International and Global Growth Equity Strategies

Q3 2017 COMMENTARY

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CHAUTAUQUA CAPITAL MANAGEMENT
A DIVISION OF BAIRD

INTRODUCTION

Global markets continued to melt up in the third quarter, shrugging a temporary "risk off" period in early August and then enjoying a broad-based rally through the end of the quarter. In general, large capitalization growth stocks moved higher throughout the quarter, but the market leadership changed in September with a big rally in small capitalization value stocks. The market action has been buoyed by strong economic growth and generally positive central bank commentary in all the major economic regions (i.e. U.S., E.U., and Japan). Together these have overshadowed the impacts from natural disasters, the threat of nuclear exchange between the U.S. and North Korea, confoundingly low inflation, and ever-higher valuations of financial assets.

We invest in growing businesses that benefit from secular growth trends and possess sustainable competitive advantages which allow them to earn high returns on capital, and in turn reinvest into their businesses and keep on growing. Typically, our portfolio companies deal in mission-critical or value-added products and services, and these tend to lead in demand during periods of coordinated global growth.

But to our thinking, risks have increased. The biggest risk is the unwinding of expansive monetary policies, which have been exemplary for both size and the amount of time they have been applied in the global financial systems. As a result, valuation multiples in the equity markets (and generally in all financial assets) have reached levels that are both historically and absolutely expensive. The other big risk is the enormous presence of value-agnostic entities in the markets (e.g. ETFs, algorithmic traders), which is somewhat of an "X factor" that could contribute to disorder in the markets. Accordingly, we have made meaningful adjustments to our portfolios to protect on the downside of such events, such as de-emphasizing stocks with higher beta and higher valuation relative to their underlying business fundamentals, and also reducing less liquid stocks. Further, we also raised our cash positions in order to mitigate the harm from a sell-off and to redeploy where we may find valuation anomalies.

MARKET UPDATE

For the MSCI ACWI ex-U.S. Index®, growth style slightly outperformed value style. Within emerging markets, growth style materially outperformed value style. Large capitalization stocks underperformed small capitalization stocks in the developed sub-index, but the relative performance was reversed in the emerging market sub-index.

For the MSCI ACWI Index®, growth style outperformed value style, but large capitalization stocks underperformed small capitalization stocks. Within emerging markets, growth style materially outperformed value style.

For the MSCI EAFE Index®, growth style underperformed value style, and large capitalization stocks also underperformed small capitalization stocks.

Performance by country, in which the portfolios were invested and as measured by MSCI, is as follows: Brazil 23.00%, Canada 8.10%, China 14.76%, Denmark 7.84%, France 8.42%, Germany 7.74%, Hong Kong 5.11%, India 2.95%, Ireland 6.14%, Italy 13.85%, Japan 4.10%, Korea 2.71%, Netherlands 9.36%, Singapore 3.12%, South Africa 3.98%, Spain 4.35%, Switzerland 2.00%, Taiwan 1.40%, and U.K. 5.18% and U.S. 4.46%.

Sector performance was similarly dispersed, though mostly positive:

INVESTMENT TEAM

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Averaging 22 Years investment experience

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

MSCI Sector Performances (as of 09/30/2017)	
Sector	**QTD Performance**
Energy	9.75%
Materials	9.22%
Information Technology	8.97%
Financials	5.73%
Industrials	5.38%
Telecommunication Services	3.94%
Consumer Discretionary	3.64%
Real Estate	3.63%
Utilities	3.46%
Health Care	2.54%
Consumer Staples	-0.10%

Global economic growth was broad-based and synchronized for the first time since 2010 in the reported second quarter numbers. The latest commentaries from the major central banks were largely upbeat, but the focus has been on low inflation, which has persisted despite the otherwise positive economic data points. Sector returns were generally strong across the board, but most robust within energy, materials, and information technology. Emerging markets returns were particularly strong, while the big three developed markets of the U.S., E.U., and Japan also notched some attractive gains. In general, the risk appetite within the markets remains elevated.

In the U.S., the Federal Reserve left rates unchanged after their September policy meeting but signaled for one additional rate hike in 2017. The mystery of missing inflation was the source for pause, and it continues to confound Chairwoman Janet Yellen, who only offered that because of the unexplained phenomenon, a slow and cautious approach to rate hiking is all the more warranted. In previous years, palpable economic data, such as the decline in energy prices, stronger dollar, and slack in the labor markets, contributed to weak inflation numbers that undershot the Fed's target. But now that the impacts of those factors have abated, inflation still has not picked up. Core inflation in the U.S., which excludes food and energy prices, has grown barely over 1% this year and most recently grew only 0.1% in the month of August. This is out of step with the evidence for galvanizing conditions in the rest of the U.S. economy. For example, the unemployment rate reached a 16-year low in July, and GDP growth during the second quarter was the fastest in the last two years at 3.1%.

Strong early-cyclical stock performance indicates that market participants believe that a reduction in corporate taxes is imminent. Nevertheless, many details still need to be worked out. The dollar continued to weaken in the third quarter and is down over 7% for the year. A weak dollar has enhanced returns of non U.S. holdings. Geopolitical tensions between the U.S. and North Korea may be stoking dollar depreciation as well. On the other hand, the Fed commentary for continued rate increases, along with the new tax framework to lower taxes, helped the dollar stage a modest rally late in the quarter.

In Europe, currency effects are imposing the opposite problem. A strong euro emerged as a source of pause for a shift towards tighter monetary policy by the European Central Bank (ECB). A strong currency not only makes exports more expensive for trade partners, but also pushes down inflation by making imports cheaper. Accordingly, ECB President Mario Draghi struck an incrementally cautious tone following the central bank's September meeting, referencing the unexpected strength of the euro as a source of uncertainty. On the policy front, the ECB held steady, keeping interest rates and the central bank's €60 billion (approximately $71 billion) monthly bond purchase program unchanged but indicating that a pivot toward normalization could begin in October. The Bank of Japan (BoJ) also elected to keep its policy unchanged, though it provided no hints of wanting to move towards a more restrictive monetary stance.

"Regionally, performance was entirely driven by security selection with notable contributions from developed Europe and Asian/Pacific Basin."

Chancellor Angela Merkel won a fourth term in office, but her Christian Democrats party suffered a steep drop in support, losing the majority they held in the legislature. A small but vocal "Alternative for Germany" party, who opposes immigration and refugee resettlement, gained seats. France and Germany have taken steps to drive a stronger unification agenda for the European Union. Among their proposals are to create a common investment budget, create a new office for a euro-zone finance minister, and rewrite the tax code to prevent tax rate imbalances between E.U. countries.

Emerging market stocks are on pace for their best returns since 2009, with the rally reflecting faster earnings growth, a weak dollar, and investors' healthy appetite for risk. The equity markets in Brazil, Russia, and China were all particularly strong and rose double digits. Crude oil also enjoyed a significant bounce-back after a steady flow of positive news, and the price of oil is at two-year high. As a result, energy was the best performing sector for the quarter. The Organization of Petroleum Exporting Countries (OPEC) stated that oil inventories have fallen by nearly half of their target since the beginning of the year, providing evidence that their decision to regulate supply would be beneficial for prices. Additionally, lower oil output in the Kurdistan region of Iraq and from U.S. shale producers have also reduced global over supply.

PERFORMANCE ATTRIBUTION

Overall security selection was beneficial in the global portfolios. Investments in the information technology sector, combined with the portfolios' overweight to the sector, were strong contributors to outperformance. Investments in the consumer discretionary sector, along with an underweight to consumer staples, were additive to returns, while the portfolio's overweight to health care and no weight to materials detracted from returns. Regionally, performance was entirely driven by security selection with notable contributions from developed Europe and Asian/Pacific Basin.

Overall security selection was beneficial in the international portfolios. This was particularly true in the information technology, consumer discretionary and financial sectors. A slight overweight to the strongest performing energy sector, along with an overweight to information technology, helped returns, while the portfolios' overweight to health care and no weight to materials detracted from returns. Regionally, performance was entirely driven by security selection with notable contributions from developed Europe and Asian/Pacific Basin.

As is often the case, and as evidence of the effectiveness of conviction weighting, the top 5 weighted holdings had a much larger positive contribution to performance than the smallest 5 weighted holdings (in the international composite, the top 5 weighted holdings averaged a 23.92% return for the quarter; in the global composite, the top 5 weighted holdings averaged a 21.79% return for the quarter).

COMPOSITE PERFORMANCE FOR THE PERIODS ENDING SEPTEMBER 30, 2017*

International

	Q3 2017	YTD 2017	1 Year	3 Year	5 Year	Since Inception 1/1/06	Cumulative Since Inception 1/1/06
International Growth Equity - Gross	**10.32%**	**29.12%**	**21.12%**	**10.12%**	**10.00%**	**8.35%**	**156.51%**
International Growth Equity - Net	**10.25%**	**28.80%**	**20.68%**	**9.68%**	**9.57%**	**8.11%**	**150.06%**
MSCI ACWI ex-U.S. Index® -GD	6.25%	21.61%	20.15%	5.19%	7.45%	5.03%	78.07%
MSCI EAFE Index® - GD	5.47%	20.47%	19.65%	5.53%	8.87%	4.75%	72.54%

Global

	Q3 2017	YTD 2017	1 Year	3 Year	5 Year	Since Inception 1/1/07	Cumulative Since Inception 1/1/07
Global Growth Equity - Gross	**8.69%**	**30.06%**	**22.91%**	**14.03%**	**13.95%**	**9.42%**	**163.08%**
Global Growth Equity - Net	**8.50%**	**29.36%**	**22.02%**	**13.34%**	**13.32%**	**9.08%**	**154.54%**
MSCI ACWI Index® -GD	5.31%	17.75%	19.29%	8.02%	10.79%	5.42%	76.33%
MSCI World Index® - GD	4.96%	16.53%	18.83%	8.30%	11.62%	5.59%	79.48%

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

Top 5 International Holdings (as of 09/30/2017)

Security	Avg. Weight	Contribution
Wirecard AG	5.89	2.33
ASML Holding NV ADR	5.84	1.67
Keyence Corporation	4.90	0.98
HDFC Bank Limited	4.48	0.49
Julius Baer Gruppe AG	4.14	0.50

Bottom 5 International Holdings (as of 09/30/2017)

Security	Avg. Weight	Contribution
CI Financial Corp.	0.22	-0.03
Ctrip.com International Ltd	0.87	-0.03
Olympus Corp.	1.17	-0.15
Sinopharm Group Co.	1.32	-0.01
Roche Holding Ltd	1.73	-0.00

Top 5 Global Holdings (as of 09/30/2017)

Security	Avg. Weight	Contribution
Wirecard AG	4.38	1.69
Mastercard Incorporated Class A	4.05	0.65
Celgene Corporation	3.38	0.41
Julius Baer Gruppe AG	3.35	0.40
NVIDIA Corporation	3.21	0.81

Bottom 5 Global Holdings (as of 09/30/2017)

Security	Avg. Weight	Contribution
Coherent, Inc.	0.63	-0.14
Olympus Corp.	0.71	-0.10
Grifols, S.A. Sponsored ADR Class B	0.88	-0.04
Reckitt Benckiser Group plc	0.89	-0.09
Amorepacific Corp.	1.43	-0.23

*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.

PORTFOLIO HIGHLIGHTS | BUYS AND SELLS

Due to our growing cautious view on macroeconomic conditions and the related impacts we think they will have on equity valuations, we made significant adjustments to the portfolios in the third quarter. Our overall objectives were to reduce our exposures to higher beta and valuation stocks, emphasize businesses with more defensive characteristics or that benefit from higher interest rates, and raise cash to have on hand to redeploy in the event that a sell-off presents us with attractively valued opportunities. We intend that these adjustments will help safeguard the portfolios in the event of a disorderly sell-off, yet allow us to still participate in further upside if markets grind higher.

Despite generally elevated stock valuations we continue to evaluate a significant number of new investment opportunities and traveled extensively overseas to conduct in-person research and explore trends. We analyze these companies intensively and judge each of them along our proprietary, multi-factor scoring model, taking into account a company's growth, profitability, and valuation characteristics. Finally, we compare these metrics for all companies that we own and that we are vetting for investment, in order to construct our conviction-weighted portfolios of quality growth stocks.

In the international strategy, we exited our positions in Olympus, Grifols, and Iliad. We took some profits in Hargreaves Lansdown and Wirecard, which have performed well in the quarter but trade with less liquidity than our average holdings. We also adjusted our exposure to China slightly, by trimming in Alibaba and adding to Ctrip. We invested the proceeds from these sales by initiating some new positions in the financials sector, including Toronto Dominion, CI Financial, and DBS. Further, we added to our positions in Recruit Holdings, Temenos and Novo Nordisk.

In the global strategy, we exited our positions in Olympus, Grifols, and Iliad. We reduced positions in some of our higher beta holdings such as Hargreaves Lansdown, Regeneron, Illumina, and Alibaba. Further, we took some profits in select higher valuation stocks that have performed well for us including Priceline, Amazon, Palo Alto Networks, and Wirecard. We invested the proceeds from these sales by initiating some new positions in the financials sector, including Toronto Dominion and CI Financial, as well as the defensive off-price retailer TJX Companies. Further, we added to our positions in Keyence, Recruit Holdings, Temenos, Novo Nordisk, Nvidia and Ctrip.

For the Chautauqua Capital International Growth Equity Composite, 64% of portfolio companies that reported earnings during the quarter exceeded consensus expectations.

For the Chautauqua Capital Global Growth Equity Composite, 71% of portfolio companies that reported earnings during the quarter exceeded consensus expectations.

"As is often the case, and as evidence of the effectiveness of conviction weighting, the top 5 weighted holdings had a much larger positive contribution to performance than the smallest 5 weighted holdings.

In the international composite, the top 5 weighted holdings averaged a 23.92% return for the quarter.

In the global composite, the top 5 weighted holdings averaged a 21.79% return for the quarter."

OUTLOOK

In October, the U.S. Federal Reserve will begin shrinking its $4.2 trillion portfolio of bond holdings. This marks the final act in a policy experiment conceived during the financial crisis to stimulate the economy by lowering interest rates and increasing the money supply.

To do this, the Fed will allow the bonds it owns to roll off its balance sheet at maturation instead of reinvesting the principal payments into more bonds. This will be done first at a rate of $10 billion per month and increase by $10 billion every quarter until a limit of $50 billion per month is reached. Admittedly, the pace seems slow and protracted as it will take the Fed over seven years to unwind its positions.

The Fed is the first among the major central banks to move towards more normal monetary policy. At this stage, we believe that there are at least a few things we can ascertain. First the direction of rates is clear: rates are moving up. Second, with rates moving up and the Fed exiting the market as a buyer of bonds, there will be downward pressure on bond prices. Third, and more generally, higher rates will be a headwind for all financial assets, including equities. With valuations in the equity markets at levels already both historically and absolutely expensive, we believe that the risk in markets is to the downside.

Valuations in the U.S. are even more expensive than in other major markets. And this is despite an economic recovery fueled by easy monetary policies that has lasted for nearly nine years now. Thus, it would behoove the Fed to plan for long-run interest rates at a higher level in order to give themselves some room to stimulate in the event of a future economic down turn.

The economic recovery is finally under way in Europe, and equity market valuations are more reasonable. Like the Fed, the ECB also deployed quantitative easing policies to stoke growth but ultimately did so at a lower volume. At the current time, the ECB holds about €2 trillion (approximately $2.4 trillion) in bonds from quantitative easing, which is just over half of what the U.S. accumulated. And perhaps most important, the ECB has provided indications that it may also pivot towards tightening once the current program ends in December.

President Draghi had indicated wanting to decrease the level of stimulus as the euro-zone economy accelerates. The euro-zone continues to lead the major developed economies in growth. Most recently, the ECB revised growth expectations in 2017 from 1.9% up to 2.2%, and President Draghi has been bullish about the euro-zone recovery's broad-based participation. Low inflation is the only dim part of the outlook. The ECB lowered the inflation forecast in 2018 from 1.3% to 1.2% in light of the recent appreciation by the euro.

Stronger unification within the European Union is certainly favored by France and Germany. But Chancellor Merkel will need to navigate a new political regime in Germany and form a governing coalition with the left and center-left parties. However, they are skeptical of some of the euro-zone policy goals. Another potential challenge for Chancellor Merkel will be to deal with the Alternative for Germany, the far-right nationalist party which surprisingly won dozens of seats in the legislature. The outcome is a breakthrough, considering that the far-right had been effectively locked out of parliament for the last 50 years.

Among the big three central banks, the BoJ remains the sole holdout from moving towards tightening. The Japanese economy has enjoyed six consecutive quarters of economic growth, which is the best run in over a decade, and yet inflation remains weak. It seems that the BoJ will continue to bank on the hope that the labor shortages in Japan will set off a cycle of higher wages, higher consumption, and higher prices. But perhaps this thinking is only good in theory. BoJ Governor Haruhiko Kuroda has had to revise down his estimates for inflation six times since 2013.

Chautauqua Capital is proud of the returns that were achieved in the third quarter. This performance stands as a proof statement of the core elements of our investment philosophy and process. From our long-time horizon trend work to our near-term conviction weighting process, everything worked. That said, the ability to generate good short-term results is heavily influenced by the absence of damaging forces. Financial markets are complex systems and, as a result, despite best efforts we cannot always beat the benchmark, quarter to quarter. Accordingly, we can only do what we do well, and that is to work as a cohesive, focused, but nimble team that deploys a time-tested approach. We believe it is important to remind our readers that the past is not prologue. So, while you can be assured that we are working hard at the start of the fourth quarter, we cannot assure, nor should you expect, that we will be able to match the third quarter of 2017's returns.

"This performance stands as a proof statement of the core elements of our investment philosophy and process.

From our long-time horizon trend work to our near-term conviction weighting process, everything worked."

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 company Robert W. Baird.

Respectfully submitted,

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

Investment Professional	Degrees	Years of Experience	Prior Affiliation
Brian Beitner, CFA *Managing Partner*	MBA, University of Southern California BS, University of Southern California	38	TCW Group Scudder Stevens & Clark Bear Stearns Security Pacific
Daniel Boston *Partner*	MBA, Yale University BS, Brigham Young University	12	Ensign Peak Advisors Artisan Partners Wasatch Advisors
Jesse Flores *Partner*	MBA, Stanford University BS, Cornell University	11	Roth Capital Partners Blavin & Company Lehman Bros.
Haicheng Li, CFA *Partner*	MBA, Stanford University MMSc, Harvard Medical School MS, Harvard University BA, Rutgers University	16	TCW Group
David Lubchenco *Partner*	MBA, University of Denver BA, The Colorado College	25	Marsico Capital Management Transamerica Investment Management Janus Capital
Michael Mow, CFA *Partner*	MBA, University of Southern California MS, University of Iowa BA, California State University, Northridge	31	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 September 30, 2017.

The Chautauqua Capital Management Strategies are available to institutions and persons with a minimum account asset value of $50,000,000, which is negotiable in certain instances.

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