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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NEITHER A MARATHON NOR A SPRINT

The Global Leaders strategy reached its three-year anniversary in May 2018 and like any big birthday we thought it was an opportune time to reflect on our progress so far. Three years is an incredibly short space of time for the long-sighted investor and although we have succeeded in generating meaningful relative outperformance and absolute returns for our clients we feel it is premature to break out the champagne. There is much mythology and heuristical half-truths in the investment world. Seemingly like-minded peers often remark that investment is '*a marathon not a sprint*' which we think understates the nature of the activity. The reality is that investment is much more than a marathon for long-sighted investors. It is more akin to an odyssey – a life-changing journey in which we encounter temptation and danger on a regular basis. Only by keeping our eyes on the horizon and constantly appraising how we can get better (develop our processes) and do better (personally develop) can we hope to reach our destination. Accordingly, we felt that the end of this first chapter was a suitable time to share with our clients some of our most important reflections from the last three years as we strive to get better and develop as custodians of your capital.

PROCESS ENGINEERS

As we have mentioned previously human beings are uniquely disadvantaged for this activity. Human behaviour dictates that it is all too easy for us to succumb to our emotions and get sideswiped by mental shortcuts. The only way to have a fighting chance of success is by implementing a process that you believe will create value over the long term. Over the last three years we have realised two key points about any process. Firstly, a process has to facilitate investment success – it is a modus operandi that is frequently refined. In many ways, we subscribe to the Ray Dalio view that a good investor is like an engineer frequently tinkering with his or her machine-like process to achieve the optimal output. As Amazon's Jeff Bezos reminds us - '*Good process serves you so you can serve customers*'[1]. Accordingly viewing a process as a constantly evolving tool rather than a quasi-religious immovable set of rules is a baseline realisation for us. We constantly ask ourselves how we can improve this tool to get better whilst believing that our process is one of the few aspects of investment that we can control. In addition to this realisation, we have crucially delineated our investment process between two key components – stock selection and capital allocation. Stock selection is where the majority of investors focus their time when in reality capital allocation is more important. Stock selection is about picking winners and we feel that our checklist, which helps us whittle down the global universe, and tear down process, with its emphasis on primary research and cash flow have been hugely beneficial in this regard. As previously mentioned, investors often neglect capital allocation and we have refined our approach over the last three years to include probability (likelihood of return), factor and behavioural analysis. For the last of these, behavioural analysis, we use a third-party consulting firm to help us get better and with their help we have developed a number of behavioural rules to help us become better capital allocators. A constantly evolving process that focuses on both stock-picking and crucially capital allocation is one of our fundamental achievements over the last few years and like Dalio's engineer we will continue to optimise our process in the years ahead.

DON'T HATE THE MIRROR

We fervently believe that ego is one of the most dangerous and pervasive forces in investment. If left unchecked ego can accentuate some of our most damaging human behaviours and builds on the fight element of our fight or flight mechanism that resides in the brain's amygdala. Ego fosters overconfidence and suppresses cool objective thinking. Although this is hardly a new realisation for the Global Leaders team, we feel that we have increased our focus on self-reflection and self-improvement so that we can understand

[1]Source: *Amazon 2016 Letter to Shareholders*, Jeff Bezos.

our own weaknesses and develop. At our recent Global Leaders offsite we spent time not only discussing how we can improve our process but also how we can do better as individuals and as a collective. For our offsite we shared our (the managers Mick and Bertie's) psychological profiles and the results of our blind spot survey. In the survey we asked the team members to answer a selection of questions on our blind spots. The results were illuminating and actually stirred a temporary fight or flight reaction when we received the findings a week before the offsite. The dust had well and truly settled by the meeting and we were able to have a fruitful discussion about who we are as people and how we can individually and collectively do better. This exercise enabled us to reflect on our own characteristics and weaknesses and think about how we can improve. The next step in completing the circle is to analyse the rest of the team's profiles and blind spots. The aim is to be able to use complementary psychological skill sets to be able to solve different problems and eliminate our individual blind spots through the combined strength of the collective. The last three years have solidified our belief in the power of self-reflection as we attempt to improve as investors and disarm our own egos.

CLINGING TO THE RAFT OF OUTDATED BELIEFS

As investors we are regularly bombarded with a deluge of information and the long journey can create different memories in our minds. When we look at the large universe of global equities the temptation is to overly rely on past information in the form of heuristics. The reality is that the world is constantly changing – industries change, economies change and crucially customer preferences change. Accordingly, one realisation from the last three years is that we need to remain as objective as possible at all times. For us notable business model examples are financial exchanges, semiconductor manufacturers and video game publishers. We were mistakenly clinging to old beliefs when we started taking a fresh look at the video gaming industry. The outdated simplistic view is that the gaming publishers have hit-driven business models with boom-bust return profiles as expensive content is launched and then managed as it declines with age. Today's reality is that whilst blockbuster content is as important as ever the transition to a model where the games are consumed digitally through the internet, as opposed to a shrink wrapped disc, has extended the longevity of content with team-based gaming, periodic new downloadable releases and the development of rich ecosystems. In short, successful gaming companies have migrated to more valuable recurring revenue business models. This evolution has improved the customer outcome for the gamer with the evolution of different gaming ecosystems and a lower per-hour cost of content consumption. We currently hold Electronic Arts in the Global Leaders strategy and it serves as a great reminder of the importance of objectivity. Electronic Arts continues to evolve and has developed multiple recurring revenue ecosystems – most notably in FIFA's Ultimate Team mechanic. Although we like to think that we are objective and mentally agile reality often develops faster than our belief systems.

SUPPLY-SIDE SURPRISES

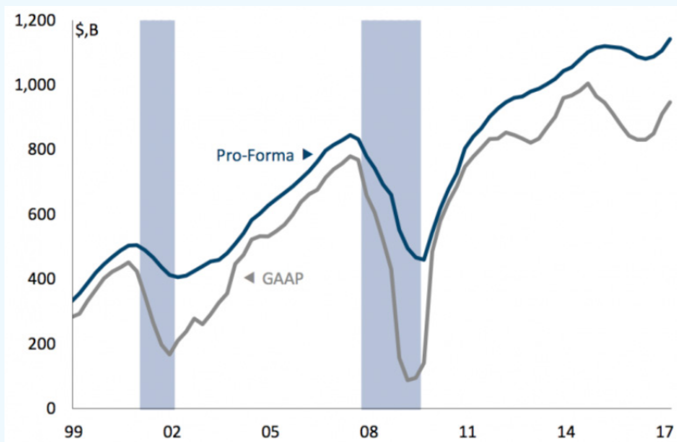
As many of our readers know, we look to invest in companies that deliver superior customer outcomes. Businesses that serve their customers in a unique way usually, but not always, get rewarded with superior economics of high sustainable returns and prodigious streams of free cash flow. The entrepreneurial spirit of mankind means that over time challenger companies will typically spring up and try and disrupt this great customer relationship and ultimately drive down returns for the first mover. This law of the corporate jungle analogy of excess returns being competed away is what we are taught in business school and it is true in many instances. The exception to this rule is when businesses develop barriers to entry or moats that insulate their franchises from aggressors. From iron ore in China to mortgages in the U.S., investors spend the majority of their time talking about demand trends. It is human nature to attempt to disrupt industries and one realisation of the last three years is – pay attention to the supply-side and focus on economic moats. One great example of supply-side disruption was our investment in Denmark's Novo Nordisk. Novo Nordisk is an outstanding company that specialises in producing innovative medicines for the treatment of diabetes and it is exposed to a market that is unfortunately set to grow exponentially in the decades ahead. Novo Nordisk boasts an outstanding return profile (89% 2017 ROIC[2]) and had historically delivered robust topline growth (10% average 2012-2014[3]). These characteristics were not lost on generic insulin manufacturers who decided to produce cheap insulin by copying Novo Nordisk's main rival Sanofi's product Lantus. The moral of the Novo Nordisk story is that high returns attract competition and economics can be disrupted if capital flows into an industry when economic moats (in this case the intellectual property of basal insulin) are breached. Novo Nordisk was a major detractor to the Global Leaders performance in 2016 and serves as an excellent reminder that supply-side shifts and breached moats pose significant risks to our clients' capital given our investment approach. Accordingly, we spend a considerable amount of time analysing competitors and any new investment has to have multiple economic moats (ideally more than two) in our Global Leaders moat framework.

[2]Source: Brown Advisory estimates
[3]Source: Company reports

CASH MONEY

It continues to amaze us how much focus the investment and corporate communities place on earnings. Whilst we understand the textbook logic, earnings are inherently flawed as they are based on accounting – someone's opinion of the financial health of a company. One of the other key realisations is that investors have given management teams almost unfettered freedom to adjust statutory results into what have become known as 'Non-GAAP' or 'adjusted' pro-forma earnings. This convention layers opinion onto opinion with management teams being able to tweak the very numbers they are supposed to be judged on. As you can see below the difference between adjusted pro-forma and reported GAAP income has increased over time which reinforces our view that free cash flow analysis is even more important than ever. In the emperor's new clothes world of adjusted earnings it is worth remembering that companies cannot pay dividends with earnings, they cannot pay down debt or other liabilities with earnings and they cannot buy other companies with earnings – these actions are only possible with free cash flow.

Chart 1:
Pro-Forma vs. GAAP Earnings S&P 500



Note: Trailing 4Q sum
Source: S&P, Thomson Financial, Compustat, FactSet and RBC Capital Markets

So while cash flow analysis is crucial another realisation is that it is important to look at the stream of cash flow that a company produces through net present value analysis rather than relying on near-term multiples that embed many features such as ROIC, reinvestment rate and growth into a single number. For our standard discounted cash flow framework we use a 10-year forecast period, a 10% weighted average cost of capital and a 3% terminal growth rate. Using these parameters you can see below that even for a company that does not grow its cash flows for 10 years, 85% of its value today is derived beyond the first two years in the future[4]. For a company that can grow its cash flows at a GDP-esque 3% on these assumptions, 88% of the net present value lies outside of the first two years in the future and for a 10% growth business it is 92%. The point of this simple analogy is that by focusing on near-term multiples investors are embedding multiple variables into a single number and assuming that those variables effectively last forever – it is essentially like assuming that the rest of your life is going to be like the next two years. Can you imagine living in 2018-20 or even 2007-08 forever? Short-term earnings multiples have numerous drawbacks – the only way to capture the entirety of any business's value creation profile is through discounted cash flow analysis.

Chart 2:
Percentage of Net Present Value Beyond Year 2

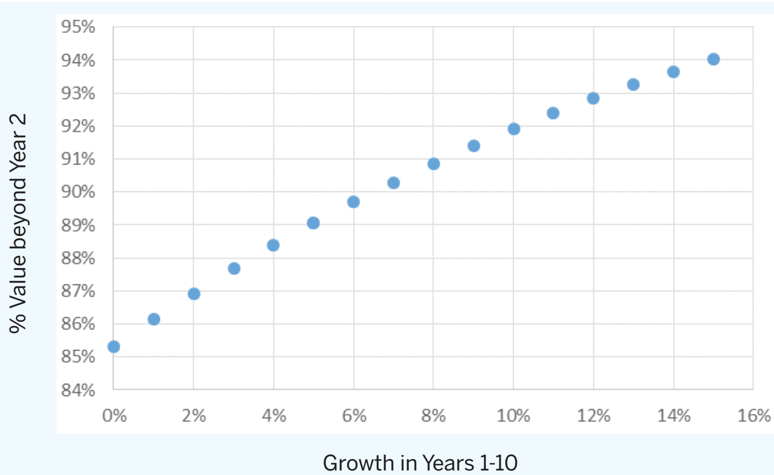


Chart 1 source: *This one chart shows why you should be skeptical of 'adjusted' earnings*, Sam Ro, Yahoo Finance, July 10, 2017.
[4] Source: Brown Advisory estimates
Chart 2 source: Brown Advisory estimates

ESG = GOOD BUSINESS SENSE

Over the last 3 years we have seen increased client interest in environmental, social and governance (ESG) focused solutions. This is a welcome development and one that dovetails with our own investment philosophy. In Global Leaders we look for companies that deliver a superior customer outcome and frequently their goods and services deliver benefits that we term 'sustainable business advantages'. A great example would be our Swedish industrial investment Atlas Copco that has put significant investment into developing compressors that consume 35% less energy than their peer group's products. These savings are considerable as 80% of the life-cycle running cost of a compressor is energy and the saving allows Atlas Copco to sell its products for a modest premium. This advantage is a triple win – a win for the customer, the company and the environment and we think that around 80% of our holdings have sustainable business advantages. We place the customer at the forefront of business analysis and we won't invest in any company that doesn't deliver a positive outcome. If any company is abusing its customer or damaging the environment or society and has questionable governance it will cease to exist over the long term. We are long-term investors who believe in customer relationships and the powerful economics of compounded returns. For us this means sustainable returns delivered through sustainable business models. We welcome the ongoing ESG focus and realise that it makes good business sense for both companies and long-term investors alike.

KEEPING IT REAL

We hope you have enjoyed a few of our key reflections from the last three years. Of course, it is not an exhaustive list and there have been many other topics that have influenced us along the way. Investment is the most fascinating discipline as our subject matter, companies and economies, is constantly evolving but what is equally as fascinating is our own evolution – as process engineers, investors and human beings. As the first chapter of the Global Leaders odyssey closes we remain as reflective as ever and focused on improving our processes and ourselves so that we keep delivering outstanding returns for our clients. We would like to thank our investors for their support and for placing their faith in us – as principal-minded fiduciaries we take this responsibility incredibly seriously. We look forward to updating you on our progress in the future and leave you with some evergreen wisdom from Peter Drucker that struck a reflective chord with us.

'*Follow effective action with quiet reflection. From the quiet reflection will come even more effective action*'[5].

The Global Leaders Team

GLOBAL LEADERS PORTFOLIO MANAGEMENT

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[5]Source: www.druckerinstitute.com

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.

Return on Investment (ROI) is a performance measure, used to evaluate the efficiency of an investment or compare the efficiency of a number of different investments. ROI measures the amount of return on an investment, relative to the investment's cost. To calculate ROI, the benefit (or return) of an investment is divided by the cost of the investment. The result is expressed as a percentage or a ratio.

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