U.S. Flexible Equity Fund

2018 Year in Review

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For the calendar year, the U.S. Flexible Equity Fund[1] returned -4.78% outperforming the -4.94% return for the S&P 500 Net Index.

The U.S. stock market was up and down throughout the year as positive and negative world headlines and company developments created volatility in the day-to-day share prices.

The first quarter saw this play out as early investor enthusiasm for the tax reductions and strong corporate earnings reports gave way to concerns over rising interest rates, inflation and international trade. Even with a slight pullback, equity prices reflected a favorable environment of general economic expansion, with low interest rates and high levels of business, and investor and consumer confidence resulting in generally high valuation levels compared to history. As we have noted in the past, positive sentiment can carry prices too far for unexpected events, or any erosion in the environment, to maintain.

The U.S. stock market rose in the second quarter, and positive and negative headlines of events in the world and company developments created volatility yet the averages finished higher than where they started. Finishing higher than they started should be the usual expectation for investors in U.S. equities, especially as time periods stretch from quarters to years and beyond. But many investors seem built to worry. When investors are making money, they worry that winning may turn to losing or that they are not making as much as the next person. When they are losing money, investors may worry that their losses will not stop. When investors are just holding steady, they may worry about finding another more exciting game to play. All this worry makes it hard to enjoy the ride in productive businesses when, in fact, that is exactly what most investors should be doing over long periods of time.

In the third quarter, the U.S. stock market hit new highs before falling sharply in the fourth quarter, resulting in a decline for the full year of 2018. The Fund declined more than the market in the fourth quarter but less than the market for the year. Since September, the mood of the market devolved from confident to concerned as focus turned to the length of time (ten years) since the last retreat in global economic activity. This concern was exacerbated by signs of slowing economic expansion, fears about the effects of higher interest rates (ten-year U.S. Treasury rates had more than doubled from their low of 1.4% in July 2016), a flattened and almost inverted U.S. yield curve (sometimes a signal of a recession to come), the U.S. election results (moving from one-party to two-party control in Congress), a 40% decline in the price of oil, U.S. trade tensions with China and a federal budget impasse leading to a U.S. government shutdown. Interestingly, these news items, or their ilk, have all happened before in modern economic and financial history. They are the "usual suspects" for a market retreat, especially after sustained gains, and all are subject to change.

Price declines are the offsetting mechanism when the markets sense a dimming, though far-from-dark, outlook. Since you cannot expect to get bargain prices when the news is thoroughly wonderful, a dose of bad news is helpful if you like to buy your goods on sale. The markets had a sale in the fourth quarter, reaching a 20% decline on Christmas Eve from the top of September 20, 2018. Whether 20% is the first or final wave of markdowns remains to be seen, but it gets our attention! Since we like lower prices when we put capital to work, we were more active buying than selling towards the end of the year, but because we did not have big holdings in cash and equivalents, you will see both purchases and trims in our activities. As stocks declined, bonds rallied strongly, which begins to relieve the pressure point of higher interest rates we noted above. At current interest rates and equity valuations, we continue to view stocks as more attractive than bonds, though obviously having some cash to add to equities when the markets go on sale is helpful.

Prices are set in the moment and reflect the meeting point of the most eager buyers with the most eager sellers. The most dramatic price changes occur when the urgency of one side causes the other to step back. Consequently, prices can swing far above or below prior levels or long-term values depending on the actual events and the perceptions, fears and dreams of investors. Markets can

[1]Brown Advisory U.S. Flexible Equity Fund B USD share class, net of fees.

be placid, but the potential for volatility always remains. On the other hand, human ingenuity, economic and business progress, and moderate rates of inflation are usually reflected in higher business values and, short-term volatility aside, securities' prices over time.

Earlier this year, we discussed "growth" stocks and "value" stocks, putting these labels in quotes because the stocks themselves do not innately and immutably possess these traits. Investors assign these labels to companies based on recent results and expectations for the future—or, in the case of style-based indices, largely by sorting the highest valuation stocks into the "growth" category and the lowest into the "value" category. In reasonably efficient markets, neither type of investment should be expected to permanently outperform the other, despite periodic long runs favoring one or the other. In recent years, "growth" stocks have outperformed "value" stocks, but in the fourth quarter, as markets retreated, "value" outperformed "growth" perhaps as "value," not having gained so much as "growth" previously, had less to retreat.

The U.S. Flexible Equity Fund contains both "growth" and "value" stocks as the market labels them, but we have neither a value nor a growth style of investing. We always want to get a lot for our money, so you should think of us first as having a value philosophy. However, we recognize that companies that can grow their sales and earnings while earning a strong return on invested capital offer more favorable long-term prospects to investors than those that cannot, so you can think of us as having a growth philosophy as well. We distinguish philosophy from style because value judgements are subjective, more so than objectively quantifiable.

Over the year the information technology and health care sectors contributed the most to the portfolio's return. In the information technology sector, **Mastercard** (+25.3%), **Microsoft** (+20.8%), **PayPal** (+14.2%) and **Visa** (+16.5%) achieved double-digit gains with Mastercard and Visa being the top contributors for the year and currently the largest holdings. Both companies posted strong quarterly results, increased their financial guidance and continue to invest in new initiatives to support and enhance their future growth. All health care holdings increased in value and **Edwards Lifesciences Corp.** (+35.9%) was the top third contributor for 2018. The company is a global leader in treating heart disease with a minimally invasive procedure for heart valve replacement known as transcatheter aortic valve replacement (TAVR). The stock price advanced after positive results from clinical trials for its next generation of the TAVR system were released. This should expand the potential market for its TAVR procedure as it demonstrated efficacy in a wider variety of patient segments.

The financials and consumer staples sectors were the biggest detractors to returns. The financials sector had a greater decline and a higher weighting than the S&P 500 Index. The consumer staples sector declined more than the index. Our financial stocks were generally lower for the year with **Charles Schwab Corp.** (-18.4%), **Wells Fargo** (-21.8%) and **Ameriprise Financial** (-36.8%) being amongst the bottom contributors for the year. Consumer staples holding, **Conagra Brands Inc.** (-42.0%), was a bottom contributor due to its disappointing results and its outlook for its recently acquired Pinnacle Foods business.

As referenced earlier, we put capital to work as lower prices emerged, making both purchases and trims throughout the year. We eliminated **Chipotle Mexican Grill Inc.**, one of the top contributors for 2018, in the third quarter. Its stock price recovered and its valuation expanded which we believe reflects a more positive view of the company given its changes to management. We eliminated the shares and reinvested the proceeds in companies with lower valuations and, in our estimation, better return potential. In the fourth quarter, the decline in **Amazon.com**'s share price gave us an opportunity to invest in the market leader with strong future growth prospects and excellent entrepreneurial leadership by founder and CEO Jeff Bezos. We added **DowDuPont** as a new holding in October and early November after its shares declined with the market sell-off. We see the merger of Dow and DuPont, two leading chemical and materials companies, under the leadership of Ed Breen as a positive development and believe that the company is making strides in rationalizing its cost structures. We believe its decision to divide the company into three more focused companies later in 2019 will further enhance its ability to create value.

The Flexible Equity team searches for investment bargains among long-term, attractive businesses with shareholder-oriented managers—those with productive assets and productive managers. These businesses should have or should develop competitive advantages that result in attractive business economics, managers who allocate capital well, a capacity to adjust to changes in the world and an ability to grow business value over time. Bargains in these types of stocks can arise for various reasons but are often due to short-term investor perceptions, temporary business challenges that will improve, company or industry changes for the better, or as-yet-unrecognized potential for long-term growth and development. Despite the occasional investment that will go awry and stretches when the general stock market is unrewarding, we are optimistic about the long-term outlook for equities of good businesses purchased at reasonable prices and our ability to find them.

Past performance may not be a reliable guide to future performance and you may not get back the amount invested.

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. An investor cannot invest directly into an index.