Global Leaders Fund

2018 Year in Review

Brown ADVISORY
Thoughtful Investing.

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For the calendar year, the Global Leaders Fund[1] returned -3.09% versus -9.52% for the Russell Global Large-Cap Net Total Return Index. The Fund reached its three-year anniversary in May 2018 and has succeeded in generating meaningful relative outperformance. Since inception the Fund[1] has outperformed its benchmark by c.4% net of fees (7.07% versus 3.28% for the Index).

The Global Leaders Fund invests in market-leading companies from across the globe that deliver exceptional customer outcomes. We believe that companies that combine superior outcomes for their customers with strong leadership can generate high and sustainable returns on invested capital (ROIC), which leads to outstanding shareholder returns. This "win-win" firstly for customers and ultimately for shareholders is fundamental to us but is not easily achieved. We are long-term focused and look for franchises that can compound excess economic profit at above market growth rates for extended periods of time. We believe that a concentrated low-turnover portfolio of global leaders will produce attractive risk-adjusted returns for our clients.

We are bottom-up stock-pickers and invest in companies and management teams, not countries, economies or macro factors. We are primarily focused on how a company makes its money, its business model, and where it makes its money: the market that it sells its goods or services into. Accordingly our sector and country allocation is very much an output of the business models that we choose to invest in and the end markets they are exposed to. The Fund's regional gross revenue, which we think is a good indicator of the underlying economics of the Fund, is split 38% to North America, 25% to Europe and 32% to the Rest of World (which is predominantly Asia) as of year-end 2018. We are intently focused on the endmarkets that we are exposing our clients to and we continue to be active searching the four corners of the globe for special customer-focused companies that we feel are mispriced by the equity markets.

We believe that we have a very high-quality portfolio and offer downside protection as a key attribute to the Fund. The Global Leaders Fund has demonstrated a c.75% monthly downside hit rate (outperforming c.75% of time) in down months since inception. As an illustration the Global Leaders Fund[1] outperformed its benchmark by 6.43% in 2018 and it also outperformed in four of the five down months of the year (80% monthly downside hit rate). Our investment approach is built on lasting customer relationships that foster long-term structural growth, multiple economic moats, high and durable return profiles, bullet-proof balance sheets and cash flow based value – ingredients that we feel will stand our investors in very good stead.

The Fund continues to retain its quality bias with sector allocation primarily being an output of our stock-picking. Accordingly we continue to have no exposure to three sectors, real estate, utilities and energy, where we have been unable to find companies that satisfy our strict investment criteria. Performance during the year benefited from our stock selection in the financials and technology sectors. Conversely, communication services and healthcare were sectors that detracted from performance during the period. Our underweight to healthcare relative to the benchmark contributed to underperformance as it was the top performing sector in the benchmark. We have been very active on the research front in healthcare and have not found any companies that satisfied our investment process primarily due to valuation. We will continue looking for future investments in this area.

At company level the biggest positive contributors for the year were **Microsoft** (+20.8%), **Edwards Lifesciences** (+35.9%) and **Mastercard** (+25.3%). The biggest detractors were **eBay** (-32.4%), **Ctrip.com** (-36.6%), and **Hoshizaki** (-25.5%).

Microsoft was the biggest positive contributor for 2018 as the company reported strong earnings throughout the year with continued progress in its cloud-based offering. **Edwards Lifesciences** shares outperformed during the year, as underlying market demand growth for transcatheter aortic valve replacement continues pacing ahead of initial expectations. **Mastercard** and **Visa** continue producing robust results as they benefit from the ongoing structural shift to the cashless global economy. **Safran**, the multinational aerospace company, was also one of the top contributors due to an encouraging operational performance during

[1]Brown Advisory Global Leaders Fund C USD share class, net of fees.

the year and a better-than-expected transition to its new LEAP engine.

eBay was the largest detractor for 2018 and we eliminated the holding from the portfolio following its lackluster results and decelerating gross merchandise value growth in the fourth quarter. It became clear to us that the competitive picture was deteriorating and the self-help initiatives which were being pushed through were having less impact on rehabilitating the business. **Ctrip** underperformed on macro concerns about China's economic slowdown. Over the long term, we still view it as an attractive investment, and we added to our position during the period. **Hoshizaki** shares were weak in the fourth quarter due to an internal investigation on conduct at one of its sales subsidiaries at the end of October. The lengthiness of the investigation caused us to lose confidence in management's control of the company and we decided to exit our investment. Other positions that detracted from the performance of the Fund over the year were **Electronic Arts** and **Cigna**. Electronic Arts' share price eased on gaming delays and the staggered release of its Battlefield V title. We remain attracted to the company's core sports franchise and topped up our position during the year. Cigna announced the acquisition of Express Scripts earlier this year, which caused concern among investors. We had already passed on Express Scripts in our review process. This acquisition changed our original thesis on Cigna, and we subsequently liquidated our position.

We believe that capital allocation is equally as important as stock selection, and we are pleased that our biggest weights contributed the largest amount of alpha for the year. In addition, we are happy that the portfolio outperformed its equal weighted portfolio—an accomplishment we also achieved in 2017.

During the year the Fund added new positions across the industrials, consumer discretionary, information technology and communication services sectors. Examples of two new investments are **Wolters Kluwer** and **Tencent**. **Wolters Kluwer** engages in the provision of professional information services and solutions. Having undergone the transition away from traditional print publishing content toward a digital offering, the company is now pursuing a solutions-based business model where products become ever more embedded in their customers' workflows, resulting in higher customer retention and organic growth. **Tencent** is China's largest gaming and social messaging platform. Tencent is among the most powerful two-sided network business models in the world and is in the early stages of addressing its largest long-term opportunities in advertising and payments. We bought Tencent in the third quarter on rare weakness based on transient issues. A mix shift from gaming to new platforms of advertising, payments and video is just ramping up, albeit at the cost of margins in the short term.

We have been diligently executing our investment process over the past year and this was particularly evident in the fourth quarter. Central to this process is our drawdown review, using our teardown framework that seeks to shield our investors from one of the most damaging behavioural traits in investment: loss aversion. The review is triggered once a company's equity either falls 20% from purchase or underperforms by 20% relative to the Fund's benchmark over a rolling 12-month period. During the recent bout of volatility, we conducted several drawdown reviews. The drawdown review has one of two outcomes: we either eliminate the position due to thesis violation or add to it if we believe that there is a moment of temporary inefficiency that we can exploit for our clients. As an illustration, we sold our position in eBay having conducted a -20% drawdown review. We felt that the investment thesis had shifted due to structural, competitive challenges on the supply side. This facet of our process hinges on our belief that markets can be inefficient over the short term and that they periodically serve up opportunities for the long-sighted investor. We continue to be very active on the research front and have a full research pipeline as we see more opportunities now than we have in the recent past.

As we exit 2018 and look forward to the fourth anniversary of the Global Leaders Fund 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.

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

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