BROWN ADVISORY

Small-Cap Growth Equity

4th Quarter 2009

The fourth quarter of 2009 lacked much of the volatility that was experienced over the prior several quarters. The Small-Cap Growth portfolio finished modestly ahead of the benchmark Russell 2000 Growth Index's 4.1% gain.

In the investment profession, the past is certainly not prologue. 2008 was a year of intense economic pain as the financial world collapsed upon itself in an alphabet soup (i.e. ABS, MBS, CMBS, CDO, ARS, etc.) of leverage. The Small-Cap Growth strategy suffered along with the broader market. In 2009, however, equities played their role of leading indicator, surging higher after an early decline, as leading economic indicators showed signs of life. In particular, as wide-scale bankruptcy fears subsided, the lower-quality companies that had borne the brunt of share price declines earlier rallied the most sharply. Despite a high-quality bias and relatively conservative positioning, stock selection allowed the portfolio to advance approximately 42% over the past 12 months. This compares favorably with the 34.5% rise of the Russell 2000 Growth Index, 27.2% increase of the Russell 2000 Index, and 26.5% gain of the S&P 500 index.

Our focus on process versus outcome means that our investment results are best measured over a full market cycle (3-5 years), and it is likely that 2009's performance will be very difficult to match in 2010 and beyond. At the end of the first quarter of 2010, the present managers of this strategy will have amassed a four-year track record. While this is still a relatively brief period of time compared to one's investment lifetime, it is certainly more meaningful than the oft-emphasized quarterly or annual return. We are proud that the hard work of our equity research team and the continuous support of the strategy throughout our firm have produced the investment results shown below (see Exhibit I). Although pleased to be off to a relatively good start, we are far from satisfied and will continue to push ourselves and our colleagues in the pursuit of long-term investment excellence. Our goal remains well above average risk-adjusted returns powered by careful, well-researched stock selection.

	Full Year 2009	Annualized Trailing 3 Years	Annualized 3-31-06 To 12-31-09
Small Cap Growth Portfolio - Gross of Fees	**42.6**	**1.2**	**1.0**
Russell 2000 Growth	34.5	-4.0	-3.4

Economy and Portfolio

The popular press and a host of authors have written much about recent economic history. An extensive review here would likely not provide any additional insights. However, a very brief assessment of the facts may shed light on the market vacillations that have taken place and, more importantly, how they shape our view of the future and the positioning of the portfolio.

The turning of the new millennium represented the changing of an economic regime. The Federal Reserve responded to the aftermath of the bursting of the technology bubble and the attacks on September 11, 2001 with a surge in liquidity, dropping the Fed Funds target rate from 6.5% to 1.0%. Our economy staged a seemingly quick and effective recovery from the 2001 recession, but it was fueled more by the expansion of credit – an illusory form of growth – than underlying economic activity. Due to favorable legislative

policies, Wall Street creativity, and investors yearning for yield, the flood of new money was channeled into the U.S. housing sector, driving an unprecedented wave of home price appreciation.

As we all know, this story ended badly. The financial crisis ensued, the Federal government injected huge sums of taxpayer money to keep the system afloat, and the S&P 500 plunged from nearly 1,500 to below 700, driving historical valuation measures to well below average (and attractive) levels for the first time in decades. In early 2009, stocks were actually on sale!

If 2008 was the year of the great recession, 2009 was the year of the great revaluation. The market rally since early March 2009 was driven in part by a more than trebling of the trailing price-to-earnings multiple from roughly 10x to 35x, due to the combination of rising prices and falling earnings. Given this huge expansion in market multiples, the consensus view is that the easy money has been made. We agree. The economy is still on partial life support and federal officials still have the Herculean task of withdrawing stimulus at just the right pace. The lower quality, early-cycle, broad-based rally appears poised to narrow. Stock selection will likely play an outsized role in generating alpha.

Our process is predominantly bottom up and fundamental in nature. Our answer to the complexity of the macro picture is simply to try to buy good companies at good prices where we believe earnings and cash flow generation will be appreciably higher in three to five years. However, after a low-quality, beta-driven, cyclical move higher in 2009, we do believe some areas are more attractive than others in which to concentrate our search for new ideas in 2010. Our "barbell" strategy is to focus on the following offensive and defensive areas:

Offensive

Selective Technology – Although it was the best performing sector last year, technology remains reasonably valued relative to the broader market, possesses cash-rich balance sheets, has exposure to the economic cycle should the recovery prove stronger than we expect, and is experiencing seismic shifts in much of the landscape, increasing the odds of M&A activity in our investable universe. The opportunity is selective, however, as the market has largely indiscriminately driven this sector higher. Our focus on long-term secular growth versus a cyclical recovery should add value.

Global Industrials – Due to demographic trends, more favorable pro-growth policies, and the law of large numbers, GDP growth is likely to be demonstrably higher in many developing and emerging economies around the globe when compared to the U.S. Domestic industrial companies focused on niche end markets with above-average pricing power and exposure to these high-growth countries should be beneficial to portfolios. Again, it is important to beware of highly cyclical industrials where aggressive positive earnings expectations have been priced into the shares.

Oil Service – This sub-sector of the energy landscape contains the most robust and sustainable long-term earnings growth stories given the exposure to activity levels driven by expectations of an inexorably slow, but erratic rise in oil prices. It is worth emphasizing that we value these companies in the same manner we would value any business – the discounted value of future cash flows – as opposed to a speculation on near-term commodity price fluctuations.

Non-discretionary Consumer – The U.S. consumer remains over-leveraged and requires a period of years to reach sound financial footing, in our view. A higher savings rate, less access to credit, and rising rates (over time) all bode poorly for consumption. Thus, we will likely tread gingerly in this sector, focusing our time and attention on a few companies with unique idiosyncratic factors.

Defensive

Health Care – With the dramatic debate and compromise surrounding health care reform in full swing, this has been a much maligned area of the market. However, pronounced negativity tends to provide opportunity for those willing to take a multi-year view. We believe valuations now reflect an appropriately bearish scenario, thus making this somewhat non-cyclical sector of the economy an interesting defensive play in case the recovery stalls or disappoints. Our emphasis is on businesses that lower cost, drive productivity, or improve the quality of patient care.

Homeland Security and Defense – The recent bout of terrorist activity is a sober reminder that we remain at war with an enemy that fights without rules. Furthermore, our recent escalation of troop levels in Afghanistan likely represents a continued commitment to heightened military activity in the Middle East, at least over the intermediate term. We view these sectors as an insurance policy against terror with the potential for above-average returns without adding cyclical leverage to the portfolio.

Financial Processors – We tend to shun pure financials represented by regional banks, insurance companies and investment/merchant banks. The rationale is that we struggle to find the differentiating characteristics we seek as a part of our disciplined investment philosophy and strategy. However, we do see a fairly low-risk way to gain exposure to financial activity through a handful of processors that support various sub-sectors.

Portfolio Drivers

Since we have placed renewed emphasis on stock selection in 2010 and alluded to its primacy in our overall investment process, we herewith reference some portfolio drivers of the past 12 months that highlight our decision process. The simple matrix below shows the fundamental framework used to prospectively and retrospectively assess our actions. In the pre-mortem stage of the decision, we think about what we are doing, why we are doing it, and what could go wrong. In the post-mortem review of the decision, we discuss whether the intended outcome was achieved, why it was or was not achieved, and how we can improve our process to reach better conclusions in the future.

This framework is a way to honestly assess our successful and unsuccessful decisions. It allows us to consider the role of chance and the unpredictable in investment outcomes. A decision can fall into one of four boxes:

		Cause	
		Right	**Wrong**
Outcome	**Right**	Right for the right reasons: - Stock purchased due to expectation that margins will improve. - Margins expand. - Stock appreciates.	Right for the wrong reasons: - Stock purchased due to expectation that margins will improve. - Margins contracts. - Stock appreciates on new product launch.
	Wrong	Wrong for the right reasons: - Stock purchased due to expectation that margins will improve. - Margins expand. - Stock price declines due to litigation expenses related to patent infringement.	Wrong for the wrong reasons: - Stock purchased due to expectation that margins will improve. - Margins contracts. - Stock price declines as competition increases; management dramatically increases infrastructure spend to support growth.

In 2009, despite a higher-quality bias and relatively conservative portfolio positioning, we benefitted substantially from some sizeable, well-timed bets that enabled the portfolio to outpace the market on the upside. **Oceaneering International**, the leading operator of remotely operated vehicles (ROVs) to support the construction, repair, and maintenance of offshore drilling activities by oil companies, is a good example of a positive contributor to 2009 returns. Following a dramatic decline in oil prices from nearly $150 to $35 per barrel, the stock staged an impressive rebound as the commodity price recovered to in excess of $70 per barrel. Our substantial history with the Company provided us with the confidence to make Oceaneering our top holding within the Energy sector and one of our largest positions. The thought process was as follows:

Oceaneering International

Pre-mortem

Decision: Increase position with stock trading between $20-30 due to oil sell-off
Reasoning: Competitive positioning and long-term outlook for deepwater projects should keep secular earnings growth story intact
Intended outcome: Stock could double as economy improves and oil prices move back toward more rational levels

Post-mortem

Actual outcome: Stock increases three- to four-fold off bottom
Cause vs. Reasoning: Rebound in oil prices was much greater than anticipated and earnings held up better than expected
Framework: Right for *mostly* the right reasons, but we clearly could have been even more aggressive based upon actual fundamentals compared with our expectations. It was a scary time to be buying anything, particularly given the volatile history of energy prices.

The negative contributors represented a wide variety of decisions, and some were clearly mistakes. Others, however, were high-conviction, long-term holdings that suffered a temporary set-back. Fortunately, we have the analytical resources to really know and understand what we own, allowing for conviction in the face of transitory negative news, and work at a firm that judges results over years, not months. While we likely could fill several pages highlighting our not-so-great decisions over the past year, the following example reveals an opportunity for us to learn from a mistake. **Orient Express Hotels** owns a collection of irreplaceable, unique hotels that provide guests best-in-class service that has led to room revenue growth well in excess of its peers. We made what we thought was an opportunistic entry into the stock, taking advantage of a drop in share price following a rejected takeover attempt. However, as the global economy worsened and the Company's earnings began to suffer, we made a capital allocation decision between adding to the existing position and using the shares to fund other ideas. The takeaway from the example below is that when we have analyzed the situation correctly and removed emotion from the decision, investment opportunities are greatest when market sentiment is at its worst.

Orient Express Hotels

Pre-mortem

Decision: Sell remaining position in January 2009 slightly below $7 a share
Reasoning: Hugely negative sentiment surrounding lodging industry and more specifically, the Company's long-term solvency
Intended Outcome: Stock will trade much lower because bankruptcy issues are real, creating no valuation floor

Post-mortem

Actual Outcome: Stock bottomed at approximately $3 in March along with the overall market.
Cause vs. Reasoning: Asset sales, bottoming of the financial crisis, and management execution in streamlining cost structure as part of turnaround plan.
Framework: Wrong for the wrong reason. Management stated that bankruptcy was not an issue because they could sell assets providing them with liquidity. This is exactly what they did. We weighted the probability of the stock going to $10 too greatly.

Outlook

Hopefully, 2009 marked the turning point for the global economy, ushering in many years of growth and prosperity. While we are willing to concede that the worst-case scenario is most likely off the table, we do not want to be cavalier regarding the systemic risks that still exist. Therefore, we are using the barbell framework we have described. We also see the market narrowing, placing an increasing premium on stock selection to drive performance. Fortunately, this philosophy does not force us to alter our process as we always work from the bottom up versus the top down.

Our strategy produced solid relative and absolute investment returns over the past 12 months, helping to heal some of the wounds inflicted by the financial crisis of 2007-2009. However, these results will be difficult to repeat going forward. Our long-term approach, shunning the temptation of near-term portfolio repositioning to capture what is “working” vs. taking a 3-5 year view on select business models with favorable competitive positioning, means that we are likely to endure a period of underperformance over shorter periods of time. We will work diligently to avoid such an outcome, but unfortunately we can only control our investment process, which is a long-term endeavor. Lady luck and randomness tend to dominate week-to-week and month-to-month market moves.

We are sure 2010 will bring a new set of challenges, but look forward to facing them with your support.

Small-Cap Growth Team
January 2010

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