Global Leaders Strategy

INVESTMENT LETTER | APRIL 2020

The Global Leaders Strategy invests in a concentrated portfolio of market-leading companies from across the globe. We believe that companies that combine exceptional outcomes for their customers with strong leadership can generate high and sustainable returns on invested capital (ROIC) which can lead to outstanding shareholder returns.

BLINDED BY THE FLASHES OF LIGHT

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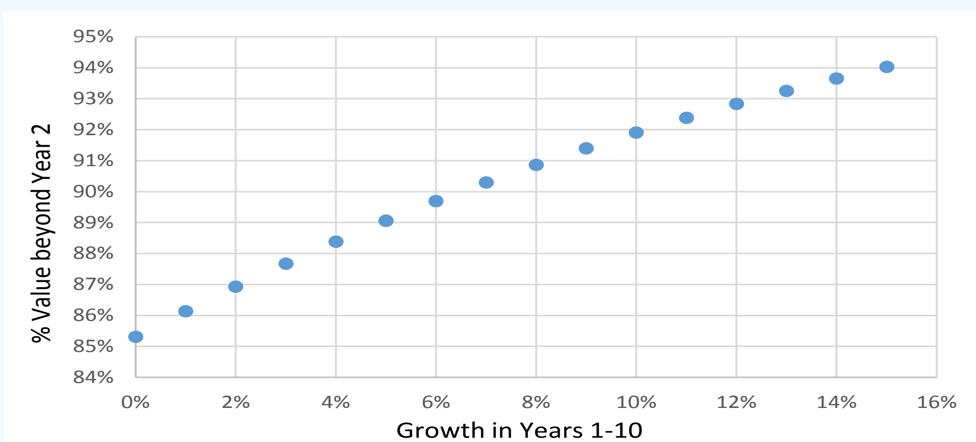
"Daily stock price moves are just flashes of light—try not to read too much into them."[1]

Despite having lived through multiple crises before, the speed and ferocity of the COVID-19 crisis of 2020 on people and businesses is unparalleled in the decades that we have been investing. Before we share some of our observations and actions, we hope that you and your families are healthy and safe at this difficult time. Self-isolation and lockdowns make us appreciate the value of human interaction that can easily be taken for granted—we hope that you are managing to keep your friends and loved ones as close as is possible given the circumstances.

The opening quote comes from a recent conversation with one of our colleagues—Robert Hutchings 'Hutch' Vernon. Hutch successfully managed the Brown Advisory U.S. Flexible Equity strategy for 30 years generating an enviable track record and making a material positive impact on his clients' capital. Hutch's wisdom is evergreen, which can easily be lost in the current COVID-19 fog, and dovetails with where we feel we generate our biggest source of investment edge—our long-term vision. We fervently believe that equity markets are inefficient over short-time periods but more efficient over longer time periods and ultimately the compounding nature of the cash flow of companies that have a high return on capital is what we believe will generate outperformance for our investors over time. A business generating a 20% return on capital should typically produce its entire balance sheet by year 5 which is a powerful economic engine, on the proviso that the company can keep satisfying its customers and keep the competition at bay. The other obvious but frequently forgotten point right now, especially during crises, is that very little of any growing company's value actually lies within the immediate future. Any enterprise is only worth the net present value of its future cash flows. As we have written about before (Q2 2018 Letter *Neither a marathon nor a sprint*) and as you can see below using our standard 10/10/3[2] discounted cash flow model more than 85% of a growing company's value lies outside of the first two years in the future. Based on our model, for a firm that can grow its cash flow in excess of 7% for 10 years, more than 90% of its net present value lies beyond years 1 and 2 on our framework. Let's think about that startling finding again—less than 10% of the value of any company that can grow its cash flow by 7% lies within the next 24 months. In today's time frame this would take us to April 2022 when humanity's progress in the war with COVID-19 should hopefully look very different. The obvious question is if this is true then why do most investors only value companies on near term, typically earnings, multiples? The answer stems from where we feel we derive our second source of investment edge—our understanding of human behaviour.

Percentage of a Company's Net Present Value Beyond Year 2 at Different Growth Rates



Source: Brown Advisory Analysis. The chart is for illustrative purposes only based on a hypothetical company and may not be indicitive of future results.

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[1] R. Hutchings Vernon, March 2020
[2] 10/10/3 = a 10 year forecast period, 10% weighted average cost of capital and 3% terminal growth rate

"Leaving the trees (or perhaps the oceans) may have been our first mistake but it certainly wasn't our last."[3]

We are firm believers that human beings are uniquely disadvantaged for the activity of investing. Many of our behaviours have been shaped by evolution—we are hardwired to survive and reproduce and rely on pre-programmed biases and heuristics to achieve these aims. As we have written about before (Q1 2017 Letter *The Investing Ape 'Homo Investus'*) in many ways we are doing a four-hundred-year-old activity with a two million year old brain. The accepted wisdom of social proof embeds the heuristic of focusing on near-term multiples into most investors' minds as they succumb to the failure of imagination, myopia and forget about net present value that we get taught in our CFA and business school classes. Acceptance is the first step towards improvement, and we have spent a considerable amount of time thinking about how human behaviour can damage our clients' capital—indeed it is why we work with a team of behavioural consultants so that we can short circuit our own potentially harmful biases. Interestingly it is our hardwired evolutionary focus on survival and pain avoidance that can be incredibly damaging to long-term returns at a time of crisis. As Montier mentions above, leaving the trees (or perhaps the oceans) may have been our first mistake. Loss aversion is the idea that human beings feel pain at least twice as much as pleasure and in investing this manifests itself in losing positions where we don't want to face up to the painful loss—in moments of crisis loss aversion can suffocate rational long-term thought. In addition, humans really don't like thinking about selling a loser as we will be crystallising a loss forever and will expose ourselves to another source of pain—the pain of regret that the loser will rebound after the sale. Loss-aversion manifests itself in another way that can undermine our long-term thinking. When faced with stress our natural reaction is to avoid pain and focus on the immediate source of that pain which is helpful when you are trying to escape a wild animal or marauding tribe but less helpful in the world of investment. This natural instinct dramatically shortens our time horizon and given the COVID-19-induced market turmoil it is much harder for investors to think about the years beyond 2022 today, and the 90% of present value that should lie beyond, than at the start of this year. This effect is most acute when the timeframe which we evaluate our investments over—the evaluation period—is different from our stated investment horizon—our planning horizon. We have written about this bias before (Q4 2018 Letter *Turn on, tune in and drop out*)—it's called myopic loss aversion, a term coined by Richard Thaler. Myopic loss aversion is particularly acute in moments of market stress when the temptation is to frequently check the sources of pain, falling stock prices, despite our best intentions of being long-term investors. In a weird circle of wealth destructive evolutionary bias, the more we check falling security prices, the more we succumb to loss-aversion, the shorter our time horizons become and the more our long-term time horizon advantage is undermined. As we recommended in the past there has never been a more important time to switch off from the daily deluge of news and share price volatility—we have deliberately rationed how frequently we check the prices of the equities we invest in. It might sound counterproductive, or possibly irresponsible, but it's incredibly important to avoid getting distracted by Hutch's flashes of light and insulate ourselves from myopic loss aversion.

A LITTLE LESS CONVERSATION

Given where we feel we derive an edge in the competitive world of investing—the obvious question is what have you been doing to exploit this edge for your investors in the early innings of the COVID-crisis? We have been incredibly busy executing both parts of our investment process—our investment selection and capital allocation processes. Our checklists and teardown frameworks are the key components of our investment selection process and they contain numerous questions that make us focus on the long term and address our biggest sources of risk—competitive disruption, regulation, solvency and valuation. Indeed, our key valuation tool, the aforementioned discounted cash flow framework, uses a 10 year forecast period which also forces long-term thinking. This crisis will affect each of our companies in different ways, some positively and some negatively, and we have been going through each of our bull, bear and base scenarios to see how our best estimates for each company will impact the prevailing value within the strategy. Given the level of near-term uncertainty facing certain industries, such as travel and aerospace, one helpful piece in addition to our standard analysis has been to assume our investments make no money in 2020 and 2021. In each instance we zeroed free cash flow in both years and then analysed how close each equity value is to this draconian neo-crisis view of net present value. In many cases negative price actions were more than pricing in zero free cash in 2020 and 2021 scenarios. Such analysis was incredibly helpful when one of our key behavioural rules, the drawdown review, was triggered in the quarter. We reviewed eight of our holdings in the first quarter, interestingly a similar number to the fourth quarter of 2018, as their equity prices fell either 20% from our initial entry price or underperformed by 20% over a rolling twelve month basis. This process plays to our behavioural advantage and it has never been more helpful than most recently when loss aversion was at fever pitch. It took the emotion out of dealing with our underperformers and enabled us to triage our weakest positions. We added to six of the eight losing positions as we viewed the issues that were being priced in by the equity markets as being ultimately transient and presented no credible risk to our long-term investment theses. Conversely, we sold two of the drawdown companies where we decided that long-term prospects had changed and that we had better use for the capital elsewhere—again this enabled us to focus on the long term by taking the behavioural sting out of each losing position.

FAT PITCHES

"The stock market is a no-called-strike game. You don't have to swing at everything—you can wait for your pitch. The problem when you're a money manager is that your fans keep yelling, 'Swing, you bum!'"[4]

Sometimes investing can be like watching paint dry—you diligently wait for the elusive moment of inefficiency when equity market myopia provides an opportunity for long-term investors to buy great companies—Warren Buffett's fat pitch. During such periods it

[3] The Little Book of Behavioural Investing - How Not to be Your Own Worst Enemy by James Montier

[4] Warren Buffett, 1999 Berkshire Hathaway Annual General Meeting quoted in The Tao of Warren Buffett by Mary Buffett and David Clark

is easy to convince yourself these opportunities are gone forever. The human mind extrapolates current trends in a linear fashion into the future—as we know with the unfolding of the current crisis, and the responses of political and business leaders, the path of least mental resistance is a continuation of the status quo. After going through an almost two year period of relative inactivity, where between August 2018 and March 2020 we only bought two companies, we have been on a relative shopping spree so far in 2020 by purchasing three companies and we can see ourselves buying more if we get another sell-off. We run an active subs-bench, our ready to buy list, with thirty companies that we would like to buy at the right price—we were lucky enough to get the right price on three occasions so far in 2020. We are pleased to report that we invested in two high quality vertical software companies, Autodesk and Intuit. Both of these companies have been on our subs-bench for multiple years and the recent market dislocation gave us the opportunity to invest in them at prices that were at discounts to our estimation of intrinsic value. We believe these businesses have high market shares in each vertical, multiple economic moats, high returns on capital, strong balance sheets and recurring revenue—ingredients which, when combined with the good value, should set us up for great long-term returns from these investments. We are in the process of investing in another new company, but we aren't at liberty to disclose this currently—it rounds out the three new investments we have made year-to-date.

"There are two kinds of forecasters: those who don't know, and those who don't know they don't know."[5]

We don't have any particular ability to predict when the ravages of the COVID-19 crisis will abate. Like many of the biases we have discussed, overconfidence is dangerous. Our whole approach to investing is designed to reduce risk and get the odds working in the favour of our clients. A repeatable set of processes that deliberately accentuate our two sources of investment edge, a long-term vision and an understanding of human behaviour, and the team we have to execute them are what we believe will drive great compounded returns for the investors we are fortunate enough to serve as far-sighted fiduciaries. Despite the uncertainty, we are genuinely excited by the future for the strategy and hope to capitalise on any more equity market weakness by maintaining our sources of investment edge. Thank you for taking time out from your no doubt busy day to read this letter. We hope that you and your families stay safe and healthy and we look forward to updating you again next quarter when the strategy will have passed its five year milestone.

The Global Leaders Team

[5] John Kenneth Galbraith

Disclosures, Terms and Definitions

Year	Composite Total Gross Returns (%)	Composite Total Net Returns (%)	Benchmark Returns (%)	Composite 3-Yr Annualized Standard Deviation (%)	Benchmark 3-Yr Annualized Standard Deviation (%)	Portfolios in Composite at End of Year	Composite Dispersion (%)	Composite Assets ($USD Millions)	GIPS Firm Assets ($USD Millions)*
2018	-2.2	-2.8	-9.6	11.0	10.5	2	N/A	303	30,529
2017	35.1	34.0	24.0	N/A	N/A	2	N/A	77	33,155
2016	-0.6	-1.4	8.0	N/A	N/A	2	N/A	38	30,417
2015**	1.2	0.7	-4.4	N/A	N/A	2	N/A	24	43,746

**Return is for period May 1, 2015 through December 31, 2015

Brown Advisory Institutional claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Brown Advisory Institutional has been independently verified for the periods from January 1, 1993 through December 31, 2018. The Verification reports are available upon request. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.

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1. *For the purpose of complying with the GIPS standards, the firm is defined as Brown Advisory Institutional, the Institutional and Balanced Institutional asset management divisions of Brown Advisory. As of July 1, 2016, the firm was redefined to exclude the Brown Advisory Private Client division, due to an evolution of the three distinct business lines.
2. The Global Leaders Composite aims to achieve capital appreciation by investing primarily in global equities. The strategy will invest in equity securities of companies that the portfolio manager believes are leaders within their industry or country, as demonstrated by an ability to deliver high relative return on invested capital over time. The minimum account market value required for composite inclusion is $1.5 million.
3. This composite was created in 2015.
4. The benchmark is the FTSE All-World Net Index. This index is a free float market cap weighted index representing the performance of the large & mid cap stocks from the FTSE Global Equity Index Series. The index covers Developed & Emerging Markets. Base Value 100 as at December 31, 1986. "FTSE®", "Russell®", "MTS®", "FTSE TMX®" and "FTSE Russell" and other service marks and trademarks related to the FTSE or Russell indexes are trademarks of the London Stock Exchange Group companies. An investor cannot invest directly into an index. Benchmark returns are not covered by the report of the independent verifiers.
5. As of January 1, 2019, the composite benchmark was changed from Russell Global Large-Cap Net Index to the FTSE All-World Net Index. The change was applied retroactively from the composite inception date. The Russell Global Large-Cap Net Index was decommissioned as of 12/31/2018 and is no longer published.
6. Composite dispersion is an equal-weighted standard deviation of portfolio returns calculated for the accounts in the composite for the entire calendar year period. The composite dispersion is not applicable (N/A) for periods where there were five or fewer accounts in the composite for the entire period.
7. Gross-of-fees performance returns are presented before management fees but after all trading commissions, and gross of foreign withholding taxes (if applicable). Net-of-fee performance returns reflect the deduction of actual management fees and all trading commissions. Other expenses can reduce returns to investors. The standard management fee schedule is as follows: 0.80% on the first $50 million; 0.55% on the next $50 million; 0.45% on the next $50 million; and 0.40% on the balance over $150 million. Further information regarding investment advisory fees is described in Part II A of the firm's form ADV. Actual fees paid by accounts in the composite may differ from the current fee schedule.
8. The three-year annualized ex-post standard deviation measures the variability of the composite (using gross returns) and the benchmark for the 36-month period ended on December 31. The 3 year annualized standard deviation is not presented as of December 31, 2015, December 31, 2016 and December 31, 2017 because 36 month returns for the composite were not available (N/A) and the composite did not exist.
9. Valuations and performance returns are computed and stated in U.S. Dollars. All returns reflect the reinvestment of income and other earnings.
10. A complete list of composite descriptions, policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.
11. Past performance does not indicate future results.
12. This piece is provided for informational purposes only and should not be construed as a research report, a recommendation or suggestion to engage in or refrain from a particular course of action or to make or hold a particular investment or pursue a particular investment strategy, including whether or not to buy, sell or hold any of the securities mentioned, including any mutual fund managed by Brown Advisory.

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The **FTSE All-World Index** is a market-capitalisation weighted index representing the performance of the large and mid cap stocks from the FTSE Global Equity Index Series and covers 90-95% of the investable market capitalisation. The index covers Developed and Emerging markets and is suitable as the basis for investment products, such asfunds, derivatives and exchange-traded funds. FTSE® is a trade mark of LSEG and is used by FTSE under licence.

ROIC is a measure of determining a company's financial performance. It is calculated as NOPAT/IC; where NOPAT (net operating profit after tax) is (EBIT + Operating Leases Due 1-Yr)*(1-Cash Tax Rate) and IC (invested capital) is Total Debt + Total Equity + Total Unfunded Pension + (Operating Leases Due 1-Yr * 8) – Excess Cash. ROIC calculations presented use LFY (last fiscal year) and exclude financial services.

Earnings Per Share (EPS) is calculated as a company's profit divided by the outstanding shares of its common stock.

Free Cash Flow (FCF) represents the cash a company generates after accounting for cash outflows to support operations and maintain its capital assets.

Weighted Average Cost of Capital (WACC) is a calculation of a firm's cost of capital in which each category of capital is proportionately weighted.