POLEN | CAPITAL

# POLEN INTERNATIONAL GROWTH STRATEGY

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## Summary


- During the second quarter of 2018, the Polen International Growth Composite Portfolio (the "Portfolio") returned 4.62% gross of fees. The MSCI All Country World Index (ex-US) (the "Index") returned -2.61%.

- Since inception on January 3, 2017, the Portfolio returned 25.76% annualized gross of fees versus 14.42% annualized for the Index.

- During the second quarter, holdings in the health care and information technology sectors contributed to Portfolio returns, as did a complete lack of exposure to financials, the largest single sector weighting of the Index.

- We don't see negative implications from trade policy for the Portfolio's holdings today. Should we find trade policy changes impairing the competitive position of a business in our portfolio, we will reconsider our investment thesis.


## Commentary

In the second quarter of 2018, the Polen International Growth Composite Portfolio (the "Portfolio") returned 4.62% gross of fees. The MSCI All Country World Index (ex-U.S.) (the "Index") returned-2.61%. Since inception on January 3, 2017, the Portfolio returned 25.76% annualized gross of fees versus 14.42% annualized for the Index. During the second quarter, the Portfolio's high-quality growth companies outperformed in a tough environment. Contributions by companies in the health care and information technology sectors contributed to Portfolio returns, as did a complete lack of exposure to financials, the largest single sector weighting of the Index.

Second quarter returns for most non-U.S. equity markets were negative. A strengthening U.S. dollar and fears of a brewing trade war were factors. At the end of this commentary, we share more extensive thoughts about global trade and tariffs as well as reasons for long-term optimism in investing outside the U.S. For those interested in our higher-level thoughts on these topics, we'd encourage you to read on. For those who would prefer to simply understand what drove performance during the second quarter, we cover performance attribution in the first part of the letter.

Our bottom-up approach to investing requires a long-term mindset, often with minimal changes to the Portfolio. This quarter we made no changes to the Portfolio and outperformed on the back of broad-based contributions. Despite most international markets being down during the quarter, six of the Portfolio's 25 holdings were up more than 10% during the quarter while just five holdings had negative returns. Among the five negative-returning securities, only three underperformed the Index. We believe that this quarter's results demonstrate the power of concentration and owning the right businesses.

Geographically, our Portfolio's overweighting to Europe and underweighting to emerging markets helped performance.

## Portfolio Performance & Activity

As of June 30, the Portfolio was comprised of 25 high-quality companies. During the second quarter, the leading contributors (Portfolio average weight multiplied by return) to the Portfolio were **CSL Limited** (0.72%), **ICON Plc** (0.67%), and **SAP SE** (0.55%).

Australian biotech CSL Limited (CSL) is a global leader in the highly-regulated market for blood plasma derivatives. CSL's varied products include immunodeficiency treatments, vaccines and a variety of other drugs. CSL operates a global network of collection centers to draw blood from humans and "fractionate" blood into its separate components. These components can be infused into other humans with immunodeficiencies or other medical needs. Significant regulations and capital intensity form barriers to entry in this industry such that today only three companies operate globally. Scale is also important. CSL generates a higher level of sales than competitors, which enables it to invest ~10% of sales on research and development. We believe that this has allowed CSL to commercialize more products from each liter of plasma it collects, leading to higher sales and margins, and allowing CSL to make investments that could drive significant future growth opportunities. CSL delivered solid first half results with double-digit sales growth in its core immunoglobulin business, 19% sales growth in its high-margined specialty products business and exceptionally strong results from its flu vaccine business that CSL has been turning around recently, likely aided by an unusually strong flu season. We believe CSL has the potential to compound earnings at a 15% rate for the next five years.

ICON Plc is a contract research organization (CRO) based in Dublin, Ireland. ICON provides services, primarily drug trials, for the pharmaceutical and biotechnology industries globally. CROs provide drug companies an outsourcing partner to handle the details of drug trialing, including patient recruitment and enrollment. ICON's proven value to customers came over 20 years of sharp execution, particularly within late-stage trials. Healthcare product development is expensive, with more than $70 billion spend in areas where CROs like ICON can add value. Interestingly, more than half of drug trials and their related expenses are still handled by biopharma companies in house. This creates a long-tailed growth opportunity. We like ICON's chances of continuing to gain market share in this fragmented industry through further sharp execution and by tapping new growth opportunities in Asia and Australia. We think the company can deliver low double-digit earnings growth over the next five years.

German software giant SAP SE is the global leader in enterprise applications software. The company invented Enterprise Resource Planning (ERP) software, a critical tool for managing the operations of a business. In terms of both functionality and insight, SAP's software, once implemented, could be viewed as the glue holding many corporations together and allowing them to function.

The company has continued to make its latest version of ERP software ("S/4") available in cloud versions, which, though less customizable, appears to be both (a) easier for smaller corporations to implement and use "out of the box" and (b) increasingly the deployment method of choice for at least part of its large enterprise customers' technology workloads. So, cloud software is expanding SAP's addressable market. Furthermore, as SAP customers increasingly decide to use this latest ERP software version, they are also choosing to adopt the use of SAP's HANA database, which is a supercharging enhancement lying underneath the core applications software programs. In time, we expect SAP to drive more of its applications customer base to this database offering, thereby opening a new market to SAP and increasing the company's already impressive stickiness in its customer base. SAP's market leadership, competitive advantages, and consistent execution in the way of new product development and business-line extensions make it a classic Polen Capital business. We believe SAP can drive low double-digit EPS growth for the next five years.

The leading detractors for the quarter were **adidas AG** (-0.35%), **Tencent Holdings Ltd.** (-0.29%), and **Sage Group plc** (-0.25%).

German athletic footwear and apparel maker adidas AG was our worst performer in the quarter. The company enjoyed a spate of U.S. sales growth in recent years from market share gains versus peer NIKE. NIKE may have found its footing as the company's North American sales have begun to reaccelerate. adidas continues to execute well, both in seeing solid sales growth and with CEO Kasper Rorsted's plan to realize efficiencies. Under prior management, the company employed a federated organizational structure, which featured seemingly redundant business functions in different markets around the world. The new strategy aims to focus the business around a centralized organization. Next to NIKE, adidas is the only other globally-scaled sportswear company. The scale these two firms bring to advertising creates a lasting advantage. Each company spends billions annually on endorsements, marketing and brand identification. These investments aim to ensure their brands stay front of mind whenever observers of sports see professionals achieving great things in competition. We marvel at this method of driving brand identity. Through a combination of revenue growth and cost reductions, we think adidas can deliver high-teens earnings growth for the next few years.

Tencent Holdings Ltd. operates a platform connecting more than 1 billion users, most of whom are in China. Tencent has done an impressive job layering services – both wholly-owned and via partnerships – from e-commerce, to financial services and myriad other offerings atop the communications and gaming features that supported its initial adoption. Users access Tencent's network to communicate and use various services. With each user visit, the breadth and depth of Tencent's data grows. In turn, Tencent knows more of its users' interests, habits and needs. We expect this to facilitate improving user experiences over time and create enormous monetization potential.

Tencent's first quarter sales growth was nearly 50% over the prior year's first quarter. As long-term investors, we very much like the fact that Tencent is plowing money into investments intended to expand the reach of the platform, increase user affinity for its services and enhance potential business growth into the future. We believe Tencent can grow its earnings at a strong double-digit pace for the next five years despite heavy ongoing investments.

Another laggard in the quarter was U.K.-based small and medium-sized business software provider Sage Group plc ("Sage"). Sage provides business management software for entrepreneurs to manage their accounting, payments and human resources needs easily. These functions are essential to operations, and once in place, are very sticky. Sage – similar to SAP in some respects – is undergoing a transition in its business model to embrace cloud-oriented software, which we expect will be easier for customers to adopt and facilitate better economics for Sage in the long run. In April, management acknowledged some execution issues associated with moving the salesforce away from its legacy on-premise software (which was purchased with a relatively large upfront payment) to this new cloud-first subscription model. Management candidly communicated the challenges it was facing as well as a pathway to implementing corrective action. As Sage finds its footing, the company could soon see faster revenue growth and higher profits. We think profit margins could be far higher than today's levels and sales growth could begin to accelerate relatively soon. We believe Sage could grow earnings at a 12-15% rate for the next five years if it successfully executes on its plan.

The remainder of this letter covers some of our high-level thoughts about trade and our continuing long-term optimism about international investing.

## Globalization in Retreat

The recent rise of populist nationalist political actors threatens to shift global economic policy. For seventy years, global trade has been governed by post-World War II ("WWII") structures intended to reduce friction among nations.

In the same way that "*democracy is the worst form of government, except for all those other forms that have been tried from time to time,*"[1] the current multilateral system governing trade seems preferable to yesteryear's bilateral, strong-armed negotiating tactics. We think it's clear there are abuses of the current scheme. Individual countries still enact policies that benefit the home market over external players, often with market-distorting effects. Examples here include a 10% duty on certain U.S. automobiles sold in Europe and the tens of billions in subsidies passed by the U.S. government to farmers. With international institutions now under a microscope, we're thinking about tariffs and trade.

## A Few Thoughts on Tariffs

*"Those who cannot remember the past are condemned to repeat it." George Santayana (1905)*

With a ceaseless barrage of news flow around global trade and tariffs, we caution that international trade serves as a pathway to peace. By extension, the policies on the table today are potentially dangerous in our view. Tariffs have historically not appeared to foster economic growth. Today's situation is highly fluid and likely vexing business leaders who desire the sort of stability that supports real strategic planning.

President Herbert Hoover signed off on the Smoot-Hawley Tariffs in 1930, sparking a trade war as trading partners responded to U.S. tariffs with tariffs of their own. According to an article in *The Economist*, by 1932, as tariffs ratcheted higher "the average American tariff on dutiable imports was 59.1%."[2] Within two years of implementation, the tariffs reduced the volume of imports to the United States by 40%, and ultimately wiped out two thirds of global trade by the peak of the Great Depression. After 1932, President Franklin Roosevelt tried to reduce the effect of his predecessor's policy with halting success. WWII brought tariffs down further still, but trade-weighted tariffs still averaged greater than 22% as of 1945. Reversing the effect of the Smoot-Hawley trade war took decades.

Following WWII, global leaders sought ways to reduce the threat of future wars. Their efforts in economics attempted to align international interests. The General Agreement on Tariffs and Trade (GATT), implemented in 1948, and its successor the World Trade Organization, implemented in 1995, fostered 70 years of globalization by reducing tariffs and trade quotas. By the mid-1960s, trade-weighted tariffs were considerably lower than they had been pre-GATT. By encouraging global supply chains and freer trade flows, this utilitarian approach benefitted the largest number of global citizens. However, as capital and goods flowed more easily around the world, low-skilled labor in developed countries watched its standing erode with little recourse. Low-cost manufacturing displaced high-cost workers. In the last few years, disenfranchised laborers found a voice supporting populist nationalist leaders.

New tariffs, such as those proposed by the Trump administration, seem to aim to put the globalization genie back in the bottle by returning us to a pre-GATT world. Belief that slowing global trade flows will encourage local manufacturing and reinvigorate the labor force that missed the globalization wave seems misplaced. We'll save the rise of automation and robotics for another letter but suffice it to say the history of human

[1] Winston Churchill speech to the House of Commons, 11 Nov 1947
[2] Author not listed. "The battle of Smoot-Hawley," *The Economist,* 18 Dec 2008

innovation casts significant doubts on the view that the future of manufacturing anywhere will involve scores of laborers. In the near term, tariffs would create a hiccup in economic flows and spark second and third-order repercussions, each of which could cause their own respective disruptions.

Abusive practices and policies by trading partners within the current WTO framework are cited as a cause for the Trump administration's efforts in trade. Time will tell if new policies can be enacted within existing structures, or if multilateral organizations will collapse. We'll continue following developments to see how they affect Portfolio holdings. Zooming out from the dizzying what-if scenarios can offer clarity, and we prefer to consider the shape of things to come beyond the next tweet storm or daily news cycle.

## Reasons for Optimism

As international investors, we must consider the impact that White House policy could have on global trade flows. We do this on a case-by-case basis with each company in the Portfolio. Should we find policy changes impairing the competitive position of a business in our Portfolio, we will reconsider our investment thesis. Short of that point, we consider broad changes to the economic landscape in search of shifts that could become a source of turbulence. Disruption in the form of tariffs and trade wars distract attention from the long-term evolution of markets. The Portfolio's high quality and superior long-term growth potential drive our confidence as investors.

Last quarter we talked through three reasons to believe the world and markets may be in transition. We now want to walk through reasons to be optimistic about the Portfolio's long-term prospects. To do that we'll draw on a few analogies from physics.

Kinetic energy is energy of motion, combining mass (size) and velocity (speed). Economically, China is using a program which will thrust economic energy into the economies of more than 60 trading partner nations. The Marshall Plan, in which the United States contributed more than $13 billion of funding (~$135 billion in today's dollars) toward rebuilding post-WWII Europe offers a guide here.

Beyond rebuilding war-torn cities, the Marshall Plan created political and economic linkages, which kept communism from advancing westward and drove the developed world's advance for decades. Skeptics view China's plan, called the Belt and Road Initiative (BRI) as 21st century mercantilism, but perhaps the plan's intent follows the Marshall Plan's example for establishing a global leader in economics, politics and influence.

China's growing influence is apparent: more than 100 countries count it as their largest trading partner today, whereas in the year 2000, that figure stood at just five countries. BRI already poured an estimated ~$200 billion of investment capital into economies and trade routes across Asia, Africa and Europe. Although credit availability could crimp BRI, China holds broad ambitions. The Marshall Plan demonstrated that infrastructure investments, cooperation and influence across oceans can all be linked. We believe China has a similar plan in mind with BRI, though social and security imperatives, like those paired with the Marshall Plan, are on the backburner when China funds development.

BRI represents a significant kinetic boost to emerging economies. An undertaking of this magnitude will require extensive collaboration with partner nations. In the best-case scenario, China's multinational relationships could mirror the success of trans-Atlantic collaboration that followed the Marshall Plan. In the same way trade benefits both parties involved, BRI developments may create distribution channels to new markets for Chinese goods, and for new economic development in Africa, Asia and Eastern Europe to take shape. Widespread economic growth may well follow China's BRI investments.

Besides capital investment by China, how else might emerging world growth occur? One answer is urbanization and population density. According to the McKinsey Global Institute's "City 600" research, more than 50% of the incremental GDP growth over the next decade will occur within 440 cities in Asia and the emerging world. This figure highlights the importance of population density to fostering growth, a topic we'll circle back to. With more than 40% of the Portfolio's constituent revenues coming from emerging markets,[3] we like our current mix of businesses and their respective exposures to these high-growth markets.

Urbanization trends offer an example of economic potential energy. Potential energy is stored energy, as the image of a "coiled spring" suggests. By pooling economic potential, mass migrations toward urban centers position citizens to become growth-driving workers and consumers. With density comes economies of scale, which can lower the cost of doing business and attract talented workers. Entrepreneurship can flourish. Rising incomes create consumer spending power and improved standards of living.

This is when the economic flywheel really kicks into high gear, as we've seen over the last 30 years in China. McKinsey estimates that more than 90% of the growth in consumer spending globally through 2030 will occur within the emerging world (meaning the world ex-U.S., Western Europe and Japan). China's working-aged (citizens aged 15-59) population, already 550 million strong, is a big part of that growth and the

[3] The Portfolio is underweight Emerging Market domiciled companies.

Portfolio's Chinese investments aim to capitalize on consumer spending growth there.

The proportion of a population in their youth is another example of potential energy in economics. When populations are young, the collective peak earning and spending potential for a large swath of a country's population lies in the future. The table below shows some notable countries, regions or continents and their median age versus the global average of 30.4 years old. You may notice that on this measure China looks less interesting than its BRI trading partners across Africa and the rest of Asia:

| **Region or Country*** | **Median age** |
|---|---|
| Japan | 47.3 |
| Germany | 47.1 |
| *EU* | *42.9* |
| United Kingdom | 40.5 |
| United States | 38.1 |
| China | 37.4 |
| *Asia* | *30.7* |
| *World average* | *30.4* |
| India | 27.9 |
| *Africa* | *19.4* |
| **Regions and continents in italics* | |

*Source: CIA World Factbook 2017 estimates*

There are some good counter points to this optimistic emerging world review. Capital has on occasion flooded away from the emerging world, creating bouts of panic and pain. China's banking system is another potential source of volatility, as a big unwind could disrupt the global financial system. We note our Portfolio's quality is a source of stability in the face of these negative potential scenarios. Portfolio companies operate with strong balance sheets and advantaged business models, so either negative scenario described here could present opportunities for the Portfolio's quality companies to benefit from volatility by investing for the long term. Such volatility would also offer long-term investors, like us, the ability to follow Ben Graham's advice to make "[the market] our servant, not our master."

There are numerous reasons for optimism about humanity's continued advancement creating economic success. Note, too, that there are ample sources of growth outside the United States. We remain confident about the future and our ability to find high-quality growth companies outside the United States.

Thank you for your interest in Polen Capital and please feel free to contact us with any questions or comments.

Sincerely,

Todd Morris

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# Historical Performance

| Polen International Growth (SMA) Composite as of 06-30-2018 | | | |
|---|---|---|---|
| | **Polen (Gross)** | **Polen (Net)** | **MSCI ACWI ex-USA** |
| **Jun-18** | 0.58 | 0.58 | -1.88 |
| **3 Month** | 4.62 | 4.41 | -2.61 |
| **YTD** | 4.42 | 3.99 | -3.77 |
| **1 Year** | 15.70 | 14.74 | 7.28 |
| **Since Inception (1/3/17)** | 25.76 | 24.72 | 14.42 |

*Source: Archer*
*Returns are trailing through: June 30, 2018*
*Annualized returns are presented for periods greater than 1 year.*

# GIPS Disclosure

## Polen Capital Management
## International Growth Composite-Annual Disclosure Presentation

| | | UMA | Firm | Composite Assets | | Annual Performance Results | | | | 3 Year Standard Deviation* | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | Composite | | | | | |
| Year End | Total (millions) | Assets (millions) | Assets (millions) | U.S. Dollars (millions) | Number of Accounts | Gross | Net | MSCI ACWI | Composite Dispersion | Polen Gross | MSCI ACWI (ex-USA) |
| 2017 | 17,422 | 6,954 | 10,468 | 0.3 | 1 | 35.06% | 33.94% | 27.19% | N/A | - | 12.04 |

*Total assets and UMA assets are supplemental information to the Annual Disclosure Presentation.*
**A 3 Year Standard Deviation is not available for the composite due to the composite's January 3, 2017 creation date.*

# GIPS Disclosure

*The International Growth Composite created on January 1, 2017 contains fully discretionary international growth accounts that are not managed within a wrap fee structure and for comparison purposes is measured against MSCI ACWI (ex-USA). Polen Capital invests exclusively in a portfolio of high-quality companies.*

*Polen Capital Management claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Polen Capital Management has been independently verified by ACA Performance Services, LLC for the periods January 1, 2016 through December 31, 2016. A verification covering the periods from April 1, 1992 through December 31, 2015 was performed by Ashland Partners & Company LLP, which was acquired by ACA Performance Services, LLC, whose report expressed an unqualified opinion thereon.*

*Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.*

*Polen Capital Management is an independent registered investment adviser. The firm maintains a complete list and description of composites, which is available upon request. In July 2007, the firm was reorganized from an S-corporation into an LLC and changed names from Polen Capital Management, Inc. to Polen Capital Management, LLC.*

*Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Past performance is not indicative of future results. Effective January 1, 2018, accounts must be fully invested at the market open on the first business day of the month, in order to be included in that month's composite.*

*The U.S. Dollar is the currency used to express performance. Returns are presented gross and net of management fees and include the reinvestment of all income. Net of fee performance was calculated using actual management fees. The annual composite dispersion presented is an asset-weighted standard deviation calculated for the accounts in the composite the entire year. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.*

*The management fee schedule is as follows:*
*Institutional: Per annum fees for managing accounts are 85 basis points (0.85%) on the first $50 Million and 65 basis points (0.65%) on all assets above $50 Million of assets under management. HNW: Per annum fees for managing accounts are 150 basis points (1.5%) of the first $500,000 of assets under management and 100 basis points (1.0%) of amounts above $500,000 of assets under management. Actual investment advisory fees incurred by clients may vary.*

*Past performance does not guarantee future results and future accuracy and profitable results cannot be guaranteed. Performance figures are presented gross and net of management fees and have been calculated after the deduction of all transaction costs and commissions. Polen Capital is an SEC registered investment advisor and its investment advisory fees are described in its Form ADV Part 2A. The advisory fees will reduce clients' returns. The chart below depicts the effect of a 1% management fee on the growth of one dollar over a 10 year period at 10% (9% after fees) and 20% (19% after fees) assumed rates of return.*

*The MSCI ACWI (ex-USA) Index is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world (excluding the United States). The MSCI ACWI (ex-USA) is maintained by Morgan Stanley Capital International, and is comprised of stocks from both developed and emerging markets.*

*The information provided in this document should not be construed as a recommendation to purchase or sell any particular security. There is no assurance that any securities discussed herein will remain in the composite or that the securities sold will not be repurchased. The securities discussed do not represent the composite's entire portfolio. Actual holdings will vary depending on the size of the account, cash flows, and restrictions. It should not be assumed that any of the securities transactions or holdings discussed will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein. A complete list of our past specific recommendations for the last year is available upon request.*

| Return | 1 Year | 2 Years | 3 Years | 4 Years | 5 Years | 6 Years | 7 Years | 8 Years | 9 Years | 10 Years |
|---|---|---|---|---|---|---|---|---|---|---|
| 10% | 1.1 | 1.21 | 1.33 | 1.46 | 1.61 | 1.71 | 1.95 | 2.14 | 2.36 | 2.59 |
| 9% | 1.09 | 1.19 | 1.3 | 1.41 | 1.54 | 1.68 | 1.83 | 1.99 | 2.17 | 2.39 |
| 20% | 1.2 | 1.44 | 1.73 | 2.07 | 2.49 | 2.99 | 3.58 | 4.3 | 5.16 | 6.19 |
| 19% | 1.19 | 1.42 | 1.69 | 2.01 | 2.39 | 2.84 | 3.38 | 4.02 | 4.79 | 5.69 |