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# US Large-Cap Value Strategy Update

*Third Quarter, 2018*

## US MARKET & PORTFOLIO REVIEW

The Russell 1000 Value Index (the "Index") rose +5.7% during the third quarter. This was the second strongest rise in nearly five years, even as headlines continued to focus on escalating trade relations, the heightened partisanship of US politics, and extreme weather events. In September, the Federal Reserve raised interest rates by 25 basis points, the third such hike this year. The 2-year Treasury ended the quarter with a yield of 2.8%, a significant increase from last December's 1.9%. The 10-year Treasury advanced at a slower rate to end the quarter at 3.1%, causing the yield curve to flatten further. US markets were the sole bright spot in the otherwise downbeat global investment markets.

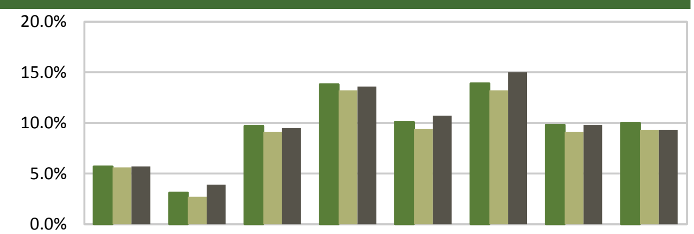
Healthcare (+15.7%) was the strongest sector, reflecting perceptions that rhetoric regarding pricing has diminished as a political issue area. Ongoing confidence in the US economy supported strong returns from the Industrials (+8.3%) and Information Technology (+7.8%) sectors. Telecommunications (+7.4%) also performed strongly. Commodity-oriented Energy (+1.4%) and Materials (-0.1%) and interest-rate sensitive Real Estate (+0.9%) were the weakest sectors.

Boston Common's Tax-Exempt US Value Equity account composite delivered strong absolute returns of +5.7% this quarter, in line with the Index, gross of fees. Over the last twelve months the strategy has returned +9.7%, modestly outperforming the Index (+9.5%), gross of fees.

Both allocation and stock selection in the Industrials and Materials sectors were primary contributors to relative performance. Buoyed by investor confidence in US consumption growth, airline operators Southwest Airlines and Alaska Air as well as waste water company Xylem rebounded after earlier declines. In Materials, while the sector was weak, portfolios benefited from the strength in specialty chemical companies Ecolab, Albemarle, and PPG.

Technology holdings continue to deliver strong absolute returns. Secular trends towards all things internet support growth prospects for Microsoft and Apple, both ESG leaders and among the portfolio's best relative performers. Biogen, Merck, and Johnson & Johnson were also top performers, reflecting the strong rebound in Healthcare stocks. After a period of lackluster returns, concerns regarding industry-wide regulation and pricing have receded, and the markets shared our confidence in the attractive valuations and cash flow growth prospects of this sector. Off-price retailer TJX Companies and money center bank JPMorgan were top ten contributors, demonstrating strong results within lagging sectors. In a reversal from last quarter, our underweight to the Energy sector benefited portfolio returns.

## PERFORMANCE




| | QTD | YTD | 1Yr | 3Yr | 5Yr | 7Yr | 10Yr | Since Inception* |
|---|---|---|---|---|---|---|---|---|
| **Gross** | 5.7% | 3.1% | 9.7% | 13.8% | 10.1% | 13.9% | 9.8% | 10.0% |
| **Net** | 5.6% | 2.7% | 9.1% | 13.2% | 9.4% | 13.2% | 9.1% | 9.3% |
| **Russell 1000** | 5.7% | 3.9% | 9.5% | 13.6% | 10.7% | 15.0% | 9.8% | 9.3% |

## CONTRIBUTORS & DETRACTORS

| TOP 10 | % OF CAPITAL | RETURN | RELATIVE CONTRIB. | SECTOR |
|---|---|---|---|---|
| MERCK & CO INC | 2.9% | 17.7% | 0.32% | Healthcare |
| MICROSOFT CORP | 2.3% | 16.4% | 0.22% | Technology |
| ORACLE CORP | 2.2% | 17.4% | 0.22% | Technology |
| APPLE INC | 1.4% | 22.4% | 0.21% | Technology |
| JPMORGAN CHASE & CO | 4.9% | 9.0% | 0.21% | Financials |
| SOUTHWEST AIRLS CO | 1.3% | 23.1% | 0.20% | Industrials |
| JOHNSON & JOHNSON | 2.1% | 14.6% | 0.20% | Healthcare |
| XYLEM INC | 1.5% | 18.9% | 0.17% | Industrials |
| BIOGEN INC | 1.2% | 21.7% | 0.16% | Healthcare |
| TJX COS INC | 1.3% | 18.1% | 0.15% | Consumer Discretionary |
| | | | **2.06%** | |

| BOTTOM 10 | | | | |
|---|---|---|---|---|
| MOHAWK INDS INC | 1.4% | -18.2% | -0.35% | Consumer Discretionary |
| WEYERHAEUSER CO | 1.7% | -10.6% | -0.29% | Real Estate |
| CIMAREX ENERGY CO | 1.8% | -8.5% | -0.28% | Energy |
| AVANGRID INC | 1.8% | -8.6% | -0.27% | Utilities |
| INTEL CORP | 2.3% | -4.3% | -0.24% | Technology |
| T ROWE PRICE GROUP INC | 1.5% | -5.4% | -0.16% | Financials |
| ANALOG DEVICES INC | 1.5% | -3.1% | -0.14% | Technology |
| NORTHERN TR CORP | 2.0% | -0.2% | -0.12% | Financials |
| MORGAN STANLEY | 1.8% | -1.2% | -0.12% | Financials |
| PNC FINL SVCS GROUP INC | 2.3% | 1.5% | -0.12% | Financials |
| | | | **-2.09%** | |

Our relative performance was impacted primarily from stock selection, especially in the Healthcare sector. Despite strong absolute returns in our biopharma portfolio holdings, performance was overshadowed by outsized gains in several healthcare providers and equipment suppliers the portfolio did not own. Other notable detractors include technology holdings Intel and Analog Devices, US shale producer Cimarex, as well as flooring company Mohawk, whose leading recycling processes we highlighted in our last quarterly memo.

Interest rate-sensitive sectors such as Real Estate, Utilities, and Financials lagged. Utility holding Avangrid, the country's #2 producer

*Since Inception: December 31, 2002

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of wind power, and REIT holding Weyerhaeuser, the country's largest steward of timberland, declined this quarter. Company-specific issues were exacerbated by market worries that their respective sectors could lag when interest rates rise. PNC Financial was a poor relative performer this quarter. Banks, usually beneficiaries of rising interest rates, in fact saw funding costs continue to rise without a corresponding increase in loan rates. Northern Trust, Morgan Stanley, and T. Rowe Price were also hurt by fears about rising rates.

## PORTFOLIO ACTIVITY

Eco-Efficiency is one of the overarching themes within the portfolio. We continue to invest in companies that are thinking "circular" with a focus on reducing costs via efficiency, eliminating wastes, and recycling throughout their business model and back through their customers and supply chains. Savings on resources employed, from energy to water and landfill, have the potential to boost sustainability and profitability, thereby creating shareholder value. We look for companies like Target, which successfully decreased energy use by 405 million kilowatt-hours per year since 2015 through its Store Remodel Program – an accelerated replacement program aimed at upgrading equipment with more efficient designs; or companies that employ large data centers, like Verizon and Digital Realty Trust, which reduce their greenhouse gas emissions by improving energy efficiency and sourcing renewable electric power. Supporting companies in their quest for efficiency can provide business opportunities as well: infrastructure financier Hannon Armstrong supports infrastructure projects targeting energy efficiency, while building materials provider Carlisle expands energy efficiency into roofing technology.

We purchased Target Corporation this quarter, reducing our relative underweight to the Consumer Discretionary sector. This large store retailer has shown ESG leadership by becoming the first retailer to step up to a $15 per hour minimum wage for its employees. This strong investment in its workforce, plus a program to update its stores, has helped sales growth recover, a trend we expect to continue.

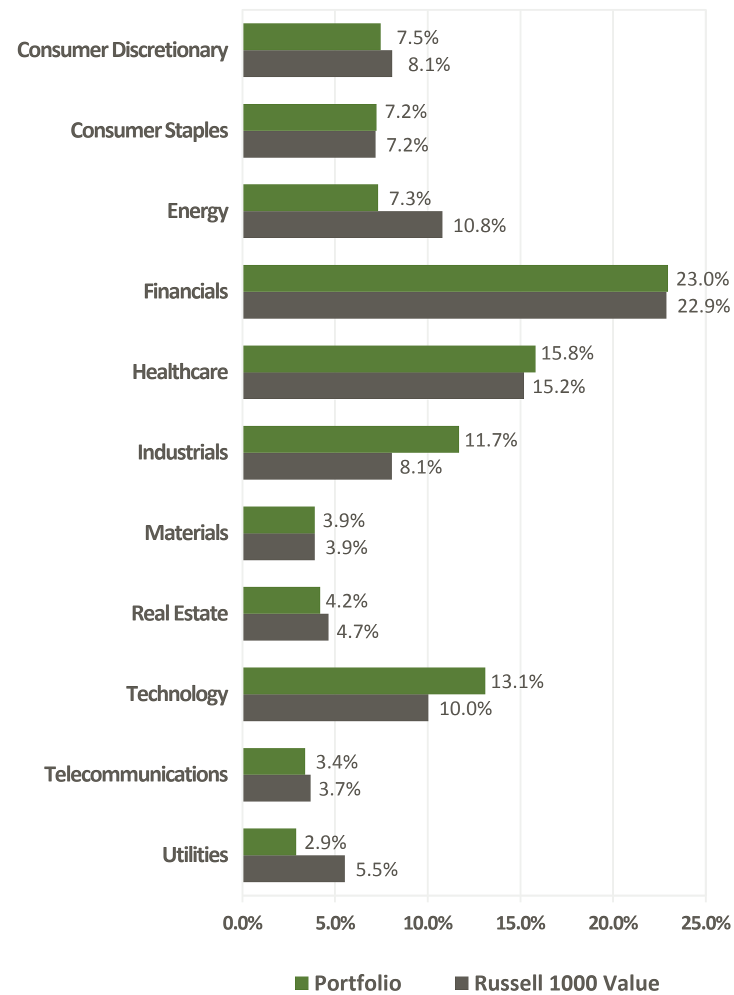
In the Technology sector, we exited our position in semiconductor and telecommunications equipment manufacturer Qualcomm. The Chinese government's refusal to approve a key acquisition weakened our conviction in the company's strategic positioning. Proceeds were used to purchase First Solar, a leading solar panel manufacturer and operator of some of the world's largest grid-connected PV power plants. We also initiated a positon in Worldpay, the number one payment processer globally. The company, newly merged with its closest competitor, has broad coverage across all market segments, including ecommerce, merchant, and B2B. Global ecommerce is the newest growth market and Worldpay's global reach is a competitive advantage.

We selectively added to current holdings where we believe company fundamentals are improving yet valuations have not adjusted. We also trimmed several holdings after strong upward performance.

## ECONOMIC & MARKET OUTLOOK

In recent quarters, market strength was supported by investor expectations that base line US economic growth would rise, fueled by fiscal stimulus, deregulation, consumption, and global corporate profit growth. Positive sentiment, capital flows, and low interest rates have

## SECTOR ALLOCATION




## PORTFOLIO CHARACTERISTICS

| | BOSTON COMMON | RUSSELL 1000 VALUE |
|---|---|---|
| # HOLDINGS | 64 | 727 |
| ***Valuation*** | | |
| Next 12m Price to Earnings | 15.4 | 14.3 |
| Price to Book Value | 2.7 | 2.2 |
| Price to Sales | 2.7 | 1.7 |
| Dividend Yield | 2.0% | 2.5% |
| ***Growth*** | | |
| 5yr Sales Growth | 2.2% | 2.2% |
| 5yr EPS Growth | 8.3% | 7.0% |
| ***Risk*** | | |
| Wtd Avg Mkt Cap | 127,146 | 126,291 |
| LT Debt/Cap | 37.5% | 43.5% |
| Beta | 0.99 | 1.00 |

supported the market's multiples, and volatility has remained subdued despite political risks and rhetoric. With 3Q 2018 GDP expected to touch 4%, some of these components now appear to be less certain. Tariff threats and retaliations could jeopardize economic growth and create uncertainty in business decision-making, thereby changing the trajectory of corporate profits and global growth. At the same time, wage increases and rising energy costs could challenge earnings, while rising interest rates could stifle economic activity.

On balance, we believe economic growth will moderate but continue at a more sustainable 2% level. The relative strength of consumer spending, the driver of two thirds of the US economy, has both positives and negatives. With rates of unemployment now at levels last seen in 1969, wages have finally begun to pick up, particularly at the bottom of the pyramid. High energy and health care costs have taken a toll, however, and higher mortgage rates could dampen housing and related discretionary spending.

Tax changes have incentivized capital spending by effectively creating full deduction of capital purchases in the first year through bonus depreciation. In addition, the cost of borrowing still remains very attractive even after the recent increases in interest rates. Rising wages, labor shortages, and skill mismatches exacerbated by low immigration will propel the trend towards automation and technological use across all sectors, including services. In the medium term, this could keep capital spending high, avoiding the capacity constraints that normally characterize the end of business cycles. In the long run, this may lead to a higher level of productivity and prolonged potential for growth without accelerating inflation.

The Federal Reserve will likely continue to steadily reverse the extreme monetary stance of the post-Crisis era. The Fed's actions have provoked anxiety among investors – each gesture is scrutinized and debated. We believe normalizing monetary policy will give the Fed a more sustainable set of policy options for future action, if needed. However, this transition will inevitably cause stress in several sectors of the economy. At the same time, long-term rates are also rising. This could be viewed as a sign of healing, particularly as the yield curve has not inverted. We expect 10-year bond yields to remain above the psychologically important 3% level, but be range bound, given global capital flows and moderate inflation.

Although the long-term direction of the US Dollar should be lower, anchored by the trade and fiscal deficits, current monetary policy and economic growth could continue to support the currency. Given trade uncertainties, monetary authorities around the world are likely to remain steadily stimulative for some time. The Dollar's rise has been a disinflationary force in the US, keeping energy and import costs lower than they might otherwise be.

We anticipate market volatility, as investors revise downward their expectations of economic growth and corporate earnings. However, we do not expect either recession or runaway inflation or interest rates in the coming year. Barring political risks, the economy should be moderately positive, impressive for a recovery in its tenth year!

## NEW & CLOSED POSITIONS

| CLOSED | SECTOR | % OF PORT. |
|---|---|---|
| QUALCOMM INC COM | Technology | 0.6% |
| **TOTAL CLOSED** | | **0.6%** |

| NEW | SECTOR | % OF PORT. |
|---|---|---|
| FIRST SOLAR INC COM | Technology | 0.9% |
| TARGET CORP COM | Consumer Discretionary | 1.0% |
| WORLDPAY INC CL A | Technology | 1.0% |
| **TOTAL NEW** | | **2.9%** |

## COMPANY SPOTLIGHT: MICROSOFT CORP.

### *ESG Integrated Investment Thesis*

Microsoft Corporation, known for its ubiquitous Windows and Office products, continues to balance its core software business while accessing new avenues for growth. Its cloud business, Azure, has become the number two provider. Leveraging the Windows operating system, Azure can communicate easily with a company's existing infrastructure. Though datacenters are energy intensive, they offer important environmental benefits. Their centralized nature significantly reduces overall energy requirements compared with self-hosted solutions, especially as Microsoft increasingly relies on renewable energy sources.

Microsoft is harnessing its massive customer base to transition to a more profitable Software as a Service (SaaS) model. Additionally, the company is complementing its core products with a suite of business management offerings such as SQL Database, Customer Relations Management, and LinkedIn. With revenue growth accelerating into the mid-teens and earnings growing at a mid-20% annualized rate, the stock appears attractively priced at 15x next-twelve-months EV/EBITDA. Risks include slower cloud services adoption and supply chain sourcing.

### *Company Profile*

A household name, Microsoft Corporation develops and supports software, services, devices, and solutions, with products ranging from operating systems to server applications to personal electronics. The company generated $110 billion in revenues for its fiscal year ending June 2018 within the following segments: More Personal Computing (38% of sales), Productivity and Business Processes (33%), and Intelligent Cloud (29%). Microsoft is pursuing significant energy and emissions reductions throughout its operations, from carbon neutrality since 2012 to 50% renewable energy sourcing by 2018. Externally, Microsoft offers energy efficiency solutions that underpin "smart grid" technology. This allows electric utilities to upgrade outdated systems and support renewable power distribution as well as generate significant energy savings through efficient delivery.

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We are continually assessing our portfolio holdings, and any unpredictability arising from the market's concerns affords us a chance to make portfolio changes, adding to high-quality companies operating sustainably in growing end markets. We retain a neutral to modestly positive equity position within balanced accounts. We have revisited the shorter-duration, high-quality stance we have held for some time in fixed income portfolios and are holding some cash as we redirect our portfolios.

## Shareholder Engagement Highlights

| | |
|---|---|
| *Milestones* | **Achieving Impact in Global Equities:** We published our second annual Engagement Impact report, **Achieving Impact in Global Equities**, which details **60 measurable impacts** and improvements in corporate policies, processes, or products in our global engagement efforts in 2017. We also shine a spotlight on our **alignment with the UN Sustainable Development Goals**. |
| | **Lobbying Disclosure:** We commended **Verizon Communications** for leaving the **American Legislative Exchange Council (ALEC),** a powerful lobbying group and will now urge Verizon to advance its transparency and accountability by adopting **comprehensive lobbying disclosure**. We called on Verizon to report its direct spending of shareholder resources on lobbying, including its indirect funding and support for ALEC. **Our resolution** at Verizon's May 2018 annual meeting received **strong support from shareholders (36.3% in favor).** |
| | **Climate Change: Standard Chartered** published a revised **Position Statement on Power Generation** and acknowledged Boston Common's input and review, which helped inform the company's position. |
| *Work in Progress* | **Tax Transparency:** A recent Oxfam America report, "Prescription for Poverty", concluded that some US pharma companies could be using tax havens to avoid paying up to $100 million in taxes every year to numerous Emerging Market countries. Our collaborative engagement focused on responsible tax management and transparency seeks to shine light on this topic. In our role as lead investor, we sent letters to Dr. Reddy's and Johnson & Johnson and will also engage Biogen, GlaxoSmithKline, Microsoft, and Novartis on this issue. |
| | **Advancing Engagement in Emerging Markets:** We urged **HDFC**, a bank in India, to recommit to responding to the **CDP** questionnaire in 2018, which aligns with the **Taskforce on Climate-related Financial Disclosures (TCFD**). We are leading an engagement with **Grupo Bimbo** on performance gaps identified in its **Access to Nutrition** policies and practices as part of the **2018 ATNI Global Index**. We met with the managements of South Korean companies to discuss material sustainability issues: With **Coway**, we discussed product safety protocols after nickel was found in its water purification products. With **SK Telecom** we engaged on the rights of users and data security. |
| *New Initiatives* | **Banks & Human Rights Due Diligence:** We initiated another layer of dialogue with global banks, intentionally integrating human rights due diligence into our meetings with **Barclays, ING, Morgan Stanley, PNC Financial, Standard Chartered,** and **TD Bank**. We are urging banks to: **address gun violence** and **Indigenous peoples' rights** with fossil fuel projects in the US, apply the **Equator Principles** beyond developing countries, and **respect human rights by adhering to the UN Guiding Principles**. We engage standard setting bodies (e.g. OECD) with the **aim of ensuring the integration of human rights into corporate lending and project finance oversight**. **ING** has one of the most advanced human rights policies supported by formal oversight with a Steering Committee across business lines and a transparent human rights policy. |