



### *Performance*

For the fourth quarter and the year as a whole, our U.S. Equity Value Fund's return outperformed both the S&P 500 Index and the Russell 1000 Value Index. For the quarter, the Fund returned 9.16%, vs. the S&P 500 at 6.04% and the Russell 1000 Value at 4.22%. For the year, the Fund returned 28.21% vs. the S&P 500 at 26.46% and the Russell 1000 Value at 19.69%. (*This performance relates to the Brown Advisory U.S. Equity Value Fund USD B Share Class.*)

Leading contributors to performance during the quarter included **Snap-On, Inc., Deere & Co., Harris Corp., American Express Co. and Medtronic, Inc.** Laggards, none with meaningful declines, included **Assurant, Inc., ACE Limited, The Bank of New York Mellon Corp., BB&T Corp. and Dell, Inc.** The industrials, financials, information technology, materials, and health care sectors contributed the most to our positive relative performance this quarter, while consumer discretionary and materials fared the worst.

### *Changes to the Portfolio*

During the fourth quarter, we initiated three new positions that illustrate our thinking with regard to positioning the portfolio as we look ahead. **Darden Restaurants, Inc.** is a long-standing, well-managed consumer company that has held up exceptionally well during the downturn. Its key restaurant concepts are Olive Garden and Red Lobster; both offer a good casual family dining experience at affordable prices. At around 10 times "doable" earnings, with leverage to an improving economy, proven/creative management, upgraded menus, solid finances, and a 3% dividend yield, Darden offers a very solid return profile with very manageable risk. **Harsco Corp.**, another example, is primarily a diversified industrial service company serving the global steelmaking, construction, refinery/chemical, and railway businesses. Operating for years in a non-integrated, hierarchical, unfocused manner, the company has a new management team with lots of running room for improvement, especially if industrial production picks up meaningfully over the next several years. Substantial cost savings through long overdue restructuring and asset productivity should provide a high free cash flow yield limiting our downside risk. Finally, **Jacobs Engineering Group, Inc.** is a leading global engineering and construction company serving diverse markets. Its long-term record of profitable growth is considerably better than most industrials. Current operating conditions have made for an uninspiring 2010 outlook and a weak stock price. However, we believe that the weak near-term outlook is offset by its long-term business strategy, good finances, a very low valuation (ex-cash), and a very attractive reward/risk profile.

Our sales during the quarter were largely based on good performance and what we feel is an unattractive reward/risk ratio. The exception to this was the divestiture of our remaining position in **BB&T Corp.** which was based on a review of its accounting policies and commercial real estate credit exposure versus its peers. This analysis suggested a considerably higher level of risk than we were comfortable with. The decision was augmented by our generally cautious stance on credit providers and better long-term opportunities elsewhere. Our sale of **Franklin Resources, Inc.** was an example of both fundamentals and valuation improving sufficiently that a limited margin of safety was left in our view. We sold our remaining modest position in **Devon Energy Corp.** as its price appreciation had lifted expectations and present valuation to less attractive levels. In order to reduce cyclical risk, we sold our position in **Tiffany & Co.** after it had almost doubled. This remains a wonderful company with a true global franchise, but at 25 times probable earnings, expectations were overly inflated.

The general characteristics of the portfolio have remained constant: a low absolute valuation (13x estimated 2010 EPS), a low historic valuation, and a level of expectations that appear to be much more reasonable and achievable than that of the broad market. Although we maintain an economically sensitive global bias, we

have reduced this recently and continue to mitigate the associated risk via two avenues: business franchise quality and valuation.

### **Outlook**

Life is, at times, truly stranger than fiction. The roller coaster ride that was 2009 had so many twists and turns that its Hollywood movie version would have been declared preposterous by most knowledgeable critics. Yet, here we are. As the ride's dizziness dissipates and we survey the landscape, we recognize that the climate for investing is likely to be more challenging for awhile--maybe a long while. For most of today's investors, their investment framework was simple and reliable: the economy gets in trouble, consumer spending declines; Fed lowers borrowing costs, so investors buy stocks. Then wait a few years until the next crisis and repeat. This worked for over two decades as the discount rate worked its way from around 10% to essentially zero. During this period, of course, consumer (and most other) debt ballooned. Indeed, during this disinflationary period, with its lower rates, rising indebtedness, and rising valuations, it was hard not to make money in stocks. Our view is that a new, less accommodative framework will be at work over the foreseeable future. In that light, selectivity and nimbleness will be much more important, as the headwinds will be much stronger.

Since March, we have had a blistering equity rally, especially pronounced among lower-quality and more cyclical companies. Remarkably, this rally has occurred with no support from equity mutual fund inflows or evidence of a solid recovery. Ah, the wonders of government intervention, institutional money management pressures, and derivatives! We remain skeptical of the expectations we are willing to believe as government stimulus has played a large part so far. The Fed's exit strategy remains unclear, and private sector animal spirits remain moribund. As such, we have been, and probably will continue, to reduce our cyclical exposure when we believe their valuation levels price in too much of a good thing. While we continue to find some new attractive investments, the target list of companies with "the total package" has become a lot smaller over the last several months. Nevertheless, we are cautiously optimistic about this year as the portfolio's expectations and valuation remain at meaningful discounts to the broad market and should therefore hold solid prospects for this year.

Richard M. Bernstein, CFA  
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