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.

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THE HUNT FOR RED OCTOBER

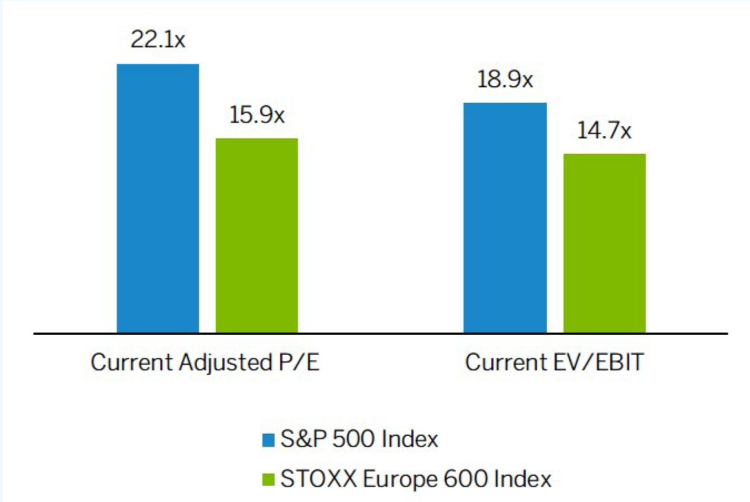
The fourth quarter of 2018 arrived with a jolt for investors with a sharp sell-off in global equity markets in October. One has to be incredibly careful to not find method in madness but to us, at least, the sell-off felt like a return to some kind of normality with corrections being a part of investing in equities. Indeed, at a team event in the summer we discussed the Game of Thrones-esque inevitability that '*winter is coming*' – given this realisation the seasonal timing of the equity market weakness verged on the ironic. Although the Global Leaders strategy modestly underperformed by -1.9% in October every sell-off is different and the latest episode felt indiscriminate. Despite Red October the strategy has outperformed its benchmark, the Russell Global Large Cap, by +4.4% year-to-date. We have written before about the growing impact that exchange-traded funds (ETFs) and passive investment strategies are having on the equity markets and we felt their presence in October. One perceived source of the correction was rising U.S. interest rates which prompted selling in companies' shares that were labelled as 'long-duration' assets. In the equity world, a 'long-duration' asset is code word for a company with a high valuation multiple but as we will discuss later shorthand techniques over-simplify the art of valuation. Against this backdrop, we should welcome dumb, passive, money selling assets based on lazy valuation approaches, as it should create opportunities for the long-term investor. In this context, it felt as though companies whose share prices had outperformed in 2018 were harshly punished with the only real motive being the previous outperformance itself. Indeed, the majority of our companies continue to generate free cash flow, the ultimate driver of value, in a manner that is entirely consistent with our long-term investment theses. In addition to this crucial point, we also take some heart from the downside protection that we feel the Global Leaders strategy has. Since inception to the end of September, we have enjoyed 74% downside capture with outperformance in 77% of the down months (monthly downside hit rate). Simply put the portfolio has historically captured fewer losses than the equity market in 77% of the down months during this period. Importantly, the monthly downside hit rate is not 100% – as mentioned not every sell-off is the same and we need to be careful not to make method out of the short-term madness. A string of data points is more instructive given our quality focus. In addition, we feel that the Global Leaders strategy remains excellent value trading on 4.1% FCF yield – at a discount to its benchmark trading on 3.7% FCF yield. We believe the strategy maintains its attractive attributes with superior and sustainable ROIC (31.2% vs 11.7%) and higher sales growth (9.8% vs 6.9%)[1]. In addition to these sense checks, our long-run practice of using a default through-cycle 10% cost of capital (WACC) in our discounted cash flow analysis should give us an added margin of safety in a rising rate environment – especially in a world where many of our peers have been using sub 8% costs of capital in the recent past. As 2018 draws to a close, we cannot rule out further turbulence in the equity markets and we will look to embrace inefficiencies where possible whilst remaining true to our beliefs and the investment process that expresses them.

PASSIVE PIGS IN INDEX POKES

As we frequently remind our investors, the Global Leaders sector and country allocations are primarily outputs of our stock-picking – we are more focused on how (business model) and where (end market economics) a company makes its money rather than the sector or country it is classified in. Currently 41% of the Global Leaders portfolio derives its revenue from the U.S., 27% from Europe and 29% from the Rest of World[2]. Although we are vigilant of the prevailing economic environment, we are not macro-economists and we feel that this is a fair composition given the shape of the world today. One question we frequently get asked is why do you have such a sizeable allocation to the U.S. when European markets are cheaper? The nub of this question stems from a cursory glance of the shorthand valuation multiples of the U.S. and European markets as you can see on the next page.

[1]Source: FactSet and Brown Advisory calculations. ROIC and FCF Yield show the average returns and due to data availability are as of 31 December 2017. Sales growth is the weighted average return as of 30 September 2018. Characteristics are shown vs the strategy's benchmark, the Russell Global Large-Cap Net Index.
[2]Source: Brown Brothers Harriman and Brown Advisory calculations. Geographic composition by country of revenue as of 30 September 2018.

Chart 1: U.S. vs European Valuation Multiples[3]



Regular readers of the Global Leaders investment letter will know that we take a cautious view of placing too much emphasis on shorthand valuation multiples as the key value drivers are embedded into a single number – especially growth, asset productivity (ROIC) and fade. Applying this approach to an entire market creates even more opacity as these variables are embedded for a myriad of different business models and the composition of different indices can have a hugely distorting impact on a single aggregate multiple. If one succumbs to this folly, it is tempting to deduce that the European markets, and ergo European companies, are cheaper than their American counterparts. At the company level, the reality is very different. We recently spent a week travelling across Europe, visiting numerous industrial and technology companies that we felt could have a number of the features that we require each Global Leaders investment to have. The trip was hugely helpful as it enhanced our understanding of a variety of different industries. One key reflection from our European tour is that the optical European valuation discount does not currently exist at the company level – especially for the good quality businesses that we are looking for. Perhaps the best illustration of this phenomenon is to step back from the shorthand valuation of multiples and look at what is being priced into different equity markets using reverse discounted cash flow analysis. In this approach we use analyst-derived consensus free cash flow forecasts for three years into the future and our default 10 year forecast period, 10% cost of capital (WACC) and 3% terminal growth rate to deduce what medium-term (years 4-10) free cash flow growth assumptions are currently being priced in by the equity markets. Using near-term consensus estimates and a standard framework, we are able to gauge the level of free cash flow growth that investors are baking into each equity price. This analysis reminds us of Warren Buffet's description of his teacher Ben Graham's famous voting machine analogy. In many ways a standardized reverse discounted cash flow framework can act as an excellent ballot box for investor expectations.

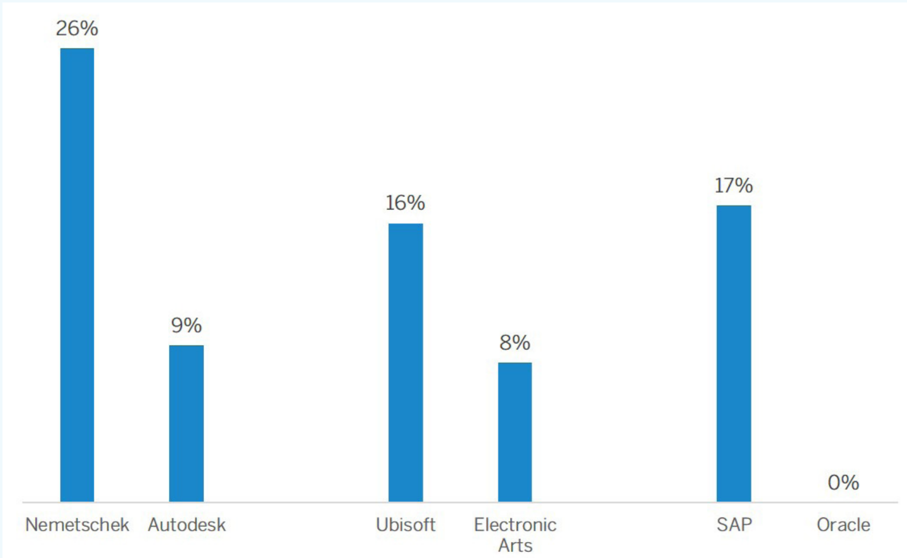
'In the short-run, the market is a voting machine - reflecting a voter-registration test that requires only money, not intelligence or emotional stability - but in the long-run, the market is a weighing machine.'[4]

Using this tool to compare a number of the European companies to their American peers, we gained some notable insights. One good example is German Architecture Engineering and Construction (AEC) software company, Nemetschek, that competes head-to-head with U.S. peer Autodesk. Both companies are exposed to similar levels of secular growth as the building process digitizes and have returns on capital in excess of 20%. Interestingly, when running the reverse DCF for both businesses, the medium-term (years 4-10) free cash flow growth that is being priced in is 26% for Nemetschek versus only 9% for Autodesk despite both having similar business models[5]. Running the same analysis on French video game publisher Ubisoft and its American competitor Electronic Arts yields similar results with Ubisoft having an implied medium-term free cash flow growth of 16% compared to only 8% for Electronic Arts[5]. One final example from the world of technology can be made by comparing SAP to Oracle – Germany's SAP has an implied medium-term free cash flow growth of 17% whereas 0% free cash flow growth is being implied at Oracle[5]! These examples serve as

[3]Source: Bloomberg. Data as of 30 September 2018.
[4]Source: Berkshire Hathaway Inc. Shareholder Letter 1993.
[5]Source: Brown Advisory estimates. Data as of 30 September 2018.

great reminders of the dangers of generalisaiton in investment with different market structures driving different shorthand valuation results. In each instance the European equity markets are pricing in substantially higher levels of free cash flow growth than the U.S. equity markets are for their American peers. As mentioned composition can have a big impact - in Europe technology only accounts for 5% of the STOXX Europe 600 versus 20% of the S&P 500 and the lower returning financial services sector account for 20% which is less than 14% for the S&P 500. As our reverse DCF analysis shows (see below) above-market European returning technology companies trade at a hefty premium to their prevailing indices and their U.S. peers. Like the Italian white truffle that is currently being harvested in the hills of Piedmont, European technology companies are highly prized and benefit from scarcity value that is reflected in their equity prices.

Chart 2: Market Implied 4-10 Year Free Cash Flow Growth[6]



In a world where passive investing is becoming increasingly popular '*caveat emptor*'[7] is more important than ever when considering investment decisions based on aggregate shorthand valuations. Indeed, the growth of dumb money that relies on shorthand approaches should provide significant opportunity for the long-sighted, company-focused investor. We continue to dig deeper and look to capitalize on inefficiencies that gross generalisations can provide. Whilst it is easy to cross-compare different markets at the high level, the reality is that corporate valuations can be wildly different and composition can create huge distortions. This reminds us of the historical precedent in the Middle Ages in England when meat was scarce but dogs and cats were plentiful. The unscrupulous merchant would sell what the gullible customer believed was a suckling pig tied up in bag, known as a poke. Frequently the unsuspecting buyer would open the sack and find that the real animal was not a plump pig but a dog or a cat – a distinctly less appetising purchase. In keeping with the English maxim, our investment process is designed to avoid the generalisation of today's investment world that can lead investors to buy the twenty-first century equivalent of a passive pig in an index poke.

Leaving the Middle-Ages behind we are grateful for your interest in the Global Leaders strategy and despite recent market turbulence we are encouraged by our company's long-term fundamentals and their ability to keep delivering outstanding goods and services to their customers. We believe that these qualities will drive long-term value for our clients and we look forward to updating you on our progress in early 2019.

The Global Leaders Team

[6]Source: BrownAdvisory estimates.
[7]Source: Latin translation 'let the buyer beware'.

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

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. One cannot invest directly in an index.

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