

The Case for Active U.S. Small-Cap Value

Did you know that from March 2001 to December 2014, U.S. small-cap stocks returned 8.4% a year, outperforming the 6.1% return of U.S. large-cap stocks, as measured by the Russell 2000® Index and the Russell 1000® Index, respectively? The outperformance of small caps vs. their larger brethren also holds true going further back, according to a number of popular long-term analyses.

One factor cited to explain that outperformance is market inefficiency. Because information on small caps is less widely available, analyst research can generate more value-added insights, in theory. At the end of 2014, for example, nearly half of the constituents (787) in the small-cap Russell 2000® Index had five or fewer research analysts covering the underlying companies, and 118 companies had no analyst coverage at all. This stands in stark contrast to the widely covered large-cap Russell 1000 Index®, which had less than 8% of its constituents with five or fewer analysts and less than 1% with no coverage at all. With limited equity research coverage and data available, active managers have a greater opportunity in the small-cap universe to recognize business value that is unappreciated or misunderstood by the market.

After eight consecutive quarters of absolute gains, U.S. small-cap stocks posted a loss in the third quarter of last year. However, the Russell 2000® Index ended up 4.9% for the year. Interestingly, there is a widening spread between the

performance of small-cap stocks and the positive 13% calendar year return large-cap equities posted in 2014. The question is whether this is the beginning of a prolonged period of small-cap underperformance.

THE OUTLOOK FOR SMALL CAPS

Smaller companies tend to do most of their business within the U.S. and should benefit particularly from the modestly improving U.S. economy. Large-cap stocks derive 28% of their revenue internationally, while small caps generate just 19% of sales from outside the U.S. That makes smaller stocks far less exposed to the sensitivities of global demand—and the challenges of a strengthening U.S. dollar. During the second half of 2014, U.S. economic data firmed while that of other major global economies slowed down, causing investors to anticipate further monetary stimulus, particularly from the Bank of Japan and European Central Bank, and creating a flight of capital to the U.S. dollar. For U.S. businesses relying on international demand, this creates a headwind to consumption abroad and a potentially negative impact to revenue growth.

U.S. small-cap stocks may also benefit from an active mergers and acquisition environment, as M&A activity was strong in 2014. Though it nearly ground to a halt after the financial crisis, M&A deal volume has been steadily picking up for the past five years—and we believe that this trend can continue. Activity is far from historical highs, and the combination of

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healthy corporate balance sheets and low interest rates makes for an accommodative M&A environment. In North America, deal volume is up 63% year-over-year, according to Bloomberg as of December 31, 2014. In total, more than 1,750 companies have been removed from the Russell 2000® Index over the past 15 calendar years.

Continued acceleration of deal flow last year and potentially this year may serve as an attractive tailwind for small-cap investors. Overall, M&A activity is an indicator of corporate confidence and business health, and has tended to be positively correlated to U.S. GDP growth and market returns. Companies that choose to enter deals do so because they believe that cost and revenue synergies can help to boost profitability and returns. As a result, such companies often enjoy higher equity multiples, and an active M&A environment can boost valuations for the market as a whole. Additionally, greater deal volume bodes well for smaller companies, as they tend to be the take-out targets and can be paid attractive premiums, benefiting shareholders.

FINDING VALUE

According to the Russell 2000® Value and Growth indices, from January 1, 1979, to December 31, 2014, U.S. small-cap value stocks have outperformed U.S. small-cap growth, returning 13.0% and 9.7% a year, respectively. Small-cap value stocks also managed to generate substantially less volatility, with a standard deviation of 17.4% vs. 22.9% for small-cap growth.

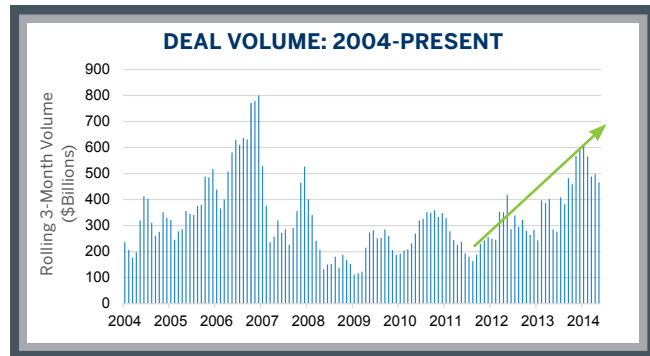
In more recent months, investors have been on a search for perceived safety and potentially higher yield, and we expect the current shift away from growth and toward value to continue. We believe that cyclical-value companies, like those typically found in financials, industrials and technology, are attractive today relative to other sectors of the U.S. equity market. (See the price to sales ratio chart to the right.) Many cyclical companies have turned in solid revenue and earnings growth since the 2008-2009 financial crisis, but their stock prices have somewhat lagged. Instead, investors have typically favored high-growth stocks and economically defensive stocks. As a result, these stocks currently trade at much higher earnings multiples than they did four years ago. In contrast, cyclical-value stock valuations have barely increased.

THE WAY TO PLAY THE SMALL-CAP VALUE OPPORTUNITY

There is a growing body of academic work that suggests that the top-quality active equity managers who are able to consistently outperform the market share certain attributes. We expound on those attributes in a recently published white paper, *Active Alpha* (available at www.brownadvisory.com), but one of the common characteristics is high active share. Active share measures the degree to which a portfolio's holdings differ from those of its benchmark, from 0 (identical to the benchmark) to 100 (nothing in common with the benchmark). To have a good shot at persistently beating the index, you need to differ from it significantly. As a group, small-cap managers have tended to have higher active share scores than large-cap

M&A Activity on the Rise

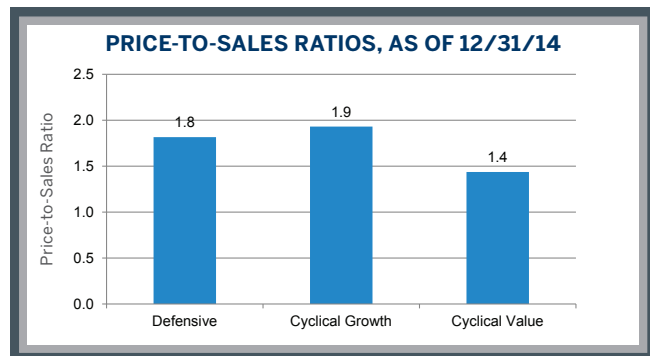
Mergers and acquisition activity has been rising for nearly four years, but has only recently reached historical norms.



SOURCE: BLOOMBERG, JANUARY 1, 2004 - DECEMBER 31, 2014

Price-to-Sales Lowest for Cyclical Value

Comparing the median price-to-sales ratio of companies in the Russell 2000® Index, data shows that cyclical value stocks are the least expensive within U.S. small caps.



SOURCE: BLOOMBERG

managers because the investable universe is larger and there is greater flexibility to deviate from a benchmark. This backdrop combined with the current market shift toward a stockpicker's market given greater dispersion of returns sets the stage for potential outperformance.

Another way to think of the issue is that unlike index and other passive strategies, actively managed strategies can choose to invest cash inflows in stocks that they believe offer the greatest return and risk reward. A small-cap passive fund pegged to the Russell 2000® Index has a portfolio where 25% of the companies have zero earnings. Active managers do not need to invest in such lower-quality companies.

OUR APPROACH TO SMALL-CAP VALUE

At Brown Advisory, we follow a philosophy that low-turnover, concentrated equity portfolios derived from sound, bottom-up, fundamental research provide an opportunity for attractive performance results over time. We have a culture and firm equity ownership structure that help us attract and retain professionals

who share those beliefs, and we follow a repeatable investment process that helps us stay true to our philosophy.

The Brown Advisory Small-Cap Fundamental Value Fund embodies that philosophy and has a differentiated approach from other small-cap value managers. Portfolio manager David Schuster focuses on free cash flow, capital allocation and valuation in an effort to produce attractive risk-adjusted returns. David has nearly 20 years of investment banking experience at a number of distinguished firms and joined Brown Advisory in 2008 to help launch this small-cap offering in collaboration with associate Portfolio Manager Mike Poggi, CFA. The two’s knowledge of how to “rip through” financial statements to uncover mispriced market opportunities is essentially their edge. They focus on business models that generate consistent potential levels of sustainable free cash flow, and they have found that many investments that they have uncovered with this approach have done well in turbulent market periods.

The result has been attractive risk-adjusted returns. As shown in the table below, as of December 31, 2014, the Brown Advisory Small-Cap Fundamental Value Fund has outperformed its Russell 2000® Value Index over trailing annualized periods and has earned a distinguished five-star Overall Morningstar rating in its U.S. small-blend fund category for its investor share class as of December 31. Since inception, the Fund has provided less downside market capture vs. its Morningstar small-blend peer universe compared to the Russell 2000® Value Index, though it has slightly weaker upside market capture. Many investors are finding appealing the combination of the long-term outperformance of U.S. small-cap value stocks and the ability of the Brown Advisory team to add alpha to that asset class. [B](#)

Brown Advisory Small-Cap Fundamental Value

The Fund seeks to achieve attractive risk-adjusted returns over time by investing in companies that the managers believe have sustainable free cash flow and management that demonstrates effective capital allocation. The team’s research process identifies valuation disparities overlooked by the market. We believe that these valuation gaps provide a “margin of safety” and have the potential to generate additional returns.

Data as of 12/31/2014	EV/EBITDA (LTM)	Free Cash Flow Yield	P/E (FY2)
Brown Advisory Small-Cap Fundamental Value Fund, BIAUX (Investor Class)	8.58	3.6%	17.9x
Russell 2000® Value Index	8.91	1.9%	16.5x
Russell 2000® Growth Index	12.11	2.7%	19.4x
Russell 2000® Index	10.53	2.4%	17.8x

SOURCE: FACTSET

The managers adhere to a philosophy that low-turnover, concentrated equity portfolios can outperform over time.

Data as of 12/31/2014	# of Holdings	Top 10 Holdings % of Net Assets	Portfolio Turnover (1 YR)
Brown Advisory Small-Cap Fundamental Value Fund, BIAUX (Investor Class)	54	37%	30%
Morningstar U.S. Small-Blend Funds, Average	532	22%	63%

SOURCE: MORNINGSTAR DIRECT

Consistent Long-Term Excess Return: Brown Advisory Small-Cap Fundamental Value Fund

Data as of 12/31/2014 <i>Returns greater than one year are annualized</i>	3 Mo.	1 YR	3 YR	5 YR	Inception-to-Date
Brown Advisory Small-Cap Fundamental Value Fund					
Inception Date: 12/31/08 (Investor Class)					
Morningstar Category: U.S. Small Blend					
Gross Expense Ratio:					
Investor Class: 1.23%					
Advisor Class: 1.48%					
Institutional Class: 1.08%					
Overall Morningstar Rating: ★★★★★ (Investor Class) out of 624 Funds					
BIAUX (Investor Class)	9.33	5.98	21.78	18.63	19.80
BAUAX (Advisor Class)	9.24	5.70	21.48	--	16.28
BAUUX (Institutional Class)	9.38	6.12	--	--	22.62
<i>Russell 2000® Value Index</i>	9.40	4.22	18.29	14.26	15.29*
EXCESS RETURN (Investor Class)	-0.07	1.76	3.49	4.37	4.51
% Rank (Investor Class)		29	9	4	
# Funds in Category		737	624	567	
Morningstar Rating (Investor Class)			★★★★★	★★★★★	

THE FUND’S OVERALL MORNINGSTAR RATING™ IS BASED ON THE INVESTOR SHARE CLASS AND IS RATED AMONG 624 SMALL BLEND FUNDS FOR THE PERIOD ENDING 12/31/2014. DERIVED FROM A WEIGHTED AVERAGE OF THE FUND’S THREE-, FIVE- AND 10-YEAR RISK ADJUSTED RETURN MEASURE, IF APPLICABLE.

Performance data quoted represents past performance and is no guarantee of future results. Performance for periods greater than one year is annualized. Current performance may be lower or higher than the performance data quoted. Investment return and principal value will fluctuate so that an investor’s shares, when redeemed, may be worth more or less than original cost. Performance for other share classes will vary. Shares redeemed or exchanged within 14 days of purchase will be charged a 1.00% fee. Performance data quoted does not reflect the redemption or exchange fee. If reflected, total returns would be reduced. For the most recent month-end performance, please call 1-800-540-6807.

Before investing, you should carefully consider the Fund's investment objectives, risks, charges and expenses. This and other information is in the summary or statutory prospectus, a copy of which may be obtained by calling 1-800-540-6807 or visiting the Fund's website, www.brownavisoryfunds.com. Please read the prospectus carefully before you invest.

Investments in smaller companies generally carry greater risk than is customarily associated with larger companies for various reasons, such as narrower markets, limited financial resources and less liquid stock. The value of the Fund's investments in REITs may change in response to changes in the real estate market, such as declines in the value of real estate, lack of available capital or financing opportunities, and increases in property taxes or operating costs. The Fund may invest in ETFs, which may trade at a discount to the aggregate value of the underlying securities, and although expense ratios for ETFs are generally low, frequent trading of ETFs by the Fund can generate brokerage expenses. The Fund may invest in foreign securities, which involve greater volatility and political, economic and currency risks and differences in accounting methods. These risks are greater in emerging markets. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Derivatives may involve certain costs and risks, such as liquidity, interest rate, market, credit, management, and the risk that a position could not be closed when most advantageous. Investing in derivatives could lose more than the amount invested. Investments in lower-rated and non-rated securities present a greater risk of loss to principal and interest than higher-rated securities. Private Placement issued securities are restricted securities that are not publicly traded. Delay or difficulty in selling such securities may result in a loss to the Fund. The recent growth rate in the stock market has helped to produce short-term returns for some asset classes that are not typical and may not continue in the future. Because of ongoing market volatility, fund performance may be subject to substantial short-term changes.

Performance figures and charts include the reinvestment of dividend and capital gain distributions.

The Fund is the successor to the investment performance of the Predecessor Fund as a result of the reorganization of the Predecessor Fund into the Fund on October 19, 2012. Accordingly, the performance information shown for periods prior to October 19, 2012, is that of the Predecessor Fund. Investor Shares commenced operations on December 31, 2008, as part of the Predecessor Fund and Advisor Shares commenced operations on July 28, 2011, as part of the Predecessor Fund. Performance shown prior to inception of the Advisor Shares is based on the performance of Investor Shares, adjusted for the higher expenses applicable to Advisor Shares. Prior to July 1, 2011, the Advisor Shares were known as A Shares. Institutional Shares commenced operations on October 19, 2012. Prior to October 19, 2012, Investor Shares were known as Institutional Shares.

The **Russell 1000® Index** measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000® Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 represents approximately 92% of the U.S. market and is constructed to provide a comprehensive and unbiased barometer for the large-cap segment and is completely reconstituted annually to ensure new and growing equities are reflected. The **Russell 2000® Index** measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000 Index is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set. The **Russell 2000® Value Index** measures the performance of the small-cap value segment of the U.S. equity universe. It includes those Russell 2000® Index companies with lower price-to-book ratios and lower forecasted growth values. The Russell 2000® Value Index is constructed to provide a comprehensive

and unbiased barometer for the small-cap value segment. The Index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect value characteristics. The **Russell 2000® Growth Index** measures the performance of the small-cap growth segment of the U.S. equity universe. It includes those Russell 2000® Index companies with higher price-to-value ratios and higher forecasted growth values. The Russell 2000® Growth Index is constructed to provide a comprehensive and unbiased barometer for the small-cap growth segment. The Index is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set and that the represented companies continue to reflect growth characteristics. The Russell 1000®, Russell 2000®, Russell 2000® Value and Russell 2000® Growth indices are trademarks/service marks of the Frank Russell Company. Russell® is a trademark of the Frank Russell Company. An investor cannot invest directly into an index.

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The **Overall Morningstar Rating™** for a fund is based on risk-adjusted returns, derived from a weighted-average of the performance figures associated with its three-, five- and 10-year (if applicable) Morningstar Rating metrics. For each fund with at least a three-year history, Morningstar calculates a Morningstar Rating™ based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a fund's monthly performance (including the effects of sales charges, loads, and redemption fees), placing more emphasis on downward variations and rewarding consistent performance. The top 10% of funds in each category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars and the bottom 10% receive 1 star. (Each share class is counted as a fraction of one fund within this scale and rated separately, which may cause slight variations in the distribution percentages.) The Brown Advisory Small-Cap Fundamental Value Fund (BIAUX) was rated against 624 and 567 U.S. domiciled Small Blend funds in the three- and five-year period, respectively, ended 12/31/2014. With respect to these Small Blend funds, Brown Advisory Small-Cap Fundamental Value Fund received a Morningstar Rating of 5 stars for the three-year and 5 stars for the five-year period, respectively. Morningstar Rating™ is for the Investor share class only; other classes may have different performance characteristics.

TERMS AND DEFINITIONS

Market Capitalization is the value of the Fund as determined by the market price of its issued and outstanding stock. **Price-Earnings Ratio** (P/E Ratio) is determined by dividing the price of the stock by the company's forecasted earnings per share. P/E calculations presented with FY1 earnings estimates refer to the next unreported fiscal year, and FY2 estimates refer to the fiscal year following FY1. All of the aforementioned ratios for a portfolio are expressed as a weighted average of the relevant ratios of each portfolio holdings; EXCEPT for P/E ratios which are expressed as a weighted harmonic average. **Earnings Growth 3-5 Year Est.** is the forecasted growth rate of a company's earnings per share. Estimated EPS Growth Rate is not a measure of the Fund's future performance. **Price-to-Sales** measures the market capitalization divided by the company's total sales over the past 12 months. **EV/EBITDA** measures a company's return on investment and is calculated as earnings before interest, tax and depreciation (EBITDA) divided by a company's enterprise value. **Free Cash Flow Yield** measures the financial performance of companies calculated as operating cash flow minus capital expenditures divided by the company's market capitalization. **Portfolio Turnover** is the ratio of the lesser of the portfolio's aggregate purchases or sales during a given period, divided by the average value of the portfolio during that period, calculated on a monthly basis. Portfolio turnover is provided for a one-year trailing period. **Margin of safety** refers to conceptually purchasing securities when the market price is significantly below its perceived intrinsic value. Alpha is a measure of performance on a risk-adjusted basis. Standard deviation is a measure of an investment's volatility and is calculated as the square root of variance. **Alpha** takes the volatility (price risk) of a mutual fund and compares its risk-adjusted performance to a benchmark index.

Quasar Distributors, LLC, distributor.