico, Novozymes and Nestle were added to on weakness, while positions in MercadoLibre and New Oriental Education were trimmed on strength.

Purchases

M3 is a global network of 4.5 mm doctors that is monetized in multiple ways via subscriptions to the members-only web site, career services, advertising etc. While 80% of its sales come from Japan, it has a sprawling and budding overseas business in

the U.S., the U.K., mainland Europe, China, South Korea and India. In Japan, M3 operates a member's only medical portal, M3.com, which serves as the source for prescription drug details. Doctors access the site frequently, resulting in high recurring revenues. The Company's Evidence Solution unit is focused on designing and supporting clinical trials which are longer-term in nature. The Company utilizes its access to doctors, via its M3.com portal, to recruit patients faster. The company faces little competition in this area of its business. M3's third primary business is career development services whereby the Company leverages its doctor profiles and access to identify and connect doctors with possible new career opportunities. It also has many other related emerging businesses. Overseas, the company is using its expertise to build similar businesses on top of the member networks.

M3's business offers attractive pricing power as it is not easy to replicate its offering or network of doctors. Our research indicates that M3 offers attractive growth potential over our 3-5 year time horizon as it replicates its successful business model in Japan, and offers such services elsewhere in Asia, Europe and the U.S. We also see additional benefit from the company's M&A activity as they purchase network businesses that can benefit from M3's systems, and offer synergies through vertical integration, cost savings and marketing through their system.

Among the key risks we see, M3's Japanese business serves very large pharmaceutical companies, and there is ongoing risk of client turnover. However, M3 faces little direct competition in its businesses. There is also the potential for regulatory risk in Japan. While the company is diversifying is business across geographies and revenue sources, the majority of its sales remain in Japan.

We initiated a below average size position in the stock, and expect to build it opportunistically moving forward.

Sales

The portfolio's position in **Core Labs** was sold to fund the portfolio's new position in M3. We continue to expect North American well completions to grow as Core Labs helps customers generate better production from existing wells and provides critical cost saving data to producers involved in exploration, but saw other more attractive opportunities in the portfolio and on our Qualified Company List.

Outlook

The portfolio participated strongly in the rebound of global equity markets in Q1, outperforming its benchmark by a wide margin. Cyclicals and value assumed leadership briefly in January amid renewed optimism over future global growth opportunities, but leadership quickly transitioned back to growth stocks with higher quality in February. New data pointed to continued economic malaise in Europe, with Germany seeing the yield on long-term Bunds briefly go negative, uncertainty over Brexit growing and Chinese economic data disappointing. While macro-economic forces continued to play a large role in widely varying price movements and emotions in the market, our approach to taking advantage of attractively valued high-quality secular growth opportunities during a period of market weakness was rewarded with the top three contributors to performance in Q1 2019 being positions which were either initiated or added to on weakness during Q4 of 2018.

We continue to believe that we are in the early stages of a fundamental transition in the markets where increased volatility and greater differentiation between businesses will be more widely apparent. There will undoubtedly continue to be variations in market sentiment influenced by macro-related issues, but given peak profit margins, slowing PMI's and a sluggish global economic back drop, we continue to believe the outlook for high quality businesses that can grow their revenues and earnings sustainably, regardless of the macroeconomic backdrop, is particularly attractive at this late stage of the business cycle. Over the next three years, we expect the company's in this portfolio to generate 11.7% revenue growth and 14.0% earnings growth relative to 2.6% and 7.0% revenue and earnings growth projected for the broad international equity market as measured by the ACWI ex-U.S.A.

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

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performance has been reduced by the amount of the highest published fee that may be charged to SGA clients, 1.0%, employing the International Growth equity strategy during the period under consideration. Actual fees charged to clients may vary depending on, among other things, the applicable fees schedule and portfolio size. SGA's fees are available upon request and also may be found in Part 2A of its Form ADV. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. Upon request, free of charge, SGA can provide a list of all portfolio holdings held in SGA's International portfolio for the past twelve months. Past performance is not indicative of future results.