

The Value of Value Investing

Fast Reading

- Despite the long-term track record of value investing, the space has been generally out of favor for the last decade versus its growth counterpart.
- Value stocks are companies trading below their intrinsic value, often with steady profits and strong fundamentals. These stocks tend to perform well during high inflation and rising interest rates due to their stable earnings and higher dividend yields.
- Brown Advisory's long-held value approach focuses on companies generating high free cash flow, maintaining capital discipline, and trading at discounted valuations. Our rigorous stock selection and thorough review process ensure investments align with our disciplined value criteria.
- Talen Energy and CRH plc are examples of value stocks held in our Small-Cap Fundamental Value and Large-Cap Sustainable Value strategies, respectively. Talen's transformation as a new entity following bankruptcy and CRH's re-positioning towards North American markets showcase how value can be found across different market caps, sectors and market conditions.

History has proven that timing markets is a daunting task. The preference for growth stocks in recent times has led to the virtues of value investing being largely overlooked. Yet, instead of arguing why value is now ripe for a comeback, perhaps it is more helpful to remind investors why value remains a proven investment strategy.

In simple terms, value stocks are defined as companies that are trading at a discount to their intrinsic value. These are often well-established companies with steady profits that tend to redistribute those cashflows back to investors in the form of dividends or share buybacks. The goal of value investing is finding stocks that are not only undervalued but also well-positioned to regain their fair value over time. In other words, these companies present a favorable risk/reward for investors.

While the identification of such outperformers is largely down to good stock selection, certain macro and market conditions can tilt the market in favor of value stocks. Historically, value stocks generally perform well during periods of high inflation and rising interest rates, as these conditions lead investors to seek out companies with strong fundamentals and stable earnings. The higher free cash flow yields offered by value stocks can provide a steady income stream that is especially appealing during times of economic uncertainty. Consequently, in an economic slowdown or during turbulent market conditions, value companies' reliable and durable business models can often present a stark contrast with their growth peers by offering greater stability and downside protection.

Finally, there have occasionally been prolonged periods of time where value stocks have fallen out of favor with investors. Such environments can enhance the valuation discounts of unloved stocks, particularly in relation to highly-valued growth stocks and create an even more compelling reason to include value within a portfolio.

What value means to us

The term "value" can undoubtedly mean many things to investors, including deep value and relative value approaches. Our value framework is different.

Our definition of value is centered on three distinct criteria. First is **Free Cash Flow**. We aim to invest in companies with attractive and durable free cash flow that generate returns through both good and bad times. Second, we seek **Capital Discipline**, focusing on a company's capital allocation and its capital structure. Finally, as value investors, we pay close attention to **Valuation**, seeking those companies that trade at a discount. We believe identifying stocks that meet this combination can deliver downside protection as well as provide optionality on the upside over time.

A big misconception about value investing is that it equates to a sacrifice in quality. In our view, the value universe is full of attractive, leading franchises that generate high levels of sustainable free cash flow with defensible market positions and ample financial flexibility. Such companies

exhibit capital discipline and trade at attractive valuations, which can lead to compelling risk-adjusted returns over the long term while providing a margin of safety for investors.

Another differentiated dimension of our approach is that we also scrutinize capital allocation. If a company is generating a lot of free cash flow, we explore what it is doing with that capital and how it is being allocated. Ideally, we look for companies where a large part of their excess cash generation will be distributed back to its shareholders either through recurring dividends or a share repurchase program.

At Brown Advisory, we aim to be highly discerning in terms of the value companies that make it into our portfolio. Rather than using a rule-based screening approach to filter through our stock universe, we set the bar higher. Our non-exclusionary stance encompasses the entirety of the value universe, leveraging our 50+ dedicated research team to look at companies one by one, evaluating potential new ideas with existing names in the portfolio to see which names will potentially fit. Engaging with management teams, customers, suppliers and other subject matter experts is a critical component of our value-added due diligence process, as is ensuring that all investment decisions are informed by solid data and clear insights about a company's prospects. Consistently applying these rigorous principles results in what we believe to be a differentiated perspective on how our investments can navigate the complexities of various market environments and achieve success over the long term.

CASE STUDY: Talen Energy¹

Value can be found across different market caps, geographies and segments. Sometimes a stock is simply overlooked, or there may be corporate actions on the horizon. Often, this is a result of the non-traditional way in which the company goes public.

Talen Energy is an independent power producer with a flagship nuclear plant in Pennsylvania. This business had previously gone bankrupt in 2022 after being over-leveraged and under-hedging its input costs under private equity ownership. The restructured entity, Talen Energy, emerged in 2023 with an appropriate capital structure and unburdened by many legacy environmental and pension liabilities. It had an attractive set of cash-generating assets and a motivated management team, but lacked sell-side coverage, and its valuation was attractive and also traded at a significant discount to other nuclear power-oriented utility companies.

Electricity pricing has been under significant upward pressure over the past several years due to several factors. Data center growth has been an increasingly significant user of base load

electricity. Talen has a long-term power purchase agreement with Amazon Web Services' (AWS) for a significant portion of the power from its nuclear facility. The re-shoring of industrial capacity, along with a continued trend towards electrification, has also increased demand. In addition, supply growth has been muted by a lack of new generation capacity, along with continued closures of coal-fired plants.

We believe that Talen incorporates many elements of a successful investment: a business model with a significant portion of the revenues tied to a long-term contract; a management team with a focus on building shareholder value through buybacks; and an attractive valuation. There is also the potential for a mergers & acquisitions (M&A) exit that would add to the success of this already attractive investment.

CASE STUDY: CRH plc²

Similarly misunderstood opportunities also exist in the large-cap space. Our rigorous attention to combing through the entire universe helps us identify differentiated opportunities.

Despite being one of the largest building materials company in both North America and Europe with a \$60bn market cap, CRH has remained somewhat under the radar. When our research process uncovered the company nearly two years ago, it only traded under a sponsored ADR, there was no direct US analyst coverage, and it was not included in any relevant indices. Today, CRH has moved its primary listing on the NYSE, and it features in the Russell indices.

CRH operates a unique, vertically-integrated model across the entirety of its value chain. There are inherent barriers to entry in the US heavy materials market, where CRH generates over 75% of its EBITDA. Its foothold in the US, coupled with an increasingly consolidating industry, has led to strong underlying pricing power for the business and consistent free cash flow generation. CRH's management has also been divesting slower-growth assets and redeploying proceeds into less cyclical, faster-growing markets, helping revenues grow at an 8% CAGR.

The company has persistently maintained discipline from a capital structure perspective, operating with limited balance sheet leverage. This has allowed the company to allocate an increasing amount of its excess free cash flow back to shareholders through dividends and share repurchases. Despite this, CRH still holds an attractive absolute valuation and a sizable discount to its closest peers.

Margin of safety

With high valuation multiples come high expectations. Value investing offers an attractive complement to growth strategies as its lower multiples provide a margin of safety for investors that can help enhance portfolio diversification.

At Brown Advisory, we offer a range of solutions across the equity spectrum, including value strategies. Our thoughtful approach to investing embeds patience, rigor and humility to ensure our strategies consistently pursue their objectives to deliver a first-rate performance for each and every client.

For further information about Brown Advisory's strategies and how our platform can meet your investment needs, please contact us or visit our website.



[1]Source: Talen Energy is a current holding in the Small-Cap Fundamental Value portfolio as of 03/31/2025 and was selected because the investment team believes it demonstrates the strategy's stated investment and value philosophy; It does not represent all of the securities purchased, sold or recommended for advisory clients.

[2]Source: CRH plc is a current holding in the Large-Cap Sustainable Value portfolio as of 03/31/2025 and was selected because the investment team believes it demonstrates the strategy's stated investment and value philosophy; It does not represent all of the securities purchased, sold or recommended for advisory clients.

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Terms & Definitions

Free Cash Flow is a measure of financial performance calculated as operating cash flow minus capital expenditures. Free cash flow (FCF) represents the cash that a company is able to generate after laying out the money required to maintain or expand its asset base. Free cash flow is important because it allows a company to pursue opportunities that enhance shareholder value. Without cash, it's tough to develop new products, make acquisitions, pay dividends and reduce debt. **Compound annual growth rate (CAGR)** is the rate of return that an investment would need to have every year in order to grow from its beginning balance to its ending balance, over a given time interval. The CAGR assumes that any profits were reinvested at the end of each period of the investment's life span. **EBITDA** (earnings before interest, taxes, depreciation, and amortization) is an alternate measure of profitability to net income. EBITDA attempts to represent the cash profit generated by a company's operations.

Small-Cap Fundamental Value

Investment Philosophy:

The strategy seeks attractive risk-adjusted returns by identifying and capitalizing on market inefficiencies within the small-cap value asset class. It focuses on companies with strong and consistent free cash flow, prudent capital management, and attractive valuations

Key Features:

- Utilizes a research-intensive approach combined with broad industry relationships and experience, and leverages sector expertise to uncover overlooked opportunities.
- Active management using bottom-up research and ongoing portfolio & risk management across a broad range of industries and sectors.
- Maintains a concentrated portfolio of high conviction positions, emphasizing financial flexibility and capital returns to shareholders through buybacks and dividends.

Strategy Profile:

- **Benchmark:** Russell 2000® Value Index
- **Inception Date:** 12/31/2008
- **Concentrated Portfolio:** Typically 60-80 holdings

Large-Cap Sustainable Value

Investment Philosophy:

The strategy seeks competitive risk-adjusted returns over a full market cycle by investing in a concentrated portfolio of companies that we believe have proven durable fundamental strengths, exhibit capital discipline, attractive valuation and a Sustainable Cash Flow Advantage (SCFA). Companies that exhibit SCFA are leveraging sustainable strategies through their People, Process and/or Product to drive enhanced financial performance over time.

Key Features:

- Integrated research approach combines fundamental and sustainable investment research to find attractive investments meeting sustainability and value criteria.
- Active management using bottom-up research and ongoing portfolio & risk management across a broad range of industries and sectors.
- Capital Discipline focuses on financial flexibility and capital returns to shareholders through buybacks and dividends

Strategy Profile:

- **Benchmark:** Russell 1000® Value Index
- **Inception Date:** 09/30/2022
- **Concentrated Portfolio:** Typically 30-45 holdings

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