

Conversation with the Portfolio Manager: Brown Advisory Mid-Cap Growth Strategy



Over time, the Brown Advisory small-cap growth team, led by Christopher Berrier and George Sakellaris, watched numerous successful investments compound and grow out of their investible universe. Many of these businesses were still viewed as compelling investment opportunities, but market capitalization limits precluded incremental purchases. While this was frustrating at times, it produced a valuable asset – a sizeable library of fully vetted “up cap” growth ideas.

This growing body of company knowledge, coupled with evidence that mid-caps “act” a lot like small-caps, sparked a simple hypothesis. The team believed it could generate attractive risk-adjusted returns up the market cap spectrum by applying the same philosophy and process that worked in the Small-Cap Growth strategy. In early 2012, institutional investors provided seed capital to test that theory and our Mid-Cap Growth strategy was born.

Now, more than five years later, the team believes it has produced a body of work that supports the initial hypothesis. So far, the Mid-Cap Growth Strategy has mimicked many of the attractive performance characteristics generated in the Small-Cap Growth Strategy over the past 11-plus years, outperforming its benchmark, the Russell Midcap Growth Index, since inception. More importantly to Chris and George,

however, is that it did so through stock-selection and downside protection, which is the team’s ultimate goal.

Chris and George are both seasoned managers – each with over 16 years of experience – but with complementary backgrounds. Chris spent his formative years as a research analyst on a prominent small-cap growth product at a Baltimore competitor. In early 2006, he took over the small-cap initiative at Brown Advisory, pioneering the current approach. George started out in a different field—he earned a degree in physiology and worked in a genetics lab. After joining the investment industry in 2001, he served as director of research at two firms, creating a small-cap growth strategy at one of them before joining Brown Advisory in 2014.

While both mid-cap portfolio managers believe their experience gives them an advantage, other factors set them apart as well. They view the world through a small-cap lens – looking for change at the margins, rather than a reversion to the mean. “Because mid-caps are nearly as dynamic as small-caps, focusing on change gives us a leg-up on some of our peers who take a large-cap approach to picking mid-cap stocks,” George says. Moreover, they are growth managers that, perhaps ironically, are keenly focused on downside protection.

In a recent conversation, George took a deep dive into the unique qualities of mid-caps and explained the strategy he and Chris employ.



GEORGE SAKELLARIS, CFA
Portfolio Manager

Q: Why should investors consider mid-cap growth exposure?

A: Quite simply, we believe that mid-caps tend to have the best risk-adjusted returns. With mid-caps, you avoid the fraud and failure that you see more frequently in small-caps; but many mid-sized companies still have similar growth prospects. We find opportunities in the \$1.5 to \$30 billion market cap range that look a lot like what we see in the \$0.5 to \$4 billion range.

Q: Don't investors get this exposure as a byproduct of large-cap managers going down-cap?

A: Investors that have gone passive in large-caps through an S&P 500 index fund may be underweight mid-caps. Given that this asset class has historically generated the best risk-adjusted returns, this structural tilt away from mid-caps can be detrimental over time. Even when investors have mid-cap exposure through an active large-cap manager, their carve-out portfolio tends to be highly concentrated in 10 to 15 stocks and usually tilted to two or three sectors.

Q: Can you describe your investment process?

A: Our process consists of three steps: idea generation, due diligence and portfolio construction.

Idea generation is purposefully labor-intensive and entirely forward-looking. We believe one makes or loses the most money in small- and mid-caps when historical relationships change or forecasts prove woefully wrong. So, we do not rely on backward-looking quantitative screens or sell-side estimates. Instead, the team interviews over 400 management teams each year looking for companies that might fit our philosophy.

If we think a company might conform to our approach, we move into step two—due diligence. This starts with more primary-source work. That includes multiple management interviews, scouring SEC filings, building detailed financial models, and so on. However, the bulk of our time is

spent talking to secondary sources, including customers, competitors, suppliers and vendors. Basically, we form a highly-specific hypothesis for each company through primary sources, then we test our assumptions by interviewing other industry participants.

After that, we set target prices and model multiple scenarios. How does one assess a company's worth without knowing what it will look like in three to five years? While valuation is critical to our approach, it occurs near the end of our process.

In step three, we construct a "prudently concentrated" portfolio with 50-80 investments. We target position sizes between 0.5 and 5.0% and concentrate 20%-40% of the portfolio's weight in the top 10 holdings. Chris and I spend a great deal of our time ensuring the portfolio is eclectic and diversified—hopefully giving it a chance of outperforming due to stock selection in various market environments.

Q: What is the "3G" filter?

A: We believe there are three traits that give a company a higher probability of compounding earnings over a multi-year period. We call them the 3Gs: durable growth, sound governance and scalable go-to market strategies.

Durable growth captures the company's opportunity. We target firms that address large markets with growth prospects from secular tailwinds. We also look for companies that prove they can gain share profitably. By combining these two dynamics, we believe growth can stay "stronger for longer." For us, the durability of growth is more important than the absolute level.

Companies with **sound governance** are run by the right people to tackle that opportunity. We look for management teams with proper incentives and meaningful ownership stakes. We also seek transparency, candor, and appropriate board structures.

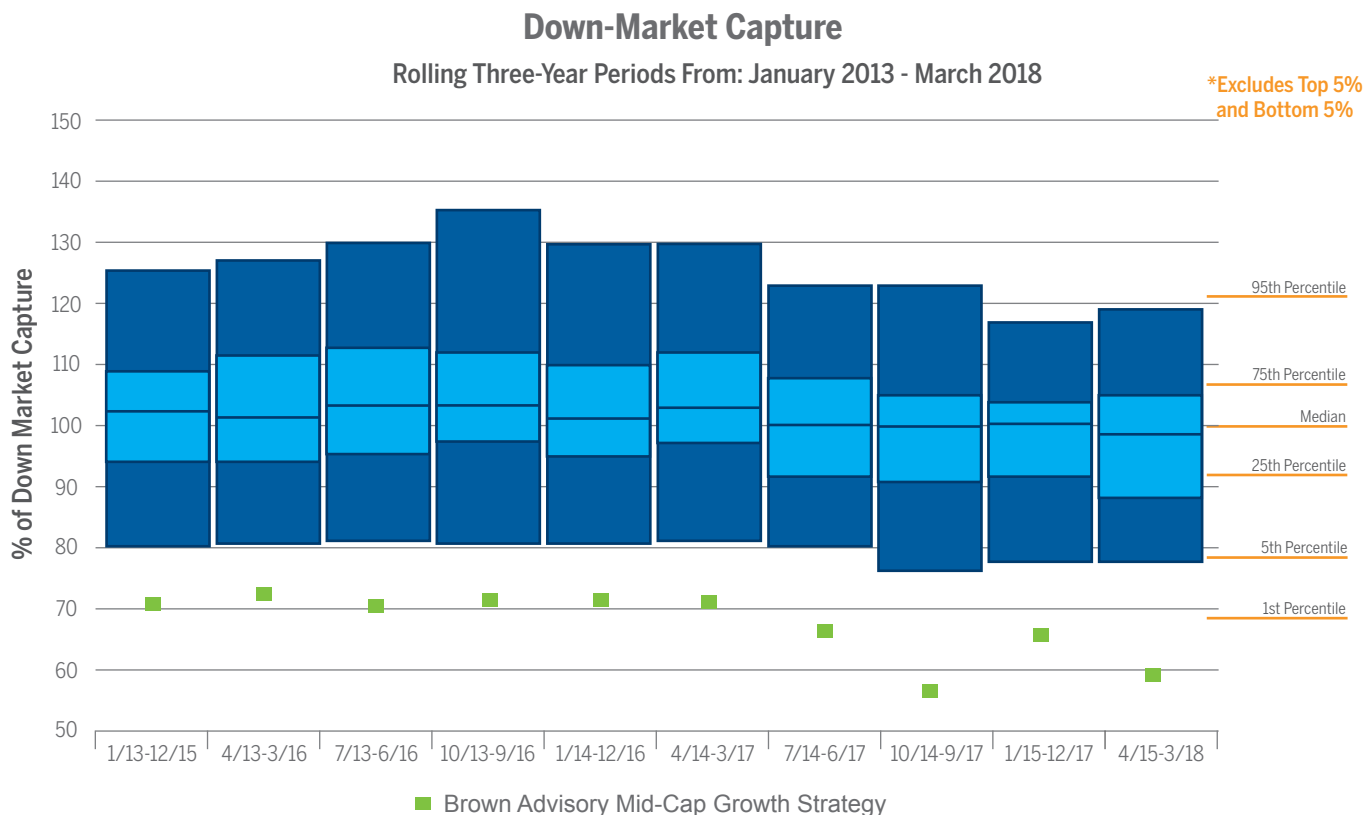
Lastly, **scalable go-to-market strategies** captures how the right people turn an opportunity into cash flow for investors. The ultimate small- or mid-cap investment is one that generates a surprisingly higher return on capital in the future. We target companies that we believe can generate growth with high gross margins while deploying incrementally less capital.

Q: What are some examples of how this comes into play?

A: One is Cogent Communications (CCOI). Cogent went through a long investment phase many years ago to build a uniform IP [Internet Protocol] network. Now it handles over 20 percent of global Internet traffic and is gaining share as the low-cost provider of dedicated internet access. Cogent's incremental customer comes in with a high contribution

A Growth Portfolio With a Focus on Downside Protection

Since inception, the Brown Advisory Mid-Cap Growth Strategy has incorporated a focus on downside protection in selecting securities. The byproduct has been downside capture that has ranked in the first percentile in every rolling three-year period since inception.



Source: eVestment U.S. Mid-Cap Growth Equity universe vs. the Russell Midcap Growth Index; see back for universe description

margin. Meanwhile, the company is deploying a steady capital budget. This grows its return on capital. Most importantly, its free cash flow, dividends, and share buybacks are increasing faster than many expect.

Another is Catalent (CTLT), which is an outsourced manufacturer of pharmaceutical dosage forms with a solid reputation. Penetration of outsourcing is only 30% and growing due to various trends in the pharma industry. That's attractive in and of itself. But what we liked most about Catalent was a rapidly growing biologics manufacturing business we found buried in one of its reported segments. That division is more profitable and is growing faster than the rest of the company. If one looks out three to five years, we believe that they should see a more attractive growth and return-on-capital profile.

Q: What is your downside protection strategy?

A: It consists of three levels. First and foremost are the types of firms we invest in. Our “3G” filter focuses our attention on higher-quality companies. Second, we keep a keen eye on valuation. Given this, our approach more closely resembles “core” than “momentum” growth. Finally—our portfolio construction—we size positions based on potential payoffs and the range of possible outcomes. Companies that have a wider range of possibilities—like clinical-stage biotechnology firms—tend to be small positions. Firms that generate recurring revenue with a narrower set of potential outcomes, like Cogent, become larger position sizes. We believe this methodology lets us generate attractive downside capture (see chart above) and a lower volatility profile than our benchmark. [B](#)

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