Global Leaders Strategy

QUARTERLY LETTER | FOURTH QUARTER 2017

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.

THE CRYSTAL MAZE

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'He who lives by the crystal ball is destined to eat ground glass.'[1]

The first few weeks of January always bring a smile to our faces as certain members of the investment community emerge from the woodwork and unveil their predictions for the year ahead. These soothsayers provide forecasts on a range of big-picture variables—global GDP growth, interest rates and the performance of key equity indices, amongst others. In most cases, these predictions are brimming with overconfidence as they are crafted by experienced individuals and their complex economic models. Such was the level of confidence that we even received an invitation to a conference in January hosted by a well-known investment bank that was entitled 'The Road Ahead.' The messaging here is that the path of the future is clearly defined like a major motorway, and just in case we were unclear as to the road ahead, the institution would provide the navigation. Such overconfidence can in turn create informational cascades that capture investor imagination and coalesce towards a consensus view. This year's New Year consensus seems to be built around one notable bearish investor's belief that we are in the 'melt-up' later stages of a bull market that could result in a bubble. Such a consensus can of course become a self-fulfilling prophecy, thanks to reflexivity, with some investors attributing the New Year rally to the fact that global markets are entering a melt-up phase. The real irony is that the term 'melt-up' hadn't featured in most investors' lexicons before the commentator published his paper. As ever, our minds work in two speeds and the temptation is to take the path of least resistance—System 1[2] mental short-circuits are hard to ignore.

The reason we smile when we read annual predictions is that we believe that when it comes to the big picture, the future is largely unknowable. We can look at present conditions of solid economic growth, accommodative monetary policy and current equity market levels and the temptation is to extrapolate these trends into the future. The reality is that the world doesn't work in a linear fashion due to you and me. Human behaviour is inherently unpredictable, and by making big-picture predictions, we are essentially distilling the behaviour of millions of humans down to a single measure—to us, this is incredibly dangerous. Investors, like most humans, have been described as suffering from a failure of imagination and nowhere is this failure more evident than when a consensus forms around a New Year informational cascade.

Given our views on big-picture predictions the obvious question is: *how do we deal with investing our clients' money in a world with an unpredictable future?* The first realisation is that when it comes to making big-picture forecasts based on a myriad of variables, you should trust no one—especially the experts. Having lived through the internet bubble of 2000/01, the Global Financial Crisis of 2008/09 and the collapse of the oil price in 2014, we have had firsthand experience of management teams sitting in their ivory towers surrounded by armies of overpaid advisors who succumbed to overconfidence, either in the status quo or the future, that resulted in significant capital destruction. Many managers suffered from a failure of imagining a collapse of credit conditions in 2008 or the disruption of the OPEC cartel that sent oil tumbling in 2014. Most oil company executives have multiple arrows in their backs from destroying value by allocating capital based on oil price predictions that proved to be wrong. The reality is that however charismatic managers are, their prowess for predicting the big picture is typically no better than yours or mine. Phillip Tetlock takes this idea further in his feted book *Superforecasting*, where he demonstrates that although we cannot accurately predict the future, we can use certain techniques to improve our forecasting abilities. What is more striking is that Tetlock shows that it is possible for novices to routinely beat acknowledged experts in the art of forecasting. The bottom line is that when it comes to big-picture predictions, you should trust no one—especially those who project any sense of certainty in what the future might hold.

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1 Ray Dalio, *Principles*
2 Daniel Kahneman, *Thinking, Fast and Slow*. Daniel Kahneman describes human thought as being the product of two systems: System 1 is fast, instinctive and emotional; System 2 is slower, more deliberative and more logical.

One of the reasons that big-picture forecasting is so difficult is that numerous variables are driven by numerous human behaviours. Although we keep one eye on the prevailing economic environment we are more focused on the small stuff—the fundamentals of each franchise in which we are investing our client's capital. Crucially, we like businesses that enjoy strong relationships with their customers and robust business models insulated by multiple economic moats. Implicitly this means that we are exposing our clients to fewer variables and therefore fewer forecasting errors than big-picture investors. One noteworthy example is our core holding Schindler, which generates the majority of its cash flow from servicing its installed base of over 1 million elevators. Although nothing is certain, Schindler's close relationships with its customers, its business model and associated contracts mean that management has reasonable visibility on a meaningful amount of its 2018 cash flow right now. By investing in Schindler, we feel we are isolating the investment down to a handful of risk factors. This is very different from a macroeconomic investor who has to make predictions on a variety of different factors such as interest rates, currencies and commodities—all with their own myriad of different and largely unpredictable inputs.

As well as focusing on the small stuff, we try to avoid fixating on accurate predictions by using scenario analysis. Each of our analysts produces multiple scenarios for each investment and what we are looking for is asymmetric upside skew, where the potential downside of an investment is dwarfed by the potential upside. This process combines a range of possible outcomes with different valuation techniques to develop a holistic picture of upside and downside. We look at each investment on a wide screen as opposed to through a telescope.

However tempting, we try and ignore the January big-picture navel-gazing. We prefer to develop a level of scepticism and focus on franchises with limited forecast variables to help us develop a picture of the risks to which we are exposing our clients. When it comes to big-picture predictions, we are reminded of Philip Fisher's evergreen comments that, despite the prevailing consensus in a soothingly benign environment, are just as true today as they were when he wrote them in 1958.

> *'The conventional method of timing when to buy stocks is, I believe, just as silly as it appears on the surface to be sensible. This method is to marshal a vast amount of economic data. However I believe that the economics which deal with forecasting business trends may be considered to be about as far along as was the science of chemistry during the days of alchemy in the Middle Ages.'*[3]

LEVERAGE: WHO WANTS TO LIVE FOREVER?

As the economic cycle broadens and equity markets rise, we continue to see signs of corporate behaviour that remind us of a decade ago when certain companies would releverage their balance sheets on the assumption that current conditions last forever. The lure of seemingly attractively priced debt can prove to be irresistible for some. The cornerstone of the concept of solvency is that an enterprise has adequate cash flow, or assets that can be easily turned into cash flow, to service its obligations and ultimately repay its creditors. We continue to be wary of the investment community's shorthand for solvency—net debt to earnings before interest tax, depreciation and amortization (EBITDA). This metric has been embraced by companies, creditors and investors, and conceptually at a high level it makes sense—EBITDA is a crude proxy for cash flow and the lower the ratio, the faster the indebted company can pay back its creditors. The real risk stems from the application of the measure in a positive economic environment where creditors and investors seem to have succumbed to a form of collective amnesia. The nub of the issue is that cash flow (and EBITDA) is typically more volatile than debt. When times are good, cash flow and EBITDA grow and maintaining a static net-debt-to-EBITDA ratio encourages companies to take on more debt. This behaviour is inherently pro-cyclical as when conditions deteriorate, cash flow and EBITDA come under pressure, which in turn increases the net-debt-to-EBITDA ratio. The real danger of using the net-debt-to-EBITDA ratio is that EBITDA isn't static and rising net-debt-to-EBITDA ratios can dramatically undermine the concept of solvency. This can lead to overly leveraged companies breaking the promises they have made to their creditors in their covenants and in some extreme cases this can lead to default, insolvency and equity destruction. Imagine a theoretical company with $100m of EBITDA that had borrowed $300m using a 3x net-debt-to-leverage ratio that is below its <4x covenant. In this example, it would only take a 25% hit to the EBITDA of $100m for the <4x net-debt-to-EBITDA covenant to be breached ($300m/$75m = 4x). Investors with long memories will remember that a 25% hit to cash flow is part of the economic cycle for many companies. As the CEO of a cyclical French industrial company retorted when we probed him about breaching his covenants in 2009: 'It wasn't that we had too

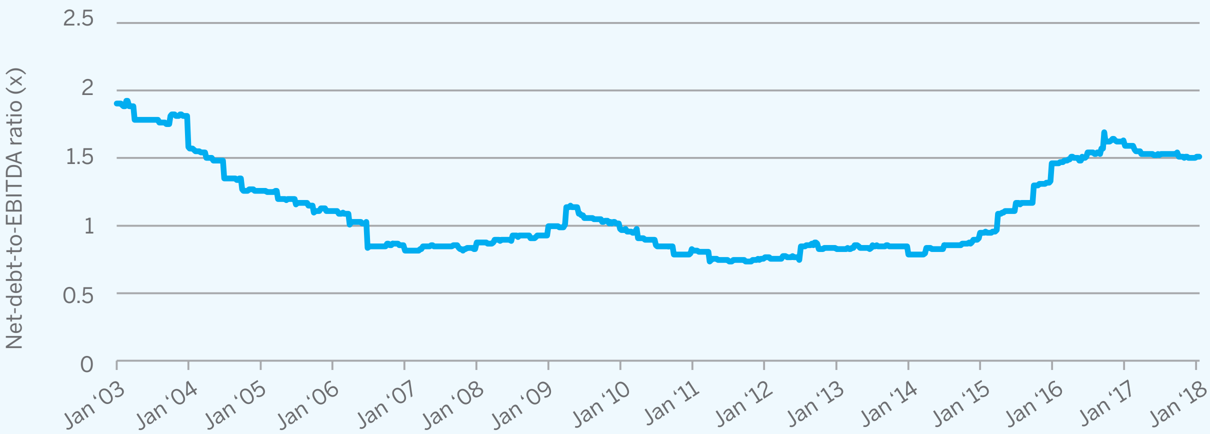
3 Source: Philip A. Fisher, *Common Stocks and Uncommon Profits*

much debt—we just didn't have enough EBITDA.' Managers and investors who forget the core concept of solvency, especially in the good times, do so at their peril.

U.S. LEVERAGE

The chart below shows the net-debt-to-EBITDA ratio (x) of the S&P® 500 Index excluding the financial services sector over the last 15 years.

From January 3, 2003 to January 19, 2018; weekly



Source: Bloomberg

As the good economic times roll on, many companies continue to add more debt to their balance sheets—frequently by indiscriminately buying back equity. The trend is particularly prevalent in the U.S. where the net-debt-to-EBITDA ratio for the S&P 500 Index has actually increased (see above) despite the rising weight of technology companies with net cash balance sheets, like Apple, in the Index. Buying back equity only makes sense when the equity trades at a discount to a company's net present value—it is quite alarming that very few managers actually understand and practice this philosophy. As Warren Buffett reminds us when it comes to capital allocation, "*What is smart at one price is dumb at another.*"[4]

Crucially, leverage has to be viewed in the context of a company's business model and cost base. Businesses that have weak relationships with their customers who consume their goods and services on an infrequent basis should avoid leverage—housebuilders and automotive manufacturers spring to mind. In addition, combining this relationship with a fixed cost base and high leverage can be a recipe for disaster. We prefer to invest in companies with healthy balance sheets and sustainable free cash flows that we believe can service their obligations in the direst situations imaginable. Such an approach to solvency not only gives our investments staying power, which is a prerequisite for compounding, but also gives them optionality to invest in moments of stress when most competing buyers are on strike. Incidentally, 50% of the Global Leaders nonfinancial holdings have net cash balance sheet positions as of December 31, 2017. Despite current conditions, investors need to remember that the net-debt-to-EBITDA leverage ratio is pro-cyclical for the majority of businesses over a full economic cycle. It is very much a case of 'caveat emptor' for investors considering franchises with weak customer relationships, high fixed costs and high net-debt-to-EBITDA ratios.

Although we think that a year is an incredibly short period of time in investment, the strategy succeeded in generating attractive relative and absolute returns for our clients in 2017. As we approach our three-year anniversary in May 2018, we are encouraged by our progress and believe that our disciplined investment process, long-term vision and ongoing self-reflection should stand our investors in good stead. We look forward to updating you on our progress in 2018 and the years to come.

The Global Leaders Team

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4 Source: Warren Buffet, *Berkshire Hathaway Letter to Shareholders 2011*

GLOBAL LEADERS PORTFOLIO MANAGEMENT

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

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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.

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