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Manager Q&A: **Mick Dillon and Bertie Thomson, Global Leaders Strategy**

Mick Dillon is a seasoned global investor who has witnessed his share of both gradual and rapid change around the world. But the unpredictability of the past two years – from global conflict to Brexit to pivotal elections in the U.S., U.K., Italy and France – can test the mettle of even the steadiest hands.

Indeed a host of macro-economic and political events have impacted global markets since Mick Dillon and Bertie Thomson launched the Brown Advisory Global Leaders strategy. However, this duo strives to keep it simple by focusing on what they believe is the constant that cuts through macroeconomic noise: great companies producing shareholder value by delivering a special outcome to their customers.

Mick explains, "Companies stand out by providing an exceptional and unique customer experience, which we believe leads to a high return on invested capital". This is not only his belief, but empirically proven through a McKinsey study which found that companies generating high ROIC are also likely to outperform in the long-term. Companies generating ROIC of 25%+ in 2003 sustained that level a decade later 83 percent of the time (*see Figure 1 on page 3*).

Beyond that indicator, the managers look for companies with three other qualities: solid fundamentals, strong leadership and reasonable valuations. Due to these high standards, less than one percent of potential investments in developed and emerging markets are suitable for the portfolio.

This quality bias gives the team conviction in its holdings. They have only replaced seven to eight names in the portfolio per year since its 2015 inception, resulting in portfolio turnover well below peers and holding periods long enough to realise the potential of the companies in which they invest.

MICK DILLON, CFA
Global Leaders Portfolio Manager

BERTIE THOMSON, CFA
Global Leaders Portfolio Manager

IN THEIR OWN WORDS...

Q: The global equity market euphoria year-to-date seems to know no bounds; how do you feel about valuations in this environment?

BT: This question is at the front of many investors' minds and it is clear that volatility is low and aggregate equity market valuations are above historical averages. As a result of the 'hunt for yield', we believe several sectors such as consumer staples, telecoms, utilities, and real estate have become overly stretched. Our performance was particularly impacted in the second half of 2016, having a zero weighting in three of these four sectors and an overall dividend yield below our benchmark Russell Global Large Cap index. But we have avoided these areas intentionally while some of our peers have embraced them. We think in absolute terms, valuing each investment on its merits. We see value in companies with a high return on invested capital (ROIC) and sustainable growth but these can have low or zero dividend yields. Pricing equities relative to bonds only makes sense if you think bonds are cheap. While this did not prove out in our results in 2016, we are boosted by year-to-date performance and feel confident in the long-term prospects for our portfolio.

MD: I would add that we prefer enterprise value of a company divided by its earnings before interest taxes (EV/EBIT) and free cash flow yield as shorthand valuation approaches rather than price-to-earnings multiples. With this in mind, the Global Leaders strategy has an aggregate projected median EV/EBIT multiple of 16.5x which is a modest premium to its benchmark of 14.0x. Using free cash flow yield, the premium is almost indistinguishable with the strategy trading on a historic median 4.4% yield compared to the global equity market which trades on 4.6%. For this modest premium our investors are getting close to double the sales growth (8.2% vs 4.3%) and more importantly double (17.9% vs 8.8%) the ROIC of the market.

Q: Given this continuation of an upward market trajectory, are you still able to find new investments that meet your criteria?

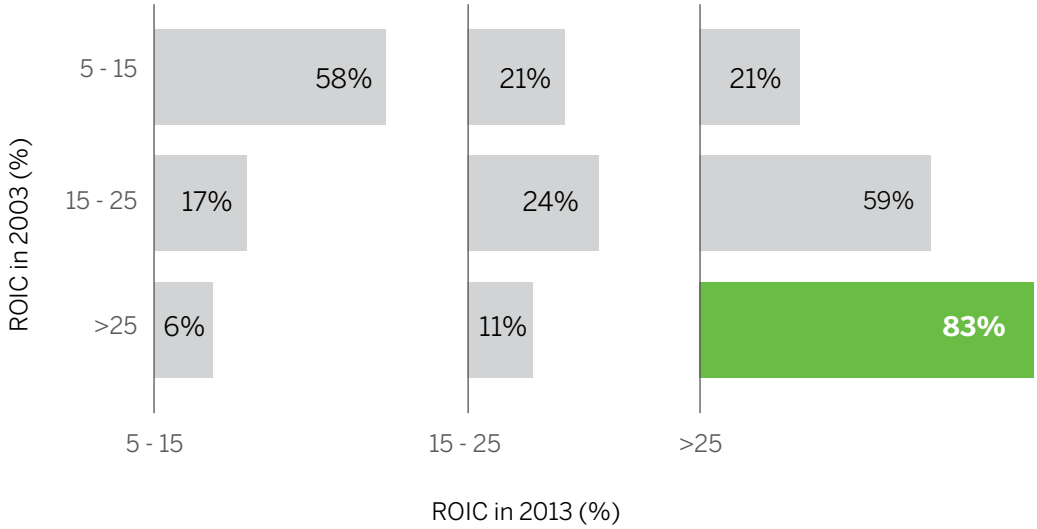
BT: Our performance is an output of our stock-picking and we remain focused on searching all four corners of the globe for outstanding companies that trade at discounts to intrinsic value. One question we hear a lot is which areas of the world do we like more than others. We do not buy geographies though, we buy companies. We are excited to have found several European companies over the last year to add to the portfolio which are global businesses trading at discounts to international peers. Uncertainty in the market often creates opportunity, and as patient long-term investors, we look to take advantage of that.

Q: Can you give us an example of a special customer outcome?

MD: One of my favorites is Taiwan Semiconductor Manufacturing. They make the chips for Apple, Qualcomm, and other leading technology companies who sell most of the smartphones and devices we all use every day. All of their customers say the same thing: Taiwan Semiconductor de-risks technology for them, and at a fraction of the cost. Morris Chang, the company's 86-year-old founding chairman, gets it. He always says, "It's all about the customer." His company provides a truly exceptional outcome for its customers, in that they do not need to worry about manufacturing investment. They can simply compete

Figure 1: Leaders Tend to Stay Leaders

High-ROIC (>25%) companies typically stay high-ROIC companies and do not have their excess economics competed away. As seen below, companies generating high ROIC in 2003 were still still generating high ROIC in 2013 in 83% of instances.



Source: McKinsey & Company

Chart reproduced with permission from McKinsey & Company Inc. as featured in the book, "Valuation: Measuring and Managing the Value of Companies, University Edition." 6th Edition, 2015. ROIC is calculated as % without goodwill. Please see the end of the presentation for important information. The selected sample size is the S&P500 Index.

on the strength of their designs, which is where companies like Apple want to focus.

In this way, the company has set itself apart and you can see it in the results. The company has grown from $1.5 billion in revenue in 1997 to nearly $30 billion today, is larger than its next 10 competitors put together, and most important to us, produced ROIC of over 20% each year in the past decade, apart from 2009.

Q: Your strategy hit its two-year mark in May. What are some of the things you learned in that time?

MD: One of the biggest lessons we have learned is to pay close attention to disruptive companies that are changing how business is done. For example, the dynamics between suppliers and customers have changed materially. Previously, companies created a product and sold to distributors, who in turn sold to consumers. Suppliers of goods had the upper hand in this model. Now, a company like Priceline has aggregated consumers and built a scalable business model in offering this pool of potential customers to suppliers of goods and services. This is a massive shift in intermediation and has removed a substantial amount of pricing power from the hotel industry. We believe the disruption is so pronounced that loyalty and rewards programs are the last vestiges of the hotel industry's hold on customers. Priceline continues to dominate the room reservation market, but does not own a single room. In our view this business model is brilliant and we are hoping to identify other similar disruptors in the future.

To read more about our current thinking please refer to our second quarter letter found *here*.

Price-Earnings Ratio (P/E Ratio) is the ratio of the share of a company's stock compared to its per-share earnings.
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.
EV/EBIT is a financial ratio used to measure a company's return on investment. EV/EBIT calculations presented use NTM (next twelve months) estimates.
ROIC, or Return on Invested Capital is a measure of determining a company's financial performance. For the Global Leaders strategy, it is calculated as NOPAT/IC; where NOPAT (net operating profit after tax) is (EBIT + Operating Leases Due 1-Yr)*(1-Cash Tax Rate) and IC (invested capital) is Total Debt + Total Equity + Total Unfunded Pension + (Operating Leases Due 1-Yr * 8) –Excess Cash. ROIC calculations presented use LFY (last fiscal year) and exclude financial services.
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.

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