Global Leaders Strategy

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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.

CRYSTAL BALL WATERFALLS

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In our last fourth quarter letter we wrote about the difficulty of making big picture predictions ('*The Crystal Maze*'). In many ways the first few weeks of 2019 have been the typical start to a year with the usual soothsayers-in-suits of the investment community offering up their interpretations of their economic crystal balls for 2019. Indeed we even received a compendium of different investment firms' economic outlooks from one enterprising individual – an early contender for the navel-gazing award of the year. Whilst last year's narrative coalesced around a 'melt-up' scenario offered by one well-known commentator, this year's narrative is firmly centred on one view – a global recession. Whilst we acknowledge that a number of economic lead indicators are flashing amber (PMIs, ISM survey, US yield curve – take your pick) there seems to be a similar inevitability about the current narrative that exudes as much overconfidence as the melt-up scenario of 2018. Recently we have had a number of conversations with other investors who are already referring to the next cycle as if an imminent global recession is a forgone conclusion. In many ways such a coalescence of ideas can be a form of diversity breakdown when a group of individuals believe the same idea which in turn makes a diverse set of views uniform and lost in group-think. One of the main processes that leads to a diversity breakdown is an information cascade whereby individuals rely on the information of others rather than forming their own views. Michael Mauboussin touches on this idea in his book '*Think Twice*':

'*Scientists have made good headway in understanding the processes that lead to diversity breakdowns. For example, information cascades occur when people make decisions based on the actions of others, rather than on their own private information. These cascades help explain booms, fads, fashions and crashes. Social network theory, the study of how individuals or organisations are interconnected, provides a framework for understanding how these cascades propagate across large populations*'[1].

Whilst it is not clear if the current market narrative is an information cascade or not, it is vitally important to recognise the role that human behaviour can have in convincing us that different scenarios, melt-up, recession or otherwise, are inevitable. Financial markets are driven by two forces, fundamentals and psychology, and the correlation of individual views can result in the slow drip of information turning into a cascade that breaks down diversity of thought in a collective. As we have discussed before this process can be reflexive and entirely self-reinforced through feedback loops. As more and more market participants become either bearish or bullish they produce price actions which create feedback loops which create even more negative or positive sentiment until the process runs out of psychological steam. What frequently amazes us is that this process isn't typically coordinated with the real world and that information cascades can develop much faster in financial markets as investors shoot first and ask questions second. As we don't try and second guess the short-term ebbs and flows of the world economy we are by no means taking the view that a global recession isn't possible in 2019. We do however firmly believe that diversity breakdowns can result in assets trading at significant premiums or discounts to their intrinsic value. These inefficiencies will exist for as long as human behaviour has a hand in shaping financial markets and we hope to be able to capitalise on moments of exuberant or cataclysmic inevitability as the Global Leaders journey continues. One encouraging thought on the inevitable outlook is that we focus intently on downside protection and the Global Leaders strategy has demonstrated a c.75% monthly downside hit rate (outperforming c.75% of time) in down months since inception. As an illustration Global Leaders outperformed its benchmark by 6.72% in 2018 (the strategy returned -2.80% vs -9.52% for the Russell Global Large-Cap Net Index) and it also outperformed in four of the five down months of the year (80% monthly downside hit rate)[2]. Our investment approach is built on lasting customer relationships that foster long-term

[1]Source: *Think Twice: Harnessing the Power of Counterintuition* by Michael Mauboussin.
[2]Source: Factset. Composite performance is based on the Brown Advisory Global Leaders Composite. Returns are nets of fees and are shown through 12/31/2018. The composite performance shown above reflects the Brown Advisory Global Leaders composite managed by Brown Advisory Institutional. Brown Advisory Institutional is a GIPS compliant firm and is a division of Brown Advisory LLC. Past performance is not indicative of future results. Please see the Brown Advisory Global Leaders compliant presentation on the last page for additional information and a complete list of terms and definitions.

structural growth, multiple economic moats, high and durable return profiles, bullet-proof balance sheets and cash flow based value – ingredients that we feel will stand our investors in very good stead if the crystal ball gazer's inevitable global recession becomes a reality.

TURN ON, TUNE IN AND DROP OUT

One of the ongoing challenges that we have as investors is to separate signal from the cacophony of noise that emanates from the financial markets. With this in mind one of the more interesting books that we read over the festive break was Tim Wu's '*The Attention Merchants*' which chronicles the evolution of industries that try and harvest our attention in a variety of products such as advertising, propaganda and sponsored social media. As well as being useful for its company specific commentary Wu's book piqued our interest as investors who are subjected to an almost endless barrage of information peddled by the attention merchants of the financial world. As Wu lays out, information is only valuable when it has our attention:

'*Information cannot be acted upon without attention and thus attention capture and information are essential to a functioning market economy, or indeed any competitive process like an election (unknown candidates do not win)*'[3].

Historically attention merchants have monetised our focus by selling products to us (paid for with money or intangible currency such as data), by selling us *as* products (our eyeballs and data) or a combination of the two. One good example of these monetisation streams are newspapers which capture our attention with their headlines and content, we then pay for the content and they in turn sell our attention (or eyeballs) onto their advertisers who are attracted to the readership that we are now part of. Indeed this is the exact strategy of the financial press and television stations – the mind-numbing soap opera of speculation about US monetary policy that dominates Bloomberg TV and CNBC is one hook that tries to snare our attention. To the professional investor perhaps the most obvious attention merchants are the intermediaries that operate in the financial markets. Financial data providers like Bloomberg and Factset sell us products in their fancy analytical terminals with real time pricing and in turn they also sell us as products in the form of advertising and data. Given the dual role these companies have it is perhaps no surprise that they invest significant amounts of resource in developing new functionality that investors feel they can't live without. Elsewhere another set of double-sided attention merchants are the investment banks. These financial behemoths of Wall Street are not unlike newspapers as they charge professional investors for their services in the form of research and trading but they also sell their clients as products in trading flows and investment banking services to companies looking to raise equity or debt. Indeed we are constantly bombarded by hundreds of emails from investment banks on a daily basis. The reality is that the majority of sell-side output is short-term focused and designed to get investors to use additional services such as trading.

One of the obvious effects of being exposed to the attention merchants of the financial world for too long is that investors become acutely aware of small moves in security prices and therefore volatility. Professional investors should keep one eye on the pricing of their holdings, in case value emerges or recedes, but does exposure to real-time pricing, performance and commentary make us better investors? We don't think so – for psychological reasons that need some explanation. For this topic we are reminded of Richard Thaler's seminal paper, '*Myopic Loss Aversion and the Equity Premium Puzzle*', in which he leverages Daniel Kahneman and Amos Tvesky's ground-breaking work on prospect theory to explain the existence of the equity risk premium. At the outset Thaler looks to understand why investors demand a higher return for equities than bonds despite equities having offered substantially better returns. In this work Thaler breaks down investor time horizons between evaluation periods and planning horizons. A planning horizon is the time frame that fits with an investment strategy, for us this is a minimum of 3 years, but the evaluation period is the length of time that an investor evaluates his or her returns over. For most investors the planning horizon is substantially longer than the evaluation period – at one extreme imagine an investment manager of a pension fund with thirty year liabilities that evaluates his or her performance daily. This mismatch combines with loss aversion to contribute to the equity risk premium – essentially why investors require a higher return for equities despite equities having historically delivered substantially higher returns over time. Indeed Thaler suggests that one year is the minimum evaluation period where investors are indifferent between holding equities and bonds. Part of the answer to the equity risk premium riddle lies in the increased short-term variability that comes with being an equity investor and a phenomenon which he termed myopic loss aversion:

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[3]Source: *The Attention Merchants* by Tim Wu.

'*The longer the investor intends to hold the asset the more attractive the risky asset will appear, as long as the investment is not evaluated frequently. Put another way, two factors contribute to an investor being unwilling to bear the risk associated with holding equities, loss aversion and a short evaluation period. We refer to this combination as myopic loss aversion*'[4].

The crucial point about myopic loss aversion is that our susceptibility to loss aversion is influenced by our evaluation period – the shorter the period the more susceptible we are. To us this concept makes perfect sense given we feel loss (pain) at least twice as much as we do gain (pleasure). Accordingly, exposing ourselves to the daily volatility of the equity markets can dramatically reduce our evaluation periods and therefore make us more susceptible to myopic loss aversion. As investors we feel that being genuinely long-term focused is one of the few advantages that we have as we believe markets are inefficient over short time periods and more efficient over longer time periods – a belief that shares many of its underpinnings with Thaler's work. Indeed one of the questions we frequently ask ourselves when faced with negative price actions stemming from transient, typically demand-based, factors is – *are we going to care about this issue in three years time?* To maintain this advantage we crucially need to have genuinely long-term evaluation periods that are more aligned with our long-term planning horizon. For this we ask our clients to evaluate our performance on as long a time-frame as they feel comfortable – Thaler's one year is too short. For this to work effectively we, us and our investors, need to insulate ourselves as best as possible from the siren calls of the attention merchants of the financial world whose modus-operandi is to shrink our evaluation periods. Whilst many consumers are currently dieting after festive over-consumption we are planning to restrict our intake of the bad calories of informational junk food that the attention merchants peddle in 2019. This means limiting our exposure to the financial press, all but the most relevant sell-side output and self-imposed rationing of Bloomberg and Factset screen time. The perfect antidote is a diet of primary research, company meetings and annual report reading – good calories for the long-term investor. In '*The Attention Merchants*' Tim Wu makes the point that most mediums face some form of revolt after an extended period of time as consumers become over saturated with information and push back. Incidentally, this idea of revolt and disengagement is one of the reasons we sold our position in one of the twenty first century's most effective attention merchants, Facebook, in 2018. Although the current Global Leaders revolt is not new for us it needs constant effort as we seek to maintain evaluation periods that are more closely aligned with our planning horizons. We would encourage you to join us in tuning out of the cacophony of financial noise this year.

The Global Leaders Team

[4]Source: Shlomo Bernartzi & Richard H. Thaler, *Myopic Loss Aversion and the Equity Premium Puzzle*, *The Quarterly Journal of Economics*, 1995, Volume 110, Issue 1, Pages 73-92, by permission of Oxford University Press.

Global Leaders Composite

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)*
2017	35.1	34.0	24.6	N/A	N/A	2	N/A	77	33,155
2016	-0.6	-1.4	8.1	N/A	N/A	2	N/A	38	30,417
2015**	1.2	0.7	-7.1	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 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.
3. This composite was created in 2015.
4. The benchmark is the Russell Global Large-Cap Net Index. This index offers investors access to the large-cap segment of the entire global equity universe. The index is constructed to provide a comprehensive and unbiased barometer for the large-cap segment and is completely reconstituted annually to accurately reflect the changes in the market over time. Russell® is a trademark/service mark of the London Stock Exchange Group companies. One cannot invest directly in an index. Benchmark returns are not covered by the report of the independent verifiers.
5. The dispersion of annual returns is measured by the equal weighted standard deviation of portfolio returns. The composite dispersion is not applicable (N/A) for periods where there were five or fewer accounts in the composite for the entire period.
6. 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 $25 million; 0.70% on the next $25 million; 0.65% on the next $50 million; and 0.50% on the balance over $100 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.
7. 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 (NA) and the composite did not exist.
8. Valuations and performance returns are computed and stated in U.S. Dollars. All returns reflect the reinvestment of income and other earnings.
9. A complete list of composite descriptions, policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.
10. Past performance does not indicate future results.
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