

# Growth Fund

## FUND FACTS

The fund seeks to invest in companies with sustainable competitive advantages, long-term structural growth drivers, attractive cash flow returns on invested capital, and management teams focused on creating long-term value for shareholders. The fund's portfolio manager also aims to invest in companies when they trade at a significant discount to the estimate of intrinsic value.

Strategy AUM <sup>1</sup>	\$73.6 billion
Fund AUM	\$13.8 billion
Share Class	Y
Inception	5/16/1991
Ticker	LSGRX
Benchmark	Russell 1000 <sup>®</sup> Growth
CUSIP	543487110
Portfolio Manager	Aziz Hamzaogullari
Manager Since	June 2010

<sup>1</sup>Strategy assets are comprised of Loomis Sayles Large Cap Growth style accounts.

## Portfolio Review

- The fund posted negative returns of -2.13% vs. 1.16% for the Russell 1000<sup>®</sup> Growth Index, underperforming the benchmark by 3.29% net during the third quarter. Oracle, Alphabet and Salesforce were the three largest contributors to fund performance. Alibaba, Illumina and Boeing were the largest detractors to performance during the quarter.
- Stock selection in the information technology sector as well as our allocation to the healthcare sector contributed positively to relative return. Stock selection in the consumer discretionary, healthcare, consumer staples, energy, communication services and industrials sectors as well as our allocation to the industrials and information technology sectors detracted from relative performance.
- The fund is an actively managed strategy with a long-term, private equity approach to investing. Through our proprietary bottom-up research framework, we look to invest in those few high-quality businesses with sustainable competitive advantages and profitable growth when they trade at a significant discount to intrinsic value (our estimate of the true worth of a business, which we define as the present value of all expected future net cash flows to the company).

## TOP TEN HOLDINGS (%)

Alphabet Inc.	7.2
NVIDIA Corporation	6.6
Amazon.com, Inc.	6.4
Facebook, Inc.	6.3
Visa Inc.	5.2
Microsoft Corporation	4.7
Oracle Corporation	4.5
Autodesk, Inc.	4.3
salesforce.com, inc.	4.2
Boeing Company	4.1
Total	53.5

Data is based on total gross assets before any fees are paid; any cash held is included. The portfolio is actively managed and holdings are subject to change. References to specific securities or industries should not be considered a recommendation. Holdings may combine more than one security from the same issuer and related depositary receipts. Portfolio weight calculations include accrued interest. For current holdings, please visit [www.loomissayles.com](http://www.loomissayles.com).

## PERFORMANCE AS OF SEPTEMBER 30, 2021 (%) CLASS Y

	CUMULATIVE TOTAL RETURN		AVERAGE ANNUALIZED RETURN			
	3 MONTH	YTD	1 YEAR	3 YEAR	5 YEAR	10 YEAR
<b>FUND</b>	-2.13	11.19	20.72	19.47	18.99	18.85
<b>BENCHMARK</b>	1.16	14.30	27.32	22.00	22.84	19.68
<b>EXCESS RETURN</b>	-3.29	-3.11	-6.60	-2.53	-3.85	-0.83

**Performance data shown represents past performance and is no guarantee of, and not necessarily indicative of, future results. Investment return and value will vary and you may have a gain or loss when shares are sold. Current performance may be lower or higher than quoted. For most recent month-end performance, visit [www.loomissayles.com](http://www.loomissayles.com).**

Performance for periods less than one year is cumulative, not annualized. Returns reflect changes in share price and reinvestment of dividends and capital gains, if any. You may not invest directly in an index.

Additional share classes may be available for eligible investors. Performance will vary based on the share class.

Gross expense ratio 0.65% (Class Y). Net expense ratio 0.65%. As of the most recent prospectus, the investment advisor has contractually agreed to waive fees and/or reimburse expenses once the expense cap of the fund has been exceeded. This arrangement is set to expire on 1/31/2022. When an expense cap has not been exceeded, the fund may have similar expense ratios.

The Class Y inception date is 5/16/1991. Institutional. Class shares (Class Y) are available to eligible investors with a minimum initial investment of \$100,000 and without a sales charge.

**NEW PURCHASE  
HIGHLIGHTS**

There were no new purchases during the period.<sup>2</sup>

## Portfolio Activity

- All aspects of our quality-growth-valuation investment thesis must be present for us to make an investment. Often our research is completed well in advance of the opportunity to invest. We are patient investors and maintain coverage of high-quality businesses in order to take advantage of meaningful price dislocations if and when they occur. During the quarter, we added to our existing position in Alibaba as near term price weakness created an attractive reward-to-risk opportunity.<sup>2</sup>

## Contributors

Oracle, Alphabet and Salesforce were the three largest contributors to fund performance.

- **Oracle** is a leader in the enterprise software market, with a strong market position in database, infrastructure and application software, and cloud-based software and services. The company's competitive advantages include its direct sales force, a founder-driven management team that reinvests relentlessly to maintain a differentiated product suite and leading intellectual property portfolio, and a large installed base of clients where it consistently achieves client renewal and retention rates in the mid-90% range. We believe Oracle is well positioned to benefit from the continuing growth in data storage and enterprise application software, as well as the shift to cloud-based solutions.

A long-term fund holding, Oracle reported fundamentally strong quarterly results that were better than consensus expectations for earnings before interest and taxes (EBIT) and earnings per share (EPS), but modestly below expectations for revenue, despite exceeding management's guidance. Total revenue for Oracle rose 2% year over year in constant currency to \$9.7 billion. At \$8.2 billion, software sales represented 84% of total revenue and rose 4% year over year. Oracle's infrastructure business (59% of total software revenue) grew 3% year over year, benefiting from the company's autonomous database offering, which grew 56% in the quarter and already has thousands of customers following its 2018 launch, demonstrating the product's early success. Oracle's cloud infrastructure (OCI) grew by over 80% versus the prior-year quarter. Oracle's applications business (41% of total software revenue) generated 7% organic growth. Driven by 25% growth in its strategic back office applications, which include its Fusion suite of cloud-enabled enterprise software solutions, the company experienced much faster growth in several key cloud products such as enterprise resource planning (ERP) and its NetSuite small-business ERP offering, demonstrating the company's progress in transitioning to a cloud-based model and positioning the company to improve its growth rate over time. While Oracle remains the world leader in its largest business segment, enterprise database software used in customer on-premise IT environments, the company continues to focus on transitioning its business from a traditional on-premise, up-front software licensing and maintenance revenue model to a cloud-computing subscription-based model where software revenue is recognized over the life of the client's contract. While there has been pressure on year-over-year overall revenue comparisons during this transition as up-front license revenue shifts to subscription revenue, we expect this to lead to faster growth as the transition progresses over time due to a higher customer lifetime value. The cloud model also allows Oracle to monetize its services and technology more efficiently and yield savings to the customer. The company recently reported that its two largest cloud businesses, which include its software-as-a-service (SAAS) and infrastructure-as-a-service (IAAS) offerings, now represent 25% of total revenue and had an annual run rate of over \$10 billion.

<sup>2</sup>Quarter-to-date transactions as of September 30, 2021.

In Oracle's hardware segment, revenue of \$763 million declined 7% year over year, which was below consensus expectations. The hardware business accounted for approximately 8% of total revenue and a smaller percentage of total cash flow. With the ongoing transition to the cloud and faster growth in its larger software businesses, we expect hardware to continue to decline as a percentage of revenue and cash flow. In its services segment (about 8% of revenue), revenue of \$781 million rose 7% compared with the same quarter last year.

Even though the company is in the midst of a major business model transition, Oracle's financials remain strong. Adjusted EBIT of \$4.3 billion rose 2% versus the prior-year quarter in constant currency and was above consensus expectations. Operating margins declined 18 basis points to 45%, due primarily to a decline in gross margins. Over the trailing four quarters, Oracle generated \$12.6 billion in free cash flow, which rose 9% year over year and represented 90% of net income, demonstrating the company's strong cash generation ability. The company repurchased \$8 billion of shares during the quarter and has reduced its outstanding share count by 8% year over year. Oracle's financial leverage has increased over the past several years, due primarily to its increased allocation of capital to share repurchases. However, given its persistently strong cash flow and resulting debt servicing capability, we believe the balance sheet remains solid. We believe Oracle's stock price embeds free cash flow growth assumptions that are well below our long-term forecast. As a result, we believe its shares are selling at a significant discount to our estimate of intrinsic value and offer a compelling reward-to-risk opportunity.

- **Alphabet** is a holding company which owns a collection of businesses, the largest and most important of which by far is Google. Google is the global leader in online search and advertising and also offers cloud solutions to businesses and consumers globally, with a goal of organizing the world's information and making it universally accessible and useful. Non-Google businesses comprise less than 1% of Alphabet revenues and are held in the company's Other Bets segment.

A long-term fund holding, Alphabet reported strong quarterly financial results that reflected accelerated revenue growth, expanded adjusted operating margins, and EPS (earnings per share) that more than doubled, all of which were better than consensus expectations. For the quarter, total revenue of \$61.9 billion represented a 62% increase year over year in constant currency and was 10% above consensus expectations. Alphabet reports results in three segments: Google Services, Google Cloud, and Other Bets. Google Services reported quarterly revenue of \$57.1 billion, which rose 63% year over year and represented 92% of total revenue. Advertising revenue accounted for 88% of Google Services revenue and grew 69% compared with the year-ago quarter, powered by the secular shift of advertising to online and mobile platforms. With growth well above that of traditional advertising, Google continued to take market share. Advertising revenue growth was driven by continued recovery in the search business, which grew 68% year over year, and 84% growth in YouTube. Both businesses benefited from strong growth in direct response ads, particularly for YouTube, where direct response ads have grown to become what we believe to be one of the largest advertising businesses on YouTube after contributing almost nothing three years earlier. YouTube has benefited from strong demand from brand advertisers due to its reach and engagement with 2 billion monthly users who spend over 1 billion hours daily on the platform. Non-advertising revenue, which includes Google Play, hardware, and YouTube non-advertising revenues such as subscriptions, represented 12% of Google Services revenues and grew 29% year over year. Growth was driven by YouTube and Google Play.

Google Cloud reported quarterly revenue of \$4.6 billion, which rose 54% year over year

and represented 7% of total revenue. Google's cloud business includes Google Cloud Platform (GCP), the company's infrastructure- and platform-as-a-service offerings, and G Suite, which includes the company's software-as-a-service offerings such as Gmail, Docs, Drive, and Calendar. Cloud growth was led by GCP, which grew well above the overall cloud business. The segment generated an operating loss of \$591 million on EBIT (earnings before interest and taxes) margins of -13%, which improved from -47% in the prior-year period. The operating loss reflects substantial up-front investments that the company is making to drive long-term growth in advance of revenue. Significant areas of investment include a direct sales force that has tripled over the past few years and substantial expansion of distribution via partners, large investments in its product offerings that are being tailored for six industry verticals, and expansion of network computing capacity to serve customers around the world. Alphabet's Other Bets segment reported revenue of \$192 million that increased 30% in the quarter and represented 0.3% of total revenues. Many of these businesses are still early stage and results are volatile on a quarterly basis. Revenue in this segment is currently driven by Fiber and Verily. We believe Google's key revenue drivers of mobile search, YouTube, programmatic advertising, and an emerging cloud business that is growing approximately three-times faster than the core search business, each continue to benefit from secular drivers including increased mobility, video advertising, better use of advertising technology to drive performance, and increased penetration of public cloud services.

Alphabet continues to have a high-quality financial profile and strong financial position. The company reported gross margins of 58% that rose 600 basis points year over year, due to improvement in traffic acquisition costs and lower other cost of goods sold. Adjusted operating margins of 38% rose over 1,400 basis points compared with the year-ago quarter, benefiting from operating leverage in all expense items. Google's attractive financial model generates strong free cash flow and earns high returns on invested capital, enabling it to reinvest significantly in its business. Over the past five years, Google has invested over \$100 billion in R&D, an amount very few other companies could replicate. In the quarter, Alphabet generated free cash flow of \$16.4 billion that rose 91% and represented 26% of revenue. Capital expenditures increased by 2% year over year to \$5.5 billion and represented 9% of gross revenue. The company's capital expenditures continue to focus on infrastructure spending required to support growth, including servers, data centers, and office facilities.

We believe market expectations underestimate Alphabet's long-term sustainable growth rate. Therefore, we believe the company is selling at a significant discount to our estimate of intrinsic value and offers a compelling reward-to-risk opportunity.

- **Salesforce.com** is the leading provider of cloud-based enterprise software, services, and applications focused on customer relationship management (CRM) for companies of all sizes and industries. The company offers individual cloud applications in multiple CRM market segments but is focused on its Customer 360 platform that unites sales, service, marketing, commerce, and other functions to provide a comprehensive customer view, enable companies to create and share custom applications and analytics, and automate all aspects of customer relationships. Salesforce sells its products globally, primarily through a direct sales force and indirectly through consulting firms, system integrators, and other partners.

A fund holding since the first quarter of 2020, Salesforce reported strong quarterly financial results that exceeded consensus expectations for revenue, operating margins, and earnings per share (EPS). Management raised its revenue, operating income, EPS, and

free cash flow outlooks for the company's 2022 fiscal year (FY), all of which were above consensus expectations. The company also reported that customer retention improved to approximately 92% from approximately 91% over the past few quarters. More recently, at the company's analyst day and annual Dreamforce conference, Salesforce again increased its 2022 FY revenue guidance and provided initial guidance for 2023 FY revenue and operating margins, all of which were above consensus expectations. The company also reiterated its long-term guidance for revenue to reach \$50 billion in its 2026 FY, up from \$21 billion in its most recent 2021 FY. We believe Salesforce's strong and sustainable competitive advantages, which include its brand, comprehensive CRM solutions, large installed base of clients with high switching costs, and scale, will enable it to benefit from secular growth in adoption of its cloud-based applications and to grow faster than the industry as a whole.

For the quarter, revenue of \$6.3 billion increased 23% year over year in constant currency, driven by strong growth in the company's service, marketing and commerce, and platform and other segments, all of which experienced greater-than 20% organic growth. Subscription revenue for the company's core CRM cloud software services accounted for 93% of total revenue and rose 22% versus the prior-year quarter. With three of its cloud service offerings growing organically at 20% or more, the company continued to grow its share of the enterprise and CRM application markets. The company's sales cloud represented 25% of subscription revenue and grew 15% year over year. Service cloud represented 27% of revenue and grew 23% versus the prior-year quarter. Platform and other, which includes the company's key Customer 360 platform, accounted for 32% of revenue and grew 24% year over year. The company's marketing and commerce cloud segment represented 16% of revenues and grew 28% year over year. Outside of its subscription products, professional services revenue accounted for 7% of total revenues and grew 37% versus the prior-year period. From a geographic standpoint, the Americas accounted for 68% of revenue and grew 20% year over year in constant currency. Europe accounted for 22% of revenue and grew 32%, while Asia-Pacific accounted for 10% of revenue and grew 26% in constant currency.

Reported revenue from recently acquired Slack Technologies, which was only consolidated late in the quarter, was immaterial for the period, but growth accelerated to 39% due to strong enterprise growth. Slack has been one of the fastest growing providers in the collaboration applications market, growing from approximately 6% market share in 2016 to 19% in 2020, behind only industry leader Microsoft with approximately 27% share. The company generated revenue of approximately \$900 million in its most recent-fiscal year and its subscription-based business model has generated net client retention of over 120%, suggesting continued year-over-year growth in revenue from existing customers. While the company is not currently profitable, it earns gross margins of approximately 88% and generates positive free cash flow. Following the acquisition, Slack became an operating unit of Salesforce, led by its CEO and co-founder Steward Butterfield. The company's products will continue to be sold directly to all enterprises, but Slack will also be deeply imbedded in every Salesforce cloud and become the new net interface for Salesforce's Customer 360 platform, with a focus on providing a unified platform to connect employees, customers, external partners and their apps. While there are risks relating to the acquisition, we see significant potential in driving long-term value for the company. We believe the acquisition has the potential to improve Salesforce's competitive positioning by facilitating even better collaboration and decision making across CRM functions and further improving client experience. We believe Slack will be the engagement layer across all of Salesforce's cloud products and can ultimately become the system of engagement for its Customer

360 strategy. A second potential benefit we see is that Salesforce will significantly improve the distribution strength of Slack, whose strong and successful viral offering will now be able to leverage the massive installed base of Salesforce clients and its direct sales force of approximately 10,000 employees. We expect Salesforce to grow Slack's revenue in excess of 20% compounded annually over our forecast period. We also expect the combined business will improve its margins and benefit from further scale. Ultimately, as a function of the Slack's strategic fit and Salesforce's history of successfully integrating acquisitions within its core competencies, such as ExactTarget, Demandware, and MuleSoft, we believe Salesforce is one of very few companies capable of successfully delivering on the proposed integration and realizing value from the acquisition. However, we recognize this was a much larger acquisition and we will continue to carefully monitor and assess the company's progress for any impact to our investment thesis and intrinsic value estimates.

Salesforce has an attractive financial model that we believe will continue to improve over our long-term investment horizon. Adjusted operating income of \$1.3 billion rose 24% year over year on margins of 20.4% that expanded by 20 basis points, benefiting primarily from operating leverage in research and development expenses. Free cash flow declined 45% versus the prior-year period to \$173 million, due largely to capital expenditures which increased 87% to \$213 million, after being temporarily depressed in 2020. The company's balance sheet remains solid, with a net debt position of approximately \$1.75 billion, or 11% net debt to equity, following its acquisition of Slack.

We believe Salesforce's share price continues to embed expectations for key revenue and cash flow growth drivers that are well below our long-term assumptions. As a result, we believe the company is selling at a significant discount to our estimate of its intrinsic value and offers a compelling reward-to-risk opportunity.

## Detractors

Alibaba, Illumina and Boeing were the largest detractors to performance during the quarter.

- **Alibaba Group**, launched in 1999, is a leading China e-commerce and consumer engagement platform provider. The company operates several increasingly connected businesses across commerce, technology, advertising, digital media and entertainment, logistics, payments, and local services. Collectively these businesses form a powerful ecosystem, providing Alibaba with advantaged insights that facilitate e-commerce and enable merchants and brands to engage with customers across the entire consumer lifecycle via an unparalleled platform.

A fund holding since its initial public offering in the third quarter of 2014, Alibaba reported quarterly financial results that reflected strong fundamentals and continued market share gains, but were mixed with respect to consensus expectations, with revenue slightly below and earnings per share (EPS) well above. However, shares remained under pressure despite good fundamentals due to concern regarding increased regulatory intervention by the Chinese government in a growing number of industries, most recently the education sector, and the uncertainty these measures have created among investors questioning the ultimate impact on the businesses.

Earlier this year, China's State Administration for Market Regulation (SAMR) released regulations aimed at preventing monopolistic practices across China's internet industry and conducted investigations regarding anti-competitive practices by a number of companies, including Alibaba. In August, China passed the Personal Information Protection Law

(PIPL) which is focused on protecting personal information rights and interests by standardizing the handling and usage of personal information by businesses.

We believe SAMR and other Chinese regulatory efforts are focused on promoting sustainable and healthy development of China’s online ecosystem, fair competitive behavior, compliance with social responsibility, and setting reasonable limits on the usage of personal information. We believe that many of the companies to which the regulations pertain, including Alibaba, are engaged in activities that are supportive of the Chinese government’s long-term strategic goals. These goals include promoting domestic consumption as well as the development of domestic cloud technologies in order to reduce China’s dependence on foreign companies and countries. On both of these counts, Alibaba is a leader and its continued success advances those long-term goals. We also believe that China may have other reasons to wish to exert greater regulation in sectors such as education, where we do not have any holdings.

Regarding Alibaba specifically, SAMR investigated allegations that the company required merchants to enter exclusive relationships which prevented them from offering the same products on competing platforms. In April, SAMR concluded that Alibaba’s practices had violated antitrust law. The company was fined approximately \$2.8 billion and ordered to carry out “comprehensive” self-inspections to standardize business practices and ensure compliance with anti-monopoly laws. Alibaba cooperated fully with the investigation and had already established a special task force, including leaders of its business units, to conduct internal reviews, and has changed certain business practices. Before the ruling, we believed that Alibaba could potentially be fined a meaningful percentage of prior-year revenue if it was found to have violated the rules. The \$2.8 billion fine represents under 3% of FY 2021 revenues, approximately 20% of Alibaba’s free cash flow in the preceding quarter, and a fraction of the company’s approximately \$73 billion of cash and short-term investments. We do not believe the investigation, fine, or any potential remedies will ultimately impact Alibaba’s strong and sustainable competitive advantages, which include the power of its platform and business ecosystem, scale, and brand strength.

With respect to PIPL, companies such as Alibaba may continue to collect, maintain, and use personalized data in their operations with certain restrictions. The law requires that companies must have legitimate reasons for collecting personal information, which will require consent from consumers and should be limited in scope. The law also requires that companies establish compliance systems and an independent body which includes outside members to supervise the processing of personal information. We believe the focus of PIPL is similar to the General Data Protection Regulation (GDPR) which went into effect in the European Union in 2018. The GDPR impacted other portfolio holdings such as Alphabet and Facebook, which incurred increased compliance costs and other disruptions as they adjusted certain business practices to comply with the new regulations. However, both companies continued to generate strong growth in revenue and free cash flow due to their competitive advantages and strong value propositions. While PIPL will go into effect beginning in November, we believe Alibaba has already started to implement portions of PIPL’s requirements into its business. As with Facebook and Google, we expect that Alibaba will experience other short-term disruptions as it further modifies its practices to fully comply with the law and other changes in regulations. During the quarter, the company announced that it will be contributing \$15 billion to China’s sustainable social values program by 2025. This may include operating expenses, capital expenditures, and equity investments aimed at social initiatives aimed at key stakeholders of the Alibaba ecosystem. However, we do not believe that PIPL’s provisions or other regulatory developments will

ultimately impact the company's difficult-to-replicate competitive advantages, and we believe the company remains well positioned to benefit from secular growth in China e-commerce, as well as advertising growth, digitizing offline retail, cloud computing, and international expansion. As we do with any legislative or regulatory developments, we continue to monitor and assess any potential structural impact to our investment thesis for Alibaba. However, we do not believe the investigation, fine, or any potential remedies will ultimately impact Alibaba's strong and sustainable competitive advantages.

During the quarter, reported revenue grew 34% year over year, faster than our estimate of China consumer spending or e-commerce sales, indicating the company continued to expand its market share. Excluding the recent consolidation of supermarket chain Sun Art, organic revenue growth was 22% year over year. With gross merchandise volume (GMV) that exceeded \$1 trillion in its 2021 fiscal year across the Alibaba digital economy, which includes its commerce, local services, and digital media and entertainment offerings, Alibaba is the world's largest retail platform. The company continues to be driven by its core commerce segment, which accounted for 87% of Alibaba's \$31.9 billion of total quarterly revenue and grew 35% year over year. China commerce retail accounted for 75% of core commerce revenues and grew 34% year over year. The company ended its 2021 fiscal year with 811 million active consumers in its China retail marketplaces, up 12% from 726 million a year earlier. In the broader Alibaba digital economy, the company ended the year with 891 million annual active consumers in China and approximately 240 million international consumers. During the quarter, mobile monthly active users grew 7% to 939 million, aided by investment in content and technology to drive strong user engagement. Data gathered from strong consumer engagement on the company's e-commerce and digital media sites provide powerful insights into consumer behavior. Alibaba is thereby able to deliver more personalized content, which enables a growing number of merchants to better target and engage customers throughout the consumer lifecycle and drives improved e-commerce monetization. Benefiting from this insight, customer management revenues grew 14% versus the prior-year quarter.

A growing initiative within the China commerce retail segment is Alibaba's new retail strategy, in which it seeks to leverage its data, scale, technology, and network ecosystem to digitize the entire retail value chain and create a seamless consumer experience between online and offline retail. The initiative, which includes the company's acquisitions of China department store Intime, Sun Art supermarkets, and Hema grocery stores (now Freshippo), accounts for approximately one quarter of China commerce retail revenue and is growing at a multiple of the overall core commerce business. During the quarter, the company benefited from the consolidation of Sun Art, a leading supermarket chain in China in which it first invested in 2017 and took a controlling stake in October 2020. Consistent with its new retail strategy, through the partnership Alibaba is focused on driving deeper digital transformation of China's supermarkets and hypermarkets. Other revenues, which are driven primarily by new retail, expanded 42% year over year in the most recent quarter.

Core commerce revenues also benefited from the company's substantial focus on international and cross-border commerce, with the international commerce retail business growing 54% year over year, driven by growth at southeast Asia-focused Lazada Group and AliExpress. In total, the core commerce segment reported adjusted operating profits that declined by 11% year over year. Adjusted operating margins of 33% declined 900 basis points versus the prior-year period. Margins continue to be pressured by losses at the company's strategically important but currently loss-making businesses, including new retail, local services, Lazada, and logistics operations. Absent those key strategic



investments, adjusted operating profit would have risen by 6% year over year. We believe the company's core marketplace business continues to generate stable and attractive operating profits, and that its currently loss-making newer businesses will expand the company's addressable market and become profitable over time, contributing to earnings and free cash flow growth.

Alibaba's cloud-computing revenue rose 29% year over year, well above the single-digit growth in China IT spending, and accounted for 8% of total revenue. Growth was driven by an increase in both public and hybrid cloud businesses, including growth in revenue from customers in the internet, financial services, and retail sectors. Growth was negatively impacted by the earlier loss of a large cloud client and partial competitor that is no longer using Alibaba for its operations outside of China. Alibaba remains China's top cloud services provider, and the company's top ten clients represent less than 10% of total cloud revenues. The cloud-computing business remains in investment mode, focusing on geographic and product expansion, but generated its third consecutive positive adjusted profit during the quarter, as operating margins of 2% improved from -9% margins in the year-ago quarter.

Alibaba's adjusted EBITDA (earnings before interest, taxes, depreciation and amortization) declined 5% over the prior-year quarter, and EBITDA margins of 24% were down 900 basis points year over year. For the quarter, free cash flow was \$3.2 billion, but declined 43% year over year, due in part to the partial payment of the anti-monopoly fine, as well as elevated strategic investments. We believe Alibaba continues to execute well on its business model, allowing it to expand its already dominant market position and invest to strengthen its competitive advantages. The company benefits from secular growth in China e-commerce, as well as advertising growth, digitizing offline retail, cloud computing, and international expansion. We believe the near-term uncertainty regarding the regulatory environment does not change the long-term fundamentals; namely, China remains one of the largest and most attractive e-commerce markets and Alibaba is one of the best-positioned companies to take advantage of this long-term secular opportunity. Many great businesses in our portfolio, including Microsoft, Google, Facebook, Visa, and others, have faced significant regulatory challenges around the globe over the last few decades, which often resulted in near-term uncertainty and share price weakness. We recognize that the individual circumstances of these challenges had significant differences in terms of regulatory bodies and geographies. We also recognize that China offers both unique differences and challenges that we do not take lightly. However, while all of these situations are different, what is similar is that the uncertainty associated with these challenges did not change the strong underlying business characteristics of these companies; nor did it prevent them from continuing to generate strong long-term returns for shareholders. We believe the current market price embeds expectations for key revenue and cash flow growth drivers for Alibaba that are well below our long-term assumptions, and we added to our position during the quarter, taking advantage of the long-term secular growth opportunity. With its shares trading at a significant discount to our estimate of intrinsic value, we believe Alibaba offers a compelling reward-to-risk opportunity.

- Founded in 1998, **Illumina** is the industry leader in fast-growing field of sequencing for genetic and genomic analysis, supporting research, clinical, and consumer genetics applications. The company's customers include leading genomic research centers, academic institutions, government laboratories, hospitals, pharmaceutical and biotechnology companies, commercial molecular diagnostic laboratories, and consumer genomics companies. Genetic information is carried within DNA – the molecules in our genes

that humans and all organisms need to develop, live, and reproduce. Sequencing is the process of determining the precise order of nucleotides that comprise DNA. Because genes determine cell function and characteristics, understanding genetic sequencing and variation can provide valuable information in fields ranging from disease treatment to crop optimization. Illumina also offers array-based solutions that represent a faster, less expensive way to identify genetic variation within a known gene pool. In 2020, the company's Next Generation Sequencing (NGS) products accounted for 89% of Illumina's total revenues, while arrays accounted for 11%.

A fund holding since March of 2020, Illumina reported very strong quarterly financial results that reflected strong momentum in both clinical and research applications, and raised its full-year revenue guidance. However, shares declined following news that the company had closed its acquisition of GRAIL prior to receiving approval from the EU, which had announced an ongoing review of the proposed transaction under new guidance for the application of its merger regulations. Illumina announced a definitive agreement to acquire GRAIL in September 2020 for \$8 billion in cash and stock to accelerate commercialization and adoption of multi-cancer screening genetic tests. GRAIL was founded by Illumina in 2016 and was spun out as a standalone company in 2017, with Illumina retaining an equity interest that recently represented approximately 15% ownership. GRAIL is an early leader in asymptomatic cancer screening through liquid biopsies, which utilize Illumina's Next Generation Sequencing technology to detect tumor DNA in the bloodstream before it could otherwise be sampled via a traditional biopsy. Since becoming a standalone company, the data in support of GRAIL's leading technology has become increasingly compelling, while continued reduction in sequencing costs potentially broaden the accessible market opportunity. A combination with Illumina would provide GRAIL with structural operating and distribution advantages relative to competitors that potentially position it to become the standard of care. For instance, Illumina sells its sequencers into 115 countries and is working with over 50 population sequencing studies around the globe - a majority of which are government-sponsored initiatives. Further, Illumina already has three of the largest genetic sequencing clinical labs which have processed over 1 million samples during the last 5 years. While realizing the acquisition's potential will take substantial ongoing investment that will depress Illumina's near-term financial results, we believe successful execution could yield significant value to Illumina. Illumina is challenging the EU's investigation on the grounds that GRAIL has no business in the EU and therefore falls below required revenue thresholds within any specific country or the EU as a whole. Given the deal has closed, unfavorable decisions from regulators on the outstanding issues would trigger a multi-year appeal process which could overhang the business. And if the appeals were unsuccessful, then Illumina would presumably divest the GRAIL business at what we believe should be a higher value. In spite of this potential, we believe Illumina remains highly attractive on a reward-to-risk basis. As we do with all regulatory developments, we continue to monitor and assess any potential structural impact to our investment thesis for Illumina.

For the quarter, total revenue of \$1.1 billion was up 78% year over year. Consumables revenue of \$704 million rose 82% versus the prior-year period, driven by record shipments of its NovaSeq high-throughput consumables. Revenue from the sale of sequencing instruments grew 115% year over year to \$189 million, reflecting significant strength across all instrument categories. NovaSeq shipments more than doubled from the prior-year quarter, while mid-throughput system shipments also reached a new high. Sales of both high- and mid-throughput systems benefited from demand from customers who were new to Illumina, suggesting that lower cost for sequencing is successfully increasing demand.

Even with a near monopoly on sequencing, the company continues to push to lower the cost of sequencing, which it believes is essential to unlock the total market opportunity and increase demand. Illumina was the first company to successfully sequence a human genome for \$1,000, down from an estimated cost of approximately \$100 million in 2002. The company's dominance in its field has effectively eliminated competition from the high end of the gene sequencing market. Following the announcement in early 2020 by Chinese competitor MGI that it was releasing a population sequencing machine that could lower the cost to approach \$100, Illumina lowered the cost of its NovaSeq reagents which should make whole genome sequencing broadly available at \$600. Illumina also received injunctions preventing MGI from marketing its products due to patent infringement in the US, Germany, Spain, Sweden, Finland, and the UK. Illumina has talked about having a pathway to \$100 sequencing, but continues to seek to balance supply and demand to ensure elasticity remains favorable as pricing declines. For the quarter, adjusted operating margin was 30%, down from 32.1% in the previous quarter. As the business mix further shifts to higher-margin consumables and the company benefits from its growing scale, we believe Illumina will realize operating leverage and meaningful margin expansion over our long-term investment horizon.

We believe Illumina is at the forefront of a multi-decade transformation that will see genetic analysis incorporated into multiple facets of our lives. While demand today is still predominantly from large life sciences research facilities, over the next decade we believe democratization of gene sequencing technology and greater practical application will result in the equipment becoming ubiquitous in clinical settings as well, with oncology offering the largest market opportunity. We believe Illumina is a dominant competitor whose sequencing technology represents the critical enabling technology that uniquely positions it to capitalize on an approximately \$100 billion market opportunity. The company maintains a strong balance sheet which we believe will enable it to weather Covid-19-related disruptions while continuing to invest in innovation and strengthen its competitive positioning. We believe Illumina's shares embed expectations for key revenue and cash flow growth drivers that are well below our long-term assumptions. As a result, we believe the company is selling at a significant discount to our estimate of its intrinsic value and offers a compelling reward-to-risk opportunity.

- Founded in 1916, **Boeing** is a global leader in the commercial and defense aerospace industries. The company manufactures commercial aircraft for passenger and cargo traffic as well as manned and unmanned military aircraft, missile and defense systems, satellites and launch systems, and other space and security systems. The company operates primarily through three segments: commercial airplanes (historically around 60% of revenues), defense, space and security (historically 20-25% of revenues), and global services (historically 15-20% of revenues). Along with Airbus, Boeing is part of a global duopoly that accounts for almost all commercial planes sold with greater than 125 seats – the largest market segment. The company serves customers in over 150 countries and non-US sales typically account for greater than 40% of total revenues.

A fund holding since March 2020, Boeing reported financial results that reflected positive operating trends and included the company's first quarterly profit since 2019. The company has now recorded five consecutive months of positive net orders, found customers for all of the 737 MAX planes in inventory for which original customers canceled orders after its March 2019 grounding, and expects to return to positive free cash flow in 2022. Since returning to service in late-2020, the MAX has successfully returned to the skies with 30 airlines operating hundreds of aircraft, and management believes the aircraft may receive

approval to return to service in China in 2021. However, Boeing still faces some challenges that have delayed deliveries of its 787 model. The company has approximately 100 787s for which deliveries were halted in October 2020 to address a micro fracture in the body of the aircraft. Deliveries resumed in February, but were recently halted again to address further faults. The company believes it has identified and fixed the issues, but now expects to deliver less than half of the 787s in inventory during 2021. We believe these types of developments are fairly common in the industry for both Boeing and Airbus and do not believe they have any material impact on long-term fundamentals. We estimate that Boeing has approximately \$43 billion of aircraft currently in inventory, which will generate substantial revenue and cash flow as they are likely delivered over the next 12-to-24 months. As of June quarter-end, the backlog of \$363 billion, or approximately 4,100 aircraft, was down 11% year over year, but rose sequentially for the second consecutive quarter after over two years of declines, with notable orders from United (200 MAX), Southwest (34 MAX), and 31 freighter orders.

During its annual general meeting in April, Boeing announced that it was extending the mandatory retirement age for CEO Dave Calhoun (age 64) to 70 from 65, which otherwise would have forced his retirement after only two years. Calhoun, a member of Boeing's Board of Directors since 2009 and Chairman since 2019, was appointed CEO in January 2020 following the missteps surrounding the grounding of the 737 MAX. The company also announced that Greg Smith, who served as CFO since 2012, would be retiring from the company. While the timing of Mr. Smith's departure is not ideal, we believe Boeing has taken prudent measures to ensure necessary liquidity even if travel demand takes longer to recover. Succeeding Mr. Smith as CFO is Brian West, who most recently served as CFO for Refinitiv, a privately held data analytics company, but who has a decade of experience in CFO/COO roles for public companies, as well as aerospace experience at GE where he previously worked with CEO Dave Calhoun. The company also adopted a new compensation scheme for the CEO, which we view very favorably and is consistent with suggestions we have made to the board. Recognizing the long product cycles inherent in the business, starting in 2021, the RSU (restricted stock unit) component of Mr. Calhoun's long-term compensation will be paid over 10 years following his departure as CEO, while the balance of long-term compensation will consist of premium-priced stock options which the CEO may exercise but not sell while he remains as CEO.

Boeing's financial results remain significantly impacted by the decline in global air travel due to Covid-19. As an indicator, year-to-date travel demand as of May 2021, measured by revenue passenger kilometer (RPK), which represents distance flown by paying passengers, remained 66% below the same period in 2019. We believe the impact of Covid-19, along with the 2019 grounding of the 737 MAX, the fourth generation of its most profitable airplane model, represent temporary, not structural, issues that created the opportunity to initiate our position. Since 1980, RPK has grown at a 5.3% compounded annual rate, and had been negative on just three prior occasions: during the 1991 Gulf War, following 9/11, and in 2009 after the financial crisis. While 2020 represented the fourth, and by far the largest, such occasion due to Covid-19, RPK has historically grown at approximately 1.5-times global GDP, which we expect will continue. While it may be at least a few years before travel returns to 2019 levels, over our long-term investment horizon we believe demand for global air travel will continue to grow at a mid-single-digit rate. More importantly, we believe that, as with many other cyclical growth businesses we successfully purchased in prior downturns, it is not the exact timing of the recovery but rather the margin of safety that is created between the expectations embedded by the marketplace and what we believe will happen directionally over the long term that matters. We believe Boeing is one of only two companies globally which possess the requisite expertise and

scale to profitably serve the global demand for commercial aircraft, and that its strong and sustainable competitive advantages would be very difficult to replicate.

Cyclical businesses often give rise to investor overreaction during the inevitable peaks and troughs. We believe the current market price is embedding expectations that the company will not return to its 2018 level of deliveries in the next ten years, and that margins are structurally impaired – both of which we believe are overly pessimistic versus our long-term expectations. As a result, we believe the company is selling at a significant discount to our estimate of intrinsic value and offers a compelling reward-to-risk opportunity.

## Outlook

- Our investment process is characterized by bottom-up, fundamental research and a long-term investment time horizon. The nature of the process has led to a lower-turnover portfolio in which sector positioning is the result of stock selection.
- The fund ended the quarter with overweight positions in the healthcare, communication services, industrials, energy, financials and consumer staples sectors and underweight positions in the information technology and consumer discretionary sectors. We did not own positions in the real estate, materials or utilities sectors.
- We remain committed to our long-term investment approach to invest in those few high-quality businesses with sustainable competitive advantages and profitable growth when they trade at a significant discount to intrinsic value. Though we have no stated portfolio turnover target, as a result of our long-term investment horizon, our estimated annualized portfolio turnover since manager transition of the fund is approximately 8.6%. As of September 30, 2021, the overall portfolio discount to intrinsic value was approximately 41.9%.

## About Risk

Equity securities are volatile and can decline significantly in response to broad market and economic conditions. Foreign and emerging market securities may be subject to greater political, economic, environmental, credit, currency and information risks. Foreign securities may be subject to higher volatility than US securities due to varying degrees of regulation and limited liquidity. These risks are magnified in emerging markets. Investments in small and mid-size companies can be more volatile than those of larger companies. Growth stocks may be more sensitive to market conditions than other equities as their prices strongly reflect future expectations. Currency exchange rates between the US dollar and foreign currencies may cause the value of the fund's investments to decline.

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***Before investing, consider the fund's investment objectives, risks, charges, and expenses. Please visit [www.loomissayles.com](http://www.loomissayles.com) or call 800-225-5478 for a prospectus and a summary prospectus, if available, containing this and other information. Read it carefully.***

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