

Staying the Course

When Chris Berrier became manager of the Brown Advisory Small-Cap Growth Fund in May 2006, U.S. stocks were thundering into the third year of record gains, with the Dow Jones Industrial Average soon to break through 12,000 for the first time. But the bull market's days were numbered. Equity prices tumbled in 2007 along with home values, and the U.S. economy plunged into its worst downturn since the Great Depression. During his tenure, Chris has navigated a tumultuous market adeptly, through both the severe downdraft of the 2007-09 financial crisis and subsequent recovery. We recently sat down with Chris to talk about what he has learned during his decade leading the portfolio and his thoughts about the current equity market.



What is your outlook for U.S. small-cap stocks given weak global growth, the prospect that interest rates will rise, and the transition to a White House, Senate and House run by Republicans?

Chris: Small-cap stocks jumped after the election because of several perceived changes—expectations for lower taxes, less regulation, a stronger U.S. economy and a pickup in mergers and acquisitions due to U.S. corporate repatriation of dollars. There are also expectations that a Trump administration will bring an end to gridlock in Washington. All these are seen as positives for small-caps especially because, over the long term, the companies are much more tied to the business climate in the U.S. than large-caps. The policies that Trump has proposed also suggest some degree of reflation. So commodity-oriented sectors like energy and materials have done well. Also, the yield curve has steepened on expectations of faster growth, and that's good for banks.

That said, interest rates appear likely to continue their rise, and stock valuations are a bit more punchy than a few months ago. In the short term, it's unclear where the market is headed

now, but in the intermediate or long term, I think pro-growth policies should be positive for companies with solid prospects.

If you had to choose a single sector for future investment, what would it be?

Over the long term, I would look to technology as having the most compelling and, potentially, most lucrative set of opportunities. The only caveat related to that would be that valuations within technology stocks are high and more volatile than the overall market—you need to be very careful how you select individual stocks. We are focused on software, particularly subscription businesses, as more of the tech value chain shifts to software and away from hardware.

Why have technology stocks not kept up with the broader market since the presidential election?

If you look historically, reflationary or inflationary periods tend to favor companies that produce or possess hard assets. So the sectors that gain are tied to energy, industrials and materials. Because technology has fewer hard assets, it has performed



CHRIS BERRIER
Portfolio Manager

poorly in long-term inflationary environments. So when I think of people pressing ETF (exchange-traded fund) buttons to get their exposure in line with the Trump administration and its reflationary policies, they are buying industrials, materials and related sector funds, and selling technology because of historical precedence. This has been one of the strongest, most abrupt sector rotations that I have seen in 20 years. We shall see if the fundamentals follow over the next six to 12 months.

Has the decline in tech stocks been fueled by concerns Trump will pursue policies that harm the sector?

There is a perception that Trump believes that Silicon Valley does not like him. There is also a view that tech business models create massive market capitalizations but comparatively little employment. I think it is extreme to think that Trump is going to attack tech as a whole—it is clearly the most dynamic U.S. industry and the one where we are seen as the global leader. Bottom line, I think the political fears focused on technology are probably overblown.

In light of what you know now, what advice would you have given yourself in 2006 when you were just starting out as a manager of the Small-Cap Growth strategy?

I'd say keep your emotions in check and pay attention to the sizing of the positions in your portfolio. One of the most important things in portfolio management that people don't often talk about is the importance of managing your emotions to not get too high when things are going well and too low when things are going poorly. If you let emotional swings influence your decision-making, you're going to make poor decisions. It's vital to anchor yourself on the objective of achieving strong relative performance through a full market cycle. When managing a concentrated portfolio, from time to time you are going to have pretty substantial positive and negative swings over the short term compared to a benchmark. You can't eliminate this volatility—what matters is how you deal with it.

Most portfolio managers spend a lot of time focusing on the characteristics of the businesses they seek out, their buying process and what prompts them to sell securities. But there is very little conversation about the optimal position sizing within a portfolio. I think position sizing is at least as important

for long-term performance as buy and sell discipline. That's something we've improved upon as a team over the past 10 years.

What insights from behavioral finance have been especially useful to you in portfolio management?

Generally, we have done a good job of holding onto our winners, ensuring that they benefit the portfolio without exceeding a prudent level. I am especially cautious when their valuations are extended because of their strong long-term performance. I tend to be an incrementalist at heart, doing things in steps rather than in one big move. Generally, I think that's good over the long run. But there are times when you need to take bold, aggressive action. Over time, we have learned to be more aggressive sellers and buyers when necessary. You can harm your performance by not being bold enough when opportunities arise to take advantage of excessive price movements in the market.

Why has it been so difficult for active equity managers to outperform their benchmarks during the past several years? What are the reasons you see for poor relative performance across such a broad range of approaches?

The current business cycle has been dramatically different from previous cycles. The recovery has been more anemic, and business performance in sectors like industrials and transportation has not followed previous patterns. The extraordinarily accommodative Federal Reserve policies aimed at combating some of the structural changes and cyclical problems in the economy have distorted asset prices across equity and other markets. Near-zero interest rates are something that we have never seen before, so there is no guidebook for the current circumstances. For active managers, the past and their own experience may not help them as much as it otherwise would.

At the same time, we've been in a period in which correlations have been high within many market sectors. Over time, as the economic cycle elongates and interest rates increase, you'll start to see correlations break down. This will create more pricing anomalies that active managers can leverage. The anomalies may be more pronounced given the change in market structure toward index funds and ETFs.

What is your investment focus, and what guides you in your decisions?

We are not top-down prognosticators or renters of stocks, and we are not focused on whether the next data point is going to move a stock up or down by 5%. Instead, we consider ourselves owners of businesses, selected based on bottom-up analysis. We are focused on where the company is going to be in two or three years, and what the market may pay for it at that point in time. We try to outperform by focusing on the businesses themselves and by having a long-term orientation in an increasingly short-term world. When you own a stock for a longer period of time, you become much more knowledgeable about it and how it will respond to different market and economic conditions—we think this improves our ability to size positions.

What stock pick do you consider to be your biggest success, and how did you identify it as promising?

One of the most rewarding stocks was Navteq. It fell soon after we bought it in 2007, but because of our rigorous due diligence, we knew the company had created a mapping asset that was very difficult to replicate. The proliferation of mobile handsets and the growing demand for navigation in autos meant that Navteq had a very valuable asset that had long legs. There wasn't much recognition of the long-term demand due to short-term concerns. We roughly doubled the size of our position when the price declined from close to \$40 to somewhere just above \$20 per share, making it one of our largest positions in the portfolio. Nokia acquired Navteq several months later for \$78 per share, validating our view of the company.

Another company is CoStar Group [a provider of research on commercial real estate]. I had covered the company for years and saw that it faced a challenge in growing its revenues and expanding its profit margins at the same time. The company had always traded at a high multiple because it had close to a monopoly position within the commercial real estate database space. That multiple made it difficult to clearly make money. When CoStar made a bid to buy LoopNet, which was the No. 2 player in the space, we saw that as a sea change that could catalyze revenue and profit growth for the company for a very long period of time. We bought the stock around the time of the acquisition.

After the deal, we expected CoStar would disproportionately benefit from the cyclical upswing in commercial real estate. We also

believed it had cemented the ability to push through higher prices because of its de facto monopoly position. CoStar's profit margin expanded massively as it stripped out costs after the acquisition, raised its prices, and increased revenues through the cyclical recovery and cross-selling. It became clear that the stock was not as expensive as it appeared because earnings were likely to surge in two or three years time. The stock is up multi-fold over the past few years.

Looking back, what have you found to be the most painful decisions?

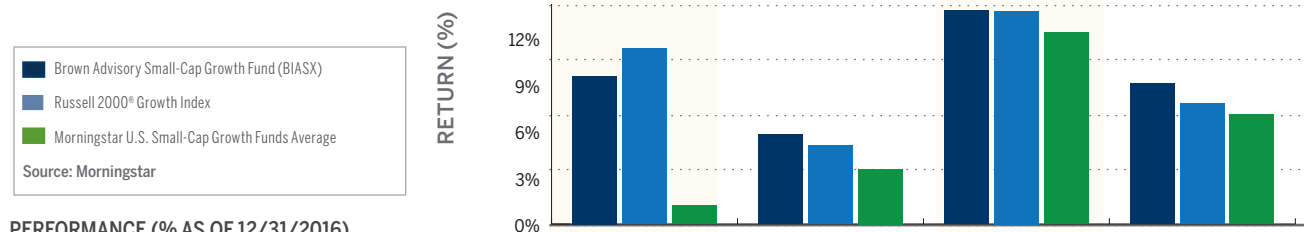
Most of the time, the mistakes we've made could be lumped into the category of believing that specific positive drivers within a company were strong enough to push through a less-than-robust secular backdrop. Over time, we have recognized that no matter how good the company and its management team, we need to be acutely aware of the long-term underlying drivers that exist, weighing them most heavily in our process. Difficult secular forces tend to overwhelm short-term positives, usually limiting your ability to make money.

Are small-cap stocks more vulnerable to rising rates than large-cap stocks?

Usually, interest rates rise because economic growth is accelerating, so early rate increases often coincide with good periods of small-cap performance as the benefits from accelerating growth trump the increase in interest rates. What tends to happen, however, is that over time, the economy slows and interest rate conditions become

CONSISTENT OUTPERFORMANCE

BROWN ADVISORY SMALL-CAP GROWTH FUND



PERFORMANCE (% AS OF 12/31/2016)

	1 YR	3 YR	5 YR	10 YR
Brown Advisory Small-Cap Growth Fund (Investor: BIASX)	9.55	5.79	13.75	9.08
Russell 2000® Growth Index	11.32	5.05	13.74	7.76
Excess Return vs. Index (Investor: BIASX)	-1.77%	+0.74	+0.01%	+1.32%
PEER COMPARISON: Morningstar U.S. Small-Cap Growth Fund Universe				
U.S. Small-Cap Growth Funds (Median)	11.20	3.55	12.33	7.08
Brown Advisory Small-Cap Growth Fund Rank (Investor: BIASX)	55%	24%	24%	Top 5%
# Funds in Category Universe	669	599	531	389

Gross Expense Ratios: 1.14% (Investor), 1.39% (Advisor), 0.99% (Institutional)

Morningstar Rankings represent a fund's total-return percentile rank relative to all funds that have the same Morningstar Category. The highest percentile rank is 1 and the lowest is 100. It is based on Morningstar total return, which includes both income and capital gains or losses and is not adjusted for sales charges or redemption fees. **Past performance does not guarantee future results.**

Source: U.S. Bank. 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.

restrictive. The headwinds then become stronger for small-cap stocks and all types of stocks. The interesting thing about this cycle is that it is so elongated and so muted that it is difficult to figure out whether past history and past cycles are going to be as good of a guide this time around. What we have seen with the Trump election is the view that the economy has the potential to accelerate, that inflation may pick up and that rates have risen. And what has happened? Small-caps have done better. If rates rise and the economy does not live up to the expectations for increased growth, that could be a combination that would not be favorable for small-cap stocks and stocks generally.

So how do you position your strategy to ensure you can ride the updraft from stronger economic growth while protecting it from the risk of a slump?

We have always believed that we would protect ourselves on the downside by focusing on high-quality businesses because quality is especially valuable when things are not going well. High quality tends not to matter that much when the world is humming right along but really matters in less robust periods.

We also look for companies with strong potential levels of profitability. We want to make sure our companies make money and that profit margins are healthy and sustainable. We want to know that our businesses are leaders in their sector and that, through a difficult market, they are likely to make the right decisions and investments to position themselves to gain even more share coming out of a difficult economic scenario. That is when you see companies lengthen their competitive lead because they have a greater wherewithal to deal with challenges.

We own high-quality companies with good balance sheets, and we try to focus on diversification. We have to make sure that we don't have too many eggs in one basket, so that if something goes wrong, the portfolio won't unduly suffer.

When you are a fully invested, long-only manager, you don't have too many tools in the toolkit to use to protect capital on the downside. First, you start at the company level with bottom-up analysis. Then you achieve portfolio diversification. And, then you think about the forces that pose the biggest risks to portfolio holdings. When you marry these three elements together, you can hopefully limit the negative impact during a down market. **B**

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Diversification does not assure a profit, nor does it protect against a loss in a declining market.

For the most recent list of portfolio holdings, please visit www.brownadvisoryfunds.com, or click here electronically. Fund holdings and sector allocations are subject to change

and should not be considered a recommendation to buy or sell any security.

Top 10 Positions as 12/31/2016	% of Total Assets
Cash & Equivalents	7.6
Waste Connections Inc.	4.2
Cogent Communications Holdings Inc.	3.6
Liberty TripAdvisor Holdings Inc.	2.9
BroadSoft Inc.	2.9
Bright Horizons Family Solutions Inc.	2.7
Charles River Laboratories International	2.6
Cavium Inc.	2.5
Hexcel Corp.	2.4
Broadridge Financial Solutions Inc.	2.3
Total % of Net Assets	33.6%

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 2000® Growth Index and Russell® are trademarks/service marks of the London Stock Exchange. It is not possible to invest directly in an index.

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Basis points: a unit of measurement that is equal to one-hundredth of one percent or (0.01%).

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