

Global Leaders Strategy

INVESTMENT LETTER | June 2022



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.



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Freezing Order

We recently read Bill Browder's *Freezing Order* which is a continuation of his pursuit for justice from the bestselling book *Red Notice*.¹ We were fortunate enough to have Bill speak at one of our conferences in London (pre-Covid) and he is an exceptional human being. His patient dedication to righting injustice is a life lesson for us all. He has achieved some remarkable results due to unwavering persistency and immense personal reserves of resilience – the same skill that a successful long-term investor needs – which, as it happens, he is also! This got us thinking about the nature of patience as an investor, and more specifically about 'duration'.

The great freeze on free money has arrived with a jolt as inflation cleaves through the global economy. Central banks globally are raising interest rates and this is having a chilling effect on equities and bonds alike. Long duration assets are losing favour given higher rates act like gravity on the price of securities whose intrinsic value is based on cash flows generated further into the future. So, what is our equity duration and how much patience and resilience might we need?

Duration is typically described in one of two ways: the weighted average time to receive the cash flows or the sensitivity to change in interest rates. Clearly, they are intertwined. Delving into the academic literature on equity duration reveals a surprising lack of consensus on how to calculate it when cashflows received are not fixed coupons but change every year. There's also the gnarly issues of variable – hopefully growing – payments into perpetuity and embedded real options when most bonds have fixed terms and flat coupons. It's tempting to reconcile these issues by resorting to shortcuts. The most common shortcuts make all sorts of unrealistic simplifying assumptions to end up using either inverse dividend yield or inverse earnings yield (a.k.a. the price-to-earnings or P/E multiple). We remain highly dubious of price-to-earnings ratios as a proxy for value given earnings

¹ *Freezing Order: A True Story of Money Laundering, Murder, and Surviving Vladimir Putin's Wrath* by Bill Browder
Red Notice: A True Story of High Finance, Murder, and One Man's Fight for Justice by Bill Browder

can be distorted by “creative” accounting and the measure embeds a range of factors into a single number. We inherently prefer actual cash flow. Intuitively, it seems obvious that higher growth equities have cash flow further out and therefore longer duration. Implicitly this means they will have a higher sensitivity to rising interest rates too. But how do we calibrate this within Global Leaders?

Fortunately, we do 10-year forecasts for each investment and we can use our base case ranges to estimate probable future annual cash flows. We discount each year at our 10% minimum weighted average cost of capital (WACC) and some infinite series maths gives us the basis for some rough approximations.² Today the Global Leaders portfolio cash flow duration in real terms is in the 15 to 17-year range using this calculation. Hence, in aggregate we are more sensitive to rising interest rates than any 10-year bond but less than a 30-year 3% coupon government bond at par. This feels about right for our high return on invested capital (RoIC) and highly cash generative companies, although we would concede our cash flows estimates are less secure than either bond’s coupons. Nonetheless, we suspect our equity duration is shorter than many quality managers (and probably the vast majority of growth managers) due to our conservative double-digit discount rate.

One way to deal with regime changes in markets is to switch styles from quality equities over to “value” as they often have a shorter duration (we would argue harsher fade back to average too). In theory this is obvious. It’s the practical application where market timing fails. If one misses the top 50 days over 10 years one loses all the performance over that entire 10-year period – good luck getting those 50 decisions right! We are low turnover investors with an average 7-8 year holding period – nearly half the investments in Global Leaders have been with us since day one. We believe that giving our high RoIC compounders the opportunity to reinvest into their business will deliver value handsomely for our co-investors in Global Leaders over the long run.

What is the half-life of our WACC?

Another interesting book that we came across recently is the *Half-life of Facts* by Samuel Arbesman.³ In it he proposes that facts’ usefulness deteriorates with time. Specifically, economics has a half-life of 9.4 years after which knowledge becomes out-of-date. In other words, half of what we knew a decade ago as true is now obsolete, wrong or has been superseded. Longtime investors know that we have used a 10% WACC as our minimum discount rate since inception over seven years ago. It is the same for all sectors and all developed market countries globally (we use a minimum of 13% in emerging markets). This standardization is not any sort of claim on accuracy but it enables comparability across geographies and industries with an in-built safety buffer, especially when global interest rates were next to zero. The question becomes is 10% still appropriate? Or is its half-life over?

² <https://ssrn.com/abstract=3742725>

³ *The Half-Life of Facts: Why Everything We Know Has an Expiration Date* by Samuel Arbesman

We often joke that we can make a discounted cash flow (DCF) say whatever you want to hear and subscribe to the view that “*more fiction is written in Excel than in Word*”.⁴ DCFs are very dangerous if not used thoughtfully. Our standard valuation framework looks out over a 10-year cash flow forecast ending with zero % real growth in the terminal cashflow (technically we use 3% nominal terminal growth). If we take the starting base year cashflow and grow for 10% per annum across the 10-year forecast then we end up with 40% of the DCF value within our explicit forecast period and 60% in the terminal term. We expect some of our companies can grow cashflow faster than this, most will not. Yet even with our conservative assumptions, 60% of the value still lies outside the next 10 years. By this valuation method, the portfolio cashflow duration is in the 16 to 17-years range. A lower WACC, say 7 or 8% typically used in sell-side models, results in a longer cashflow duration with 70-75% of the value pushed beyond 10 years and consequently a lower margin of safety and higher sensitivity to changes in discount rate.

Arbesman reminds us that we can never be too sure about our cherished beliefs, we need to question and recheck every assumption. One good piece of news is that big concepts and central theories are only overturned infrequently, it is little ideas and “mesofacts” that churn more regularly. Anyone with children in school has probably witnessed this in action in the classroom! We have been asked many times recently about lifting our 10% discount rate as central banks globally embark on interest rate rises. How different to when we wrote the 2Q 2020 letter ([link](#)) and we were being asked about taking our WACC down! The last time U.S. rates were going up in 2018 we did debate raising our WACC hurdle when the Federal Reserve (FED) funds rate was at 2.5% and appeared to be going higher. We are nowhere near 2.5% base rates at the time of writing, but this could change quickly. Back then rising rates from 2.5% would have started to narrow our margin of safety but the FED paused and we ended up without any change. We have never considered lowering the WACC as it is *our* cost of capital – we want a double-digit return per annum so our implied discount rate is 10% minimum. We view our discount rate as the return we want as investors, it needs to be above the market return.

One astute investor pointed out that 3% terminal growth sounded low with inflation running at approx. 8% in the U.S. and U.K. We have not changed this either (yet). When we started Global Leaders, zero % real terminal growth in a low inflation world meant 3% nominal growth was conservative. We should always think in real terms, not nominal, but most especially during high inflation. A higher long-term inflation assumption will *ceteris paribus* increase duration, not shorten it. One could argue for increasing the WACC and a higher terminal growth rate given today’s inflation but these are offsetting and we don’t know how long inflation will persist. For now, we remain very careful before making any changes, just as we were when rates were falling, but we are cognizant that there is a half-life to our DCF assumptions and we remain open minded to updating them given changing economic circumstances.

⁴ <https://memex.naughtons.org/quote-of-the-day-307/26023/>

Our conservative valuation framework – be it the 10% WACC or the zero % real terminal cashflow growth after 10 years – means Global Leaders has a relatively low equity duration compared to other quality portfolios and so we believe it will be comparatively less sensitive to rising interest rates too. Nonetheless, equities and bonds struggle when rates rise and with our duration around 15 years we will still be more impacted than many “value” funds. Bond proxies – which worked well in a low rate environment – won’t suffer as badly as fixed-coupon bonds but, unless they can pass on all inflationary costs without a consequent fall-off in volume, then their inflation hedging is questionable. We have always been absolute cashflow value focused, our DCF’s guardrails are rooted in the slow-changing traits of mathematics. Maths has a long half-life and a DCF correctly done accounts for inflation. Relative valuation – be it short-cut multiples or free-cash flow yield relative to government 10-year bond yields – is like a mesofact. It is changing all the time and gives little protection in a rising rate environment.

But equities are an inflation hedge! Aren’t they?

The impact of inflation and rising interest rates is not univariate into discount rates. Warren Buffett – the man with a near monopoly on folksy investing quotes – wrote about the pernicious effects in his 1977 Fortune article: “How inflation swindles the equity investor”.⁵ There are a couple of impacts worth noting, all of which impact RoIC: financial leverage and higher debt servicing cost, working capital and capital expenditure (capex) costs. The obvious higher cost of debt means our lower leveraged companies – half the portfolio has net cash – should benefit comparatively based on their equity financing. Less financial leverage means our cashflow doesn’t get diverted to debt holders when refinanced at higher interest rates. The inflation impact into working capital is already being seen in a higher cost for inventory at a couple of portfolio investments and subsequently lower inventory turns which are a drag on invested capital and RoIC. Industry-wide moves to “just-in-case” from “just-in-time” inventory management only adds to the working capital drag. Another hidden impact comes as maintaining the current asset base becomes more expensive when the replacement cost of maintenance capex rises with inflation. Depreciation rises over time too. In short, overall capital intensity rises under inflation and asset turnover falls. High and sustained inflation distorts RoIC in another way too: the current nominal profits are boosted yet the historical capital invested stays at old book cost. For Global Leaders we are *relatively* well positioned as our investments on average have no financial leverage and low capital intensity, but all companies – ours included – will see higher capital costs on top of operating expense (opex) and labour wage hikes.

Conventional wisdom believes that equities are an inflation hedge. We wrote about inflation and the different types of pricing power our companies have in our recent letter ([link](#)) but lifting price without adding any new customer value risks an offsetting decline in volume as customers budgets’ are not infinite. Recurring, non-discretionary revenues become paramount. Higher inflation leads to false growth. Yes, we all see topline revenues grow faster but equities are not an inflation hedge simply

⁵ <https://fortune.com/2011/06/12/buffett-how-inflation-swindles-the-equity-investor-fortune-classics-1977/>

because nominal earnings go up when inflation rises. In the 1970s, accounting earnings kept up with inflation but underlying free cash flow did not! Protection of equity investor cashflow in real-terms is not guaranteed, it depends upon what type of pricing power you have (if any), price elasticity of demand and cost inflation in both opex and capex (look out for that delayed depreciation). There are many moving parts, not the least is expected vs unexpected inflation. Management can plan and price for expected inflation but unexpected inflation injects uncertainty and volatile inflation makes long-term planning and investment difficult. Ask any investor in emerging markets over the past 20 years – it is only *real* cashflow growth per share that creates value for shareholders. We expect that many of our investee companies will provide good inflation hedges, however capital intensive and highly levered companies will probably not. Inflation is a malevolent force for investors that can reap a whirlwind of destruction into equity fundamentals and valuation. In the long run we believe quality is one of the only defences.

Is stock-based compensation really a “non-cash” expense?

We appreciate many companies exclude stock-based compensation (SBC) as a non-cash expense in their definition of non-GAAP EPS⁶, yet as cash flow focused investors, we include all prior claims above us including SBC so any debate had largely passed us by. Well, not entirely. Having invested during the last tech boom 20 years ago, we vividly remember the uproar as the U.S. Financial Accountings Standard Board brought stock-based compensation into the definition of U.S. GAAP in 2002.⁷ We thought this discussion had been settled, SBC is a real economic expense which dilutes existing shareholders.

However, recent discussion amongst technology companies on repricing prior SBC grants due to falling share prices has reignited some debate about this as an expense. The argument is that as the war for talent in tech companies rages on, if prior employee SBC grants are underwater then staff attrition *may* go up because the cost of poaching rival’s staff goes down. To us, logic would suggest that if it is now easier to hire talent, then costs should be going down, not up. It’s all a little bit circular and most certainly self-serving (who doesn’t want to double-dip on prior comp?). It reminds us of the furor surrounding Steve Jobs allowing back-dated option grants at Apple in 2006, it might have been (questionably) legal at the time and make employees happy but it doesn’t look good ethically, and it is still a cost to other shareholders. Any repricing down or issuance of additional awards ultimately further dilutes external shareholders for work historically performed and previously paid for.

“If options aren’t a form of compensation, what are they? If compensation isn’t an expense, what is it?”⁸

⁶ Non-GAAP earnings are an alternative accounting method used to measure the earnings of a company. Many companies report non-GAAP earnings in addition to their earnings based on Generally Accepted Accounting Principles (GAAP).

⁷ FASB Statement #148, Accounting for Stock-Based Compensation—Transition and Disclosure, 15 December 2002

⁸ Warren Buffet in the Berkshire Hathaway 1992 Annual Report

SBC is an expense to shareholders – the real question is how to account for it. Firstly, we need to differentiate between *past* awards which show up in diluted share count and further dilution from *future* grants yet to be given out. It turns out errors show up in both regularly. Many data providers use basic share count to calculate market cap or enterprise value, not fully diluted. Next to zero sell-side analysts include a cost for future grants in their EPS estimates. But wouldn't it be double counting to use diluted shares and include a cash cost for SBC? No, not if you are thoughtful. SBC expensing for *past* awards and using diluted share count would be double counting. We need to differentiate between past and future awards; forthcoming dilution will diminish any future cash per share that we receive.

Additionally, as SBC is treated as a non-cash expense it is often added back to operating cash flow. This means a common management definition of free cash flow excludes SBC (free cash flow = operating cash flow less capex). The actual cash to shareholders will be lower. The inescapable lie of SBC as a non-cash expense is found in share buybacks. Is that buyback actually returning money to shareholders or just offsetting past SBC dilution? Often buybacks are set "at a minimum to offset SBC dilution". That cash is all going to employees. It is a chimera to the external shareholder and should be accounted for correctly as a cost before it disappears. An alternate method occurs when companies target an annual rate of dilution. Again, we should not double count with a future SBC cost and a future dilution rate. At least management here are open and honest about the future impact and that calculation is easy albeit often ugly in a DCF (a 2% per annum dilution doesn't sound like much...).

There is a reckoning underway for a lot of option-based technology and biotech companies – both in equity duration addressed in the first part of this letter and the actual cash per share dilution to shareholders in the latter (Snowflake at 100x revenues anyone?). It reminds us of Scott McNealy, then CEO of Sun Microsystems, venting his frustrations at an investor conference post-internet bubble bursting in early 2002 (see below). We have endeavoured to be thoughtful (more likely just boring and old fashioned) yet we have still taken the opportunity to invest in some exciting long-term technology companies too. Time will tell how well these work out. In the end we are fundamental, bottom-up, long-term investors and so long as we can find investments with double digit cashflow IRRs passing our 10% WACC hurdle then over time, our co-investors should do just fine.

"At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes which is very hard. And that assumes you pay no taxes on your dividends which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you

like to buy my stock at \$64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?" -- Scott McNealy⁹

London Value Investors Conference & the Global Equity Forum

We were fortunate to be invited to speak at the London Value Investors Conference (LVIC) and the Global Equity Forum recently alongside numerous well-informed investors. At LVIC we had Mick present our long-term thinking on what constitutes value (great customer outcome, high RoIC and high reinvestment rate, not cheap multiples nor mean reversion) and how we believe this is on show today at Taiwan Semiconductor but not at Intel. It was great fun, there were many good debates and we recommend attending. We had a good discussion with Simon Brewer from The Money Maze podcast (check out this episode with AKO founder and current Norwegian Sovereign Wealth Fund CEO Nicolai Tangen¹⁰) who was there to interview investing legend Joel Greenblatt. The Global Equity Forum at the Royal Institute was incredibly interesting and we presented our experience in incorporating behavioural economics in a practical way into fund management. They are two very different parts to investing but both necessary and certainly good opportunities for us to learn from other professionals. We hope to see you at both events – in person – in the future.

Thanks for reading,

Mick, Bertie and the Global Leaders Team



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⁹ <https://www.bloomberg.com/news/articles/2002-03-31/a-talk-with-scott-mcnealy>

¹⁰ <https://www.moneymazepodcast.com/podcast/nicolai-tangen-ceo-of-the-norwegian-sovereign-wealth-fund>

Disclosures

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ROIC is a measure of determining a company's financial performance. It is calculated as NOPAT/IC; where NOPAT (net operating profit after tax) is $(EBIT + \text{Operating Leases Due 1-Yr}) \times (1 - \text{Cash Tax Rate})$ and IC (invested capital) is $\text{Total Debt} + \text{Total Equity} + \text{Total Unfunded Pension} + (\text{Operating Leases Due 1-Yr} \times 8) - \text{Excess Cash}$. ROIC calculations presented use LFY (last fiscal year) and exclude financial services.

The internal rate of return (IRR) is a measure of an investment's rate of return. The internal rate of return is a discount rate that makes the net present value (NPV) of all cash flows from a particular project equal to zero. It is also called the discounted cash flow rate of return.

FCF yield is a measure of financial performance calculated as operating cash flow minus capital expenditures. FCF yield calculations presented use LFY and exclude financial services.

Free cash flow represents the cash a company generates after cash outflows to support operations and maintain its capital assets. Unlike earnings or net income, free cash flow is a measure of profitability that excludes the non-cash expenses of the income statement and includes spending on equipment and assets as well as changes in working capital.

Enterprise Value to Free Cash Flow (FCF/EV) compares the total valuation of the company with its ability to generate cash flow. It is the inverse of the Free Cash Flow Yield.

Total return is the amount of value an investor earns from a security over a specific period, typically one year, when all distributions are reinvested.

Brown Advisory Global Leaders Strategy 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)* |
|--------|-----------------------------------|---------------------------------|-----------------------|--|--|--|--------------------------|------------------------------------|------------------------------------|
| 2020 | 21.0 | 20.2 | 16.0 | 16.9 | 18.1 | Five or fewer | N/A | 2,428 | 59,683 |
| 2019 | 35.1 | 34.2 | 26.5 | 11.6 | 11.2 | Five or fewer | N/A | 731 | 42,426 |
| 2018 | -2.2 | -2.8 | -9.6 | 11.0 | 10.5 | Five or fewer | N/A | 303 | 30,529 |
| 2017 | 35.1 | 34.0 | 24.0 | N/A | N/A | Five or fewer | N/A | 77 | 33,155 |
| 2016 | -0.6 | -1.4 | 8.0 | N/A | N/A | Five or fewer | N/A | 38 | 30,417 |
| 2015** | 1.2 | 0.7 | -4.4 | N/A | N/A | Five or fewer | N/A | 24 | 43,746 |

**Return is for period May 1, 2015 through December 31, 2015

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1. *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.
2. The Global Leaders Composite (the Composite) aims to achieve capital appreciation by investing primarily in global equities. The strategy will invest in equity securities of companies that the portfolio manager believes are leaders within their industry or country, as demonstrated by an ability to deliver high relative return on invested capital over time. The minimum account market value required for Composite inclusion is \$1.5 million.
3. The Composite creation date is August 26, 2015. The Composite inception date is May 1, 2015.
4. The benchmark is the FTSE All-World Net Index. This index is a free float market cap weighted index representing the performance of the large & mid cap stocks from the FTSE Global Equity Index Series. The Index covers Developed & Emerging Markets. Base Value 100 as at December 31, 1986. "FTSE®", "Russell®", "MTS®", "FTSE TMX®" and "FTSE Russell" and other service marks and trademarks related to the FTSE or Russell indexes are trademarks 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.

5. As of January 1, 2019, the Composite benchmark was changed from Russell Global Large-Cap Net Index to the FTSE All-World Net Index. The change was applied retroactively from the Composite inception date. The Russell Global Large-Cap Net Index was decommissioned as of December 31, 2018 and is no longer published.
6. Composite dispersion is an equal-weighted standard deviation of portfolio gross returns calculated for the accounts in the Composite for the entire calendar year period. The composite dispersion is not applicable (N/A) for periods where there were five or fewer accounts in the Composite for the entire period.
7. 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: 0.80% on the first \$50 million; 0.55% on the next \$50 million; 0.45% on the next \$50 million; and 0.40% on the balance over \$150 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.
8. The investment management fee for the Investor Shares of the Brown Advisory Global Leaders Fund (the Fund), which is included in the Composite, is 0.65%, and represents the highest fee charged excluding Advisor Shares. The total expense ratio for the Investor Shares of the Fund as of the most recent fiscal year end (June 30, 2020) was 0.90%. Further information regarding investment management fees and expenses is described in the fund prospectus and annual report.
9. The investment management fee for the Sterling Class B Acc Shares of the Brown Advisory Global Leaders Fund (the UCITS), which is included in the composite, is 0.75%. The total expense ratio for the Sterling Class B Acc Shares of the UCITS as of the most recent fiscal year end (October 31, 2020) was 0.92%. Further information regarding investment management fees and expenses is described in the fund prospectus and annual report.
10. 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, 2015, December 31, 2016 and December 31, 2017 because 36 month returns for the Composite were not available (N/A) and the Composite did not exist.
11. Valuations and performance returns are computed and stated in U.S. Dollars. All returns reflect the reinvestment of income and other earnings.
12. A complete list of composite descriptions and broad distribution and limited distribution pooled funds is available upon request.
13. Policies for valuing investments, calculating performance, and preparing GIPS Reports are available upon request.
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