Global Leaders Strategy

INVESTMENT LETTER | OCTOBER 2020

Brown ADVISORY
Thoughtful Investing.

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.

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Party Like It's 1999

The investing world is beset by bouts of tunnel vision that are sparked off by a seemingly plausible narrative that spirals to the point where it is easy for our attention to be diverted by scenarios that appear entirely obvious. As we have discussed before, part of this process is driven by an informational cascade whereby a drop of truth gets reflexively whipped up into a torrent of information that supports a specific narrative. Today's informational cascade centres on the premise that equity markets are reaching levels of euphoria last seen in 1999—especially in the technology sector. We have had extensive discussions with our talented team of technology analysts and like every cascade there is undoubtedly a drip of truth. We have struggled with the valuations of a number of companies that have come to market recently. Our core tool for appraising value is a discounted cash flow (DCF) analysis using a 10 year forecast period. We are happy to flex this time horizon to explore different distributions of returns—an exercise that is imprudent not to do for companies that have multiple moats and significant underpenetrated markets. Our recent work on the business-to-business opportunity for our payment network investments Visa and MasterCard is a case in point. However, we really struggle with some of the analysis that is being touted by the investment banks to justify some of the recent IPOs. One recent sell-side DCF we saw this week used a 21 year competitive advantage period, where the company generates excess returns, to justify a price for a software business that has only been in existence for 8 years. Elsewhere our technology hardware guru John Bond sent us a pitch book for a battery manufacturer that is looking to list on the equity markets. Management does not expect this company to produce any revenue until 2024 and have used a 1x enterprise-to-projected sales multiple in 8 years' time (2028!!) as a carrot to entice investors because it is significantly lower than cash burning Tesla's 13x 2021 sales multiple—and Tesla actually sells products and generates revenue today. We have numerous other examples of what we view as carefree euphoria and given this backdrop it is not hard to see how the drip drip drip of information has turned into a torrent of inevitability that we are experiencing 1999-esque levels of euphoria. We make no attempts to forecast equity markets, it is a fool's errand, but we do think it is important to avoid generalisations. The current cascade has resulted in some commentators, such as Howard Marks, to include companies in the catchy media acronym of 'FAANMG' as part of the euphoria. As we have discussed before we think it's incredibly important to avoid generalisations and look at any investment on a case-by-case basis. Our main exposure to the FAANMG group is via our investments in Microsoft and Google's parent company, Alphabet. Both companies enjoy monopoly positions in their businesses that are surrounded by multiple economic moats. In addition they have significant balance sheet optionality and most importantly we believe that both companies, with proven business models, will both trade on 9% (or 11x) free cash flow, not revenue, to enterprise value yields in 2025. Although Microsoft and Alphabet may be tarred with the euphoric brush of 1999-esque mania we think that the risk, both business and valuation, to which we are exposing our clients is a world away from the aforementioned battery maker and recently listed software company. Who knows when this informational cascade will subside, but we remain poised to capitalise on any investor myopia for the long-term benefit of our investors.

[1] FAANMG colloquially stands for Facebook, Amazon, Apple, Netflix, Microsoft and Google.

The ESGenie

'If you wanna be with me, baby there's a price to pay. I am a genie in a bottle, you gotta rub me the right way.'[2]

Confirmation bias, which we have discussed before is our tendency to seek out evidence to confirm our pre-existing beliefs—is a powerful force. Such is our recognition of the power of confirmation bias that in our research process we actively seek out others that have a diametrically opposing view to ours—for existing and potential investments this is short-sellers and the most bearish analysts we can find. Accordingly this quarter, Aswath Damodaran's article *'Sounding good or doing good? A skeptical look at ESG'* was in many ways the ideal pin for us to try and pop any bubble of confirmation bias around the way that we embrace ESG in our analysis.

'In many circles, ESG is being marketed as not only good for society, but good for companies and for investors. In my view, the hype regarding ESG has vastly outrun the reality of both what it is, and what it can deliver, and the buzzwords are not helpful. That is the reason I have tried to under use words like sustainability and resilience, two standouts in the ESG advocates lexicon, in writing this post. I believe that the potential to make money on ESG for consultants, bankers and investment managers has made at least some of them cheerleaders for the concept, with claims of the payoffs based on research that is ambiguous and inconclusive, if not outright inconsistent.'

We have immense respect for Damodaran and the numerical underpinnings that he looks for in each investment case best expressed in his book *'Narratives and Numbers'*. Indeed the investment industry is built on stories, some of which are true, such as the evolution of a company's business model, but others are not. Storytelling is so powerful that there is actually another bias, narrative fallacy, for when we believe stories that are just that—stories. As long-term investors that place the customer at the heart of business analysis, we think that embracing both the positive and negative sides of the ESG coin is common sense. We view positive ESG drivers as tailwinds for compounding, customer engagement and miminising regulators' scrutiny. On the other side, ESG risks are just some of the plethora of risks that any of our companies can be exposed to. Unlike some investors we want to maintain our investment in what we believe are great businesses for decades and therefore companies that continually mistreat the key mouthpiece they have for talking to the customer—their employees—or cause repeated damage to the environment, are not, in our opinion, going to stay the distance. So much for the narrative, let's explore some of Damodaran's criticisms of ESG.

1. Fuzzy Measures

Damodaran's opening gambit is that *'measures of goodness'* are largely subjective and that different ESG rating providers have weak correlations between their assessments of different companies. Indeed he points to differences of agreement on well covered companies like Walmart and Facebook. We would push back on some of this criticism. Firstly it is possible to measure certain ESG outputs, such as CO2 production, but more importantly isn't investing a largely subjective discipline and more art than science? Net present value is the cornerstone of value but projecting cash flows and choosing which rate to discount them back at are both subjective exercises—a realisation that we believe even Professor Damodaran would agree with. In addition, complaining about divergent ESG ratings is to some extent implying a subjugation of fiduciary responsibility to the companies that supply the ratings. In our opinion, any professional investor has a fiduciary responsibility to their clients to do their own work and derive their own opinion. Outsourcing all ESG analysis to the rating agencies is to us no different from outsourcing stock-picking to the sell-side analysts that work for the investment banks—it's irresponsible. This realisation is why we do our own ESG work and produce our own ratings 1-to-3, for both positive ESG drivers—we call these Sustainable Business Advantages (SBA)—and ESG risks. On the positive side we take it one step further when we grade companies on whether their business' positive SBA drivers are either material to the economics or meaningfully different from other players in the company's industry. Just as we require a 20% return on invested capital for all investments we also require a company to have a material amount, which we define as a minimum of 25%, of its cash flow to be generated from positive ESG drivers for it be awarded the highest SBA rating. These businesses have what we call the triple win—the win for the customer, the shareholder and society. Without imposing a fixed financial measure on the contribution of positive ESG drivers we concur with the learned professor that it is easy to be all narrative and no numbers. Indeed as an example, whilst we applaud oil major BP's ambition to be a net zero company by 2050, we believe their clean energy business is a rounding error on the economics of the business. Long narrative and short numbers.

[2] Christina Aguilera, '*Genie in a bottle*'.

[3] Aswath Damodaran, '*Sounding good or doing good? A skeptical look at ESG*'. All quotes are from this article: http://aswathdamodaran.blogspot.com/2020/09/sounding-good-or-doing-good-skeptical.html

2. The ESG Value vs Return Paradox

As mentioned we admire Professor Damodaran's relentless focus on backing up narratives with numbers—an approach he uses when critiquing whether ESG adds aggregate value:

'In fact, my favorite propositions in value is the "It Proposition", which posits that for "it" (investing, financing, dividends, ESG) to affect value, "it" has to affect either the cash flows (through revenue growth, operating margins and investment efficiency) or the risk in those cash flows (which plays out in the cost of equity and capital).

As we touched on before the value of any business is the net present value of its future cash flows discounted back to today. Applying Damodaran's 'It' test, we believe ESG has to either increase cash flow or lower the discount rate. He's pretty clear on the former that there is a weak link between profits, and ergo cash flows, and ESG:

'There are meta studies (summaries of all other studies) that summarize hundreds of ESG research papers, and find a small positive link between ESG and profitability, but one that is very sensitive to how profits are measured and over what period, leading one of these studies to conclude that "citizens looking for solutions from any quarter to cure society's pressing ills ought not appeal to financial returns alone to mobilize corporate involvement". Breaking down ESG into its component parts, some studies find that environment (E) offered the strongest positive link to performance and social (S) the weakest, with governance (G) falling in the middle'.

We would take some umbrage with this generalistion—we fervently believe that you have to look at companies on a case by case basis. As an example, we think it's pretty hard to argue that cash flow generated by Unilever's sustainable brands have no link to consumer demand for more environmentally friendly products. We do however concede that it is hard to decipher whether the cash flows, and market share gains, produced by Atlas Copco's energy leading compressors, where they target a 30% energy efficiency vs peers, is entirely a function of the customers choosing environmentally friendly products rather than the cost savings the compressors yield. In any event, this is still the triple win that we seek. In the social dimension it is a similar story with our Indonesian micro lender Bank Rakyat where demand for their loans is primarily a function of them being a better outcome for the customer, preferable to the village loan shark and knee-capper, rather than the benefit provided to society—despite what we view as the obvious 'S' benefits. Where Damodaran points to a stronger link to value is between ESG and funding costs with the cost of capital being higher for bad companies as equity markets price in the higher risk. This in turns leads to what he views as the paradox between lower risk and lower returns as lower costs of capital equate to higher valuations and ergo lower future returns. On a spreadsheet this argument holds some water if you overlook one crucial ingredient for appraising value—the length of time a company can generate returns and cash flow above its cost of capital—its fade. Fade is directly related to a company's competitive advantage period, effectively how long it can generate outsized returns as it keeps competitors at bay. If the periods and cash flows are the same for a good company and a bad company there may be less value in the good ESG company relative to the bad ESG company as the former's cash flows may be discounted at a lower cost of capital. If we extend the competitive advantage period the picture can look very different and we think this is where Damodaran's ESG value vs return paradox falls short. Let's return to Unilever that was created nearly a century ago in 1929 but its roots are traced back to Lever Brothers that was founded in Warrington in 1884. Lever Brothers were trailblazers in good employee treatment and built model villages, of such architectural quality that they are now a World Heritage Site, next to their factory Port Sunlight in 1888. In addition founder William Hesketh Lever's plans for Sunlight Soap was to improve the hygiene and cleanliness for the working classes in Victorian Britain. We think Unilever has been a model ESG citizen since the get-go, and arithmetically there is no equity risk premium imaginable that can offset a 136 year competitive advantage period as the company has deftly managed its ESG risks during a century of disruptive change in consumer habits, environmental consciousness and workers' rights. We feel that ESG risk mitigation, expressed as fade, can more than offset value premium drive by lower discount rates in certain cases like Unilever—a point that is missed in the ESG value vs return paradox.

3. Performance Misattribution

ESG as a concept has clearly captured the imagination of investors in recent years and Damodaran doesn't try to refute the fact that ESG-marketed equity strategies have attracted significant inflows in 2020 throughout the COVID crisis. There is of course a reflexivity to these capital flows that come back to the ESG value vs return paradox we just touched on. This money has to find a home and buying companies' shares that are perceived as good ESG citizens should see their equity prices rise and the prospective future returns diminish. Where we have some sympathy with the professor is when looking at the style tilts that ESG strategies are naturally orientated towards. It is very easy for ESG principles to take investors to good places—investing in high quality companies that are good corporate citizens. Naturally this means limiting exposure to sectors like energy and utilities where return profiles are meagre and overweighting areas like technology and healthcare. Indeed Global Leaders has a similar orientation with a significant overweight in technology and no energy exposure, which makes the area one of our largest factor risks. However, where we concur with Damodaran is that it is too early to attribute the outperformance of ESG strategies during the COVID crisis with ESG beliefs alone. Academic evidence suggests that sector and factor, momentum and growth, have been bigger drivers of returns for ESG strategies in 2020. Indeed there are plenty of investors who don't embrace ESG principles that have outperformed with similar sector and style tilts. Of course one year is less than a blink of an eye for long-term investors and the vital ingredient of fade that we mentioned above is missing. Damodaran's point is nevertheless well made and should hopefully provide some balance to the confirmation bias of the most Panglossian of ESG advocates.

We enjoyed reading Damodaran's '*Sounding good or doing good*' article and admire his courage in taking a sceptical view of a complex narrative that we think has been oversimplified and taken as gospel by so many in the investment industry. We hope that he doesn't get labelled as a troglodyte as he mentions. Debate is a vital ingredient in the pursuit of truth. We do however disagree on a number of fronts and feel that this disagreement stems from a different perspective. Damodaran is a gifted academic whereas we are fiduciaries who are entrusted with our investors' capital. Delivering attractive compounded long-term returns in a low risk manner is why we get out of bed in the morning. We take this mission incredibly seriously and view embracing positive and negative ESG thinking as common sense investing. We fervently agree that like everything in investing, ESG is a subjective concept and accordingly there is no substitute for doing your own work. This will remain a challenge for the companies that provide ESG ratings. In addition we also think that it is very important to not let the past overly dictate our views of the future and to continually question everything. As consumers and companies embrace the concept it might be easier to attribute more value creation to ESG principles in the future, even with the existence of companies like Unilever, despite the general jury being still out. Of course one could argue that there is an element of Pascal's Wager in incorporating ESG principles into any investment approach but as we discussed with regards to fade, mitigating unwanted risk is part of every investor's fiduciary duty. Even Damodaran agrees there is some correlation between ESG principles and downside risk. The ESG genie might be out of the bottle and we see it as an extension of good investing sense. However, like Damodaran, we do think it is important to question whether ESG principles will deliver endless streams of investment wishes on their own. Many thanks for reading this letter and our thoughts on this important topic. We hope you have a safe and healthy end to 2020 and look forward to updating you on our progress in the New Year.

'The other scenario where incorporating ESG into investing may yield a payoff is when investors are concerned about limiting downside risk. To the extent that socially responsible companies are less likely to be caught up in controversy and to court disaster, the argument is that they will also have less downside risk than their counterparts who are less careful. There is some evidence of this in this paper that finds that companies that adopt better ESG practices are less likely to see large drops in value'.

The Global Leaders Team

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Past performance may not be a reliable guide to future performance and investors may not get back the amount invested. All investments involve risk. The value of the investment and the income from it will vary. There is no guarantee that the initial investment will be returned.

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ESG considerations that are material will vary by investment style, sector/industry, market trends and client objectives. The strategy seeks to identify companies that it believes may have desirable ESG outcomes, but investors may differ in their views of what constitutes positive or negative ESG outcomes. As a result, the strategy may invest in companies that do not reflect the beliefs and values of any particular investor. The strategy may also invest in companies that would otherwise be screened out of other ESG oriented funds. Security selection will be impacted by the combined focus on ESG assessments and forecasts of return and risk.

The strategy intends to invest in companies with measurable ESG outcomes, as determined by Brown Advisory, and seeks to screen out particular companies and industries. Brown Advisory relies on third parties to provide data and screening tools. There is no assurance that this information will be accurate or complete or that it will properly exclude all applicable securities. Investments selected using these tools may perform differently than as forecasted due to the factors incorporated into the screening process, changes from historical trends, and issues in the construction and implementation of the screens (including, but not limited to, software issues and other technological issues). There is no guarantee that Brown Advisory's use of these tools will result in effective investment decisions.

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 as funds, derivatives and exchange-traded funds. FTSE® is a trade mark of LSEG and is used by FTSE under licence. An investor cannot invest directly into an index.
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.
Free Cash Flow (FCF) is a measure of financial performance calculated as operating cash flow minus capital expenditures.

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)*
2019	35.1	34.2	26.5	11.6	11.2	Five or fewer	N/A	731	42,426
2018	-2.2	-2.8	-9.6	11.0	10.5	Five or fewer	N/A	303	30,529
2017	35.1	34.0	24.0	N/A	N/A	Five or fewer	N/A	77	33,155
2016	-0.6	-1.4	8.0	N/A	N/A	Five or fewer	N/A	38	30,417
2015**	1.2	0.7	-4.4	N/A	N/A	Five or fewer	N/A	24	43,746

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

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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 (the 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. The Composite creation date is August 26, 2015. The Composite inception date is May 1, 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 December 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.
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