(HIGH-QUALITY) STOCKS FOR THE LONG RUN?

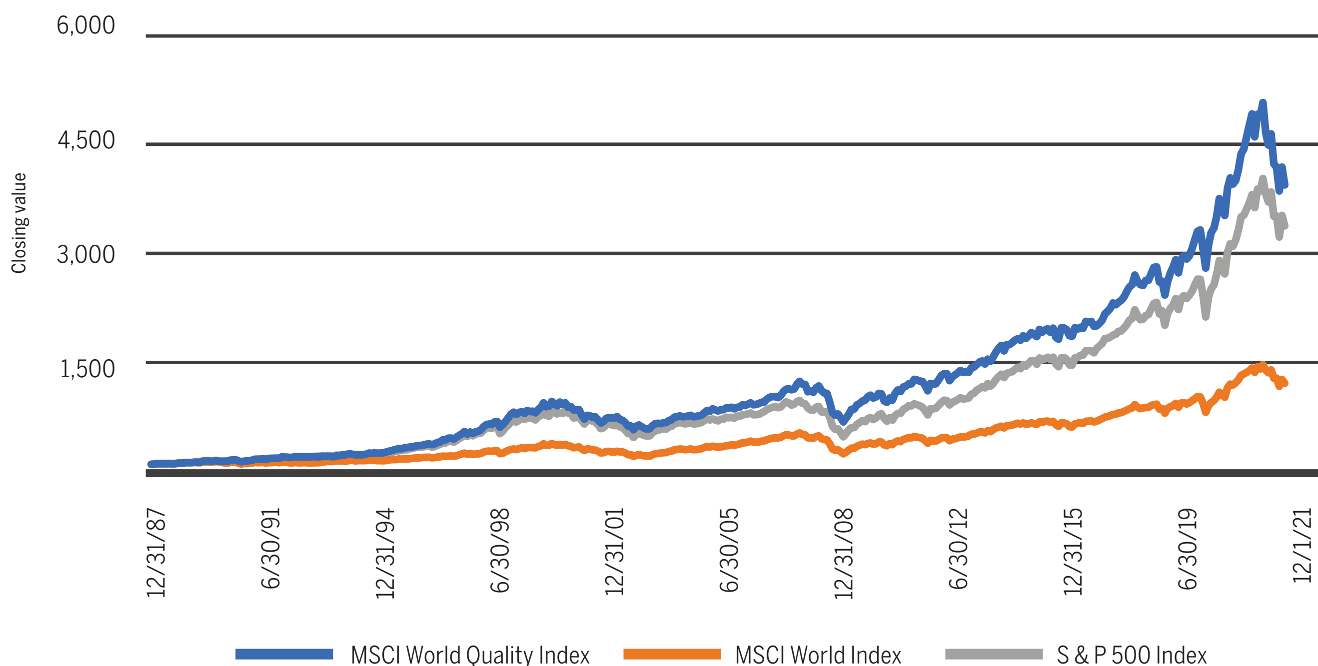
By Sid Ahl, CFA CIO for Private Client, Endowments and Foundations • Eric Gordon, CFA Head of Equities • Brandon Parrish, CFA, CAIA, Partner and E & F Portfolio Manager

Brown Advisory favors high-quality securities, strategies and allocators in its investments. In this paper, we seek to define what quality means within our investment framework and why we feel it is foundational to our decision-making for our clients. We believe that this quality at all levels of the investment process provides the confidence to allow our clients' capital to compound over time. Time in market, rather than timing the market, has shown to be among the biggest drivers of investment performance over the long term.

Thoughtful investing is a dedication to rigorous, fundamental research to gain a deep understanding of the businesses, issuers and managers in which we invest our clients' capital. It allows us to ascertain the quality of investments through a multitude of lenses and through a team-based format. We believe thoughtful investing entails an elegant combination of qualitative and quantitative elements. It requires going beyond financial metrics to assess management quality and the moat around a business. Evaluating the moat around a business can include examining the competitive quality of the product or service and whether the company delivers attractive customer outcomes. It typically requires meaningful diligence, such as talking to competitors, customers, suppliers, stakeholders and others. We believe that thoughtful investing means going beyond the numbers and addressing the deeper questions about whether the viability of those assumptions are likely to hold five or 10 years down the road. It means going beyond balance sheets and income statements to take a hard look at whether key financial metrics, like free cash flow yield, are likely to endure. It can require evaluating management teams to get a sense of their quality and examining competitors to identify their competitive positioning as well. Is a company reinvesting in its businesses, and are research and development efforts enough to stay ahead of the competition? Is a company evaluating the financial return on its investments and culling projects with low returns? To us, thoughtful investing entails taking a multifaceted approach to drill deep into questions such as these and

Long-Term Gains

High-quality stocks have outperformed over the long run, delivering meaningfully higher returns than the overall market as well as a broader basket of stocks.



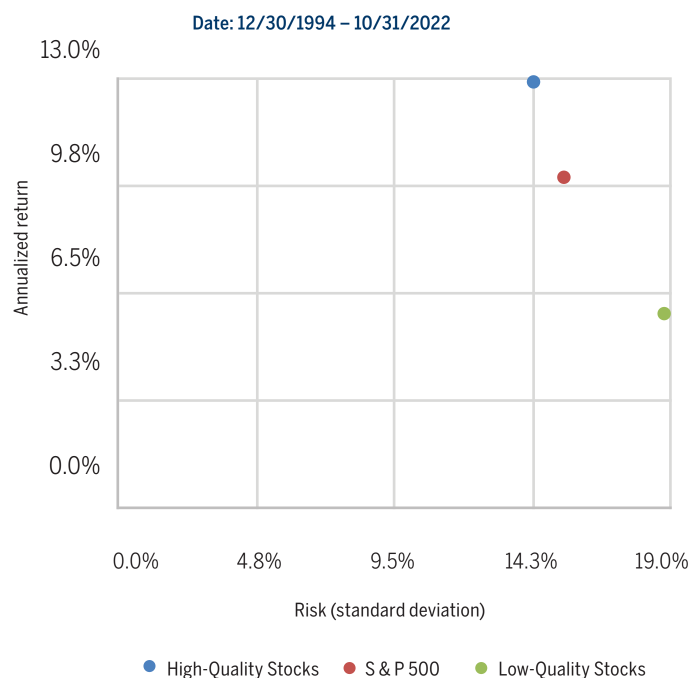
SOURCE: BLOOMBERG. EARLIEST DATA AVAILABLE.

fostering a team-based culture that allows for the synthesis of these data points in a way most likely to arrive at the best investment decisions on behalf of our clients.

In this paper, we will seek to test the thesis that high-quality companies and managers can provide long-term outperformance with lower risk, more downside protection and lower variance of outcome. Over the long term, the MSCI World Quality Index has outperformed both the MSCI World Index and the broader S&P 500® Index. This understanding of long-term dynamics may help emotional stability and time-in-market, which we believe to be key drivers of investment value and edge. A rigorous understanding of these dynamics may be especially important in times of volatility or when quality stocks are underperforming, as they do in various market regimes (please see Quality's Historical Performance on page 5).

Fewer Bumps in the Road

Higher-quality stocks have tended to deliver better performance with lower volatility than lower-quality stocks and the broader market.



SOURCE:FACTSET AND BLOOMBERG. EARLIEST DATA AVAILABLE. HIGH-QUALITY STOCKS AND LOW-QUALITY STOCKS DETERMINED USING S&P 500 QUALITY INDEX (UPPER AND BOTTOM QUINTILES, RESPECTIVELY).

We believe in an emphasis in quality at all levels of the investment process and that this quality bias is an important driver of downside protection. We view downside protection here beyond the narrow definition of "drawdowns" and as long-term capital preservation. It is the ability to withstand adverse market developments and the confidence to stay focused on long-term investment goals. Downside protection is avoiding the permanent impairment of capital. A robust investment process at all levels should contribute meaningfully to the chances of long-term outperformance.

Importantly, there are periods of time when high-quality securities will likely underperform their lower-quality peers. This dynamic can be driven by several factors, including fluctuating investor risk appetites; changes in macroeconomic conditions, such as a sudden drop in interest rates that can make companies with lower earnings relatively more attractive; or the enthusiasm of retail investors for particular categories. However, our data presented in this paper and our experience suggest that long-term investors are meaningfully more advantaged in high-quality securities over longer time frames.

We would also like to point out that from an asset allocation perspective, high-quality securities tend to amount to the bulk of our core portfolios, and we may be more opportunistic in other areas. For example, we may invest in distressed businesses, which tend to be lower quality, over shorter durations and if compelling valuations materialize. However, we tend to "rent" rather than own these positions for the long term and view them as complementary to our core portfolios that drive compounding and where we prize quality.

In this paper, we seek to illustrate what quality means to us, why we favor it and several key junctures of an investment framework. This includes asset allocation, strategy and manager selection, and security selection. We also illustrate why Brown Advisory's ownership structure and the emphasis on working as a team are instrumental to ensuring this, and why we believe that quality and thoughtful investing are greater than the sum of the parts.

Morgan Housel, the best-selling investment writer, noted that the three key investment strategies are to "be smarter than others, be luckier than others or be more patient than others." We believe that an emphasis on high-quality and thoughtful investing provides investors with the confidence to be able to be patient.

DEFINING QUALITY

We have a "high-quality" bias and seek stocks we believe we can hold for a multiyear period. While there can be variations, high-quality companies tend to have a high return on invested capital that exceeds the weighted average cost of capital, strong margins and low levels of debt.

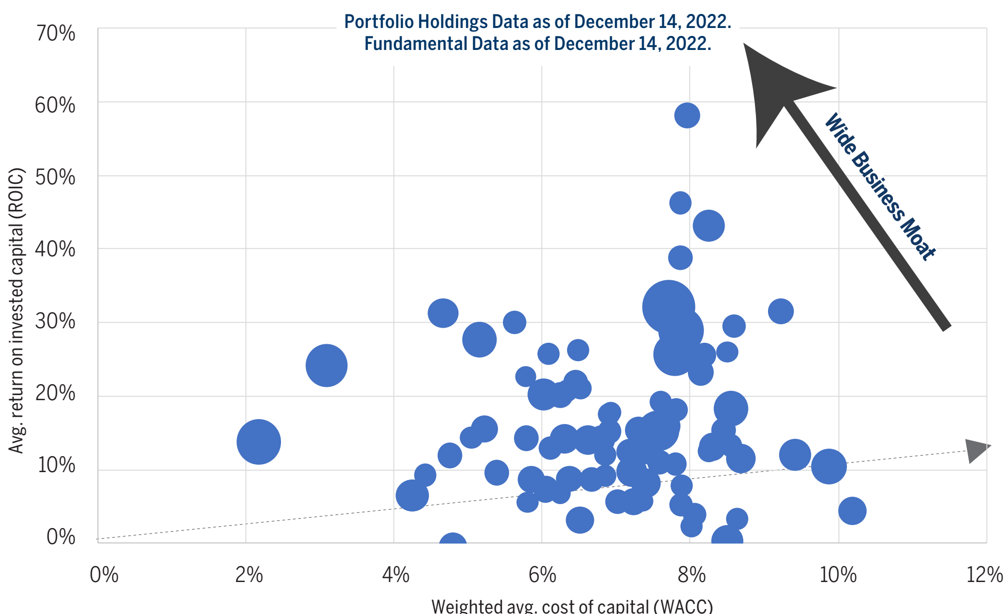
There can be some variation in how different managers think about quality, and different strategies at Brown Advisory and managers on our platforms may favor different flavors of quality (please see Different Flavors of Quality on page 8). However, when analyzing an investment, we broadly think about it in terms of business quality and management quality.

For business quality, a meaningful consideration is if we believe the company's competitive moat is strong and strengthening. There can be several reasons for this dynamic, and there are a variety of different ways to establish a moat that our team evaluates by examining different aspects of the business and having conversations with a multitude of stakeholders. Economic moats can emerge from being a low-cost producer, having scale, being a first mover with technology and having a brand presence that is unlikely to be replicated, among other factors. We seek to assess how long those factors can remain in place and if they can translate into key financial metrics, such as strong top-line growth, strong bottom-line growth, earning per share growth, free cash flow per share growth or all of the above. These kinds of robust financial metrics are usually associated with a return on capital that is consistently above the weighted cost of capital, meaning that value is being added over time. This is one of the underlying premises of investing in high-quality businesses. Generally speaking, high-quality businesses tend to have a high return on equity, predictable and growing earnings, and low financial leverage.

We also seek to assess management quality, including assessing if the management team understands and appreciates what the competitive advantages are and what they are not.

Portfolio Positioning: Defining the Economic Moat

We believe an important measure of a company's economic moat is its ability to sustainably deliver a return on invested capital that is higher than its weighted average cost of capital. This return allows shareholders to accrue value as a function of time in market, and we believe in closely monitoring the viability of the moat and the quality of management decisions.



SOURCE: FACTSET. LOOKTHROUGH OF TOP 100 POSITIONS IN THE PORTFOLIO. THE BROWN ADVISORY ISG MODEL PORTFOLIO FOR ENDOWMENT AND FOUNDATION CLIENTS SHOWN ABOVE IS A HYPOTHETICAL PORTFOLIO. BROWN ADVISORY'S MODEL PORTFOLIO ALLOCATION IS MANAGED TO MATCH THE ALLOCATION OF THE BLENDED BENCHMARK. THE BLENDED BENCHMARK IS 70% MSCI ACWI; 25% BLOOMBERG U.S. AGGREGATE; 5% BOFA/MERRILL LYNCH T-BILL INDEX. THE MODEL PORTFOLIO PERFORMANCE SHOWN IS NET OF BOTH ACCOUNT LEVEL FEES AND UNDERLYING MANAGER FEES, INCLUDES THE REINVESTMENT OF DIVIDENDS AND IS REBALANCED AT THE MANAGER'S DISCRETION. THE MODEL PORTFOLIO ASSUMES THE CLIENT IS A QUALIFIED PURCHASER WHO CAN INVEST IN A LIMITED PARTNERSHIP STRATEGY, IN ADDITION TO DAILY LIQUIDITY FUNDS. THE MODEL PORTFOLIO ALSO ASSUMES THE CLIENT IS TARGETING A 70% EQUITIES 30% FIXED INCOME STRATEGIC ASSET ALLOCATION. OTHER ASSUMPTIONS INCLUDE THE CLIENT HAS THE ABILITY TO INVEST IN ALTERNATIVE ASSETS SUCH AS HEDGE FUNDS, PRIVATE EQUITY, PRIVATE CREDIT AND REAL ESTATE. THE PORTFOLIO INCLUDES PRIVATE INVESTMENTS AND WOULD TYPICALLY BE SUITABLE FOR A QUALIFIED PURCHASER TAX-EXEMPT CLIENT. ASSET ALLOCATION COULD CHANGE DEPENDING ON RISK TOLERANCE, INVESTMENT OBJECTIVE AND ASSETS AVAILABLE FOR INVESTMENT. THE INVESTMENT TEAM WILL CUSTOMIZE PORTFOLIOS TO MEET THE GUIDELINES, REQUIREMENTS, AND RISK TOLERANCE OF THE CLIENT. IT SHOULD NOT BE ASSUMED THAT INVESTMENTS IN SUCH SECURITIES HAVE BEEN OR WILL BE PROFITABLE.

For example, sometimes a company can have an excellent business, but the management team can decide that it needs to diversify or move into peripheral business lines to demonstrate growth to the market. Unfortunately, that is not really what we are looking for. A high-quality business can be thought of as having a "crown jewel." However, there are instances when low-quality management teams may not utilize the cash flow that they are generating from this crown jewel by improving the business or returning it to shareholders, either as a dividend or by buying back stock. Instead, they may decide that they need to demonstrate to the market that we believe they can grow their top line even faster and become bigger. However, we are not looking for businesses that are growing bigger just for the sake of getting bigger. We are looking for high-quality businesses run by high-quality management teams that we believe can generate excess returns over the cost of capital for an extended period of time, and perhaps even demonstrate improvement in that excess return on capital.

As investors, we are also very cognizant of valuations. If you have a great business and great management team but it is priced to perfection, you may not make money in the security. If we cannot justify the returns based on our modeling scenarios, then we will not buy the security but instead add it to our watch list. In the event of a market sell-off or if the company may have a bad quarter and becomes out of favor, we may use it as an entry point. It is important to note that our bias toward high quality means that we may entertain paying a slight premium in terms of valuation for what we believe is an excellent business model that compounds in value over time. We tend not to favor low-quality businesses trading at discounts, however.

There are also aspects to assessing quality that may be unique to Brown Advisory. The first is the investment horizons over which we tend to evaluate investments. As long-term investors, we tend to evaluate scenarios over three to five years, which may be longer than many in the industry who may be more focused on one or two quarters. The second is our equity culture, where every colleague is an owner. This enables a team-centered approach that allows us to examine a question or a situation from a lot of different angles. We believe that our team-based approach rooted in an equity culture has been a key factor in being able to identify meaningful concerns when evaluating the quality of investments.

Other key criteria and metrics we often use in assessing quality include a strong value proposition for customers, the ability to grow organically, pricing power and low leverage/conservative capital structures. Some of our strategies also use assumptions for costs of capital that we believe are meaningfully higher than those of peers, which may result in more stringent underwriting standards and a greater margin of safety.

QUALITY'S HISTORICAL PERFORMANCE

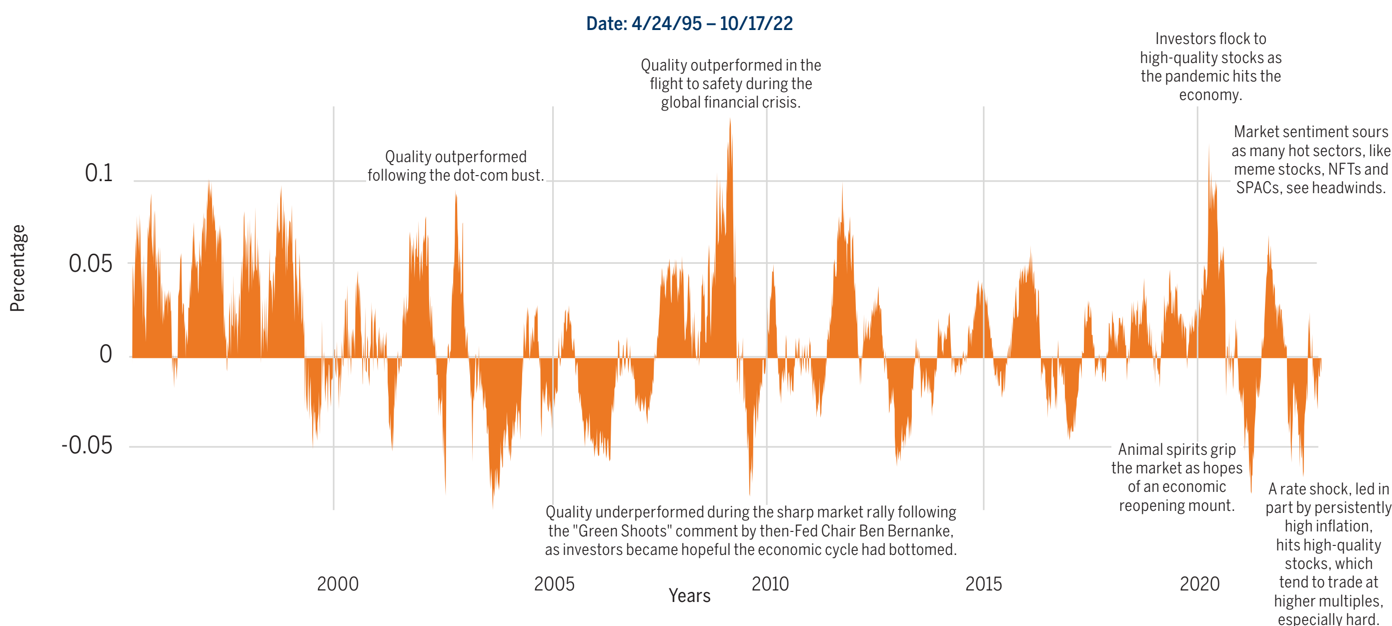
While high-quality companies tend to meaningfully outperform their lower-quality counterparts over time, there are also periods of underperformance that investors should be aware of. As shown in the chart below, such periods generally include times when risk appetites and animal spirits in the market are high. For example, high-quality companies generally underperformed in the dot-com mania at the turn of the century, coming out of the aftermath of the great financial crisis and in the "reopening trade" following the COVID-19 pandemic.

There may be several reasons for the phenomenon of high-quality underperformance at the turn of economic cycles. First, lower-quality companies, which tend to be more cyclical and highly indebted, may see a greater turn in fortunes with brighter economic prospects. Adverse economic conditions may also impact low-quality businesses more profoundly, crunching valuations and creating a "coiled spring" effect when economic conditions turn.

Secondly, high-quality managers tend to avoid companies in the energy, commodity and banking sectors. These companies tend to have less pricing power and consistency of cash flows, and more complex structures compared with peers. As shown in the chart on page 6, the MSCI World Quality Index is meaningfully less exposed to these more cyclical sectors. These sectors, however, typically see strong tailwinds from the prospects of economic recovery. The demand for energy and materials typically increases along with consumption, and higher net interest rate margins that result from a steeper yield curve can increase profitability for the financial sector.

Quality Seesaws (MSCI World Quality – MSCI World Rolling Mean)

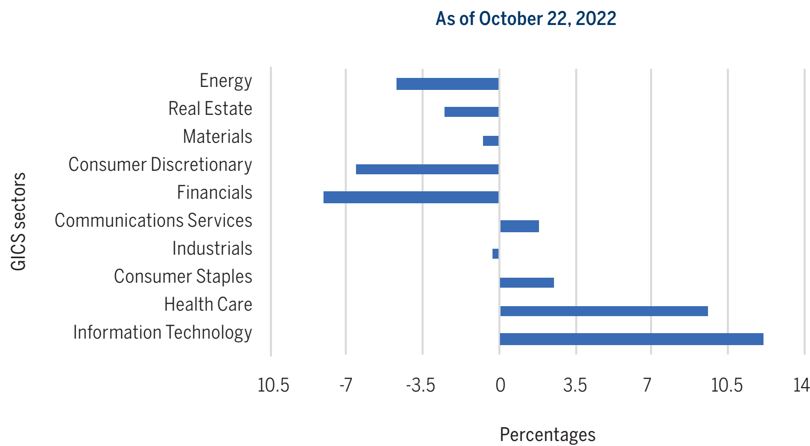
Quality stocks tend to outperform a broader basket of stocks during periods of market stress, such as the aftermath of the dot-com bust, the onset of the financial crisis or the outbreak of COVID-19. However, quality lags when markets witness "animal spirits" and at economic turning points when investors seek risk, such as when markets turned bullish in the wake of the financial crisis and during the reopening following COVID-19.



SOURCE: EARLIEST DAILY DATA AVAILABLE. 100-DAY ROLLING AVERAGE OF THE RETURNS OF THE MSCI WORLD QUALITY INDEX MINUS THE MSCI WORLD INDEX.

Low Energy? (MSCI World Quality Index – MSCI World Relative Weighting)

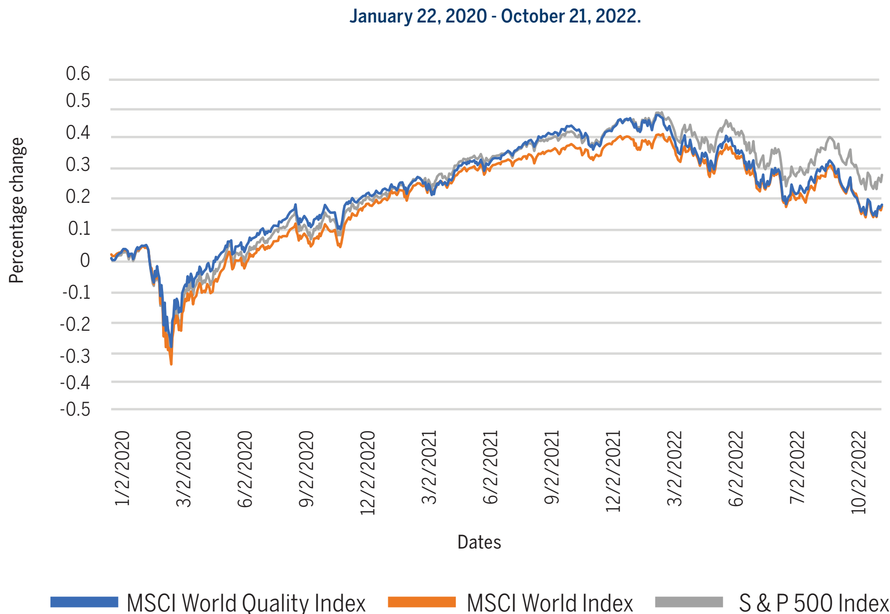
High-quality managers are sometimes underweight sectors like energy and financials, where companies lack pricing power over inputs and structures can be complex. This can lead to headwinds when more cyclically oriented sectors outperform.



SOURCE: MSCI WORLD QUALITY INDEX MINUS THE MSCI WORLD INDEX. SECTORS ARE BASED ON THE GLOBAL INDUSTRY CLASSIFICATION STANDARD (GICS) CLASSIFICATION SYSTEM.

A Tough Slog

Despite long-term outperformance, quality's relative performance since the COVID-19 pandemic has been mixed. The rally in lower-quality names during the reopening phase followed by inflationary conditions has created headwinds.



SOURCE: BLOOMBERG. 100-DAY ROLLING AVERAGE OF THE RETURNS OF THE MSCI WORLD QUALITY INDEX MINUS THE MSCI WORLD INDEX.

QUALITY SINCE COVID-19

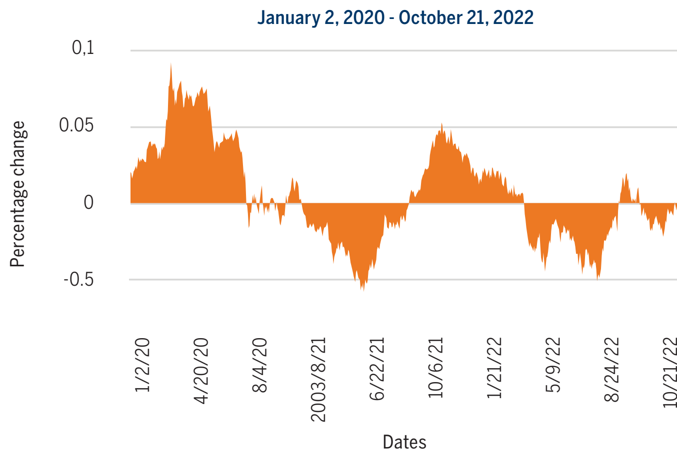
Markets have been subject to highly unusual dynamics since the onset of the pandemic in March 2020. The reopening toward the end of 2021 was subsequently followed by a rate shock, as inflation and interest rates rose at the highest pace seen in 40 years. Both of these dynamics have created headwinds for high-quality stocks at times. The market exuberance that followed the economic reopening in 2020, for example, included a phase where "meme stocks" and highly cyclical companies with crushed valuations saw meaningful momentum based on retail investor enthusiasm.

The steep rise in interest rates and market backdrop of interest rates have also created challenges for high-quality stocks. First, high-quality stocks tend to trade at higher valuations than their lower-quality peers due to investor recognition of their stronger fundamentals and earnings potential. A sharp rise in interest rates tends to disproportionately impact companies with higher earnings multiples. The underperformance of high-quality companies to their lower-quality counterparts may be understandable given the macroeconomic and market backdrop over this period.

We also spend a lot of time thinking about what it will mean to be a high-quality company heading out of the once-in-a-lifetime pandemic. What are normalized earnings, profit margins and the cadence of growth going to look like in the future? How will consumers behave on a longer-term basis, and when will supply chain bottlenecks finally clear? Will we be evaluating the same cohort of companies we were three years ago? Would a prolonged period of stagflation lead to a meaningful period of underperformance given the lack of exposure to energy and materials? There needs to be consideration about how the quality paradigm may change post-pandemic.

Patchy Pandemic Performance

High-quality's outperformance has been spottier since COVID-19 than it was over the long term. After a flight to high quality during the pandemic, the factor underperformed during the reopening phase. A potentially stagflationary environment has created further pressrues.



SOURCE: BLOOMBERG. 100-DAY ROLLING AVERAGE OF THE RETURNS OF THE MSCI WORLD QUALITY INDEX MINUS THE MSCI WORLD INDEX.

WHEN MR. MARKET CREATES OPPORTUNITY

We believe that periods when high-quality stocks are out of favor and face headwinds like the current environment can create buying opportunities. We also believe high-quality companies enjoy a significant advantage in challenging periods. Generally, lower levels of debt mean these companies are less sensitive to interest rate shocks and more in charge of their own destiny.

We also believe that recent market volatility has created attractive opportunities in high-quality companies. As shown in the chart below, investors may be "throwing the baby out with the bathwater" since the easing of pandemic restrictions. Higher-quality stocks, as measured by return on invested capital (ROIC), lagged at the start of 2021 as the "reopening trade" boosted highly cyclical and leveraged companies. The convergence in some valuation metrics between high- and low-quality stocks during periods of high-quality underperformance may offer opportunities to allocate to high-quality names.

On Sale?

Periods of market exuberance, such as the "reopening trade" that followed the easing of pandemic restrictions in March 2021, can lead to high-quality stocks trading at similar valuations to their lower-quality peers. Higher-quality stocks, as measured by return on invested captial, lagged during this period, which boosted highy cyclical and leveraged companies. However, for long-term investors, we believe these periods can create opportunities to invest in high-quality businesses at unusually low premiums to the general market.

MSCI ACWI Index Constituents Ranked by Return on Invested Capital

Qunitile Median Fundamental Statistics and Total Return

Quintile Ranked by ROIC	Total Return Since Value Rotation*	Fwd. P/E	EV/Sales	Net Debt/ EBITDA	Operating Margin	ROIC
1st Quintile	22.4%	24.2x	4.4x	0.0	22.1%	19.4%
2nd Quintile	21.6%	19.5x	3.0x	0.9	15.6%	10.0%
3rd Quintile	24.1%	16.2x	2.4x	1.6	13.2%	6.3%
4th Quintile	28.7%	17.0x	3.3x	3.4	12.6%	3.5%
5th Quintile	30.0%	19.5x	4.7x	4.0	-1.8%	-1.6%

Similar Valuations

Lower Leverage

More Profit

SOURCE: FACTSET. AS OF 9/30/2022.

DIFFERENT FLAVORS OF QUALITY

Different managers may have some variations in the factors they emphasize when they evaluate the quality of an investment. Quality can be a multifactor consideration, where different managers can "dial up" or "dial down" various components. For example, some investors may prioritize management quality above all else. Management teams that are seen as outstanding capital allocators or innovators, or that can create excellent firm culture may warrant premiums not seen in current financial results, as future results may be likely to be higher than the market anticipates due to superior management. Others can take a very quantitative approach. This can place an emphasis on projected internal rate of returns, free cash flow or unit economics. While these styles can vary, the following are aspects of quality that are often emphasized:

- Financial (free cash flow margins, leverage, return on invested capital)
- Management quality and capital allocation
- Moats, pricing power, customer outcomes
- Culture

The financial aspects of quality are fairly well accepted and have been discussed already in this piece—some quality investors rely fairly dogmatically on them. Quality companies tend to have high free cash flow margins, converting a high percentage of revenue dollars into free cash flow available to investors. As our Global Equity team says, "All that matters over time is the cash you put into a business versus the cash you can take out." Reported earnings have the ability to be manipulated in many ways through adjustments and non-cash expenses and credit. Return on invested capital shows how much money needs to be invested for each dollar of that cash flow.

Investors have a multitude of views on leverage. Some quality investors are comfortable with the concept of applying high leverage to a stable, free cash flow-generating business to maximize the return to equity holders. We have generally been of the view that leverage works well in bull markets but can be dangerous when the cycle turns. Businesses that utilize high levels of leverage, particularly for frequent acquisitions, are subject to negative reflexivity during bear markets—their cost of capital rises, and they can be put on the defensive at a time when their better-capitalized competitors lean in and buy up assets on the cheap.

Metrics are everything for some quality investors. They often run quantitative screens to find companies to research or invest programmatically in whose financials exhibit certain characteristics. But others are much more willing to de-emphasize the current financial metrics of a business

INVESTMENT STYLES THAT ARE NOT QUALITY

Here, it may also be useful to briefly discuss biases other than quality to better illustrate what we mean by the term.

Recently, there has been a great deal of interest in thematic investing that seeks to provide exposure to trends, such as innovation in technology or health care. Rather than focus on the bottom-up analysis of securities and their potential for generating cash flows, these styles may instead emphasize major technology trends and the embedded optionality they present (for example, the potential for an automarker to provide autonomous driving or robo-taxi services in the future). While these styles of investing often see lots of momentum, we do not believe they provide enough downside protection or confidence to remain in market.

Other strategies may seek to find "cheap stocks" that trade below key metrics, such as book value. These strategies have become less popular with the dominance of growth investing over the last decade, but there is academic literature to support their viability. However, even in our value investing strategies, we seek to avoid businesses that are fundamentally challenged in their business models.

Outside of quality, the following are also important styles of investing: cyclical value, momentum, size, carry and growth.

based on their assessment of business quality. We believe that Amazon is a great example of this. For more than a decade, the business was investing so heavily in "winning" in e-commerce and cloud that it was generating no free cash flow. It took a forward-looking view on the growing moat around its e-commerce and cloud businesses, and a conviction that this would eventually show up in the numbers.

Some of the greatest investment success stories have been driven by high-quality management teams with attractive capital allocation. Capital allocation includes the art of optimizing the company balance sheet, adding value through acquisitions, knowing when to buy and sell your own stock based on its valuation, and optimizing management structure and incentives. We believe the book *The Outsiders* is an excellent read for those interested in these stories. Some quality investors follow these groups of executives (e.g., John Malone, Tom Murphy, Warren Buffett) and their disciples, and back them in whatever they do. We always take note but aren't dogmatic followers of these exceptional leaders.

We believe one of the primary determinants of long-term success for businesses is the company culture, which is set by these leaders. Some investors go so far as to score the companies on the culture of the company, looking at things such as the incentives they provide to management, the investments they make toward innovation and the focus they have on customer outcomes. Some investors put culture above all else when investing, with time horizons of a decade or more. We examine company culture closely, along with governance, as a way of stacking the deck in our favor for long-term investments. But the other facets of quality must also align in order for us to make an investment.

Lastly, we find that many quality investors are less sensitive to the valuation they pay on quality companies because of the "off-balance sheet assets" and the expected "upside surprises" that are often delivered by the best management teams or companies with the best products or services. Whether this is following a management team "no matter what" or a business model regardless of valuation, our approach has always been to buy these companies at valuations that we believe are attractive without giving much credit to the unknowable upside. While we acknowledge that good companies tend to generate positive surprises in their results, we can't ignore the numbers. We will surely sell some businesses too early or miss out on some opportunities, but we firmly believe that there is a price for everything, and paying too much for a high-quality business can be just as painful as overpaying for a low-quality one.

In summary, there are many different flavors of quality investing, and there isn't necessarily a right and wrong way to do it. We have seen success from firms that put the numbers above all else as well as those that focus mostly on management quality or culture. Our approach has always been to look at the whole picture and build concentrated portfolios where the stars align on each of the elements as much as possible.

EXAMPLES OF HIGH-QUALITY BUSINESSES*

WASTE CONNECTIONS (WCN)

Waste Connections Inc. provides nonhazardous waste collection, transfer, disposal and resource recovery services in the United States and Canada. It offers collection services to residential, commercial, municipal, industrial, and exploration and production (E&P) customers; landfill disposal services; and recycling services for various recyclable materials. The company also owns and operates transfer stations that receive compact and/or load waste to be transported to landfills or treatment facilities through truck, rail or barge, and intermodal services for the rail haul movement of cargo and solid waste containers in the Pacific Northwest. In addition, it provides E&P waste treatment, recovery and disposal services for waste resulting from oil and natural gas exploration and production activity.

Moat

Waste Connections operates in an industry with significant barriers to entry. Collection revenues are typically contracted over two to seven years. We believe Waste Connections leverages its relative scale and route density versus competitors to provide a more cost-competitive and efficient service. On the disposal side, there are regulatory barriers and local political sensitivity around new landfill capacity coming to market, providing incumbents with a meaningful advantage and pricing power. Waste Connections has industry-leading margins given its focus on either rural (less competitive) or vertically integrated collection/disposal markets. We believe the company has a highly impressive management team that is aligned with shareholders due in part to compensation criteria regarding ROIC and free cash flow per share growth.

VISA (V)

Visa Inc. operates as a payments technology company worldwide. The company facilitates digital payments among consumers, merchants, financial institutions, businesses, strategic partners and government entities. It operates VisaNet, a transaction processing network that enables authorization, clearing and settlement of payment transactions. In addition, the company offers card products, platforms and value-added services. It provides its services under the Visa, Visa Electron, Interlink, VPAY and PLUS brands.

Moat

Visa is the largest payments network worldwide and exists in a duopoly market structure with Mastercard. The company is focused on providing secure, ubiquitous global infrastructure to make it as seamless as possible to pay for goods and services, and enable the movement of money anywhere in the world. The company operates in large, addressable end markets that currently represent greater than $200 trillion in opportunity relative to reported volumes this most recent fiscal year of just under $12 trillion. Despite the massive size, the end markets continue to grow as a result of a multitude of factors: cash personal consumption expenditure continues to grow, new platforms are reaching the billions of unbanked around the globe, new acceptance form factors are making it easier to accept payments, the proliferation of fintechs and wallets are driving more innovation, and new flows are expanding as areas like business-to-business modernization take hold. The company benefits from wide competitive moats, most notably network effects and scale advantages, that provide the business with durable growth with low capital intensity and ROIC. The company, through internal development and strategic partnerships, is making it possible to move money to or from virtually anywhere worldwide through connectivity of nodes that were once disparate. The immense infrastructure and investment required to create interoperability across so many financial ecosystems creates significant barriers to entry, low risk of disintermediation and highly attractive incremental margins.

INTUITIVE SURGICAL (ISRG)

Intuitive Surgical Inc. develops, manufactures and markets products that enable physicians and health care providers to enhance the quality of and access to minimally invasive care in the United States and internationally. The company offers the da Vinci surgical system, a robotic-assist surgical platform, to enable complex surgery using a minimally invasive approach, and the Ion endoluminal

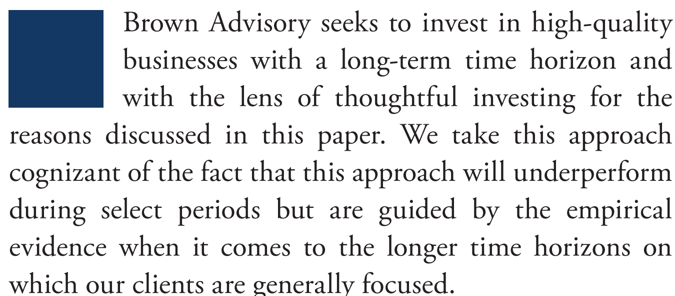
*EXAMPLES WERE SELECTED FOR ILLUSTRATIVE PURPOSES AS WE BELIEVE THEY REPRESENT HIGH-QUALITY COMPANIES. COMPANIES REPRESENT MEANINGFUL POSITIONS IN OUR PORTFOLIOS AND THEIR HIGH-QUALITY CHARACTERISTICS CONTRIBUTED TO OUR INVESTMENT THESIS. PLEASE NOTE THAT THE THREE SECURITIES SELECTED ARE PART OF A LARGER PORTFOLIO AND THEY ARE NOT NECESSARILY REPRESENTATIVE OF THE ENTIRE PORTFOLIO.

system, which extends its commercial offerings beyond surgery into diagnostic procedures enabling minimally invasive biopsies in the lung. It also provides a suite of stapling, energy and core instrumentation for its surgical systems; progressive learning pathways to support the use of its technology; a complement of services to its customers, including support, installation, repair and maintenance; and integrated digital capabilities providing unified and connected offerings, streamlining performance for hospitals with program-enhancing insights. The company was incorporated in 1995 and is headquartered in Sunnyvale, California.

Moat

Intuitive Surgical has several moats around its robotic-assist surgical platform. There are significant barriers to entry given the high capital requirement to develop and manufacture such highly specialized equipment and then to successfully navigate through the regulatory approval process. Intuitive is essentially in a monopoly position when it comes to robotic assist for soft-tissue surgery, with no competitor at any scale, a position it has maintained for over two decades since initial approval in 2001. Since first approval, Intuitive has continued to develop additional surgical applications across different indications, each requiring years of clinical trial process before submission for regulatory approval. Meanwhile, Intuitive has established quite a strong and entirely unmatched real-world track record in robotic-assist procedures, and developed strong physician and hospital relationships, reputation, and trust that will be hard to displace.

CONCLUSIONS



Brown Advisory seeks to invest in high-quality businesses with a long-term time horizon and with the lens of thoughtful investing for the reasons discussed in this paper. We take this approach cognizant of the fact that this approach will underperform during select periods but are guided by the empirical evidence when it comes to the longer time horizons on which our clients are generally focused.

High-quality stocks tend to be those characterized by companies with economic moats. These moats tend to provide companies with the ability to sustainably generate value for shareholders. The ability of a company to generate an ROIC that is above its weighted average cost of capital may be a fundamental way to evaluate this economic moat. This dynamic allows shareholders to accrue value through their time in market.

High-quality companies also tend to be characterized by other financial metrics. These include high margins, growth and recurring free cash flows, and low leverage, among others. However, key to our approach of thoughtful investing is to go beyond these metrics and use a team-based approach with multiple vantage points to assess the evolving business and management quality of a business.

Importantly, there are times when high-quality companies will underperform their lower-quality peers. These periods tend to include periods of high investor enthusiasm, such as the turns in the economic cycle following the global financial crisis and the COVID-19 lockdowns, when animal spirits are abundant. Oftentimes, we believe these points offer attractive entry points into high-quality stocks.

We believe being mindful of these dynamics can allow investors to focus on the long term and better understand why a thoughtful approach to investing in high-quality companies is core to our investment philosophy.

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ESG considerations are one of multiple informational inputs into the investment process, alongside data on traditional financial factors, and so are not the sole driver of decision-making. ESG analysis may not be performed for every holding in every strategy.

ESG considerations that are material will vary by investment style, sector/industry, market trends and client objectives. Certain strategies seek to identify issuers that they believe may have desirable ESG outcomes, but investors may differ in their views of what constitutes positive or negative ESG outcomes. As a result, certain strategies may invest in issuers that do not reflect the beliefs and values of any particular investor. Certain strategies may also invest in companies that would otherwise be screened out of other ESG oriented portfolios. Security selection will be impacted by the combined focus on ESG assessments and forecasts of return and risk.

Certain strategies intend to invest in companies with measurable ESG outcomes, as determined by Brown Advisory, and seek to screen out particular companies and industries. Brown Advisory relies on third parties to provide data and screening tools. There is no assurance that this information will be accurate or complete or that it will properly exclude all applicable securities. Investments selected using these tools may perform differently than as forecasted due to the factors incorporated into the screening process, changes from historical trends, and issues in the construction and implementation of the screens (including, but not limited to, software issues and other technological issues). There is no guarantee that Brown Advisory's use of these tools will result in effective investment decisions.

Past performance is not indicative of future results. Definitions of indices used are below. An investor cannot invest directly into an index.

The **MSCI ACWI** Index captures large and mid cap representation across Developed Markets (DM) and Emerging Markets (EM) countries. The Index covers approximately 85% of the global investable equity opportunity set. The MSCI ACWI captures large and mid cap representation across Developed Markets (DM) and Emerging Markets (EM) countries. The index covers approximately 85% of the global investable equity opportunity set. MSCI is a registered trademark owned by Morgan Stanley Capital International, Inc. The **MSCI World Index** is a broad global equity index that represents large and mid-cap equity performance across developed markets countries. The **MSCI World Quality Index** is based on MSCI World, its parent index, which includes large and mid cap stocks in Developed Market (DM) countries. The index aims to capture the performance of quality growth stocks by identifying stocks with high quality scores based on three main fundamental variables: high return on equity (ROE), stable year-over-year earnings growth and low financial leverage. MSCI Indexes and products are trademarks and service marks of MSCI or its subsidiaries.

The **S&P 500® Index** represents the large-cap segment of the U.S. equity markets and consists of approximately 500 leading companies in leading industries of the U.S. economy. Criteria evaluated include market capitalization, financial viability, liquidity, public float, sector representation and corporate structure. An index constituent must also be considered a U.S. company. The S&P 500 Total Return Index is calculated based on price changes and reinvested dividends of the S&P 500 Index. The **S&P 500 Quality Index** is designed to track high quality stocks in the S&P 500 by quality score.

The **Bloomberg Aggregate Bond Index** is an unmanaged, market-value weighted index composed of taxable U.S. investment grade, fixed rate bond market securities, including government, government agency, corporate, asset-backed and mortgage-backed securities between one and 10 years.

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Terms and Definitions:

Price-to-Earnings Ratio or P/E Ratio is a ratio for valuing a company that measures its current share price relative to its per-share earnings.

Total return is the actual rate of return of an investment or a pool of investments over a period. Total return includes interest, capital gains, dividends, and realized distributions. Total return is expressed as a percentage of the amount invested.

Return on Invested Capital (ROIC) is a calculation used to assess a company's efficiency in allocating capital to profitable investments. The ROIC formula involves dividing net operating profit after tax by invested capital.

Weighted Average Cost of Capital (WACC) represents its blended cost of capital across all sources, including common shares, preferred shares, and debt.

Enterprise value-to-sales (EV/sales) is a financial ratio that measures how much it would cost to purchase a company's value in terms of its sales.

The **net debt-to-EBITDA** (earnings before interest depreciation and amortization) ratio is a measurement of leverage, calculated as a company's interest-bearing liabilities minus cash or cash equivalents, divided by its EBITDA.

The **internal rate of return (IRR)** is a metric used to estimate the return on an investment. The higher the IRR, the better the return of an investment.

The **operating margin** measures how much profit a company makes on a dollar of sales after paying for variable costs of production, such as wages and raw materials, but before paying interest or tax.

Free cash flow (FCF) represents the cash that a company generates after accounting for cash outflows to support operations and maintain its capital assets.

Free Cash Flow (FCF) Yield measures the amount of cash generated from the core operations of a company relative to its valuation.