BBH Strategy Insight

January 2017

Good Old-Fashioned Values

At Brown Brothers Harriman & Co. (BBH), we take pride in the fact that our Firm is the oldest and largest partnership bank in the United States. Our core values of teamwork, integrity, and excellence have guided us since our founding nearly 200 years ago in 1818. Our Firm has witnessed many financial innovations throughout its history, but narrowly missed the inception of the U.S. Municipal market. Municipal bonds were first issued in the U.S. in 1812 to help finance the Erie Canal in New York. For many decades, we have successfully invested in Municipals for a wide range of institutions, wealthy individuals, and for BBH, itself.

Nowhere in the world of fixed income is there a sector more diverse than Municipals. With tens-of-thousands of issuers, dozens of bonds structures, and over one million individual securities, Municipal bonds come in a myriad of shapes and sizes. These bonds help finance critical infrastructure such as water and sewer systems, schools, airports, and hospitals. Other non-essential projects such as golf courses, executive airports, and parking facilities sometimes qualify for funding in the Municipal market as well.

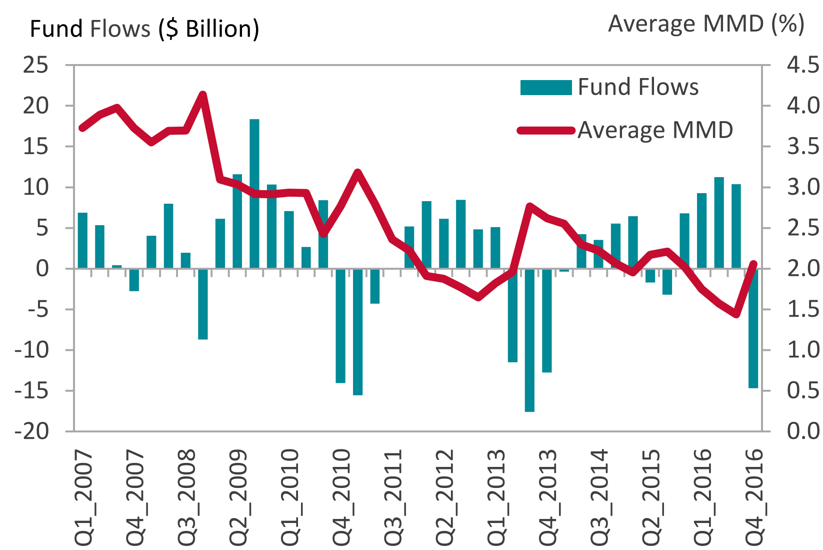
The Municipal market is unique because of its household-dominated ownership base. All other fixed income sectors are predominantly owned by institutions. This has several important ramifications for valuations and market behavior. First, household investors possess a distinct set of preferences for:

General Obligation Bonds within their state of residence

- AA-rated or higher bonds
- Coupon bearing bonds, with a fixed rate of interest
- Maturities of ten years or less
- Non-callable structures
- Bonds not subject to the Alternate Minimum Tax (AMT)

All else equal, securities with these characteristics are typically priced more expensively than other varieties. Second, history and experience tell us that the compensation for bearing Municipal credit risk is often much higher than the risk of default. This is particularly true for investment-grade securities that fall outside of the comfort zone of typical household investors. Third, the Municipal market is periodically subject to high levels of volatility that cannot be justified by fundamentals. Time and again, household investors exhibit herding behavior during good markets and bad, which creates market momentum and volatility independent of valuations and credit fundamentals.

Municipal Fund Flows vs. Yields



Data reported monthly for January 31, 2007 to December 31, 2016
Sources: Thomson Financial Services, Siebert, Brandford, Shank & Co., Lipper, MMD (Municipal Market Data), and BBH Analysis

As a result of its diversity, fragmented household ownership base, and valuation distortions, we find that the Municipal market offers attractive opportunities for active management. Although we invest for a wide range of clients and our Firm, we share the same objective for all the capital entrusted to us:

- First — protect our investors' capital;
- Second — generate attractive risk-adjusted returns.

Prioritizing capital preservation may seem conservative and old-fashioned. We all know that when bonds deteriorate, their prices can fall as fast as equities. Consequently, in order to generate attractive risk adjusted returns, it is imperative to avoid credit problems.

To achieve our goals, we employ a bottom-up, research intensive, value-driven strategy that stands in contrast to the mainstream approach in the fixed income management industry. We seek to own a limited number of durable credits that we purchase at attractive yields. Unlike many others, there are no committees in our investment process as our team makes all investment decisions collaboratively.

Consistent with our desire to protect our investors' capital, we only consider credits that we believe to be fundamentally sound under a wide range of circumstances and economic conditions. Unlike in equities, value investing in bonds benefits from contractual maturity dates. If the market fails to recognize the value we have identified in our securities, we can simply hold them, earn the yield, and get our capital back at maturity. Our strategy is predicated on the credit remaining intact, and the depth of our research gives us the confidence to hold positions for long time periods or to maturity, if need be.

To develop this confidence, we assess credits against criteria in the four following areas:

Criteria category:	Key items considered and assessed:
1. **Durability of the operating model**	essentiality of service or project, competitive position, balance sheet strength, and price autonomy
2. **Management**	governance practices, capital planning, pension management, and use of price autonomy
3. **Structure**	appropriateness of debt structure relative to the variability of pledged revenues, liquidity, and covenants
4. **Transparency**	clarity, robustness, and timeliness of disclosures, and access to management

Once we are satisfied with the merits of the credit supporting a bond, we have to assess its return potential. Although the effects of overpaying for a security are not as deleterious as having a credit problem, we want to avoid it nonetheless. We take many variables into account when we assess a bond's return potential. For starters, we evaluate our bonds over a base three-year horizon. Of course, we want to be compensated for its credit, interest rate, liquidity, and embedded structural risks, but we do not stop there.

We also seek to establish a margin of safety by demanding compensation for a bond's volatility. Although we do not consider volatility as a risk, it plays an important role in determining the attractiveness of a potential purchase. As value investors, we have a better chance of finding opportunities when markets are bouncing around. We typically own our bonds for years, so our entry points are critically important. A bond's maturity, quality, cyclicality, and structure all factor into our required margin of safety[*].

While this approach may sound simple, it is not easy to execute well in practice. Success depends on our discipline, patience, and on attracting the right clients who appreciate our philosophy and process.. Over the years we have developed a core competency in saying no to credits that don't satisfy our research requirements, or to bonds that do not offer sufficient compensation. The year 2016 provided a perfect case study as we struggled to find opportunities amid the longest Municipal bull market on record. For fourteen consecutive months, the Municipal market generated positive returns. While that proved rewarding from the perspective of short-term performance, attractive long-term opportunities were in short supply. Consistent with our approach, our purchase activity hovered at or near multi-year lows for several consecutive quarters. Last summer, we authored a commentary (No Thanks, We'll Pass) not only to highlight how expensive valuations had become, but also to shine light on the extent to which other investors were stretching for yield. We are both comfortable and proud to decline one bond after the next, knowing that we can act decisively when market conditions are replete with opportunities.

In 2016, we invested significant capital during last fall's money market fund-induced stress and during the fourth quarter's dramatic post-election sell-off. Patience pays off when you can name your price and buy from forced sellers.

For value-oriented Fixed Income strategies to endure and prosper over the long run, discerning client selection is critical. Our clients give us a lasting edge. Value strategies always risk outflows when markets are weak and opportunities are best. Our clients understand and appreciate our approach

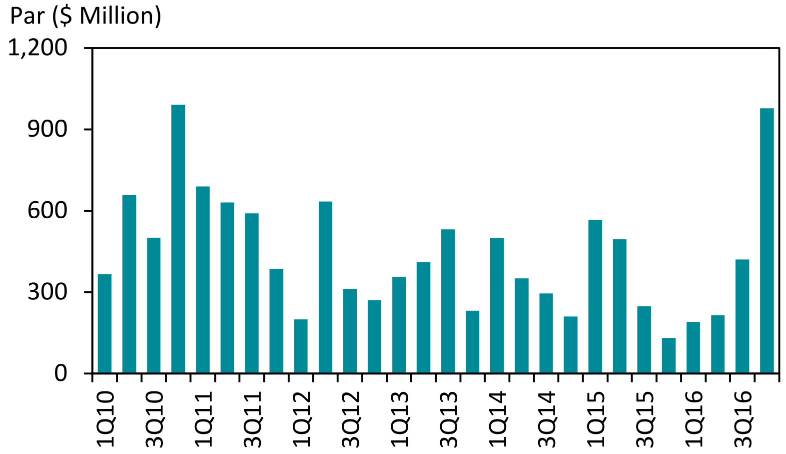
[*] With respect to fixed income investments, a margin of safety exists when the additional yield offers, in BBH's view, compensation for the potential credit, liquidity and inherent price volatility of that type of security and it is therefore more likely to outperform an equivalent maturity credit risk-free instrument over a 3-5 year horizon.

and allow us to act as effective contrarians and to take advantage of weak markets. The value of having understanding clients is even more pronounced in today's less liquid bond market.

At BBH, we view our interests as aligned with those of our clients. We understand that if we can help our clients succeed and meet their goals, then we will succeed as a firm. All too often in today's investment world, managers assess their risk and success on a relative basis. We never subjugate our research to benchmark construction and go to great lengths to protect our clients' capital from impairment. We know what we own and why — and you will never hear "because it's in the index" at BBH. We are proud of our long-term track record and believe it serves as an effective proof statement of the efficacy of our strategy, the strength of our team, and the care with which we execute.

Our approach may seem old-fashioned, but generating strong investment results never goes out of style.

Total Purchases



Data as of December 31, 2016
Sources: Barclays Capital, Bloomberg, and BBH Analysis

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