Global Leaders Strategy

Investment Letter | January 2021

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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What is Time? What is Space?

What is Time?

One of the most important investing reminders of 2020 was around one of the few sources of investment edge: time. In particular, what is the right time-frame? Behavioural psychologists have repeatedly and consistently demonstrated that in periods of intense stress, our brain's limbic system (a.k.a. survival system) overrides kick-in and our time horizon shrinks to focus on the immediate threat. It is the same in reverse for rewards: we prefer smaller immediate rewards over larger but deferred gains. The biological reason we find it next to impossible to think long-term under stress is because it requires the use of a different part of the brain (the frontoparietal network) than our survival system overrides allow. For the long-term investor, our brain can be our worst enemy. So we need to plan ahead for bad times and have a process to override our survival system. We need to override our brain's override! A well-known sports psychologist[1] calls this controlling your "inner chimp" and this is what investment process is for. The power of our clear and disciplined process was evident throughout 2020 as it enabled us to focus on our long investment horizon during a stressful and uncertain period. Honestly, a big part of investing is just committing to a thoughtful process.

In our investment book club we are currently reading *Factfulness*[2] by Hans Rosling which has many insights on calibration—updating our view when the facts change[3]—and the danger of some of the evolutionary behavioural shortcuts as described above that we all instinctively use. Hans was quite a character and it is worth watching his TED talks and taking the Gapminder test. Some other recent reading has included investing history books such as the recently published *Boom and Bust* and the twenty year old *Engines That Move Markets*[4]. Both look back over the past 200-300 years at what drives value creation and ultimately equity markets and pose questions such as: is it the adoption of new technologies that drive change in society? When does crowd psychology take hope for economic return beyond what valuation can support? And why do markets irregularly detach fundamentals from valuation to their own detriment? Unexpectedly however, a short, timeless book about physics provided some of the most pertinent lessons. In his book "What is Time? What is Space?" Carlo Rovelli reflects on a lifetime spent trying to reconcile Einstein's theory of General Relativity to Newtonian-based Quantum Mechanics. In Newton's 1687 masterpiece the Principia he notes that time is unobservable yet it enables a convenient link across variables such as speed, mass and volume. Whilst time is part of his famous laws, it is only a relative variable to enable fundamental comparisons. Rovelli's proposed solution to the biggest physics quandary of the past 100 years is called "loop quantum gravity" and is grounded in the elimination of time as we know it. If this theory is correct, then time does not exist.

It might seem absurd to even ask if time exists with quarterly letters and annual reports part of our daily lives. But is this information temporary or permanent? Is it compounding or expiring knowledge? What is its half-life? And will we care about what we learn today in five years' time? We think one of our few advantages or "sources of edge" as investors is the extension of our horizon or, taken to its extreme, the removal of time. At the right price we want to own these businesses forever. One can see this in the fundamental equation of economic value tying a company's invested capital (IC), return on capital (RoIC), the weighted average cost of capital (WACC) and long-term cash flow growth:

Economic Value = IC * (RoIC - growth) / (WACC - growth)[5]

[1] Dr Steve Peters, *The Chimp Paradox: The Mind Management Program to Help You Achieve Success, Confidence, and Happiness*
[2] Hans Rosling, *Factfulness: Ten Reasons We're Wrong About the World - and Why Things Are Better Than You Think*
[3] Recalibration was an internal catch-phrase in March!
[4] William Quinn and John D. Turner, *Boom and Bust. A Global History of Financial Bubbles*; Alastair Nairn, *Engines That Move Markets. Technology Investing from Railroads to the Internet and Beyond*
[5] McKinsey & Company (Keller, Goedhart & Wessels), *Valuation: Measuring & Managing the Value of Companies* 7th ed. Pg. 52 (nb. this equation assumes RoIC is equal to Return on Incremental Invested Capital (RoIIC) in perpetuity)

At its simplest, the fundamental value equation also has no place for time. What does this actually mean? Isn't time part of compounding? Or is it a convenient way to measure the relative economic value created between our starting and end points? To hold, this equation of perpetual value requires that the return on capital doesn't fade to the cost of capital, which is precisely our investment strategy. We aim to buy good companies which have a high RoIC that won't fade over time and compound that return for as long as we own them. A chart looking at the S&P 500® Index from the 6th edition of McKinsey's *Valuation*[6] book we used in one of our first letters is worth re-presenting. Simply put, good companies typically stay good companies over a ten year period. Our challenge is to buy them cheaply, and then have the courage and patience to wait[7].

Leaders Tend to Stay Leaders

83% of companies with a ROIC of greater than 25% in 2003 had a 25% or higher ROIC a decade later

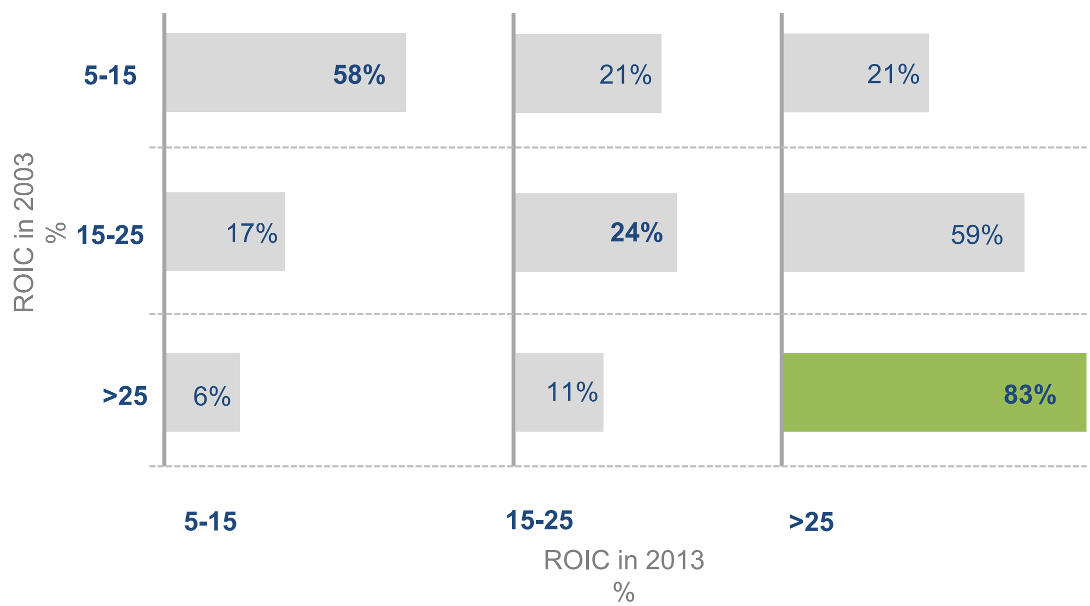


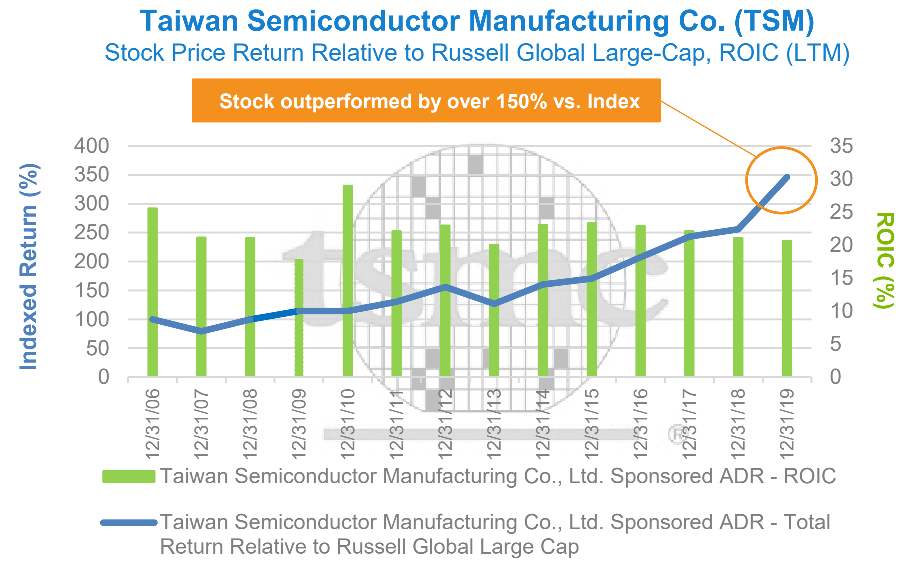
Chart reproduced with permission from McKinsey & Company Inc. as featured in the book, "Valuation: Measuring and Managing the Value of Companies, University Edition." 6th Edition, 2015. ROIC is calculated as % without goodwill. The selected sample is the S&P 500® Index.

So What is Time to an Investor?

It all depends on your investment horizon. If contemplating our children's future then it is best to include climate change and other externalities in our thinking about RoIC. If only predicting next year's earnings per share then probably not. As the equation above shows, the longer the time (i.e., forever in the perpetuity equation), the more the sustainability of RoIC matters (ie, what is the *incremental* RoIC as the cash flow grows), and that in turn needs a great customer outcome and barriers to prevent competitors stealing our company's valuable customers away. Charlie Munger and Warren Buffet regularly remind us that the longer we own an asset, the closer our internal rate of return (IRR) gets to the return on capital. In perpetuity, RoIC, invested capital and cash flow growth alone drive long-term value creation (assuming WACC is constant at our standard 10% hurdle rate). So for us the longer we look out, the more important long-term RoIC becomes. We have written before about how typically over 85% of any growing company's value lies beyond the next two years, using our conservative discounted cash flow (DCF) valuation framework (10% WACC, 10 year forecast, 3% nominal terminal growth). Ultimately the real compounding of the excess economic return for the companies we invest in happens beyond most sell-side model's two year forecast. In our benchmark only 11% of the non-financial companies over $2bn in market capitalisation have at least one free cash flow estimate for 2025. The further out you look, the less the competition. This is yet another reason we require a long horizon.

[6] McKinsey & Company (Keller, Goedhart & Wessels), *Valuation: Measuring and Managing the Value of Companies* 6th edition

[7] "The big money is not in the buying or selling but in the waiting" Charlie Munger



Source: FactSet®. Logo has been used with exclusive permission. The ROIC for TSM reflects the most recent available data point, reported from 12/31/19. From 1st May, 2015 to 31st December, 2019 the benchmark was the Russell Global Large-Cap Net Index. The information provided in this material is not intended to be and should not be considered to be a recommendation or suggestion to engage in or refrain from a particular course of action or to make or hold a particular investment or pursue a particular investment strategy, including whether or not to buy, sell, or hold any of the securities mentioned. It should not be assumed that investments in such securities have been or will be profitable. To the extent specific securities are mentioned, they have been selected by the author on an objective basis to illustrate views expressed in the commentary and do not represent all of the securities purchased, sold or recommended for advisory clients.

The chart above shows 33 year-old Taiwan Semiconductor's RoIC over the past 15 years in green bars and the relative performance of this investment during that period as the blue line. TSMC has produced a 20% RoIC or greater every year bar one (2009) in a highly cyclical, capital intensive industry by delivering an unsurpassed customer outcome. We may even see long-time industry leader Intel outsourcing significant volumes to TSMC in the near future as TSMC widen their new-found technology superiority. On a one or even two year basis it doesn't always outperform but over periods of five years or more, TSMC has delivered tremendous value firstly to its customers and as an outcome to its investors too. Another example in Global Leaders is 133 year-old Unilever (listen to our recent podcast with CEO Alan Jope) which we have been invested in since the launch of Global Leaders nearly six years ago. Unilever has delivered a RoIC of approximately 20% by our calculation since 1990. We presumed 30 years was enough to spot any fade; so far there isn't one. This is not what we remember from Microeconomics 101, and as is often the case, Warren Buffett[8] sums it up best: *"Time is the friend of the wonderful business, the enemy of the mediocre."*

Minimising the impact of time by allowing a 20+% RoIC business to compound for five years enables us to generate well over 100% RoIC from our investment during the period. Our highly productive companies will regenerate their entire invested capital base in under five years. In an increasingly capital-light business model world, we might well then ask "what is invested capital?" We will save this for a future letter.

If investing really was as simple as just finding 20% RoIC companies then a quant algorithm or Excel spreadsheet would suffice. But we believe that the customer outcome, business model, moat progression, company culture, management's time horizon, reinvestment opportunities, *incremental* RoIC and purchase price all contribute meaningfully to investment performance and spreadsheets are not as useful in judging these. The sustainability of our 20% RoIC businesses is an outcome of these less quantifiable inputs.

What is Space?

Other ideas from Rovelli that apply equally to investing and physics research are the use of probability ranges and developing team-based critical thinking. We can never know all the variables in science because to do so would require predictive accuracy on an individual atomic level. So probabilities are good enough approximations. The truth is that just as in science we can never accurately predict to a granular level all the variables going into our base case investment scenarios, so probability ranges are as good as we can get. There are just too many variables to use point estimates of value. We think there is a 67% probability that Autodesk will deliver at least $2.4bn of free cash flow after stock based compensation in calendar 2024 in our base case. As John Maynard Keynes reminds us it is better to be roughly right than precisely wrong.

[8] Warren Buffett, Berkshire Hathaway Letter to Shareholders, 1989

"Rational thinking is the idea that if we respect points of view different from ours, new ideas proposed, and different options, then we can discuss these different options, analyse them, criticize them, make them clash, until clarity and agreement is reached."[9]

Rovelli marvels at the wonder of teams and the scientific method to analyse our thinking and processes to improve knowledge. Scientists use teams to assess and progress their thinking; as do we (see an ESG example below). This is called the scientific method and peer review is an important part of developing thinking—others see things we cannot because of our own blind-spots but together we progress. All knowledge advances—what worked pre-internet in 1990 at Unilever may not work in today's online world. The same is true for investors—we must codify and update our beliefs, reproving them to be true. We have to be flexible to test our processes and adapt to changing circumstances without needlessly discarding concepts that have served us so well. One of our other "sources of edge" is having a process for thinking and decision-making that incorporates behavioural economics such as the fight-or-flight survival syndrome mentioned above. We have written extensively about our use of a coach, process discipline and annual offsite to enable ongoing improvement. We believe that we are process engineers in the mould Ray Dalio suggests, testing and retesting assumptions and beliefs to re-validate them. Of course we need the conviction of our knowledge and beliefs to deliver value to our investors, but the humility to recheck their validity. We can always get better.

"To be capable to increase our knowledge, to learn something more, we have to be ready to accept that something we believe to be true is not actually true. This is why doubt, uncertainty, is the root itself of knowledge. And this is also the reason for which the worst enemy of knowledge is certainty."[10]

Global Leaders and Sustainable Investing

We are strong believers that in the long-run it is simply good business sense to care about all stakeholders: customers, employees, suppliers, government and the society which gives our companies their license to operate. We embed sustainability into the Global Leaders' investment process both offensively using Sustainable Business Advantage (SBA) drivers and defensively with ESG Risk Assessments (ERA). We are the first to concede that much ESG research is subjective (see our last letter) so our own work is our first source of ESG opportunity and risk mitigation. In order to help meet some clients' requirements in 2019 we launched the Global Leaders Sustainable UCITS Fund. This incorporates all aspects of sustainability in Global Leaders with the addition of a third-party provider to apply a rules-based screening process which seeks to identify companies that may have controversial business involvement. Tobacco would be one example: in baseball terms, any company that ultimately kills its customer doesn't even get out of the dugout for us—let alone onto first base—but this screening process provides additional assurance for our clients. Performance of the two strategies is quite similar due to 95% overlap and we think of them as one.

If you are interested to know more about how we incorporate positive SBA drivers into Global Leaders, we recommend listening to our podcast with the CEO of **Unilever** Alan Jope, recorded in December as part of our Navigating Our World series. It offers a unique insight into how SBA drivers match up with the values and purpose on display at Unilever. The investment discussion at the end with our colleague Katherine Kroll provides additional colour to our thinking. Katherine is in our terrific ESG team. This team introduced us to the Sustainable Business Advantage drivers' framework which we wrote about in our ESG Transparency Report in 2020. The Sustainable Investing team helped us formulate and codify our thinking around SBA drivers needing materiality (over 25% of cashflow) and meaningful differentiation from peers to drive excess economic value. We hope this podcast is interesting and more on another one later.

Latent Value and Time, Again

Maintaining our process discipline to focus on a five year time period during the first half of 2020 whilst suddenly dealing with home schooling and remote working led to a lot of what Bertie and I called "latent value" in the portfolio. These were companies that on a five year view had significant moats and relative competitive advantages intact and in the long-run we believe are 20% RoIC businesses. Yet in the midst of the COVID-19 lockdowns, some of these businesses were under extreme duress such as Booking Holdings selling hotel rooms and CTS Eventim distributing tickets to sporting events and concerts. Both saw short-term revenues collapse and the distribution of outcomes had clearly widened yet there was no competitor stealing their customers away and there was no permanent supply-side threat to either business. In mid-2020 these businesses had mid-teens IRRs on a five year horizon and so we added to our positions. The Global Leaders portfolio[11] has a RoIC of approximately 25% which is three times the asset productivity of the benchmark. The trailing three year revenue growth of approximately 11% is circa 50% higher than the benchmark. Yet our portfolio's forward 12 month FCF yield is only on a small 15-20% premium. You don't have to extend your time horizon very far to see value in those numbers!

[9] Carlo Rovelli, *What is Time? What is Space?* (Pg. 65)
[10] Carlo Rovelli, *What is Time? What is Space?* (Pg. 64)
[11] Portfolio data as at 12/31//2020

Last week Mick was interviewed by Ted Seides of Capital Allocators in a new podcast. We discuss the Global Leaders strategy in detail, as well as some lessons learned from Mick's experience in business and as an investor. We hope it makes for some interesting listening. As we approach our sixth anniversary in April 2021, the whole Global Leaders team would like to thank you for your support and for placing your faith and hard-earned money with us. We endeavour to continue to deliver for you. We wish you all a safe, healthy and prosperous 2021.

Mick, Bertie and the Global Leaders Team

Disclosures, Terms and Definitions

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.

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The S&P 500® Index represents the large-cap segment of the U.S. equity markets and consists of approximately 500 leading companies in leading industries of the U.S. economy. Criteria evaluated include market capitalization, financial viability, liquidity, public float, sector representation and corporate structure. An index constituent must also be considered a U.S. company. Standard & Poor's, S&P, and S&P 500® are trademarks/service marks of MSCI and Standard & Poor's. An investor cannot invest directly into an index.

The Russell Global Large-Cap Net Index offers investors access to the large-cap segment of the entire global equity universe. The Russell Global Large Cap 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. All Russell indices mentioned above are trademarks/service marks of the Frank Russell Company. Russell® is a trademark of the Frank Russell Company. 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) represents the cash a company generates after cash outflows to support operations and maintain its capital assets. Unlike earnings or net income, free cash flow is a measure of profitability that excludes the non-cash expenses of the income statement and includes spending on equipment and assets as well as changes in working capital.

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

Enterprise Value to Free Cash Flow (FCF/EV) compares the total valuation of the company with its ability to generate cashflow. It is the inverse of the Free Cash Flow Yield.

Alpha is a measure of performance on a risk-adjusted basis. Alpha takes the volatility (price risk) of a portfolio and compares its risk-adjusted performance to a benchmark.

IRR (internal rate of return) is a measurement used to estimate the profitability of a project or investment. It is used when companies need to decide between different ways of using their money. The IRR of the investment is determined by anticipating the profit a project will produce in the future and finding out its value today.

Net debt-to-EBITDA (earnings before interest depreciation and amortization) ratio is a measurement of leverage, calculated as a company's interest-bearing liabilities minus cash or cash equivalents, divided by its EBITDA. The calculation presented excludes financial services.

Discounted Cash Flow (DCF) is a valuation method used to estimate the value of an investment based on its expected future cash flows.

Weighted Average Cost of Capital (WACC) is the rate that a company is expected to pay on average to all its security holders to finance its assets, commonly referred to as the firm's cost of capital.

The terminal growth rate is a percentage that represents the expected growth rate of a firm's free cash flow.

Global Leaders Strategy 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)*
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

Brown Advisory Institutional claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Brown Advisory Institutional has been independently verified for the periods from January 1, 1993 through December 31, 2019. The Verification reports are available upon request. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation. GIPS® is a registered trademark owned by CFA Institute.

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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