*For Marketing Purposes*

# Global Leaders Strategy

Investment Letter | December 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.*

**Mick Dillon, CFA**
*Portfolio Manager*

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## What Drives Intrinsic Motivation

In his book, *Drive*[1], Daniel Pink delves into what intrinsically motivates us to complete and master a task for no visible reward. Intrinsic motivation appears to emanate from a number of fundamental drivers which are important both individually and within a team. Financial rewards aside, we naturally seek work where we have autonomy over how we complete tasks, the possibility to master a skill and for the output to have meaning or purpose. In a knowledge-based investment role and hybrid working-from-home environment it is intrinsic internal motivation which keeps us reading the next annual report or trying to improve on our process. Knowledge accumulation is one goal but the possibility to better master our craft through practice and deliver meaningful results is an ongoing inspiration. On the flip-side, nothing is so demotivating as to spend considerable time and effort into understanding and modelling a company or deeply contemplating a checklist only to end up thinking the effort was just spinning one's wheels for no gain. This is where a danger of process without understanding or value can creep in; it undermines autonomy and deprives the output of meaning. We love our robust, measurable investment and capital allocation processes but without our team's connection and deeper meaning it is just process for process sake and it demoralises intrinsic motivation. With this at the back of our minds we recently had our 5th annual offsite which has become a focal point for reflection, improvement and motivation for the team, not to mention a great opportunity to socialise. "We can always get better" is a team catchphrase and our offsite is a great opportunity to define and refine our process and bring our minds back to why we live it.

One topic which we delve into every year is our thinking on business advantages, more colloquially known as moats. The canonical starting point is Michael Porter's five forces framework which transformed the business strategy world 40 years ago when first published in the Harvard Business Review in 1979[2]. We explored this when reading *Competitive Strategy*[3] as one of the first books covered in our book club. The five forces framework which was developed in physical asset heavy days still has much relevance today in our more digital world and is part of our investment checklist.

Our first checklist step is our moats framework. As we have developed our thinking over time we have expanded this to differentiate between absolute competitive advantages to prevent capital coming into an industry versus relative comparative advantages between participants already within an industry. After one offsite a couple of years ago we reduced the number of potential moats from six broad categories including economies of scale, intangibles, network effects etc. down to five as we felt that investment into research and development (R&D) or capital was only a temporary advantage based on size. In addition, we use our sustainable business advantage driver framework to uncover where we believe ESG factors are compounding one of these advantages.

1 *Drive: The Surprising Truth About What Motivates Us* by Daniel H. Pink
2 https://hbr.org/1979/03/how-competitive-forces-shape-strategy
3 *Competitive Strategy: Techniques for Analyzing Industries and Competitors* by Michael Porter

Please see the end of the letter for important disclosures.

One of our pre-reading books this year was *7 Powers*[4] by Hamilton Helmer which lead to some spirited debate as we delved into barriers to scale, moat formation, counter-positioning and different combinations of relative versus absolute advantages. Unravelling corporate motivation from being unable-to-enter versus unwilling-to-compete was another nuance deliberated. We seek competitively advantaged companies as long-term protection of our businesses' economics given our desire for longevity of return on capital. Where there is money being made it naturally attracts rivals hence we are cautious not to underestimate human ingenuity and the forces of competition. Yet, there have been hundreds of online retailers but only one Amazon. Nothing tests the theory of a moat harder than an all-out attack from rivals.

Often when researching companies, we struggle to neatly disentangle a business into our framework as we err on the side of caution rather than "double count" as two moats. In our last letter (link) we touched on how hard it is to beat scale and network effects when they are self-reinforcing. It is these "moat combinations" that can give a fortress business model and is one area we are deepening our understanding of both absolute barriers to entry and/or relative competitive advantages. For example, we don't need to separate brand and switching cost if they combine to keep rivals out. An outcome of having a lot of small advantages is that you can end up with ecosystem control (i.e., the value chain relies on you); for a stable long-term ecosystem value needs to be shared amongst the participants. Ultimately, the most important thing is that the moats protect the key economic drivers of our investment thesis.

## Reinvesting Inorganically

In our last letter (link) we discussed reinvestment rate as a powerful force for compounding. Our reasoning was mostly focused on organic or internal reinvestment as we believe it is the least risky way to compound our money in a fortified business. In reality management teams have more than one option and typically choose between five alternatives in their capital allocation decisions:

1. Invest organically into the business for growth via R&D or sales and marketing
2. Inorganic reinvestment a.k.a. mergers and acquisitions (M&A)
3. Pay down debt
4. Share buybacks
5. Dividends

Jonathan Chou, our U.S. Industrials analyst, challenged us recently that we were missing a big part of the value creation in his sector by not thinking openly enough about M&A driven growth, or specifically well practised serial acquirors. There are many examples such as Danaher, Roper, and Transdigm in the U.S., Rentokil in the U.K. and Assa Abloy in Sweden who have successfully executed a strategy of reinvestment into M&A in the industrials sector. One key difference in approach within industrials depends upon the level of post-acquisition integration and synergies. Another is end market specialisation or diversification across a portfolio of businesses. Roll-ups such as Waste Connections tend to tightly integrate in order to achieve scale synergies across similar services or products. Danaher is more akin to a platform where the firm's operating system, Danaher Business System (DBS), is ruthlessly implemented across all subsidiaries to drive operational excellence in varying end markets. We even see the holding company approach in Berkshire Hathaway or Investor AB with little centralised integration across a broad portfolio of unrelated businesses where one of the advantages of joining comes from access to more, lower-cost capital. The strategies and integration differ wildly but we believe all have created shareholder value in practice.

Twenty years ago (or more for Mick!) when we were starting out as bright-eyed analysts there were numerous academic studies demonstrating that most M&A in the prior thirty-odd years had failed to create excess value. It was the tail end of the deconsolidation and de-conglomerate push especially in the U.S. to unwind years of megalomania M&A into undisciplined and non-synergistic groups. Focus and specialisation were the key to great returns. We recently witnessed this value unlock yet again last year with the dismantling of United Technologies in the U.S. and subsequent value realisation at former subsidiaries Otis and Carrier.

4 *7 Powers: The Foundations of Business Strategy* by Hamilton W. Helmer

The above information is based on a Brown Advisory Global Leaders representative account and is provided as supplemental information. Please see the end of the letter for a GIPS compliant presentation and for important disclosures.

Interestingly, since the turn of the century, updated studies show that two things have changed and disciplined programmatic M&A appears to add value to shareholders. Firstly, strategy consultants refined how to systematically extract value from M&A and secondly, as the world has transitioned to digital based businesses with zero marginal cost of distribution, bolting more services onto a platform via M&A became easier to implement. McKinsey[5] and Bain[6] both now conclude that successful M&A is essentially about deliberate practice and undertaking many small acquisitions with a repeatable process. Nonetheless the statistics against large transformative deals remain overwhelmingly negative. Whilst small frequent purchases make sense (training, muscle memory, practice, repeatable process etc.) there are a couple of important caveats:

1. Deals must be small and done regularly to build up and take advantage of the "muscle memory" using a well-established M&A process to identify opportunities and execute post-deal integration
2. No "transformative" deals to improve a poor business, nor large ones without lots of prior M&A practice
3. Synergies must be clearly identified beforehand and progress measured to achievement – clear accountability, measurement and reviews on deal progress is essential
4. Never overpay – the golden rule for M&A is that the present value of future synergies are larger than the premium paid. Ideally we like to see acquisitions that are net present value positive excluding any theoretical revenue synergies.

Typically Global Leaders has shied away from inorganic driven investments as when we dig into the numbers you have to believe either in an ongoing pipeline of M&A opportunities – all at a reasonable price – to support the future growth or previously untapped revenue synergies which often fail to materialise. We typically put a low probability on this gold mine of cheap acquisition targets remaining untapped or at least unchallenged in a well-funded private equity world. Steve Schwarzman from Blackstone certainly believes in creating value from M&A. Interestingly it is not just industrials where inorganic reinvestment has worked, we think it has created particular value in vertical market software companies such as Tyler Technology, Constellation Software in Canada and Vitec Software in Sweden although arguably less well executed at Oracle.

We gave the example of Edwards Lifesciences' high internal reinvestment rate into mitral heart valves in our last letter but omitted that it has also done, what we view as, some incredible M&A. In fact its core value generating TAVR franchise came from buying Percutaneous Valve Technologies in late 2003. Edwards today is regularly reinvesting into M&A as it develops its mitral valve business. Or imagine our investee Estee Lauder & Co. without the MAC, Bobbi Brown and Jo Malone brands purchased over the years? Another portfolio example is Marvell Technologies. Under the guidance of CEO Matt Murphy over the past five years it has done a number of deals transforming a business which was over 80% consumer facing when he joined to less than 15% consumer oriented today. Cloud datacenter revenues are up from next to zero to over 20% and growing fast. Nobody gets a free pass but we have learnt to trust the Marvell management teams' judgement on M&A deals and their vision to reinvest both organically and via M&A to grow and develop their moats. They have created additional value through an ability to execute systematically on cost synergies and to deliver excess revenue growth from combined opportunities that were not previously available to either company independently – sometimes simply due to lack of scale. Increased scale boosted resources available for early reinvestment into process technology R&D such that Marvell was one of the first to launch products on leading-edge 5 nanometer semiconductor production technology. It is now quickly migrating all its relevant semiconductor designs to 5 nanometer, broadening its lead across the entire portfolio, and significantly accelerating adoption at a number of its recent acquisitions. This is the theory of a roll-up but it takes disciplined processes and measured execution to deliver it systematically in practice. We believe that Matt Murphy and team have delivered so far and Marvell today is a better business than when we first invested because of inorganic reinvestment.

5 *How lots of small M&A deals add up to big value*, Jeff Rudnicki, Kate Siegel, and Andy West, McKinsey Quarterly (July 2019)
6 *The renaissance in mergers and acquisitions*, Harding, Jackson, Leung, Meyer & Harris, Bain & Co 2014

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Historically it was hard to get large M&A through regulatory scrutiny so proposed deals were regularly blocked[7]. This has certainly changed over the past 25 years. The increasingly narrow interpretation of consumer harm as the only definition of monopoly in the U.S. meant monetarily "free" services such as Google's Maps have been given a free pass on much M&A (e.g. Waze). The switch to digital drivers with new sources of competitive advantage means the optimal price of a service can be zero – the U.S. anti-trust framework as interpreted under influential U.S. legislator, Robert Bork[8], has not been able to cope with the emergence of big tech. M&A has been value creating and moat reinforcing for all the big tech players whether it was service expansion via LinkedIn or GitHub for Microsoft or more Kronos-esque with Facebook devouring WhatsApp and Instragram. We wrote about regulation being the biggest risk to network based businesses in our 2Q 2017 letter (link). We are now witnessing the evolvement of new anti-monopoly regulation globally. China adopted explicit new anti-monopoly laws this year, the DoJ and FTC opened investigations into big tech in the U.S., there are multiple pieces of legislation in the U.S. Congress and Senate, and in Europe on top of GDPR we will soon have the Digital Services Act and Digital Markets Act enacted into law. All these could impact future cash flows at some of our investments so we are working with our investigative team to assess the risks carefully.

So what does all this mean for Global Leaders? Clearly capital allocation is where management quality and alignment with minority shareholders come into their own. Ultimately the job of a CEO is to allocate capital both internally as well as externally and we seek investor managers. We exited one investment a couple of years ago in part on the back of a CEO change and immediate reduction of their hurdle rates for M&A. We want to partner with those who fit with our investment philosophy and so long as we can see the pathway to 20% return on capital we are happy to back sensible deals at reasonable prices. We have certainly become more comfortable with serial acquirors and benefited from both organic reinvestment into R&D and inorganic M&A at a number of our companies so far.

## Investor Day 2022?

For the Global Leaders team our drive to get better is a never-ending goal, it isn't just a once per year offsite task. Why? It is motivated by our intrinsic curiosity and our commitment to deliver excellent investment returns over time. Our mantra of, "we can always get better", is driven by the desire to master our craft. In *Drive* Daniel Pink points out that mastery itself is never attained; it is a mindset. It is the process of becoming better via marginal gains in seeking mastery that leads to satisfaction; not mastery itself. We have discussed before how investing is a marathon not a sprint and small improvements over time can compound to make a big difference. We live this every day. We hope that you have had a healthy and safe 2021, it has been a tricky year for many in our communities. We certainly look forward to sharing more of our learning journey and experiences with you in 2022. Finally, we look forward to interacting with many more of you in person in 2022. We hope to hold an in-person investor day at some point soon. Hope is never an investment strategy but optimism and hope certainly work wonders as we await seeing you all again.

**Mick, Bertie and the Global Leaders Team**

7 *Goliath: The 100-Year War Between Monopoly Power and Democracy* by Matt Stoller
8 *The Antitrust Paradox* by Robert Bork

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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.

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.

# 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)* |
|---|---|---|---|---|---|---|---|---|---|
| 2020 | 21.0 | 20.2 | 16.0 | 16.9 | 18.1 | Five or fewer | N/A | 2,428 | 59,683 |
| 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

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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 gross 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 investment management fee for the Investor Shares of the Brown Advisory Global Leaders Fund (the Fund), which is included in the Composite, is 0.65% , and represents the highest fee charged excluding Advisor Shares. The total expense ratio for the Investor Shares of the Fund as of the most recent fiscal year end (June 30, 2020) was 0.90%. Further information regarding investment management fees and expenses is described in the fund prospectus and annual report.
9. The investment management fee for the Sterling Class B Acc Shares of the Brown Advisory Global Leaders Fund (the UCITS), which is included in the composite, is 0.75%. The total expense ratio for the Sterling Class B Acc Shares of the UCITS as of the most recent fiscal year end (October 31, 2020) was 0.92%. Further information regarding investment management fees and expenses is described in the fund prospectus and annual report.
10. 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.
11. Valuations and performance returns are computed and stated in U.S. Dollars. All returns reflect the reinvestment of income and other earnings.
12. A complete list of composite descriptions and broad distribution and limited distribution pooled funds is available upon request.
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