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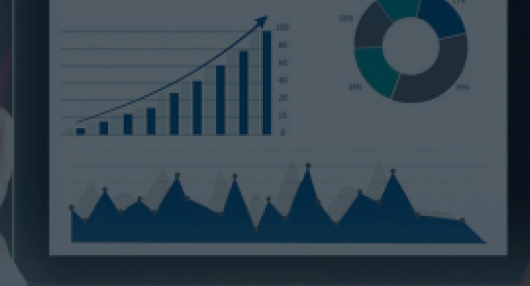


BBH Select Series-Large Cap Due Diligence Report

November 2019

Fund Information		
Ticker	BBLIX	BBLRX
Asset Class Category	Larger-Cap Blend	Larger-Cap Blend
Share Class	Class I	Retail
Min. Initial Investment	$5 million	$5,000
Availability*	S, A, F	SO, AN
Expense Ratio	0.80%	1.05%
Opinion	*Recommended*	*Recommended*
Firm	Brown Brothers Harriman & Co.	
Managers	Michael R. Keller	
Phone	800-575-1265	
Web Address	www.bbhfunds.com	

Certain restrictions apply. Please check with your broker/dealer for details. The Retail share class is not available yet on Fidelity, no transaction fee. Contact the custodian regarding availability.

We recently added BBH Select Series-Large Cap to our *Recommended List* in the Larger-Cap Blend category. The Large Cap fund was introduced in early September roughly a month prior to the liquidation of BBH Core Select (BBTEX) on October 9 due to a significant and persistent capital-gains issue. The Large Cap fund is run by the same team using virtually the same investment philosophy, approach, and portfolio construction. The new fund has lower expenses than the former BBH Core Select fund. In June, we met with the BBH investment team in their New York office and had a follow-up call with two analysts. Our confidence in the team's ability to outperform the S&P 500 benchmark is high. In our model portfolios, we swapped into the fund and out of BBH Core Select prior to the latter's liquidation. For more details on the closure of BBH Core Select see our prior report.

Investment Philosophy & Approach

The BBH team employs a risk-averse investment strategy predicated on the belief that one of the best ways to outperform the market over time is through the compounding of reasonable gains and the avoidance of major losses. In attempting to achieve their objective, the team employs a bottom-up approach, resulting in a relatively concentrated portfolio of well-managed, established, high-quality businesses selling at a discount to the team's estimate of intrinsic value. More specifically, BBH requires cash-generative businesses that are leading providers of essential products and/or services to a large and loyal customer base. Candidates for the portfolio must be leading and growing companies in attractive industries, have a strong competitive position, and have management teams that are skilled operationally and in the deployment of capital.

The pool of investment candidates is relatively stable, and totals approximately 180 or so larger-cap names (those with market caps above $5 billion). In coming up with investment ideas, the 11-person team of industry-focused analysts avoid quantitative screens. They believe a better way to invest is to first identify a universe of companies that fit their qualitative investment criteria and opportunistically invest at an attractive price. The team may follow a company for years without getting the opportunity to invest. But ultimately they believe that having a long history and deep knowledge of an industry and the companies within that industry creates a competitive advantage by enabling the team to differentiate between (and possibly benefit from) a problem that is going to change the cash-flow generation ability of a company and a transient problem that will be resolved in a reasonable period of time. Importantly, the team does not invest in turnaround or restructuring situations; they

want to invest in companies that are currently growing unit sales organically and have (modest) pricing power.

The investment criteria mentioned above are designed to create a margin of safety, which applies to both the qualitative aspects that they look for in a business and the price they pay for that business. Specific details of the investment criteria are as follows:

- Essential products and services: The team believes that companies offering "must-have" rather than "nice-to-have" products and services are better positioned to achieve pricing power over time and gain advantages through the introduction of new products and services. These companies also tend to be able to charge more for their products and services over time and are often less sensitive to risks such as inflation and economic downturns.

- Loyal customers: They believe that a loyal customer base is an underappreciated and often under-analyzed business asset. The team attempts to explicitly measure retention rates as their view is that companies with strong customer loyalty are generally able to grow faster and more profitably than companies with poor retention rates. With a loyal customer base, new customers represent additional business as opposed to replacement business, and companies with repeat customers also enjoy a higher profitability per client since they do not have to spend as much on advertising or a highly compensated sales staff. Loyal customers are also more receptive to new product introductions. Another benefit is a strong competitive position. Loyal customers are much less likely to switch to a competitor for a modestly lower price or small improvement in functionality. Loyalty discourages new entrants and if necessary the time to adjust to technology changes and competitive threats.

  The team has found that high customer retention results in more recurring and predictable revenue streams, more sustainable growth, higher profit margins, and an ability to reinvest the profits back into the businesses. Predictable revenue streams also enable a management team to plan better and use resources more efficiently. The cumulative effect of these factors is a competitively advantaged business with high returns on capital and excellent growth prospects.

- Leadership in an attractive market: Portfolio holdings must be leaders in an attractive and growing industry. The team believes that companies that are leaders in stable and growing markets typically have far more attractive investment opportunities and fewer operational challenges than companies competing in rapidly changing or declining industries. The future profit picture for companies in stable and growing industries can be predicted with a higher degree of confidence than businesses that are operating in challenging or declining areas. The team will not invest in a declining industry regardless of attractive valuations.

- Sustainable competitive advantage: Portfolio candidates must have an identifiable and sustainable competitive advantage. Enduring competitive advantages such as brand, low-cost production, superior distribution networks, highly valued products and services, products and services that are embedded in customer workflows with high switching costs, and economies of scale can improve profitability over time through higher margins and superior returns on capital.

- High returns on invested capital/free cash flow: Companies with high and improving returns on invested capital can create significant wealth for shareholders by reinvesting internally generated cash flow into growth opportunities. Companies that generate strong free cash flow reduce the likelihood of financial stress, which is particularly important during periods of economic weakness when capital is more difficult to access. It also facilitates opportunistic acquisitions or share repurchases during periods of depressed stock prices.

- Company management: The team looks for company management teams with superior track records of execution, prudent capital allocation, and high integrity. They evaluate management's historical track record and develop an understanding of how management plans to allocate capital in the future. The team will not invest without a strong management team and healthy corporate culture. They also want to see that management and shareholder interests are aligned.

- Price: With their goal of protecting capital, the team looks to invest in companies when they are trading at an appropriate discount to their esti-

mate of intrinsic value. Historically, they sought to buy when stocks are trading at 75% or less of their estimate of intrinsic value. Today, the team is willing to buy at a lesser discount provided it's justified by the quality of the business model.

In addition to their margin-of-safety criteria, understanding and trying to avoid low-probability, high-severity risks (to the greatest extent possible) is a key focus. Here, the team will specifically attempt to identify all the factors outside of management's control, such as changing industry dynamics, regulatory actions, and catastrophes, and evaluate the impact on the business. The team is only willing to accept risks they can understand and handicap with a high degree of confidence. For example, in the financial sector, the team generally avoids investment and money-center banks because of the opaque balance sheets. The investment criteria also steer the team toward businesses with relatively predictable and visible outcomes and away from capital-intensive and/or cyclical businesses, particularly in cases where companies in the industry have not earned their cost of capital over cycles. For example, in technology they avoid industries with boom-or-bust dynamics, such as semiconductors or semiconductor capital equipment makers.

In evaluating a business, the team demands that substantially all the investment criteria are met and will not hesitate to pass on a company that falls short of the criteria. They do allow for the fact that not every company will absolutely fit all the criteria. To understand a business, the team conducts bottom-up research and gathers information about the industry structure, company management, capital structure, plans for future growth, and risks. The due diligence work is collaborative, involving the portfolio manager, sector analysts, and a research associate, and sometimes takes several months to complete. The team regularly speaks to management (both senior and mid-level management), customers, competitors, former employees, suppliers, and knowledgeable industry contacts. The team reviews their analysis frequently to incorporate any changes that new information may have on their thesis. They maintain written records of the investment thesis for future reference, and if the thesis breaks down, they will sell.

Once the team establishes that a company fits well with their investment criteria, they apply various valuation methods to determine their estimate of intrinsic value. As a guideline, they aim to purchase only those companies that are trading at 75% or less of the team's estimate of intrinsic value. Discounted cash flow (DCF) analysis is the team's primary valuation approach, though additional valuation methodologies are used to verify the DCF analysis. Examples include transaction-based analysis, internal rate of return models, sum-of-the-parts analysis, and common valuation ratios such as free cash flow multiples and price-to-earnings.

BBH Select Series-Large Cap (10/31/19)	
Alphabet	7.1%
Oracle	6.4%
Berkshire Hathaway	6.4%
Comcast	5.9%
US Bancorp	5.3%
Copart	4.8%
FleetCor Technologies	4.4%
Zoetis	4.3%
Allegion	3.6%
Linde	3.5%
Total	**51.6%**

BBH Select Series-Large Cap Top Five Sectors (10/31/19)	
Information Technology	16.0%
Financials	15.3%
Consumer Staples	15.0%
Health Care	14.8%
Communication Services	13.6%
Total	**74.7%**

In constructing the DCF model, the team generally makes discrete forecasts for the first five years, and then models longer-term assumptions to identify the key drivers of business value. While the model is a tool for determining valuation, it is heavily used to understand the future risks to a company's profitability. This analysis can include the impact on a company's profitability under various economic scenarios as well as changing industry dynamics. For example, if an industry has been consolidating, a company may have been able to get away with low growth rates of invested capital, but over time there may be an increase of capital intensity in the industry to fund future growth, and the team wants to understand how that dynamic may impact a company's longer-term profitability. The team does not try to add a lot of value in determining their discount rates; they use a blend of equity and debt cost of capital. Terminal growth rates are generally 2% to 3%, though in some cases it can be 0% or 1%.

Recognizing the limitations of financial modeling, the team is very careful about appropriately constraining a company's profitability over time. For instance, projecting a low level of capital intensity in perpetuity can exaggerate profit margins as well as the estimate of intrinsic value. Over time, they expect business returns to converge toward their cost of capital.

The team is also very careful to quantify and adjust for liabilities that can negatively impact shareholder value, such as bad operating leases, environmental liabilities, and stock options.

Portfolio Construction

BBH runs a relatively concentrated portfolio of 25 to 30 holdings. They feel that maintaining this low number is important to ensure forced displacement, where better ideas push out weaker ideas. The top 10 positions typically account for 45% to 50% of assets. These are companies trading at a meaningful discount to intrinsic value that also fit their criteria most strongly and have the narrowest range of long-term outcomes. Cash is expected to be minimal, whereas cash levels for the Core Select fund reached the upper single digits.

Portfolio turnover for BBH Core Select (now liquidated) was relatively low, averaging 20% since 2006, which includes an elevated turnover rate of 50% in 2006 when former portfolio managers Tim Hartch and Rick Witmer were transitioning the portfolio from a previously more diversified investment process (reducing the number of names). Portfolio turnover for the past three years was 14%, 15%, and 12%, respectively. We believe the new fund will exhibit similar turnover levels, perhaps slightly higher.

Risk control is very important to the team, and it plays a role in portfolio construction. The team views the most important risk as losing money, not stock-price volatility. They attempt to mitigate this risk by adhering to their margin-of-safety criteria at the stock-picking level. At the sector level, they are benchmark agnostic but don't fully discount the tenets of modern portfolio theory, as they think it's prudent to have several sectors represented. While there are elements of increasing diversification, they won't own a business for the sake of diversification. There are no hard limits on sector weightings, and at times, an allocation to a particular sector may be meaningful. When comparing two potential investments, the team will often favor the company with a broader range of products and geographic diversification.

Sector analysts provide significant input but portfolio manager Michael Keller makes final investment decisions. He will opportunistically add to portfolio holdings that continue to live up to their risk/reward profile when discounts to their estimate of intrinsic value deepen. He will typically begin trimming a position when the price rises within 10% of that target, selling when stocks reach their estimate of intrinsic value. The team will also sell when there's a more compelling investment opportunity or if there's a deterioration of fundamentals.

Investment-Team Background

The Large Cap fund's inception is September 9, 2019, but the roots of the current-day investment process date back to 2005. When we initiated coverage of BBH Core Select in 2010, the fund listed three portfolio managers: Hartch, Witmer, and Keller. At that time, Witmer served in more of an advisory role providing input on certain industries, and occasionally attended team meetings. Our opinion rested on our confidence in Hartch and Keller, and the broader analyst group. In mid-2018, Hartch stepped down from his portfolio-management role on Cole Select, leaving Keller as the sole manager. Our opinion at the time was that Hartch's departure would not negatively impact the team. Since then, Keller has served as sole portfolio manager of Core Select until the fund was liquidated, and he has been the sole manager on the Large Cap fund. Today, Keller is supported by 10 team members. Two long-tenured analysts (Scott Hill and Hayley Xuereb) serve as portfolio advisors to Keller.

The team currently manages approximately $12.8 billion in large-cap equity assets, the majority of which comes from the firm's traditional wealth management business. Assets in the fund were $400 million as of early November 2019.

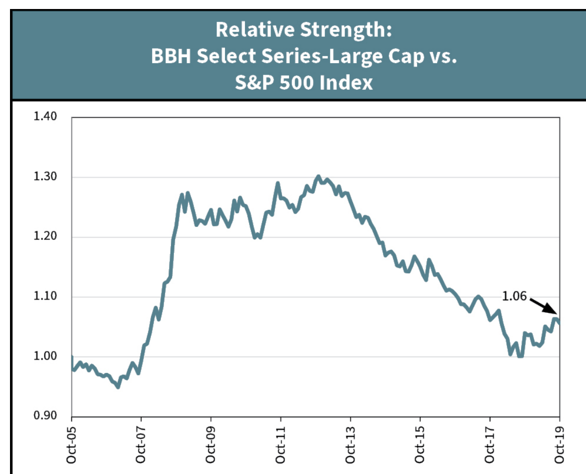
Performance

From the start of our record for the original BBH Core Select fund on October 1, 2005, to its closure in early October 2019, the fund outperformed the S&P 500 Index with a return of 9.1% compared to 8.6% for the index. Over the same 14-year period, the Morningstar Large Blend Category return was 7.2%. Over its full life, the fund performed largely as we expected—winning by compounding reasonable gains and attempting to avoid major losses. The fund outperformed in down markets, performed in line or outperformed in modestly rising markets, and lagged in strong up markets. A simple way to quantify this is the fund's upside and downside capture ratios over its life relative to the S&P 500 Index. The fund had an upside capture of 87% and a downside capture of 78%, meaning it enjoyed a good portion of the upside over time, but did a better-than-average job of protecting capital in declining markets.

Despite the strong long-term record, the fund underperformed its index in the last six calendar years of existence (2013 through 2018). Until the fund was closed in October, it was ahead of the S&P 500 year to date (21.7% versus 18.3%, respectively). While performance in recent years has been disappointing, it is not outside our range of expectations. The last 10-plus years would certainly be considered a strong up market, and so it's unsurprising that the fund has lagged by its index from March 2009 to its October close (14.4% versus 16.3%). Post-March 2009, the market has not had a sustained drawdown, which is an environment when we'd expect the fund to make up much of its relative gains. We continue to believe that relative outperformance on the downside will be an important driver of their long-term investment results. And importantly, we do not believe anything has changed with the team's investment approach to make us alter our expectations.

Litman Gregory Opinion

We think the team's edge stems from many factors. First is the discipline with which the process is executed, where there's a clear emphasis on favorable probability. During our discussions with the investment team, we found them to be extremely disciplined when it comes to sticking to the investment criteria (i.e., all elements of their margin-of-safety criteria are adhered to, as is the requirement for current and future growth). Our opinion is based on discussing stocks that are in the portfolio, stocks that are candidates for the portfolio and how they meet the criteria, and stocks that appear (to us) to meet the criteria but fall short based on the team's analysis, as well as mistakes and holdings that have subsequently fell short of the criteria and were ultimately sold. We believe their strict investment criteria eliminate the possibility of analysts becoming stubborn in defending their names, and the process provides clarity to decision making. The discipline also extends to portfolio construction (buying or adding, selling or trimming based on valuation).



Another positive is the strength of the investment team. We think the team's grassroots research is very strong based on their sector and company knowledge. We view the team as diligent, thorough, cautious, and intellectually honest, and we rank each investment team member highly. The team has expanded in recent years and we have had contact with some of the new hires, but we will continue getting to know the extended team.

We remain very impressed with the team and the firm. In all our conversations with the investment team as well as noninvestment personnel, there is a clear commitment to excellence. Whether it's an analyst's desire to thoroughly understand an industry or company, how they think about asset capacity and growing the firm, or how and when they will take on a new product, we find them to be thoughtful and deliberate. They clearly want to do what is in the best interest of the shareholders by ensuring that the factors behind the team's success remain in place. Another indication of shareholder orientation was their 2012 decision to "soft close" the mid/large Core Select fund to new shareholders below the $15 billion level, a level that we view as responsible.

Performance as of 10/31/19	MTD	Three-Month	YTD	One-Year	Three-Year	Five-Year	10-Year	Since Start of Record
BBH Select Series-Large Cap	1.50%	3.79%	25.36%	16.12%	13.20%	8.55%	11.84%	9.32%
S&P 500 Index	2.17%	2.43%	23.16%	14.33%	14.92%	10.78%	13.70%	8.89%

Inception September 9, 2019. Prior to the inception of the fund, we use the record for BBH Core Select back to October 1, 2005, when the current investment process was implemented.

As a result of our extensive due diligence, we are confident the BBH Select Series-Large Cap team has a sustainable investment edge derived from its people, process, and philosophy. We have added the fund to our *Recommended List* in the Larger-Cap Blend category and now hold this fund in our model portfolios.

—Jack Chee and Kiko Vallarta, CFA

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