

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.

THE BONFIRE OF THE UMBRELLAS AND VOLATILITY VANITIES

In our last Global Leaders letter, we discussed the futility of making big picture predictions ('The Crystal Maze', Q4/17). The real irony is that the investment community's gravitation towards a melt-up scenario in January was swiftly followed by the return of volatility and equity markets sold off in February and March. The human propensity to extrapolate current trends into the future resulted in a rude awakening for investors who had assumed that the previous period of low equity market volatility would last. Like changeable weather, volatility is an accepted part of investment life and assuming that low volatility is permanent is a bit like burning your umbrellas in a heatwave despite the inevitability that cold weather will return at some point. This assumption is a huge big picture prediction and one that is fraught with danger. We continue to focus on the small stuff – the operating performance of our companies, safe in the knowledge that their underlying cash flows are significantly less volatile than the equity markets. This realization gives us confidence to exploit volatility and invest in companies that continue to satisfy their customers and grow their cash flows. We believe that this approach is the only way to make Global Leaders a portfolio for all seasons that will thrive over the long term regardless of what the elements throw at it.



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THE RIGHT STUFF

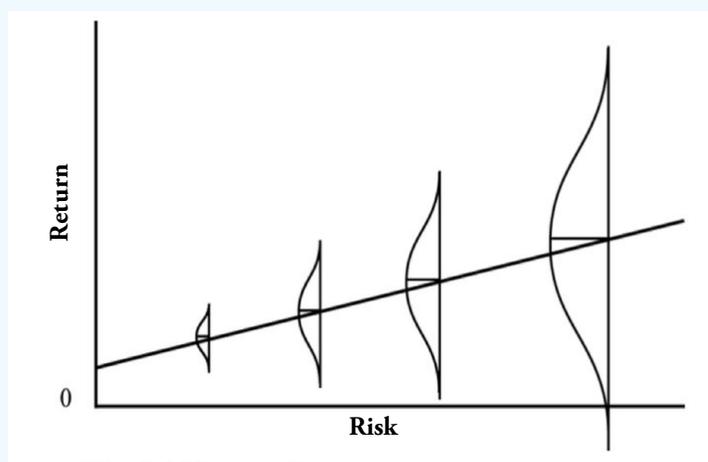
"What matters in life isn't how frequently one is 'right' about outcomes, but how much one makes when one is right. Being wrong, when it is not costly, doesn't count".¹

It continues to amaze us how little energy in the investment management world is dedicated to the subject of capital allocation. As budding analysts, we are taught in our CFA and business school classes to understand business strategy and value the streams of cash flow companies produce but very little time is dedicated to how much capital should be put behind each potential investment. Indeed, the investment banking and equity research industries have created business models that hinge on inundating investors with buy, sell or hold recommendations, in a frantic effort to encourage activity, but no help is given to the investor as to how much they should actually buy or sell. The truth is that while the investment world would like you to think that it revolves around the intellectually interesting activity of stock picking, there is another key discipline. Capital allocation is neglected by most investors yet it is arguably more important than picking winners and avoiding losers.

Our approach to capital allocation starts at the company level. Once we have identified an attractive investment we examine the base case return that we can expect over a three-year time period. Whilst the base case return assumptions that our analysts produce are suitably realistic, erring on the conservative side, they, like all estimates of upside or downside, crucially lack any indication of the likelihood that the return will be realised. To do this we use probability by subjectively applying three levels of risk weighting (50%, 67% and 75%) to each return largely based on franchise quality. This approach produces a risk-weighted IRR that incorporates both pay-off and probability. As an example consider two companies – an investment in company A is expected to produce a 50% return and an investment in company B is expected to produce a 40% return. When solely presented with this information Company A looks like the superior investment. Imagine that there is a 50% chance that Company A's return will be realised but a 75% chance that Company B's return will be realised. Under this scenario Company B actually has a superior probability-weighted return of 30% (40% X 75%) relative to that of Company A of 25% (50% X 50%). Although frequently overlooked the aim of the investment game is to get as much capital behind the opportunities with the best probability-weighted returns. When thinking about the difference between payoff and probability in our analysis we are reminded of J.L. Kelly's mathematical formula that uses probability to derive maximum theoretical exposure in betting and investment, and also Howard Marks's capital market line (see below). In Marks's

1 Source: Nassim Nicholas Taleb, 'Skin In The Game', Page 25.

analogy the important point is that higher risk doesn't always generate higher returns as the classic capital markets line would suggest. By taking higher risk investors should be rewarded by the possibility of high returns but this is frequently accompanied by a greater range of outcomes and a lower likelihood that higher returns will be realised. The range of outcomes is indicated by the bell shaped distribution that crosses the capital markets line with the key point being that you can take higher risk in the hope of generating higher returns but you can also lose a comparable amount of money. By incorporating probability into our capital allocation process we address not only projected investment returns but also the likelihood of that return being realised by our clients.



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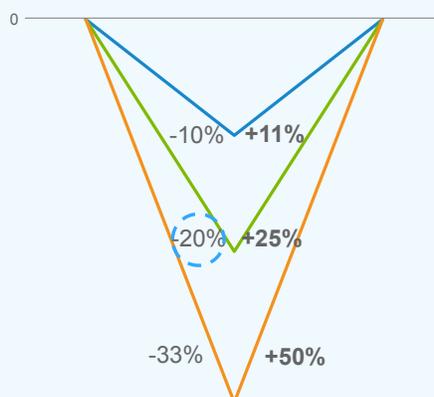
We are constantly looking to bring differentiated investments into the Global Leaders strategy. Given the complexity of thinking about the multiple cross correlations of a portfolio of 30-40 holdings the temptation is to form mental shortcuts about the level of differentiation that any new investment will bring to the strategy. In addition, it is very easy for investors to succumb to the 'shiny new toy' syndrome where after having completed extensive bottom-up work and mentally decided to invest in a new position we only view it in isolation rather than as part of a collection of different assets. To combat this failure of correlation imagination and the novelty of a new holding we use factor analysis to examine the cross-correlations between the new investment and what we already own. Like any tool, we have to constantly remind ourselves of the inputs that our factor analysis system uses, including its reliance on historical data, but it helps prevent us from sleep-walking into positions that we don't want. We find that this approach helps us ask crucial questions about the correlations within the portfolio, and focuses us on allocating capital to either new or existing investment that drive up the stock specific risk within the strategy.

As we have discussed in previous letters ('The Investing Ape' Q1/17), we realise that due to evolution human beings are uniquely disadvantaged for the activity of investment. Our survival instincts dictate that we are subject to a variety of behavioural traits that can destroy a client's capital if left unchecked. To combat the impact of the human dimension and to make us better capital allocators, we use a third party consultant as an investment coach. It still mystifies us to think that coaching is embraced in a variety of different disciplines from sport, to music and flying aircraft yet very few investors use an objective third party to help them get better. As already mentioned, capital allocation is something that investors are just meant to be good at. Like Roger Federer hitting backhands on the tennis court, our coach helps us become better capital allocators by ironing out the damaging impact of human behavior which can destroy capital values if left unchecked. We have extended this process to develop a number of behavioural rules. The best example is our loss aversion rule whereby any position that falls either 20% below where we bought it or 20% relative to the index results in an automatic review of the investment thesis leading to one of two actions - we are either adding to our position on a moment of unwarranted weakness or we are exiting as the thesis has shifted. The aim of this rule is to nip the impact of the most damaging behavioral trait of our industry, loss aversion, in the bud. Due to survival instinct we feel pain twice as much as pleasure meaning that most investors find it difficult to face up to the pain of a loser. This trait results in small losers becoming bigger losers which in turn can become huge losers that destroy significant amounts of value. The mathematics of losers is quite startling and frequently overlooked when investors look to mentally avoid the pain of loss. As you see below a 20% loss requires a +25% rebound and a 33% loss needs a +50% gain to get back to breakeven. In a world where equity markets have historically grown by 7% per

2 Source: Howard Marks, 'The Most Important Thing', Page 34.

year, the required rebound of a major loser relative to the opportunity cost of deploying that capital elsewhere can be significant. Despite this we fervently believe that equity markets can be inefficient over short time periods and some of the best investments can come from leaning into positions that have been weak due to Mr. Market's preoccupation with issues that are transient and largely immaterial to the long-term investor. The key is to be able to focus the mind on either buying more of a good thing at a better price or accepting that the goalposts have shifted and the investment thesis is corrupted. We believe that by developing a robust process for dealing with losers, which are an inevitable fact of investment life, we can preserve our client's capital by fighting the damaging effects of loss-aversion.

Percentage Gain Required to Compensate for Percentage Loss



Source: Brown Advisory

Capital allocation is the neglected side of investment and it is an activity that investors are naturally meant to be good at. By bringing probability, factor analysis and an objective coach to help us limit the impact of human behavior into our process we take capital allocation seriously. Like any good process it will keep evolving with the ambition that we continue to deliver great stock picking (having more winners than losers) and great capital allocation (having more capital in our winners than our losers.) In baseball terms this is defined as batting average (how often the batter connects) and slugging percentage (the effectiveness when he or she connects). The investment world continues to overly focus on batting averages over slugging percentages with the latter being arguably more important. With this in mind we will leave you with an evergreen quote from Michael Mauboussin that echoes Taleb's similar thought at the beginning of this piece. We hope that you are having an enjoyable and profitable 2018 so far and look forward to giving you a retrospective view of the Global Leaders journey in our three-year anniversary letter next quarter.

"Great investors recognize another uncomfortable reality about probability: the frequency of correctness doesn't really matter (batting average), what matters is how much money you make when you are right versus how much money you lose when you are wrong (slugging percentage). This concept is very difficult to put into operation because of loss aversion, the idea that we suffer losses roughly twice as much as we enjoy comparably sized gains. In other words, we like to be right a lot more than to be wrong. But if the goal is grow the value of a portfolio, slugging percentage is what matters".³

The Global Leaders Team

3 Source: Michael J. Mauboussin, 'Thirty Years: Reflections on the Ten Attributes of Great Investors', Page 9.

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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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.

Internal rate of return (IRR) is the interest rate at which the net present value of all the cash flows (both positive and negative) from a project or investment equal zero. Internal rate of return is used to evaluate the attractiveness of a project or investment.

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