

# International and Global Growth Equity Strategies

Q2 2017 COMMENTARY

## INTRODUCTION

The second quarter market action resembled the common experience of taking off from the west towards Denver International Airport. During the first 12 weeks of the quarter, as politics, economies and markets became more benign, financial markets were on a gentle glide upward. However, during the final week of the quarter, as when flights begin to cross over the mountains (and descend into DIA), we experienced turbulence. Whether the markets were abruptly spooked in the thirteenth week by somewhat misconstrued comments made by Mario Draghi and Mark Carney, or simply after such a widespread advance, participants took profits and the market's internals turned upside down. Bond prices fell, the price of oil reversed and Chautauqua Capital's managed portfolios sold off.

In this environment, the Chautauqua Capital International Growth Equity composite, which had led the benchmark for much of the quarter, appreciated 5.66%, but gave up the entire lead during the final week of the quarter to underperform the MSCI ACWI ex-U.S. Index®, which appreciated 5.99%, and underperform the MSCI EAFE Index®, which appreciated 6.37%. The Chautauqua Capital Global Growth Equity composite appreciated 7.86%, outperforming the MSCI ACWI Index®, which appreciated 4.45%.

## MARKET UPDATE

For the MSCI ACWI ex-U.S. Index®, growth style outperformed value style. Emerging markets performed a little better than developed markets. Large capitalization stocks outperformed small capitalization stocks. For the MSCI EAFE Index®, growth style outperformed value style, and small capitalization stocks outperformed large capitalization stocks.

For the MSCI ACWI Index®, growth style outperformed value style, and large capitalization stocks slightly outperformed small capitalization stocks. Emerging markets outperformed developed markets.

Performance by country, in which the portfolios were invested and as measured by MSCI, was as follows: Brazil -6.61%, Canada 0.82%, China 10.66%, Denmark 15.39%, France 9.86%, Germany 6.92%, Hong Kong 7.19%, India 2.91%, Ireland 3.84%, Italy 9.59%, Japan 5.23%, Korea 10.26%, Netherlands 8.06%, South Africa 3.63%, Spain 8.09%, Switzerland 9.41%, Taiwan 8.99%, U.K. 4.74% and U.S. 3.10%.

Sector performance was similarly dispersed, though mostly positive:

### MSCI Sector Performances (as of 06/30/2017)

Sector	QTD Performance
Health Care	7.02%
Information Technology	6.71%
Industrials	5.72%
Financials	5.27%
Real Estate	4.40%
Consumer Staples	4.29%
Consumer Discretionary	4.20%
Utilities	3.81%
Materials	2.38%
Telecommunication Services	-0.09%
Energy	-4.76%

## INVESTMENT TEAM

Generalists with Specialized skills

Averaging 21 Years investment experience

### BRIAN BEITNER, CFA

Managing Partner

### DANIEL BOSTON

Partner

### JESSE FLORES

Partner

### HAICHENG LI, CFA

Partner

### DAVID LUBCHENCO

Partner

### MICHAEL T. MOW, CFA

Partner

## ORGANIZED FOR INVESTMENT SUCCESS

- Autonomous institutional boutique
- Employee owners
- We invest alongside our clients
- Self-imposed limit on growth

This was a quarter that became more benign with the passage of time, despite the fact that the markets became turbulent in the last week of the quarter. We continue to believe that there is less uncertainty today than at the beginning of the year. At the beginning of 2017, we were concerned about the potential for disruption that might result from the European election super cycle. In the aftermath of Trump's victory in the U.S., the risks to the euro, regional trade and financial stability hung in the balance. Nationalist candidates played upon voter frustration on being forced to comply with regulations issued by the regional government in Brussels, Luxembourg and Frankfurt and each blamed the other for economic weakness. However, Gert Wilders lost his bid in the Netherlands in March and Marine LePen lost in France in May. The Italian Euro skeptic Five Star movement lost momentum too. Emanuel Macron's convincing victory in the run-off election for Prime Minister of France was followed by the success of his one year old party's taking 350 of the 577 seats in the National Assembly. He has a reform agenda and the political capital to realize it. As a result of CDU party victories in German regional elections, Angela Merkel seems to be in a very good position to be re-elected with a strong base of support.

China will hold its once-every 5 year Party Congress in the fall. It is expected that there will be significant change in the make-up of the powerful Politburo and its standing committee. Xi Jinping is expected to remain as the Party's General Secretary and further consolidate his power.

In an effort to strengthen her ability to negotiate BREXIT terms with the E.U., Theresa May called for a snap Parliamentary election. The result was nearly a "no confidence" vote. While she retained her seat as Prime Minister, her party lost seats in Parliament and they have been forced to form a coalition with a small conservative party based in Northern Ireland. Some have described her as being in office but not being in power.

In addition to the mitigated election risk, inflation moderated (partly due to soft energy prices) and employment grew in most economies around the world. Moreover, the potential risk of Italian Bank failures and capital flight was averted by Italy's bold closure of two troubled banks. All of this presented an improved backdrop for equity investors. The problem with such an amiable investment environment is that volatility is subdued and there are few valuation anomalies the skilled group of stock pickers at Chautauqua Capital can exploit. In some ways, this is our most challenging market environment.

## PERFORMANCE ATTRIBUTION

Exposure to the worst performing sector, Energy, was a drag on performance until the final week when the price of oil spiked up.

Overall security selection was beneficial in the Global portfolios. U.S. headquartered investments, particularly in the Information Technology and Health Care sectors were strong contributors to out-performance. Ironically, the North America was a weaker region and the underweighting versus an overweight to the two strongest regions, namely Europe and Asia & Pacific Basin was also additive.

Overall security selection was a detractor to performance in the International portfolios. This was particularly true in the Information Technology, Energy and Health Care Sectors. Information Technology and Health Care were the two strongest sectors in the benchmark for the second quarter and we were over-weight in both. By region our overweight to Europe and underweight to Latin America helped returns.

As is often the case, and as evidence of the effectiveness of conviction weighting, the top 5 positive contributors to performance were held at higher weights than the bottom 5 detractors to performance.

### Top 5 International Holdings (as of 06/30/2017)

Security	Avg. Weight	Contribution
Alibaba Group Holding Ltd.	3.67	0.97
Wirecard AG	5.63	0.77
Novo Nordisk A/S	3.24	0.72
AIA Group Limited	3.99	0.64
HDFC Bank	3.95	0.58

### Bottom 5 International Holdings (as of 06/30/2017)

Security	Avg. Weight	Contribution
LINE Corp.	3.74	-0.45
Core Laboratories NV	3.35	-0.43
Encana Corporation	0.62	-0.28
Eni S.p.A.	4.04	-0.25
Nielsen Holdings Plc	2.99	-0.18

### Top 5 Global Holdings (as of 06/30/2017)

Security	Avg. Weight	Contribution
Regeneron Pharmaceuticals, Inc.	3.04	0.73
Alibaba Group Holding Ltd.	2.51	0.69
Tencent Holdings Ltd.	2.69	0.62
Wirecard AG	4.03	0.58
Amazon.com, Inc.	4.13	0.41

### Bottom 5 Global Holdings (as of 06/30/2017)

Security	Avg. Weight	Contribution
Pioneer Natural Resources Company	1.81	-0.30
Eni S.p.A.	2.11	-0.13
Sinopharm Group Co., Ltd. Class H	3.05	-0.11
SVB Financial Group	1.94	-0.11
Antero Resources Corporation	1.50	-0.10

\*the holdings identified do not represent all of the securities purchased, sold, or recommended for advisory clients; and  
\*past performance does not guarantee future results.

## COMPOSITE PERFORMANCE FOR THE PERIODS ENDING JUNE 30, 2017\*

### International

	Q2 2017	YTD 2017	1 Year	3 Year	5 Year	Since Inception 1/1/06	Cumulative Since Inception 1/1/06
<b>International Growth Equity - Gross</b>	<b>5.66%</b>	<b>17.04%</b>	<b>16.87%</b>	<b>3.81%</b>	<b>9.15%</b>	<b>7.62%</b>	<b>132.50%</b>
<b>International Growth Equity - Net</b>	<b>5.57%</b>	<b>16.82%</b>	<b>16.38%</b>	<b>3.39%</b>	<b>8.72%</b>	<b>7.38%</b>	<b>126.81%</b>
MSCI ACWI ex-U.S. Index® - GD	5.99%	14.45%	21.00%	1.27%	7.70%	4.59%	67.59%
MSCI EAFE Index® - GD	6.37%	14.22%	20.83%	1.61%	9.18%	4.37%	63.60%

### Global

	Q2 2017	YTD 2017	1 Year	3 Year	5 Year	Since Inception 1/1/07	Cumulative Since Inception 1/1/07
<b>Global Growth Equity - Gross</b>	<b>7.86%</b>	<b>19.67%</b>	<b>25.81%</b>	<b>9.35%</b>	<b>14.08%</b>	<b>8.79%</b>	<b>142.05%</b>
<b>Global Growth Equity - Net</b>	<b>7.67%</b>	<b>19.23%</b>	<b>24.98%</b>	<b>8.71%</b>	<b>13.46%</b>	<b>8.46%</b>	<b>134.61%</b>
MSCI ACWI Index® - GD	4.45%	11.82%	19.42%	5.39%	11.14%	5.03%	67.44%
MSCI World Index® - GD	4.21%	11.02%	18.86%	5.83%	12.01%	5.24%	70.99%

\*These are preliminary figures from our portfolio accounting system that have yet to be verified by Ashland Partners.

## PORTFOLIO HIGHLIGHTS | BUYS AND SELLS

As we noted in our first quarter performance review, we have been broadening the opportunity set of potential candidates for inclusion into managed portfolios. And, as a result, we might be making more adjustments to existing positions and have more outright sells and new purchases.

Accordingly, in the International strategy, we sold Delphi Automotive and Tencent. Delphi had been a long-term successful position. However, we believe the auto replacement cycle that began in 2010 is getting close to running its course and the stock was trading at a full valuation. We continue to like Tencent, but opted to gain exposure via Naspers which, on a sum of total parts basis, is trading at a historically deep discount to its underlying value in Tencent shares and several other ecommerce based businesses.

In the Global strategy, we sold Athena Health, Sherwin Williams and Tencent. Athena Health has failed to meet our expectations and Sherwin Williams had traded to a premium valuation and we believe the acquisition of Valspar will dilute the company's profitability. As we mentioned above, we continue to like Tencent but opted to gain exposure via Naspers.

Throughout the quarter, there were several events that impacted the portfolios. Amazon's plan to acquire Whole Foods makes sense but we did not expect it. Google's penalty from their anti-competitive trial in Europe was eye popping. On the one hand, it represents less than 10% of the current year's free cash-flow. The longer-term challenge may be how it impairs Google's ability to maximize the profitability of its search business in Europe. Hargreaves Lansdown initially traded lower and then rebounded when it was announced that Vanguard was coming into the UK market. Wirecard announced an acquisition which will enable them to enter the U.S. market.

Price appreciation ahead of fundamentals afforded us numerous opportunities to take profits and reduce price risk. Chautauqua Capital's proprietary, multi-factor, relative attractiveness model is an important tool for us in this process and it helps us overcome confirmation bias. Such adjustments were generally comprised of taking profits in Information Technology holdings and redeploying into bio-technology and energy services holdings.

For the Chautauqua Capital International Growth Equity Composite, 67% of portfolio companies that reported earnings during the quarter exceeded consensus expectations.

For the Chautauqua Capital Global Growth Equity Composite, 75% of portfolio companies that reported earnings during the quarter exceeded consensus expectations.

## OUTLOOK

The latter half of 2017 will be interesting. As compared to the U.S., the European region languished in the aftermath of the 2008-2009 Great Recession. While the U.S. applied immediate monetary stimulus, the ECB was slow to respond. And, rather than apply fiscal help to the troubled countries in the region, the E.U. enforced harsh austerity. To no one's surprise, it took longer for the European region to expand and some of the growth potential has been permanently impaired. Now, after 9 years, the region is growing, albeit at a below world average rate. Improved consumer and business sentiment, and pent up demand, auger for sustained growth. Together, with low inflation and as a result low interest rates, we have maintained an over-weight to European headquartered companies.

Merkel's anticipated re-election combined with France's strong support for Macron will allow the two to shepherd initiatives for greater European unification. Germany wants to never again have to subsidize and bailout troubled neighbors. France seeks to lessen the risk of recession and harsh imposition of austerity of all member countries. They come together with differing needs, but they are likely to work together to create a more durable fiscal and financial union. This might include system-wide bank deposit insurance and a central authority to oversee the closure of troubled banks. They may agree to establish euro-zone backed individual country bonds. Italy's move to close two troubled banks was another favorable sign. Additionally, the euro-area finance ministers and the International Monetary Fund (IMF) agreed to release \$9.5 billion to Greece in new loans on June 15. The market indicates improved confidence in Greece's recovery as yields on Greek government debt have fallen to the lowest levels in 7 years. All of these indicators point to a less fractious euro-zone that might be able to strengthen the system before it is tested by some future crisis. It will probably also solidify the E.U.'s stance in its BREXIT negotiations with the U.K.

Meanwhile, Theresa May's weakened support will put the U.K. in a less certain position as to what they will accept in terms of labor movement in exchange for access to European customers. Before they even begin to sort that out, there is the sticky matter of what the U.K. is on the hook for in terms of pre-BREXIT spending commitments in the E.U.

In the United States, despite Republican control of the executive, legislative and judicial branches, the Party has been stymied in their ability to reduce corporate taxes and increase fiscal spending while not expanding federal debt. In order to reduce tax revenue from corporations and increase promised infrastructure spending, they hoped to reduce government expenditures for Medicare and Medicaid. As the Congressional Budget Office projects loss of benefits to the tune of in excess of 20 million people, there are not enough Republicans willing to vote in favor of the legislation. The dilemma they face is to go ahead with the fiscal stimulus with borrowed funds in the hopes that the stimulus-induced economy generates enough additional economic growth to produce required tax revenue to pay for it; or, water down the size of the tax cuts and infrastructure spending. With neither looking very compelling, investors are increasingly coming to the belief that little of the Trump stimulus agenda will be initiated in the near future.

We believe that China will be relatively quiet until the completion of the Communist Party Congress this fall. This every five year event determines leadership roles and often allows the government to set new policy directives. This gathering should be especially interesting, in that the level of turnover in key positions is expected to be more than 50%. It is generally assumed Xi Jinping will retain the position of the party's General Secretary and further increase his power through the placement of allies in more key party positions. Once this process is complete, we expect more bold actions from China. For investors, unfortunately, there will likely be few pro

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investment reforms. Instead, there will likely be an emphasis on trade with more foreign aid and investment (carrots) and a military ramp up with aggressive defense of uninhabited islands to protect China's shipping lanes (sticks). In an effort to tighten controls over the financial sector, the Chinese government has been cracking down on unsanctioned operators of lending and investing businesses. China has a high aggregate debt level, but it is primarily incurred by State Owned Enterprise (SOE) corporations. Since that debt is primarily held by SOE banks, the whole problem is self-contained and can be managed by the government. As a result, we do not believe that the Chinese economy is at risk of a hard landing. In China, the "old economy" tied to SOEs has slowed but the "new economy" typified by our holdings such as Alibaba and Ctrip is accelerating. In many ways China is ahead of most developed economies in the adoption of ecommerce. We believe that our holdings in China are nicely positioned for its economy's areas of strength.

Up until the last week of the quarter, the price of oil drifted lower. The primary culprit was a global glut of supply. To our view, the cost of finding oil has gone up while the cost of extracting proven reserves has gone down. This has resulted in a short term glut of oil. Since more drillers can make a profit by continuing to pump what they have already drilled, we have excess stored supply but new oil field development has slowed down. So eventually, the price of oil will rise as new oil fields become scarcer. Until that time, we expect the price of oil will be range bound. At the same time, the cost of renewable energy is becoming more competitive with fossil fuels. This should ultimately result in a decline in demand for oil. As these dynamics play out, we are well-positioned with low cost exploration and production companies that are profitable at current oil prices, have significant low cost growth opportunities and do not need to raise capital to achieve their goals. This did not help returns in the second quarter, but these companies are a rare source of high profits growth at a low valuation. At the same time, we are invested in the only fully integrated battery and electric vehicle manufacturer in the world.

One needs to be aware of developments of the ultra-low-cost state-owned Middle Eastern producers. In the second quarter, Saudi Arabia's King Salman has named his 31 year old son to be his successor. The new Crown Prince has shown himself to be more militarily aggressive in the region and vocal about the country's need to move beyond oil. How his initiatives play out is likely to make the price of oil more volatile.

Interest rates are relatively and absolutely low. Under the banner of "Get while the getting is good", Russia, despite sanctions, sold \$3 billion of sovereign debt. Even more astonishing, Argentina, a country that has defaulted 4 times in the last 61 years (1956, 1989, 2001 and 2014), issued \$2.75 billion in U.S. dollar-denominated 100 year bonds. Investors, who are clearly hungry for yield, are taking the risk for an 8% annual return.

As expected, in the second quarter, the U.S. Federal Reserve (Fed) raised the benchmark rate by 0.25% to 1.25%. The European Central Bank (ECB), Bank of Japan (BOJ) and Bank of England (BOE) left their rates unchanged but hinted that they were moving away from infinite monetary accommodation. Central bank rate hikes should be gradual, but the change in direction is clear. Positive global economic growth gives the central banks the cover to remove the economic life support of bond buying and artificially low rates. Current low levels of inflation give them time to adjust without shocking the financial markets. Financial institutions and people on fixed incomes will benefit from higher rates. And finally, the Central banks will need to have higher benchmark rates from which to stimulate when the next crisis occurs. Rates near zero are hard to cut. This pivot, although gradual and anticipated, is a sea change from the environment investors have operated in for the past 8 years. How should one navigate?

In the past, early and moderate rate increases percolated through to bond prices on an immediate and proportional basis. For equities, a modest pick-up in rates from low levels can improve currency values, allow banks to lend more and, as a result, be contributory to higher earnings. Dramatically higher rates, however, erode valuation multiples and lead to equity bear markets.

Along the way, the best thing an investor can do is make their portfolio of investments carefully diversified and populated with companies whose products are so high value added or mission critical to their customers, that they are resilient to economic forces that would be disruptive to most companies. That is how we invest. We do not structure a portfolio based upon our guess as to future scenarios. But we are keenly aware of forces that could negatively impact each investment. This healthy paranoia has enabled us to protect the portfolio from negative surprises. At this stage, we think low rates have resulted in elevated asset prices. On a relative basis, the U.S. is more expensive than most non-U.S. markets and we have adjusted our U.S. headquartered weight accordingly. We benefit from the fact that we manage concentrated, long-term oriented portfolios. This enables us to be very selective and ensure that each holding is well supported by long-term trends and is advantaged in the way that they conduct their business. We take care in considering quality criteria and how the business is situated geographically. Lastly, we are patient and disciplined about what we are willing to pay for a stock, based on our future expectations of cash-flow. Beyond selectivity, being concentrated and long-term oriented allows for a small cohesive team of experienced investors (such as ours) to do very in-depth work. We believe in what we are doing and, as a result, have committed substantial portions of our personal savings to the very same funds that we manage.

#### **BUSINESS UPDATE**

There have been no changes to the investment staff at Chautauqua Capital Management nor have there been any changes to the ownership structure of our parent Robert W. Baird.

Respectfully submitted,

The Partners of Chautauqua Capital Management – a Division of Robert W. Baird

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Investment Professional	Degrees	Years of Experience	Prior Affiliation
<b>Brian Beitner, CFA</b> <i>Managing Partner</i>	MBA, University of Southern California BS, University of Southern California	37	TCW Group Scudder Stevens & Clark Bear Stearns Security Pacific
<b>Daniel Boston</b> <i>Partner</i>	MBA, Yale University BS, Brigham Young University	11	Ensign Peak Advisors Artisan Partners Wasatch Advisors
<b>Jesse Flores</b> <i>Partner</i>	MBA, Stanford University BS, Cornell University	10	Roth Capital Partners Blavin & Company Lehman Bros.
<b>Haicheng Li, CFA</b> <i>Partner</i>	MBA, Stanford University MMSc, Harvard Medical School MS, Harvard University BA, Rutgers University	15	TCW Group
<b>David Lubchenco</b> <i>Partner</i>	MBA, University of Denver BA, The Colorado College	24	Marsico Capital Management Transamerica Investment Management Janus Capital
<b>Michael Mow, CFA</b> <i>Partner</i>	MBA, University of Southern California MS, University of Iowa BA, California State University, Northridge	30	American Century TCW Group Farmers Insurance

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The MSCI ACWI Index® is a free float-adjusted market capitalization weighted index that is designed to measure the equity performance of developed and emerging markets. The MSCI ACWI Index® consists of 44 country indices, including the United States, comprising 23 developed and 21 emerging market country indices.

The MSCI ACWI ex-U.S. Index® is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets excluding the United States.

The MSCI EAFE Index® is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets, excluding the United States and Canada. The MSCI EAFE Index® consists of 21 developed market country indices.

The MSCI World Index® is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. The MSCI World Index® consists of 23 developed market country indices.

Performance results will vary among client accounts. The actual return and value of an account will fluctuate and at any point in time could be worth more or less than the amount invested. The performance results displayed herein represent the investment performance records for the Chautauqua composites that include fully discretionary fee paying client accounts. The composites' returns are total, time weighted returns expressed in U.S. dollars. Composite returns reflect the reinvestment of dividends and other earnings. The net performance reflects the deduction of investment advisory fees and transactions costs and the gross performance is net of transaction costs, but gross of advisory fees. The cumulative performance information shown is the aggregate amount that the composites have gained since inception through June 30, 2017.