

# Small-Cap Fundamental Value

## QUARTERLY STRATEGY UPDATE

Third Quarter 2018

### COMPOSITE PERFORMANCE(%)

	COMPOSITE GROSS OF FEES	COMPOSITE NET OF FEES	RUSSELL 2000® VALUE INDEX
3 MOS.	3.67	3.46	1.60
YTD	6.77	6.12	7.14
1 YR.	11.72	10.83	9.33
3 YR.	15.72	14.80	16.12
5 YR.	11.10	10.23	9.91
ITD (12/31/2008)	16.47	15.40	13.05

The composite performance shown above reflects the Brown Advisory Small-Cap Fundamental Value Composite, managed by Brown Advisory Institutional. Brown Advisory Institutional is a division of Brown Advisory LLC, and Brown Advisory Institutional is a GIPS compliant firm. Please see the end of this for a GIPS compliant presentation.

### REP. ACCOUNT CHARACTERISTICS

	SMALL-CAP FUND. VALUE REP. ACCT..	RUSSELL 2000® VALUE INDEX
Weighted Avg. Market Cap.	\$2.6 B	\$2.1 B
Weighted Median Market Cap.	\$2.6 B	\$2.0 B
Dividend Yield	1.8%	1.9%
Portfolio Turnover (3 YR Avg.)	34.1%	--

### REP. ACCOUNT TOP 10 PORTFOLIO HOLDINGS

SECURITY	% PORTFOLIO
Albany International Corp. CIA	4.7
Cash & Equivalents	3.9
Echostar Corp.	3.4
Simpson Manufacturing Co., Inc.	3.2
Extended Stay America, Inc.	3.1
Nexstar Media Group, Inc.	2.9
MRC Global, Inc.	2.6
McGrath RentCorp	2.6
Assurant, Inc.	2.4
Virtus Investment Partners, Inc.	2.4
<b>TOTAL</b>	<b>31.2</b>



**J. DAVIDSCHUSTER**  
Portfolio Manager



**MICHAEL POGGI, CFA**  
Associate Portfolio Manager

## Review & Outlook

The year-to-date rise in small-cap shares finally started to slow during the third quarter and especially during September, as investors considered whether robust U.S. economic trends would continue into 2019 and/or beyond. The small-cap value equity segment diverged from broader markets and from small-cap growth specifically. The divergence between small value and small growth was driven by several factors, notably the poor performance of financials/REITs relative to technology, health care and communication services.

Our strategy posted a solid quarter and outperformed its benchmark, the Russell 2000® Value Index. Within the quarter, the strategy's outperformance was generated mostly during August due to a strong earnings season. Despite outperformance in the first and third quarters, the strategy trailed the benchmark year to date as of September 30.

Investments in consumer discretionary and industrials were positive contributors. Expectations for many consumer discretionary companies have been lowered materially over the past several years. Solid results coupled with low valuations helped drive share prices higher for **DSW** and **Core-Mark**, and **Regis** performed well as it continues executing its franchising strategy. **Albany**, our largest investment, posted another solid quarter within its aerospace segment. Also within the industrial sector, **Continental Building Products** and **Simpson Manufacturing** benefited from stronger home starts, meaningful restructuring aimed at improving earnings and cash flow, and low capex requirements.

The health care sector was our biggest detractor. The broader sector within the Index performed well, but both of our health care investments posted negative results. **Magellan**, a relatively new investment, was down early in the quarter, after announcing higher initial losses than expected for its Virginia managed care contract and reporting lost business in its pharmacy management business. Providence Service also ran into some near-term margin headwinds; this weighed on its shares, as did the overhang of a large private equity investor.

Financials were another detractor for the quarter. Banks have been under pressure due to increased competition for both loan growth and deposits. One of our large investments, **Synovus**, announced a sizable acquisition. While the pro forma economics looked solid, it was certainly unexpected. Our expectation, along with the market, was that Synovus was a seller, not a buyer, and the shares reacted accordingly. We materially reduced our investment during the quarter.

There were a number of corporate actions during the quarter. In July, Brookfield announced that it was acquiring **Forest City**. The price was in line with previously rumored ranges. **KMG** also announced its sale to Cabot Microelectronics, and Farmers Capital closed on its sale to **Wesbanco**. We continue to evaluate Wesbanco and have been generally impressed with its business model and our interactions with its management team. Finally, Linn Energy effected its previously announced spinoff of **Riviera Resources**. Riviera holds the legacy collection of low-decline natural gas and oil reserves, along with a number of midstream assets. The parent retained the company's interest in the Roan joint venture, which in turn holds a large assemblage of undeveloped acreage in Oklahoma. After the spinoff, both pieces declined in value and were a modest headwind to performance.

We made three new investments during the quarter within the industrial, consumer and financial sectors. We also sold three other investments during the quarter. One of these was **Broadridge**, a company we had owned almost since our strategy's inception; for the last few quarters, Broadridge has been a source of capital as we gradually exited. We sold our investment in **Par Pacific** and reallocated the proceeds within the energy sector to an existing holding, **MRC Global**, an industrial distributor serving the energy sector. We also sold our remaining investment in **Culp**.

In September, GICS created a new "communication services" sector to replace the old telecom sector; the new sector mapping adds companies to communication services that use technology and telecommunications infrastructure to serve consumers. In the small-cap value space, this new sector includes satellite companies (**Loral**), media companies (**Nexstar**) and cable providers (**GCI Liberty**), but interestingly does not include **Echostar**, which serves the consumer broadband market. To be clear, we did not make any changes in the portfolio linked to this sector change. **B**

## Sector Diversification

- The telecommunications services sector was broadened and renamed Communication Services to include companies that facilitate communication and offer related content and information through various media.
- Our weighting in the industrials sector increased as we initiated on a new name, **CRA International**.

SECTOR	SMALL-CAP FUNDAMENTAL VALUE REP. ACCOUNT (%)	RUSSELL 2000® VALUE INDEX (%)	DIFFERENCE (%)	SMALL-CAP FUNDAMENTAL VALUE REP. ACCOUNT (%)	
	Q3 '18	Q3 '18	Q3 '18	Q2 '18	Q3 '17
Communication Services	7.06	2.94	4.11	7.79	7.78
Consumer Discretionary	13.98	9.59	4.39	12.42	10.03
Consumer Staples	2.13	2.53	-0.40	2.09	1.09
Energy	5.51	7.49	-1.98	6.12	4.98
Financials	29.69	28.19	1.50	30.18	28.71
Health Care	2.99	5.02	-2.03	3.28	1.91
Industrials	22.34	11.88	10.46	20.47	19.36
Information Technology	6.87	10.43	-3.55	7.14	10.60
Materials	1.15	4.46	-3.31	1.41	6.06
Real Estate	7.50	11.49	-3.99	8.43	8.85
Utilities	0.77	5.97	-5.20	0.68	0.62

## Quarterly Attribution Detail by Sector

- Relative performance by sector versus our benchmark was mixed; consumer discretionary, industrials and the communication services sectors were the strongest performers, while financials, health care and utilities were the weakest.
- In September, GICS broadened and renamed the telecommunications sector the communication services sector to include companies that facilitate communication and offer related content and information through various media.

SECTOR	SMALL-CAP FUNDAMENTAL VALUE REP. ACCOUNT		RUSSELL 2000® VALUE INDEX		ATTRIBUTION ANALYSIS		
	AVERAGE WEIGHT (%)	RETURN (%)	AVERAGE WEIGHT (%)	RETURN (%)	ALLOCATION EFFECT (%)	SELECTION AND INTERACTION EFFECT (%)	TOTAL EFFECT (%)
Communication Services	7.09	18.11	2.71	10.67	0.37	0.50	0.87
Consumer Discretionary	12.71	14.08	9.59	1.87	0.01	1.43	1.44
Consumer Staples	2.18	-7.50	2.62	-6.94	0.03	0.01	0.04
Energy	5.66	-2.16	7.24	-1.77	0.02	0.02	0.04
Financials	30.29	-1.63	28.52	0.74	--	-0.72	-0.72
Health Care	3.15	-19.08	4.86	7.55	-0.09	-0.95	-1.04
Industrials	21.79	10.14	11.67	5.98	0.42	0.88	1.30
Information Technology	7.03	2.56	10.70	0.58	0.04	0.13	0.17
Materials	1.24	3.04	4.40	1.36	0.02	0.01	0.03
Real Estate	8.17	0.66	11.80	-0.85	0.11	0.12	0.23
Utilities	0.67	0.92	5.89	3.48	-0.09	-0.01	-0.11
<b>Total</b>	<b>100.00</b>	<b>3.85</b>	<b>100.00</b>	<b>1.61</b>	<b>0.84</b>	<b>1.40</b>	<b>2.24</b>

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## Quarterly Contribution to Return

- Albany was our top contributor in the quarter after the company reported second-quarter results that exceeded consensus expectations. Both of its businesses performed well. The company's machine clothing business grew revenues 8%, its highest growth in over six years, and its aerospace business is ramping up faster than expected. Management raised its guidance for the full year.
- Core-Mark produced strong second-quarter results that beat both top- and bottom-line expectations. Management cited an improved convenience store environment that saw higher sales and in-store traffic. The company also showed better cost control driven by warehouse throughput improvements, which increased our confidence that Core-Mark can hit its 2018 profitability targets.
- DSW reported a strong quarter that beat consensus expectations on every metric. The company cited multiple recent top-line initiatives as well as strong inventory management as the key reasons for a 9.7% increase in same-store sales and a 300 basis point expansion in gross margins.
- Simpson Manufacturing was a strong performer after the company reported strong second-quarter results and reiterated all of its "2020 targets." Investors have been skeptical that Simpson's long-term targets are attainable, but we believe that its second-quarter revenue growth and margin expansion suggest that its targets are not out of reach.
- Continental Building Products performed well during the quarter in our view, as the company posted better second-quarter pricing and volume growth than its other publicly traded wallboard peers. Continental has been a beneficiary of U.S. corporate tax cuts, and we believe that management has done an excellent job deleveraging the company's balance sheet and returning excess cash to shareholders.
- Despite reporting strong results that exceeded investor expectations, **McGrath** shares corrected over the last three months as the market has become concerned about a potential cyclical peak for global industrial businesses. The resulting declines in its valuation multiple led to underperformance for the quarter.
- Magellan declined after the company lowered its 2018 outlook. The company's new Virginia contract is taking longer than expected to become profitable. Despite this, we believe that Virginia represents an opportunity for outsized EBITDA contribution, especially with a recent incremental contract expansion that can be leveraged over the existing infrastructure.
- MRC was a detractor to overall performance in the second quarter despite posting solid results and reiterating its guidance for the full year. We think investor expectations may have gotten ahead of themselves going into the company's earnings report, but we believe that our long-term thesis on MRC is firmly intact. We took advantage of the weakness to build out our position further.
- **Providence** declined due to pressure on the company's core business of nonemergency patient transportation. Near-term margins have been pressured by plausible and correctable issues, and demand for such services and care assessments remains strong. Management is working diligently on these issues, but the contractual actions required will take several quarters to enact. Management remains committed to the plan it articulated to drive increased shareholder value through consolidation of resources around core operations.
- While **Virtus** posted a solid quarter, concern around its market environment and its exposure to international/emerging markets investments weighed on its share price.

SMALL-CAP FUNDAMENTAL VALUE REP. ACCOUNT TOP FIVE CONTRIBUTORS				
TICKER	NAME	AVG. WEIGHT (%)	RETURN (%)	CONTRIBUTION TO RETURN (%)
AIN	Albany International Corp. Class A	4.91	32.46	1.41
CORE	Core-Mark Holding Company, Inc.	1.58	50.03	0.69
DSW	DSW Inc. Class A	2.09	32.24	0.58
SSD	Simpson Manufacturing Co., Inc.	3.42	16.92	0.56
CBPX	Continental Building Products, Inc.	2.66	19.02	0.51
SMALL-CAP FUNDAMENTAL VALUE REP. ACCOUNT BOTTOM FIVE CONTRIBUTORS				
MGRC	McGrath RentCorp	2.94	-13.44	-0.42
MGLN	Magellan Health, Inc.	1.25	-24.91	-0.41
MRC	MRC Global Inc.	1.95	-13.38	-0.34
PRSC	Providence Service Corporation	1.90	-14.35	-0.31
VRTS	Virtus Investment Partners, Inc.	2.78	-10.79	-0.29

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## Portfolio Activity

- **Charles River Associates** (CRA) is a services firm specializing in economic consulting. We like CRA's stable mid-single-digit top-line growth driven by both organic headcount growth and disciplined talent acquisition. With stable margins and improving cash flow, we expect to see continued capital returns through share repurchases and, to a lesser extent, a growing dividend. Finally, we like that it is trading at a discount to competitors, largely due to the fact that its accounting presentation makes its underlying value less clear to many observers, in our view.
- **Hudson Group** operates over 200 airport retail concessions, including more than 1,000 stores across 88 different transportation terminals in 24 of the 25 largest airports in the United States and Canada. Hudson became a public company in February 2018 after spinning off from Dufray AG, a global travel retail operator. Hudson has developed a strong competitive position and benefits from attractive secular growth trends in travel retail. We believe that Hudson is a likely acquirer of smaller U.S. food and beverage players, which could help it gain more scale in the category and position it for greater success in winning new concessions. After adjusting for \$170 million of net operating loss on its balance sheet, Hudson currently trades at 9.0x 2018 EBITDA, which compares favorably to both travel peers and traditional growing retail peers.
- **Waddell & Reed** (WDR) is an 80-year-old franchise that trades at a low valuation, generates meaningful cash and is using that cash to retire shares. Its brokerage business is being retooled to adapt to an open-architecture environment and to increase its profitability as a stand-alone unit. A new management team embarked on this effort several years ago, and the company is starting to reap the rewards. At current prices, WDR trades at 3.8x EBITDA and has over \$9 per share of net cash on its balance sheet.
- Linn Energy completed its spinoff of Riviera Resources during the quarter.
- We received shares of WesBanco during the quarter after the Farmers Capital sale closed.
- We eliminated our small remaining position in Broadridge. We owned Broadridge for many years (we first initiated our position in March 2010) and had been paring back the position in recent quarters due to valuation.
- Culp was sold due to valuation.
- WesBanco's merger agreement to acquire Farmers Capital closed during the quarter.
- Par Pacific was eliminated, as we were increasingly concerned with the company's capital allocation plans as well as the consistency of its free cash flow generation.

SMALL-CAP FUNDAMENTAL VALUE REP. ACCOUNT PORTFOLIO ACTIVITY		
ADDITIONS		SECTOR
CRAI	CRA International, Inc.	Industrials
HUD	Hudson Ltd. Class A	Consumer Discretionary
WDR	Waddell & Reed Financial, Inc. Class A	Financials
SHARES RECEIVED FROM CORPORATE ACTIONS		
RVRA	Riviera Resources, Inc.	Energy
WSBC	WesBanco, Inc.	Financials
DELETIONS		SECTOR
BR	Broadridge Financial Solutions, Inc.	Information Technology
CULP	Culp, Inc.	Consumer Discretionary
PARR	Par Pacific Holdings Inc	Energy
SHARES DELETED THROUGH CORPORATE ACTIONS		
FFKT	Farmers Capital Bank Corporation	Financials

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# Small-Cap Fundamental Value Composite

Year	Composite Total Gross Returns (%)	Composite Total Net Returns (%)	Benchmark Returns (%)	Composite 3-Yr Annualized Standard Deviation (%)	Benchmark 3-Yr Annualized Standard Deviation (%)	Portfolios in Composite at End of Year	Composite Dispersion (%)	Composite Assets (\$USD Millions)	GIPS Firm Assets (\$USD Millions)
2017	13.3	12.4	7.8	12.2	14.0	47	0.3	1,806	33,155
2016	23.4	22.4	31.7	13.0	15.5	46	0.3	1,660	30,417
2015	-4.6	-5.3	-7.5	12.3	13.5	45	0.2	1,186	43,746
2014	7.1	6.3	4.2	10.7	12.8	41	0.4	1,002	44,772
2013	42.0	41.0	34.5	14.1	15.8	32	0.3	693	40,739
2012	23.0	21.9	18.1	17.7	19.9	13	0.1	269	26,794
2011	2.9	1.9	-5.5	20.6	26.1	9	0.6	190	19,962
2010	28.3	26.7	24.5	NA	NA	Five or fewer	N/A	61	16,859
2009	25.7	24	20.6	NA	NA	Five or fewer	N/A	30	11,058

Brown Advisory Institutional claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Brown Advisory Institutional has been independently verified for the periods from January 1, 1993 through December 31, 2017. The Verification reports are available upon request. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation. GIPS® is a registered trademark owned by CFA Institute.

- \*For the purpose of complying with the GIPS standards, the firm is defined as Brown Advisory Institutional, the Institutional and Balanced Institutional asset management divisions of Brown Advisory. As of July 1, 2016, the firm was redefined to exclude the Brown Advisory Private Client division, due to an evolution of the three distinct business lines.
- The Small-Cap Fundamental Value Composite includes all discretionary portfolios invested in the Small Cap Fundamental Value Strategy. The strategy invests primarily in U.S. smaller market capitalization equities that generate high levels of free cash flow and are currently undervalued by the market. The minimum account market value required for composite inclusion is \$1.5 million.
- This composite was created in 2009.
- The benchmark is the Russell 2000® Value Index. The Russell 2000® Value Index measures the performance of the small-cap value segment of the U.S. equity universe. It includes those Russell 2000® Index companies with lower price-to-book ratios and lower forecasted growth values. The Russell 2000® Value Index is constructed to provide a comprehensive and unbiased barometer for the small-cap value segment. The Index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect value characteristics. The Russell 2000® Value Index and Russell® are trademarks/service marks of the London Stock Exchange Group companies. An investor cannot invest directly into an index. Benchmark returns are not covered by the report of the independent verifiers.
- The dispersion of annual returns is measured by the equal weighted standard deviation of portfolio returns. The composite dispersion is not applicable (N/A) for periods where there were five or fewer accounts in the composite for the entire period.
- Gross-of-fees performance returns are presented before management fees but after all trading commissions, and gross of foreign withholding taxes (if applicable). Net-of-fee performance returns reflect the deduction of actual management fees and all trading commissions. Other expenses can reduce returns to investors. The standard management fee schedule is as follows: 1.00% on the first \$25 million; 0.90% on the next \$25 million; 0.80% on the next \$50 million; and 0.70% on the balance over \$100 million. Further information regarding investment advisory fees is described in Part II A of the firm's form ADV. Actual fees paid by accounts in the composite may differ from the current fee schedule.
- The three-year annualized ex-post standard deviation measures the variability of the composite (using gross returns) and the benchmark for the 36-month period ended on December 31. The 3 year annualized standard deviation is not presented as of December 31, 2009 and December 31, 2010 because 36 month returns for the composite were not available (NA).
- Valuations and performance returns are computed and stated in U.S. Dollars. All returns reflect the reinvestment of income and other earnings.
- A complete list of composite descriptions, policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.
- Past performance is not indicative of future results.
- This piece is provided for informational purposes only and should not be construed as a research report, a recommendation or suggestion to engage in or refrain from a particular course of action or to make or hold a particular investment or pursue a particular investment strategy, including whether or not to buy, sell or hold any of the securities mentioned, including any mutual fund managed by Brown Advisory.

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Composite performance is based on the Brown Advisory Small-Cap Fundamental Value Composite and was obtained through FactSet®. All information and returns shown are as of 09/30/2018 for each period. Returns greater than one year are annualized. Past performance is not indicative of future results. Representative account characteristics and top 10 holdings were obtained through FactSet. This information is based on a representative Small-Cap Fundamental Value account and is provided as supplemental information. Account characteristics exclude cash and cash equivalents; top 10 holdings list excludes cash and cash equivalents. FactSet® is a registered trademark of FactSet Research Systems, Inc.

Sector diversification, attribution, top and bottom five contributors and portfolio additions and deletions source: FactSet. The portfolio information provided is based on a representative Small-Cap Fundamental Value account and is provided as supplemental information. References to specific securities are for illustrative purposes only and do not represent all of the securities purchased, sold or recommended for advisory clients. The security returns listed represent the period of when the security was held during the quarter. Total portfolio return figures provided reflect the sum of the returns of the equity holdings in the representative account portfolio due to price movements and dividend payments or other sources of income, and exclude cash. Performance figures may vary from actual portfolio performance, as calculations are based on end-of-day security prices and do not incorporate the actual cost basis or sale price of individual securities. Top five and bottom five contributors exclude cash and cash equivalents. Sector diversification and attribution excludes cash and cash equivalents. Sectors are based on the Global Industry Classification Standard (GICS®) classification system. GICS® is a registered trademark of MSCI and Standard & Poor's Financial Services LLC. The individual amounts shown for top ten holdings, sector diversification and quarterly attribution may not sum to the total amount shown due to rounding. Please see composite disclosure statement above for additional information.

### Terms and Definitions for Representative Account Calculations

All financial statistics and ratios are calculated using information from FactSet as of the report date unless otherwise noted. **Market Capitalization** refers to the aggregate value of a company's publicly-traded stock. Statistics are calculated as follows: **Weighted Average**: equals the average of each holding's market cap, weighted by its relative position size in the portfolio (in such a weighting scheme, larger positions have a greater influence on the calculation). **Weighted Median**: the value at which half the portfolio's market capitalization weight falls above and half falls below. **Portfolio Turnover (3 yr. avg)** is the ratio of the lesser of the portfolio's aggregate purchases or sales during a given period, divided by the average value of the portfolio during that period, calculated on a monthly basis. **Dividend Yield** is the ratio of a stock's projected annual dividend payment per share for the fiscal year currently in progress, divided by the stock's price. The **Average Weight** of a position or sector refers to the daily average for the period covered in this report of a stock's value as a percentage of the portfolio. The **Total Return** of an equity security is the sum of the return from price movement and the return due to dividend payments or other sources of income. Standard benchmark-, sector- and portfolio-level returns are the sums of the weights of each security multiplied by its return, summed and calculated daily and summed over the period covered by the report or by an otherwise-noted period. All of the above ratios for a portfolio are expressed as a weighted average of the relevant ratios of each portfolio holding, EXCEPT for P/E ratios, which are expressed as a weighted harmonic average. **Allocation Effect** measures the impact of the decision to allocate assets differently than those in the benchmark. **Selection and Interaction Effect** reflects the combination of selection effect and interaction effect. Selection effect measures the effect of choosing securities that may or may not outperform those of the benchmark. Interaction effect measures the effect of allocation and selection decisions (i.e., did we overweight the sectors in which we underperformed). **Total Effect** reflects the combination of Allocation, Selection and Interaction effects. Totals may not equal due to rounding. **Contribution To Return** is calculated by multiplying a security's beginning weight as a percentage of a portfolio by that security's return for the period covered in the report. Numbers may not total due to rounding.