# International Growth Commentary

Q4 2022

## Performance

SGA's International Growth portfolio returned +12.1% (gross) and +11.3% (net) in Q4 versus +14.3% for the MSCI ACWI ex USA Index and +12.9% for the MSCI ACWI ex USA Growth Index. For the year 2022, the SGA International Growth portfolio returned -17.7% (gross) and -20.2% (net) compared to -16.0% for the MSCI ACWI ex USA Index and -23.1% for the MSCI ACWI ex USA Growth Index.

*Source: FactSet, MSCI. The returns shown above are for the R6 share class (SCIZX) of the Virtus SGA International Growth Fund, for which SGA serves as the sole subadvisor. Returns are net of fees.*

## Highlights

- Portfolio lagged its benchmarks in Q4's strong market rebound. For the year, the portfolio trailed the MSCI ACWI ex USA Index but outpaced the MSCI ACWI ex USA Growth Index
- Companies with higher growth prospects continued to underperform; a cyclical rally in Q4 posed a headwind for the portfolio's relative returns
- New positions were initiated in Canadian Pacific and Atlassian; no positions were liquidated. Several positions were trimmed on strength, including FEMSA, Shandong Weigao, Yum China, Novo Nordisk, and Linde, while positions in Heineken, Wal-Mart de Mexico, Adyen, and XP were added to on weakness
- Portfolio remains well-positioned to deliver attractive, above-average growth in earnings and cash flows over the next three years with greater predictability
- We are pleased to announce that Kishore Rao will replace Gordon Marchand on SGA's Executive Committee (the group charged with running SGA's business) effective July 1st, as Gordon retires from SGA

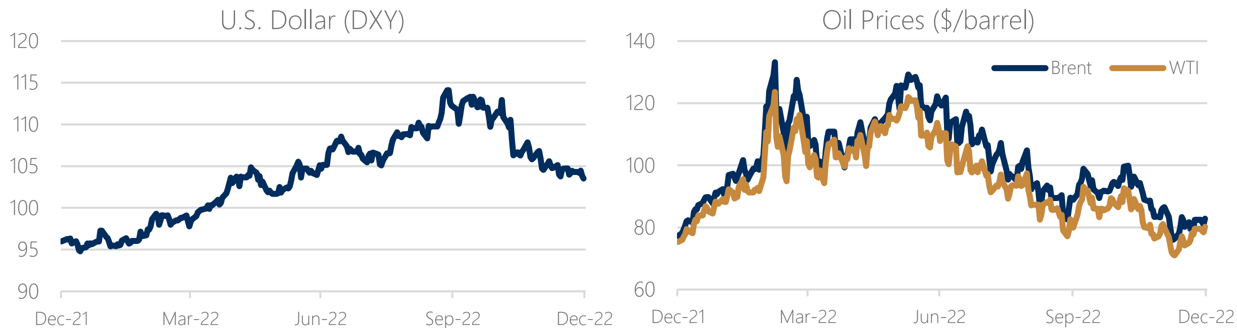
## Better-Than-Feared Economic Conditions in Europe, China Re-Opening, and a Weaker U.S. Dollar Lifted International Markets in Q4

International markets rebounded in Q4 on the back of a weaker U.S. Dollar, moderating concerns about Europe's energy crisis amid mild winter weather, better-than-feared economic data, and China's abrupt pivot away from its zero-Covid policies which supported a strong recovery in Chinese stocks.

Economic growth continued to slow in the European Union amid ongoing pressures related to the war in Ukraine, higher interest rates, tight energy supplies, and weakness in exports to China. However, better-than-feared data in Germany, which has so far escaped recession, lifted investor sentiment as fears of an imminent European recession receded. Likewise, the UK saw its markets rebound in Q4 as a new government took over and immediately took steps to rescind the tax and spending policies which had wreaked havoc on its markets in Q3. With Russia's setbacks in its war with Ukraine and better-than-expected energy supplies for the winter across Europe, market optimism led the MSCI Emerging Europe and MSCI Europe Indexes to produce strong returns for the quarter, led by Turkey, Poland, and Hungary.

Chinese markets whipsawed during the quarter as investor pessimism in October turned to optimism following the country's decision to exit its zero-Covid policy strategy in response to protests and growing civilian displeasure with its draconian restrictions. The MSCI China Index soared 36% in the final two months of the year after having lost more than 62% cumulatively since its peak in February 2021. The China Index remains nearly 50% below its peak despite its recent rally. China's anticipated economic re-opening also lifted other Asian markets which are expected to benefit from a recovery in

Chinese demand, including the Philippines, Malaysia, Thailand, and South Korea. In contrast, Latin American markets, the best-performing region for the year, lagged in Q4 as declining oil prices and political turmoil weighed on the region. Likewise, oil-exporting countries in the Middle East, including Qatar, Saudi Arabia, and UAE performed poorly, as did Indonesia, another oil and gas exporter, given falling energy prices.




*Source: FactSet*

Growth expectations, which moderated over the course of 2022, improved in Q4 given rising investor optimism around a cyclical recovery in China and a more resilient economic backdrop in Europe. While we view China's re-opening as a positive for growth eventually, the near-term remains murky as new outbreaks and rising Covid infections are likely to challenge hospital systems, pressure supply chains, and disrupt economic activity intermittently. Additionally, with the impact of a historically significant global central bank tightening cycle over the past year still flowing through to global economic activity, we continue to expect a more challenging environment for economic and profit growth ahead. Longer-term, structural issues such as an aging population in China and a more uncertain regulatory landscape in the country given its "common prosperity" goals, along with de-globalization trends, are likely to impede global growth potential. Despite such challenges we find comfort in the ability of our sustainable growth companies to compound cash flows at attractive rates over the long-term with greater predictability and resiliency and expect these higher-quality companies to be rewarded by the market over time.

## Largest Contributors

**Novo Nordisk** was the largest contributor to portfolio performance after reporting good Q3 results with sales growing 15%, earnings per share up by 20%, and the company raising its topline guidance for 2022 from 10-14% constant currency growth to 14-17%. The company's GLP-1 diabetes drug Ozempic, which accounts for 49% of sales, grew 44%+. Meanwhile, traditional insulins, which comprise 28% of sales, saw slower growth as expected. The company's recently launched obesity drug Wegovy experienced 62% sales growth even though it was only launched in the U.S. and remains supply constrained. We expect long-term sustainable growth for Novo's obesity and diabetes franchises, and we maintained an above-average weight in the stock, trimming on strength during the quarter.

**AIA Group** was the second largest contributor to performance in Q4 as stocks expected to benefit from China's reopening outperformed. The removal of restrictive zero-Covid policies should be beneficial for AIA's ability to generate new business as high-end life insurance sales are complex and typically require in-person meetings to close. AIA's third-quarter business update highlighted positive momentum as value of new business grew 7% in constant currency with growth across all geographies. Annualized new premiums grew 8% and total premiums rose 2%. With China representing the company's largest growth driver and the greater likelihood of a more supportive operating environment, we expect new business growth to improve moving forward. Longer-term we see AIA as being well positioned to benefit from key secular growth tailwinds including favorable demographics and rising penetration of insurance products across its key markets in Asia. We maintained an above-average weight during the period.

**Shandong Weigao** was the third largest contributor to performance in Q4 with its shares benefiting from strength in Chinese stocks. We continue to view Shandong Weigao as well-positioned to benefit from secular growth in healthcare demand in China as its medical products are used in routine services and surgeries. We expect Shandong to continue to gain market

share as the market consolidates in response to government value-based-purchasing policies given its scale advantages. The stock's recent strength reflects investors becoming more comfortable with the impact of China's government policies on the company's growth prospects. China's re-opening should also be a positive for the company given a likely recovery in surgical volumes and patient traffic, although some near-term disruption may be expected in the first half of 2023. We maintained an above-average weight given our favorable long-term view but trimmed the position back to target on strength.

**FEMSA** and **Linde** were the fourth and fifth largest contributors to performance.

## Largest Detractors and Smallest Contributors

**Temenos** was the portfolio's largest detractor in Q4 as weaker-than-expected results and a disruptive transition from a license-based business model towards a subscription-based model weighed on investors' confidence in the company's ability to execute. Temenos reported disappointing third-quarter results with total revenues declining 8% as total software sales dropped 19%. Operating profits declined 53% and margins contracted to 19% from 37%+ one year ago. The company attributed the weakness to a lengthening sales cycle linked to several large deals in its pipeline being postponed as banks have become more cautious given rising macro-economic uncertainty. The company acknowledged poor execution in the U.S., a key growth market, leading to the immediate departure of its Chief Revenue Officer. While we expected Temenos' transition period to impact results and anticipated that a weaker macro environment could push out deals, the magnitude of its recent miss was a surprise to us. Despite our disappointment we continue to see an attractive long-term growth opportunity for Temenos but will continue to monitor its progress on key growth initiatives and overall execution. We engaged with the company and have confidence that the Board will address management execution issues. Given reduced visibility and greater uncertainty around near-term growth, profitability, and cash flow generation, we lowered our target weight but continue to believe that the long-term future is bright for Temenos.

**XP** was the portfolio's second largest detractor in Q4 due to the continued difficult macro environment impacting its growth recovery and investor concerns over the possible impact of newly elected President Lula's fiscal policies on the Brazilian economy and markets. While XP's inflows were within the range of management's guidance during the quarter, some investors might have been disappointed as they are used to seeing the company beat expectations. Also weighing on the stock were ongoing sales from pre-IPO investor, Itau, which is liquidating its position in the company. While the company has increased its share buyback and also initiated direct purchases of the stock from Itau, this has not been sufficient to offset the temporarily increased selling liquidity. We expect this pressure to wind down over the next 2-3 quarters if the sales proceed at their current pace. With regard to XP's business, we continue to see great opportunity for XP to expand its market share of the developing Brazilian financial markets and the demand for more complex investments from a growing middle class over our 3–5-year investment horizon. We purchased additional shares on weakness during the quarter but maintained a below-average weight position.

**Atlassian** was the third largest detractor from portfolio performance in Q4. We took advantage of the appealing valuation following the company's weaker than expected Q1 FY23 earnings report to initiate a position in the enterprise software company. Although the company saw a slowdown in growth from existing customers, we believe Atlassian is positioned well to benefit from its leading competitive position as customers consolidate amid a tough macro backdrop. We initiated a below-average weight position during the quarter and will continue to build the position opportunistically over time. A more detailed description of our thesis is included below in the New Positions section.

**Canadian Pacific** and **Dassault Systemes** were the smallest contributors to performance for the quarter.

## Portfolio Activity

Portfolio turnover picked up slightly in Q4 with positions in Canadian Pacific and Atlassian initiated. No positions were liquidated but we trimmed positions in FEMSA, Shandong Weigao, Yum China, Novo Nordisk, and Linde on strength. We added to positions in Heineken, Wal-Mart de Mexico, Adyen, and XP on weakness.

## New Positions

A new position in **Canadian Pacific** (CP) was initiated in Q4. CP owns and operate transcontinental freight railways in Canada and the United States, transporting bulk commodities, merchandise freight, and intermodal traffic. The company provides services over a network of approximately 13,000 miles, directly serving the principal business centers of Canada, the U.S. Northeast and Midwest regions, and Gulf ports. The proposed acquisition of Kansas City Southern (KCS) – pending regulatory approval expected in Q1 2023 – would create a one-of-a-kind rail network spanning United States, Mexico, and Canada. Railroads possess structural cost advantages over their primary competition, the trucking industry, which continues to suffer from secular cost inflation in the form of driver shortages, higher insurance costs, highway deterioration, and increasing regulation. Furthermore, the North American industry has been consolidated into a series of regional duopolies. Canadian Pacific benefits from strong contract renewal pricing and has achieved consistent price increases exceeding inflation over the last decade. The company has contractual relationships with a broad set of shippers for essential agricultural and energy commodities, industrial products, and intermodal shipments necessary to the North American economy which leads to a high proportion of repeat revenues and predictability. CP's unique rail network and the company's success with Precision Scheduled Railroading (PSR) should sustain volume growth, pricing increases exceeding inflation and, in turn, sustained mid-to-high-single-digit profit growth moving forward.

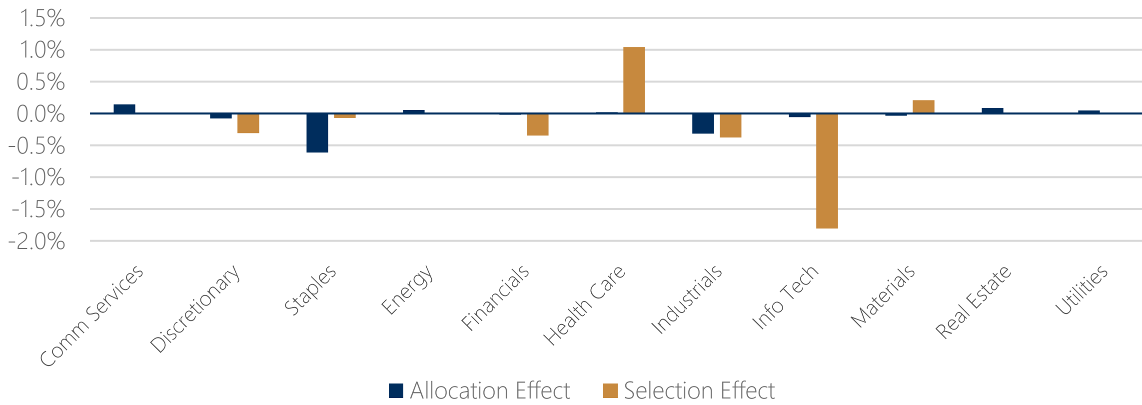
Among the risks we are monitoring for CP include potential adverse regulatory developments and interventions relating to its pricing, services, and safety. Additionally, while the approval of its KCS acquisition is expected, there could be material, unforeseen adverse concessions required by the regulators, customers, or local communities. Shifts in trade and cargo flows to ports where CP does not have a presence could impact future growth and profitability. Lastly, we continue to monitor risks from autonomous trucking or other technological innovations that could disrupt the rail industry over time.

A new position in **Atlassian** was initiated in Q4. Atlassian is an enterprise software company that provides project management, content creation and sharing, and service management products for software developers, IT departments, and business users. Atlassian is known for its unique model of product-led and low-touch sales strategy, transparent and disruptive pricing, high R&D focus, and high retention enabling a consistent land-and-expand growth pattern. Atlassian offers best-in-class products at significantly lower costs compared to competitors. The low cost along with consumer stickiness enables Atlassian to embed pricing in its growth formula. Over 95% of its revenues are recurring, including revenues from subscription services and annual maintenance, and the company's net retention rate for medium and large customers is over 130%. Atlassian's growth opportunity is supported by secular trends, including companies' digital transformations which demand increasing technology utilization to extend competitive advantages and improve efficiency. This requires more collaboration between software developers, IT teams, and business operations, which serves to increase demand for Atlassian's products over time. We see a long-duration growth opportunity ahead for Atlassian. With significant weakness in its stock price over the past year and now a more attractive valuation, we decided to initiate a below average weight position in Q4. We expect to build the position opportunistically over time.

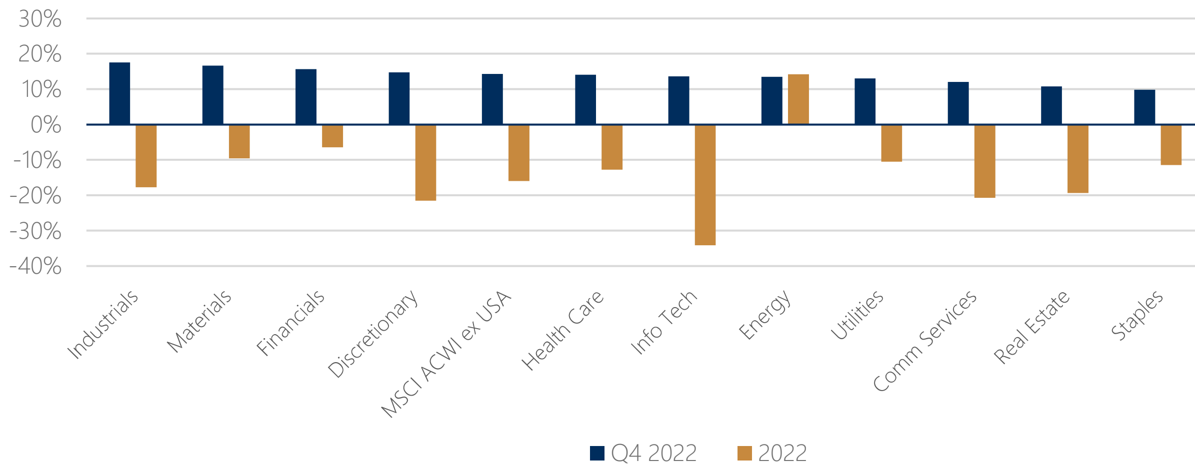
Among the risks we are monitoring for Atlassian include competition within the collaboration software market, the ability of the company to raise prices over time without materially impacting customer churn, and the pace of cloud migration by its end customers which could complicate the company's internal plan to discontinue its server products by early 2024.

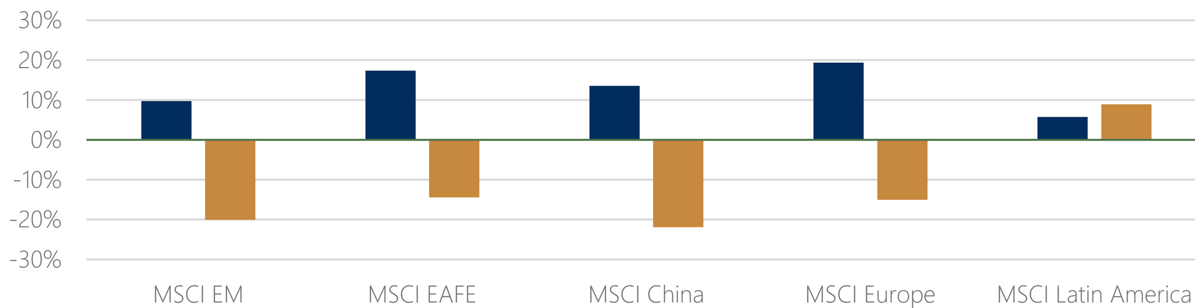
## Market and Portfolio Attribution

Stock selection and allocation effects detracted from relative returns in Q4. Selection in the Information Technology, Industrials, and Financials sectors detracted most due to weakness in Temenos, Canadian Pacific, and XP, offsetting positive selection effects in the Health Care sector driven primarily by strength in Novo Nordisk and Shandong Weigao. The portfolio's overweight in the Consumer Staples sector and underweight in the Industrials sector, purely a by-product of our bottom-up process, weighed on relative returns during the period as the Staples sector lagged while the Industrials sector outperformed. Stock selection in Non-U.S. Developed Markets detracted while selection in Emerging Markets and the U.S. contributed positively. Faster-growing companies continued to underperform and companies with higher-quality business metrics were not rewarded, posing a headwind for our approach in Q4 and 2022.




*Source: FactSet, MSCI*




*Source: FactSet, MSCI. Please see table included in this commentary for full performance presentation.*

## Summary

A weaker U.S. Dollar, a better-than-feared economic backdrop in Europe, and China's re-opening plans supported a strong market rebound in Q4. The rise in investor optimism lifted growth expectations, which had started to decline over the course of 2022, while supporting a strong rally in cyclicals and markets closely tied to Chinese growth and demand later in the quarter. Although we view China's re-opening as a positive for growth, we believe its longer-term growth potential is likely to be more muted compared to the past 20 years given its aging population, regulatory priorities, and more adversarial relations with the West. This will have significant implications for global growth broadly as China will no longer be the growth engine of the world as it once was. In the near-term there will be fits and starts accompanied with its economic recovery as mass Covid outbreaks are likely to disrupt economic activity intermittently. With the impact of global central bank tightening still feeding through to global economic activity, countering an improving growth backdrop in China, we continue to expect a more challenging growth environment ahead. Investor sentiment and style leadership is likely to remain volatile as a result of these crosscurrents, but we are confident that the more predictable, resilient, above-average growth offered by the companies in our portfolio will be rewarded over time.

We thank you for your continued to support, welcome any questions or comments, and wish you a healthy and prosperous 2023.

## Organizational Update

As we communicated to you last year, co-founding partner Gordon Marchand will be retiring from Sustainable Growth Advisers on June 30, 2023. Gordon has been a member of the firm's Executive Committee since our inception in 2003. Following Gordon's retirement, we are pleased to announce that Kishore Rao will replace Gordon on the Executive Committee, joining co-founders George Fraise and Rob Rohn.

*The opinions expressed herein reflect the opinions of Sustainable Growth Advisers, LP and are subject to change without notice. Past performance is no guarantee for future results. This information is supplemental and complements a GIPS Report that can be found with composite performance. The securities referenced in the article are not a solicitation or recommendation to buy, sell or hold securities. This commentary is provided only for qualified and sophisticated institutional investors.*

*Results are presented gross and net of management fees and include the reinvestment of all income. For interest and capital gains, SGA does not withhold taxes. For dividends, SGA will withhold taxes as reported by the client's custodian. Returns are calculated net of withholding taxes on dividends. The Net Returns are calculated based on the deduction of a model fee of 3.00% being the highest applicable fee that may be charged to SGA clients for the International Growth WRAP strategy. Net Returns do account for custodian and brokerage fees. 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 may be found in Part 2A of its Form ADV. The largest contributors and detractors are determined using a ranking of the absolute contribution to portfolio return by each security held over the period under consideration. Policies for valuing investments, calculating performance, and preparing GIPS Reports are available upon request. Upon request, free of charge, SGA can provide a list of all portfolio holdings held in SGA's International Growth portfolio for the past year. SGA's earnings growth forecast data is based upon portfolio companies' non-GAAP operating earnings.*

| Performance Results | Q4 2022 | YTD 2022 | 1-Year | 3-Year | 5-Year | 7-Year | Since Inception |
|---|---|---|---|---|---|---|---|
| SGA International Growth (Gross) | 12.1% | -17.7% | -17.7% | 4.2% | 5.3% | 8.8% | 7.1% |
| SGA International Growth (Net) | 11.3% | -20.2% | -20.2% | 1.1% | 2.2% | 5.6% | 4.0% |
| MSCI ACWI ex USA (Net TR) | 14.3% | -16.0% | -16.0% | 0.1% | 0.9% | 4.8% | 2.8% |
| MSCI ACWI Growth ex USA (Net TR) | 12.9% | -23.1% | -23.1% | -0.4% | 1.5% | 5.2% | 3.7% |

## International Growth Commentary

| | Total Return | | | | | | 3 Year Standard Deviation | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Period | Before Fees | After Fees | MSCI ACWI ex-USA Net TR Index | MSCI ACWI Growth ex-USA Net TR Index | Number of Portfolios | Composite Dispersion | SGA Composite | MSCI ACWI ex-USA Net TR Index | MSCI ACWI Growth ex-USA Net TR Index | Total Assets in Composite at Period End (USD millions) | Total Firm Assets at Period End (USD millions) | Percentage of non-fee paying accounts | Percentage of WRAP accounts |
| Mar. 1 - Dec. 31, 2015 | -4.63% | -7.00% | -10.32% | -6.77% | Five or Fewer | N/A | | | | 0.096 | 5,318 | 100% | 0% |
| 2016 | 0.65% | -2.33% | 4.50% | 0.12% | Five or Fewer | N/A | | | | 0.097 | 5,672 | 100% | 0% |
| 2017 | 37.83% | 33.85% | 27.19% | 32.01% | Five or Fewer | N/A | | | | 0.133 | 9,971 | 100% | 0% |
| 2018 | -12.42% | -15.04% | -14.20% | -14.43% | Five or Fewer | N/A | 12.85% | 11.38% | 11.55% | 89 | 9,096 | 0% | 0% |
| 2019 | 30.96% | 27.16% | 21.51% | 27.34% | Five or Fewer | N/A | 12.01% | 11.34% | 11.50% | 307 | 12,347 | 0% | 0% |
| 2020 | 25.55% | 21.90% | 10.65% | 22.20% | Five or Fewer | N/A | 15.87% | 17.93% | 16.48% | 310 | 18,780 | 0% | 0% |
| 2021 | 9.53% | 6.31% | 7.82% | 5.09% | Five or Fewer | N/A | 15.11% | 16.79% | 15.01% | 325 | 22,899 | 0% | 0% |
| Since Inception (March 1, 2015) | 11.36% | 8.09% | 5.93% | 8.30% | | | 14.32* | 14.53* | 13.66* | | | | |

N/A- Information is not statistically meaningful due to an insufficient number of portfolios in the composite for the entire year.

3 Year Standard Deviation is not shown for 2015, 2016, and 2017 as 36 months of returns are not available

* Since Inception Annualized Standard Deviation. SGA Composite Standard Deviation based on Gross Returns.

Sustainable Growth Advisers, LP (“SGA”) was formed in 2003 and is a registered investment advisor under the Investment Advisers Act of 1940. SGA manages portfolios of publicly traded equity assets according to its “Large Cap Growth Equity” investment approach for pooled funds, institutions, trusts and private accounts. SGA is an operationally independent investment management firm and an affiliate of Virtus Investment Partners. The SGA International Growth WRAP Composite was created in March 2019. The firm maintains a complete list and description of all composites, which is available upon request.

Sustainable Growth Advisers, LP claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Sustainable Growth Advisers, LP has been independently verified for the periods July 1, 2003 – December 31, 2021.

A firm that claims compliance with the GIPS standards must establish policies and procedures for complying with all the applicable requirements of the GIPS standards. Verification provides assurance on whether the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS standards and have been implemented on a firm-wide basis. Verification does not provide assurance on the accuracy of any specific performance report.

GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein.

SGA International Growth WRAP Composite contains fee-paying and non-fee paying large cap international growth equity portfolios under full discretionary management of the firm. For comparison purposes the composite is measured against the MSCI ACWI ex-USA TR Index (Net) and MSCI ACWI Growth ex-USA TR Index (Net).

The composite includes non-wrap accounts only, from 3/1/15 to 12/31/21.

The composite calculation has been appropriately weighted for the size of each portfolio on a time-weighted, total return basis. Monthly portfolio returns have been used in the construction of the composite. Results are based on fully discretionary accounts under management, including those accounts no longer with the firm.

The U.S. Dollar is the currency used to express performance. Results are presented gross and net of management fees and include the reinvestment of all income. For interest and capital gains, SGA does not withhold taxes. For dividends, SGA will withhold taxes as reported by the Client’s custodian. Returns are calculated net of withholding taxes on dividends. Wrap fees include management, transaction, custody and other administrative fees. The Net Returns are calculated based upon the highest published fees. The net performance has been calculated by reducing the gross performance by the amount of the highest published wrap fee that may be charged to SGA clients, 3.00%, employing the International Growth WRAP 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. The annual dispersion presented is an asset-weighted standard deviation calculated using gross returns for the accounts in the composite the entire year. Policies for valuing investments, calculating performance, and preparing GIPS Reports are available upon request. Past performance is no guarantee of future results.

The standard wrap fee schedule in effect is 3.00% on total assets. Actual investment advisory fees incurred by clients used in the composite may vary from the standard fee schedule.

Indices are unmanaged, hypothetical portfolios of securities that are often used as a benchmark in evaluating the relative performance of a particular investment. An index should only be compared with a mandate that has a similar investment objective. An index is not available for direct investment and does not reflect any of the costs associated with buying and selling individual securities or management fees.

Risk Considerations:

Equity Securities: The market price of equity securities may be adversely affected by financial market, industry, or issuer-specific events. Focus on a particular style or on small or medium-sized companies may enhance that risk.

Foreign & Emerging Markets: Investing in foreign securities, especially in emerging markets, subjects the portfolio to additional risks such as increased volatility, currency fluctuations, less liquidity, and political, regulatory, economic, and market risk.

Geographic Concentration: A portfolio that focuses its investments in a particular geographic location will be sensitive to financial, economic, political, and other events negatively affecting that location.

Market Volatility: The value of the securities in the portfolio may go up or down in response to the prospects of individual companies and/or general economic conditions. Price changes may be short- or long-term. Local, regional, or global events such as war or military conflict (e.g., Russia's invasion of Ukraine), acts of terrorism, the spread of infectious illness (e.g., COVID-19 pandemic) or other public health issues, recessions, or other events could have a significant impact on the portfolio and its investments, including hampering the ability of the portfolio's manager(s) to invest the portfolio's assets as intended.