Brown ADVISORY
Thoughtful Investing.

Global Leaders Strategy

INVESTMENT LETTER | AUGUST 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.

FOJI


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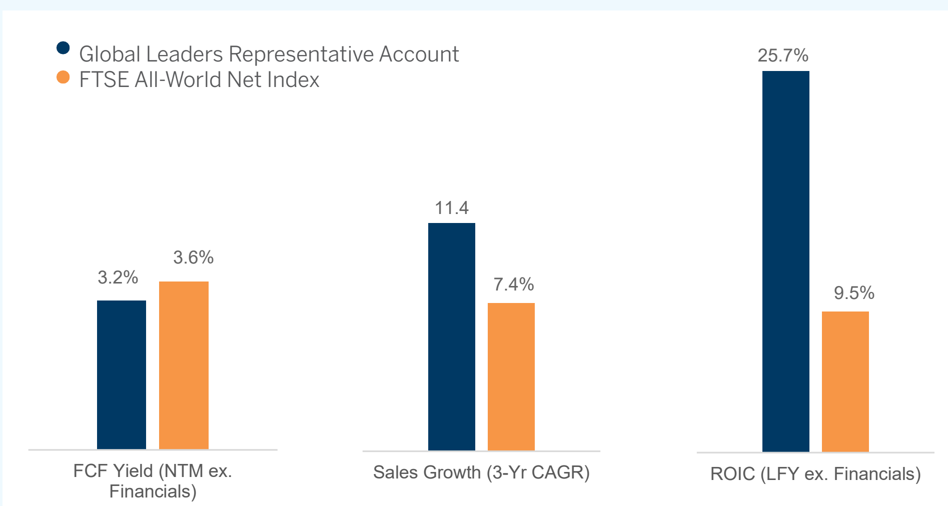
The first half of 2020 has without doubt been one of the strangest in our investing careers. Last quarter's letter was devoted to reminding our clients and investors where we feel we derive investment edge from, our long-term vision and behavioural understanding, and how we were responding to the COVID crisis—both proactively with new additions and reactively with underperforming investments. Accordingly we made three new investments, Autodesk, Intuit and Aspen Technology, and added to six of the eight companies in our drawdown process. Roll forward three months and coordinated monetary and fiscal stimulus has contributed to the benchmark that we use for Global Leaders, the FTSE All-World Net index, ending the second quarter of 2020 with a decline of only 6% year-to-date despite the sharpest contraction in the global economy in living memory. Inevitably the investment discussion du jour has returned back to whether equities are overpriced or not. Unfortunately, in our experience, both sides of this argument coalesce around generalisations and short-cut valuation techniques—even cyclically adjusted ones like the cyclically adjusted PE ratio or CAPE. We have written about the dangers of using CAPE as a guide for making investment decisions ('The Caped Crusade'), the dangers of assuming different regions are over or undervalued using aggregate benchmark data ('Passive Pigs in Index Pokes') and the dangers of tarring certain investments, and investors!, with the value or growth brush based solely on shorthand valuation techniques ('Isn't Every Investor a Value Investor?'). The reality is that the human mind relies on heuristics, rules of thumb, and generalisations—the path of least mental resistance. Coming back to the discussion du jour we would point our investors to the below skyline that we believe captures more of the economic picture than shorthand multiples. At the end of June the median ex-financials free cash flow yield for our benchmark was 3.6% vs 3.2% for Global Leaders or 28x vs 31x expressed as a free cash flow multiple. For this 11% multiple premium we are delivering 170% higher ROIC (25.7% vs 9.5%) and 54% higher sales growth (11.4% vs 7.4%) than the benchmark[1].

Portfolio Attributes
As of June 30, 2020



Source: FactSet® and Brown Advisory calculations. Past performance is not indicative of future results. Portfolio information is based on a representative Global Leaders account and is provided as supplemental information. Performance statistics are monthly, based on Global Leaders Composite net of fees since inception on May 1st, 2015. Portfolio attributes and performance characteristics exclude cash and cash equivalents which was 3.1% as of June 30, 2020 and are subject to change. Portfolio attributes show the median returns. Please see disclosure statements at the end of this letter for additional information and for a complete list of terms and definitions.

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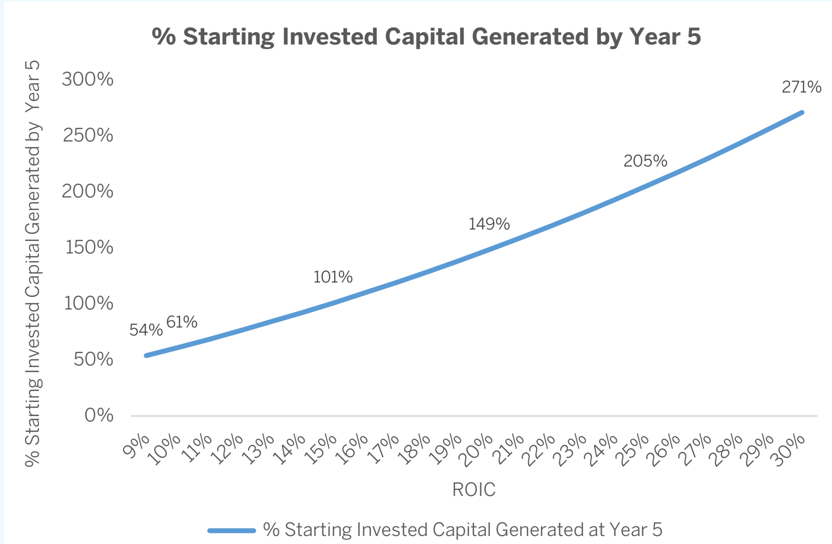


Source: Brown Advisory Analysis. The chart is for illustrative purposes only and is based on a hypothetical company and may not be indicitive of future results.

As we have discussed before, it is the compounding effect of high-return companies that are capable of generating long-term value. Let's take the example of the median Global Leaders company or 'GL.Co.' and assume it reinvested all of its capital at the prevailing ROIC of 25.7%. Based on our calculations, it should have generated 214% of its initial invested capital 5 years later, which is our investment horizon, in 2025 in cash flow. This 214% is much greater than the 57% of starting capital that would have been generated by the median company in the benchmark, or 'Avg. Co.', with a 9.5% ROIC. The 57% of invested capital produced by Avg. Co. with 9.5% ROIC might sound fine. There must be worse things than a 57% total cash flow return? But it is not free money—there is a capital cost to any enterprise. We use a 10% cost of capital for appraising all investments which suggests that the total cost of funding this business over 5 years would have been 61% of the starting capital. Using 10% Avg.Co. with a 9.5% ROIC, would have destroyed value (57% - 61% = -4%) by year 5 as its returns on invested capital (ROIC) are below the cost of capital (WACC). This value destruction is in stark contrast to GL.Co. with 25.7% ROIC where there is significant value creation in 2025 of 164% of starting capital (214% - 61% = 164%). Indeed investors should only tolerate value destructive companies if they believe that returns will improve over time, if they are willing to accept a lower return for their investment or if the company's valuation is so depressed to account for the negative economic profit.

Without going too deep into the theoretical weeds it is possible to break the enterprise value of a business down between its steady state value, assuming its current free cash flow lasts forever (a perpetuity), and its future value creation (FVC) value. Future value creation is a function of the level of future investment multiplied by the future value creation (ROIC - cost of capital) and the competitive advantage period (how long this value creation lasts for—typically a function of economic moats and competitive advantages). The steady state value assumes that all future investments earn the company's cost of capital and accordingly it is possible to derive a steady state unlevered free cash flow multiple for our companies which is the inverse of our cost of capital of 10%—a 10x multiple. The obvious suggestion is that, on this framework, any company that trades on more than 10x on enterprise to free cash flow (EV/FCF) or with a free cash yield (FCF/EV) less than 10% has to be able to generate positive future value creation for it not to be overvalued. Coming back to the investment discussion du jour of whether equities are overpriced or not we would suggest that paying 28x free cash flow or 3.6% yield for the median company in our benchmark, Avg.Co., that generates a 9.5% yield is only justified if you believe one of two things:

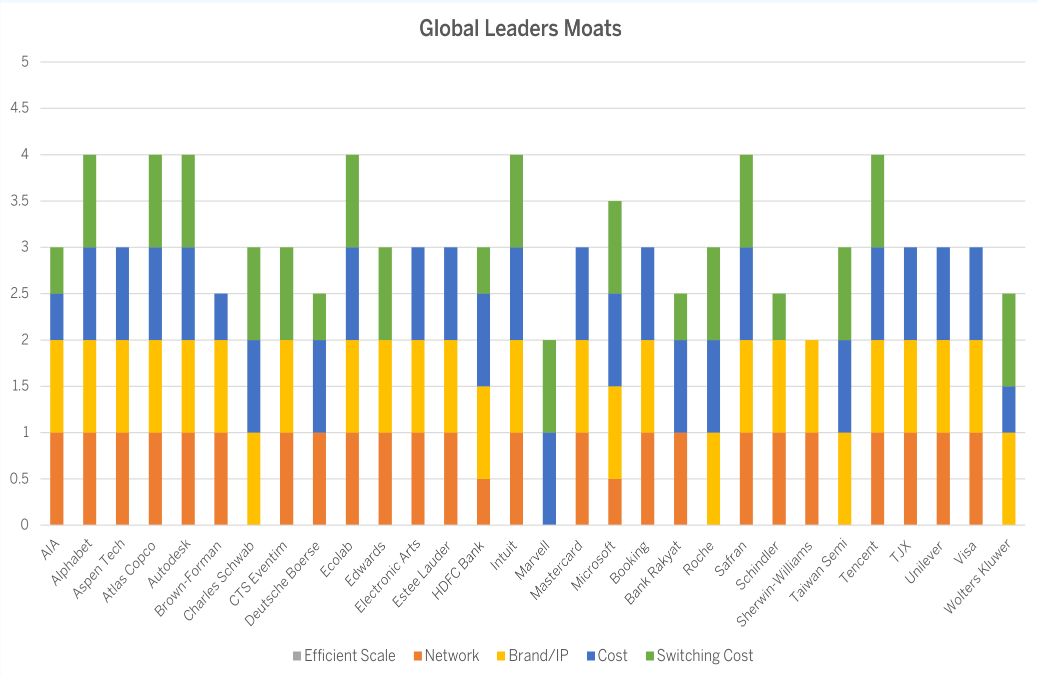
1. You think that the median company can improve its return profile. Our view is that it is possible for a company to improve its return on capital over time, indeed our recent investment Autodesk is a paradigm of economic change, but statistically it is harder to do which is why we typically raise the bar, in terms of economic moat and IRR, when looking at businesses where the investment case is predicated on a dramatic increase in ROIC (ROIIC >ROIC). This Madonna-esque reinvention from value destruction to value creation is, in our experience, not found in the average company we look at.

2. You are willing to accept a lower cost of capital by paying 28x EV/FCF for a company with a 9.5% ROIC. Indeed we have recently seen investors using as low as a 5% cost of capital for appraising investments which we feel is incredibly aggressive. This folly implies that investors are willing to accept lower returns, substantially below the historical performance of equities, and that the current low cost of debt in the current COVID crisis lasts forever—a set of assumptions that we feel are not going to end well for those that willingly or unwillingly embrace them.

Given what investors have to believe—return improvement or a lower cost of capital—to justify today's equity prices we struggle to get excited about the price you are paying for the average company, Avg.Co., in our universe. This picture is very different for our companies, such as GL.Co., which are creating value and surrounded by multiple economic moats that we feel will lead to an extended competitive advantage period. Investment is full of generalisations and heuristics and we feel that investors who settle for average by buying passive instruments are exposing themselves to an unattractive economic set up. It is incredibly important to look under the hood of any investment—both commingled vehicles and single securities. Equity market rallies such as we saw this quarter are typically fuelled by a fear of missing out (FOMO). In the current COVID crisis with infection rates still high, we have all experienced the fear of joining in, or FOJI. We feel that given the economic set-up mentioned, investors who do their homework should rightfully be feeling FOJI about the price they are paying for the average company in global equity markets and passive investment vehicles. We feel that given this backdrop, thoughtful active management is as attractive as ever and we certainly feel more FOMO, than FOJI, when we look at the price investors in Global Leaders are paying today relative to the rest of the economic picture they are getting.

MOAT-ER SPORT

COVID-19 has brought huge disruptions to all of our lives and despite not being able to travel to one location it didn't stop us from holding one of the most important events of our investing year in June. We hold the global equity offsite every year where we spend a day honestly appraising everything that we do, including both our investment selection and capital allocation processes, with one aim—continual improvement. We believe that we can always get better and by dedicating time each year to this belief we can continue to deliver investment excellence for the investors we are lucky enough to serve. Topics this year included communication, a crucial topic given our dual-location set-up and COVID-19, cash flow-based return metrics and valuation. One area of particular focus this year was a subject we have spent a considerable amount of time on—economic moats and competitive advantages. We have used an economic moat framework since the inception of Global Leaders in 2015 and we require investments in the strategy to have at least two economic moats. The reason we have this requirement is that one of the biggest risks we face with our approach is that a competitor enters our company's market place and disrupts the relationship it has with its customers. We believe this creates a significant risk which can potentially distort the economic picture we discussed earlier in the letter, with ROIC, growth and competitive advantage periods all being impacted, resulting in an often dramatic downward repricing of equity values that we alluded to above. As you can see below the median number of moats is three out of the five we have identified and although we feel comfortable that our companies are currently insulated we remain perpetually paranoid about competitive risk.



Source: Brown Advisory Analysis.

Since putting this framework in place the concept of economic moats has become increasingly popular with other investors—the idea is noticeably better understood by the clients and prospects than when we started. One issue is that the concept of economic moats is frequently conflated with competitive advantages. In recent years we have worked hard to make a distinction between an economic moat (a barrier to entry into an industry) and a competitive advantage (an intra-industry advantage between players). Indeed we now have both economic moats and competitive advantages as separate sections in our checklist. We feel there are five types of economic moat which can also be competitive advantages within an industry. Obviously we would like each investment to have a full house of five economic moats and competitive advantages but in our experience, like the mythical unicorn, such companies don't exist (or we haven't found them yet!). What we have found is that a certain combination of economic moats are stronger than others—effectively meaning that in some instances two economic moats can be more effective at repelling new entrants than three economic moats as the sum of the parts is more powerful than the individual components. A classic example is when a company with a clear network effect, such as Deutsche Borse's Eurex, combines with switching costs to reinforce the power of the network. In this instance, two moats combine to create a fortress that may be impenetrable to new entrants. Elsewhere our discussion on competitive advantages included instances where we felt it was acceptable for certain companies not to have a clear competitive advantage. Our investments in the payment networks Visa and MasterCard are prime examples as both companies operate in parallel monopolies and work in conjunction to repel new entrants. We think both companies have outstanding economics with margins and ROIC profiles (>60% for both metrics) that most chief executives dream about. In addition Visa and MasterCard have delivered out-sized equity returns for investors since their IPOs in the 2000s yet neither company possesses a clear competitive advantage over the other one.

Given how mainstream the concept of economic moats and competitive advantages has become it is important to remember why investors should focus on both—to preserve the aforementioned economic picture and engine for compounding. We constantly challenge our beliefs in order to continually improve and deliver investment excellence for our clients. This effort continues in this topic and although we haven't made any wholesale changes yet our thinking is migrating towards moat combinations, rather than an outright number, and the importance of competitive advantages in certain industry structures.

Many thanks for your interest in our strategy and for taking the time to read this investment letter. We hope that you and your families stay safe and healthy over the summer and we look forward to updating you on our progress later in the year.

The Global Leaders Team

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)*
2019	35.1	34.2	26.5	11.6	11.2	2	N/A	731	42,426
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

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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.
11. Past performance is not indicative of future results.
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Past performance is not a guarantee of future performance and you may not get back the amount invested.

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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.

Return on incremental invested capital (ROIIC) is a measure reviewed by management to determine the effectiveness of capital deployed. One-year ROIIC is calculated as a percentage.

Free Cash Flow (FCF) is a measure of financial performance calculated as operating cash flow minus capital expenditures. FCF yield calculations presented use NTM and exclude financial services.

Sales growth rate is based on reported company revenue for the past three years at the end of the current quarter, provided as a historical average.

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.