BBH Core Select - U.S. Large Cap

Brown Brothers Harriman

Quarterly Strategy Update / 2Q 2019

Performance As of June 30, 2019							
	Total Returns		Average Annual Total Returns				
	3 Mo.*	YTD*	1 Yr.	3 Yr.	5 Yr.	10 Yr.	Since Inception
Gross of Fees	7.03%	19.52%	14.34%	12.56%	8.45%	13.93%	10.26%
Net of Fees	6.77%	18.95%	13.22%	11.45%	7.38%	12.81%	9.18%
S&P 500	4.30%	18.54%	10.42%	14.19%	10.71%	14.70%	8.81%

* Returns are not annualized.

Past performance does not guarantee future results, and current performance may be lower or higher than the past performance data quoted. The investment return and principal value will fluctuate, and shares, when sold, may be worth more or less than the original cost.

The S&P 500 is an unmanaged weighted index of 500 stocks providing a broad indicator of stock price movements. The index is not available for direct investment.

Sources: BBH & Co. and S&P

Large-cap equities ended the second quarter of 2019 with moderate gains despite a sharp 6% selloff that had occurred in May following a breakdown in trade negotiations between the U.S. and China. Citing inadequate protections for intellectual property and other perceived asymmetries, the Trump administration placed higher tariff rates on Chinese imports and broadened the scope of covered products. China responded in kind, and equity markets quickly discounted the prospect of incremental growth headwinds that could stifle an already modest economic expansion. In early June, U.S. Federal Reserve officials began openly signaling the potential for interest rate cuts, citing muted inflation and softening jobs data, but we surmise their actions were also a response to the deterioration in investor sentiment during May and a strengthening bid in longer-dated Treasuries.

Apart from energy, all sectors in the S&P 500 Index had positive returns for the quarter, and the Growth subset of the Index outperformed Value despite a significant drag from the so-called 'FAANG' group of mega-cap technology companies, whose shares collectively had a negative return due to the May selloff. Generally speaking, stocks with stable growth, dividends, and low volatility attributes have outperformed the market both in the quarter and year-to-date.

The S&P 500 Index returned 4.30% in the second quarter and has risen by 18.54% year-to-date. By comparison, BBH Core Select Composite ("Core Select" or "the Strategy") rose by 7.03% in the quarter and is up by 19.52% thus far in 2019. Over the last five years, Core Select has compounded at an annualized rate of 8.45% per annum versus 10.71% for the S&P 500 Index. On a full-cycle basis, as measured from the pre-crisis market peak reached in October of 2007, the Strategy has compounded at 8.5% per annum, which compares to 7.9% for the S&P 500.

Portfolio Contribution

Gains in the second quarter were broadly spread among our holdings, as more than three-quarters of our stocks rose by at least mid-single-digit percentages, while only five had negative returns. Our largest positive contributor in the quarter was **Copart Inc.,** which returned more than 23% and was our seventh largest position at the end of June. Copart shares rose to new all-time highs in late May after the Company reported better-than-expected results for its fiscal third quarter, demonstrating not only good operational execution but also the durability of positive secular trends in the auto salvage marketing industry. Copart's core resale business is benefiting from steadily rising trends in accident frequency and lower thresholds for total loss declarations as vehicle complexity and repair costs continue to rise. We expect that these trends will persist over the medium term and that Copart will be able to leverage its scale and expertise to further strengthen its market position. Equally important to the success of its business model has been a continued rise in registered bidders for Copart's online auctions both domestically and overseas, which reinforces favorable network effects that help drive growth and subdue competitive pressures. We remain pleased with Management's moves to expand its international activities and obtain additional yard space in the U.S., as both activities are critical to support future growth and maintain high service levels for both sellers and buyers of salvage vehicles.

Other positive contributors in the second quarter included **FleetCor Technologies, Allegion PLC,** and **Linde PLC.** Shares of FleetCor and Allegion both returned more than 20% in the quarter and were up by 51% and 39% year-to-date, respectively, driven by consistently strong operational performance and favorable secular growth characteristics. The merger between Linde and Praxair, along with associated divestitures that were recently completed, has allowed the Company to begin operating as a fully combined entity as of April 2019. We believe the combination is off to a good start, and solid recent results suggest a favorable operating environment in which Linde can continue to pursue its strategic plan. We believe that Linde has an advantaged competitive position in the industrial gas industry, and we foresee opportunities for significant value creation given the long history of strong execution, focused capital discipline, and operating excellence that the legacy Praxair management team now brings to the combined Company. We added a small amount to our existing Linde position during April.

The largest performance detractors in the second quarter were **Alphabet Inc.** and **Kroger Co.** Alphabet shares fell sharply in early May after the Company reported first quarter operating results that disappointed investors as revenue growth came in below expectations. Earlier in 2019, Alphabet had disclosed product changes designed to improve user and advertiser experiences – essentially the Company was rebalancing parts of

its monetization algorithms and ad placement in order to preserve attractive return characteristics for advertisers and provide better utility to end users. We view these changes as being prudent and appropriate resets that are periodically necessary as a pacing mechanism vis-à-vis the Company's continued strong growth in traffic and users. As well, we view them as being good examples of Management continuing to 'play the long game,' even at the risk of having its quarterly performance differ from short-term market expectations. We remain pleased with the other aspects of Alphabet's recent operational performance, in particular the Company's strong profitability and free cash flow generation despite high levels of continued investment in computing infrastructure, software development, cloud services, consumer hardware, and research. Alphabet's cash-rich balance sheet, with more than $100 billion of net cash at the end of its last reported quarter, offers significant flexibility for acquisitions and share repurchases. We used the share price weakness in early May to add to our existing position.

Alphabet shares were further pressured in June after a press report suggested that the U.S. Department of Justice (DOJ) was preparing to file suit against the Company on antitrust grounds. (Alphabet's Google search business had already been the subject of an antitrust investigation by the Federal Trade Commission several years ago, but that matter was closed without substantive negative findings or remedies.) Separately, the European Union has levied a series of multi-billion-Euro fines against the Company over the last few years for alleged competitive abuses. Google's keyword search and ad network businesses are leaders in markets that have natural 'winner-take-most' dynamics, in which value and utility for users, publishers, and marketers is positively correlated with the size and quality of the layer that connects them. For this reason, market power naturally accrues to the owner of the leading platform(s), i.e., the 'aggregator(s).' The critical concern from an antitrust perspective is whether Google wields this market power in ways that harm consumers. Given that Alphabet's services are typically free for end users (search, email, calendars, cloud storage, video streaming, productivity applications, etc.), a purely antitrust argument would appear to require an updated body of legal theory compared to how matters have been adjudicated in the past. We cannot speculate at this point as to what charges the DOJ will assert if it brings a suit, or if charges will target the core advertising business, the Play content store, YouTube, or something else. Alphabet's size and level of influence virtually assure that it will be a continued target for legislative, regulatory, and judicial actions, and we have taken this into account in the risk adjustments and scenario analysis work we use in building our long-term models and establishing our estimate of intrinsic value[1]. Nevertheless, we remain aware of the potential for adverse scenarios, and we will closely monitor any legal developments that could compromise our investment thesis.

Holdings As of June 30, 2019	
Oracle Corp	7.2%
Berkshire Hathaway Inc (Class A)	6.8%
Alphabet (Class C)	6.6%
Comcast Corp (Class A)	6.0%
US Bancorp	5.2%
FleetCor Technologies Inc	5.0%
Copart Inc	4.6%
Novartis AG ADR	4.3%
Zoetis Inc	4.1%
Linde PLC	3.8%
Allegion Plc	3.7%
Diageo Plc ADR	3.6%
Henry Schein Inc	3.3%
Wells Fargo & Co	3.1%
Unilever NV ADR	2.9%
Celanese Corp	2.7%
Dollar General Corp	2.6%
Brown-Forman Corp Class B	2.5%
Colgate-Palmolive Co	2.1%
Sabre Corp	2.1%
PayPal Holdings Inc	2.0%
Mastercard Inc	2.0%
Nestle SA ADR	2.0%
Waste Management Inc	1.9%
Perrigo Co Plc	1.7%
Kroger Co	1.7%
KLA-Tencor Corp	1.7%
Alcon Inc	1.1%
Costco Wholesale Corp	1.1%
Cash and Cash Equivalents	2.6%

Holdings are subject to change.

After a mixed earnings report from Kroger in which the underlying details were less favorable than otherwise solid headline numbers, the shares came under further pressure, adding to declines already recorded in the first three months of the year. The main challenge facing the Company – and arguably the largest driver of the current investor skepticism toward the stock – is the need to show improvements in same-store sales while also carefully managing gross margins and making substantial investments in e-commerce, fulfillment, and store experience. In a highly competitive food retail environment, this is the fundamental and persistent challenge facing all participants, and while Kroger's tremendous scale and operating capabilities confer many advantages over smaller peers, it is clearly susceptible to these same headwinds, and the portfolio trims we made in late 2018 and early 2019 were largely predicated on that view (as well as a more robust valuation at that time). Nevertheless, we have maintained a small position in the Company, based in part on what we believe is a less-obvious point of differentiation and opportunity for Kroger, which is its

[1] BBH's estimate of the present value of the cash that a business can generate and distribute to shareholders over its remaining life.

ability to build additional profit streams that leverage its data insights and customer intimacy. Our current view is that these efforts, along with the remaining benefits of Kroger's 2018-2019 restructuring program, can allow the Company to achieve its stated profit goals in the intermediate term. However, top-line growth will remain an equally important driver of investor sentiment, in our view.

Portfolio Changes and Valuation

During the quarter, we initiated a new position in **Mastercard Inc.,** which has long been among our 'wish list' companies and is a leader in the attractive payments industry, where we have made several successful investments over many years. Mastercard owns and operates technology platforms that enable electronic payment transactions worldwide, connecting millions of merchants to billions of consumers and the banks with whom they have credit and deposit accounts. Through its eponymous branded network as well as its Maestro and Cirrus networks, Mastercard's infrastructure serves as the intermediary hub in multi-party, open-loop networks that connect consumers, banks, merchants, and other processors. At its core, Mastercard is a vital messaging platform that provides fast and secure authorization and settlement of electronic payments, with value-added overlays such as fraud protection and currency translation.

Our bullish investment thesis on Mastercard has three core elements: i) the attractive long-term growth prospects of the payments industry, which we believe will be driven by growth in personal consumption expenditures (PCE) and the durable secular tailwind of traditional forms of tender (cash, checks) shifting to electronic payments globally; ii) our expectation of a continued competitive equilibrium in the industry, with the key players pricing their services and operating their businesses in a rational and stable manner; and iii) Mastercard's ability to preserve its already attractive profitability and return on invested capital without requiring high rates of revenue growth or large amounts of incremental capital investment. The combination of Mastercard's difficult-to-replicate competitive advantages, its attractive margins and returns, and its structurally growing and rational industry setting align to create a 'compounder'-type investment case, in our view.

That Mastercard and its primary competitor Visa operate as a *de facto* duopoly is largely a consequence of the strong network effects that have driven the growth of the industry and the natural convergence towards a limited number of hubs (in this case, two) that sit at the middle of a diffuse system of parties that need a common mode of commercial interaction. We believe that the quality and ubiquity of the existing payment networks make it unlikely that a new entrant could feasibly replicate their scale and reach without an exceptionally large commitment of capital and time. Critically, the major incumbent networks (Visa and Mastercard) enjoy a high level of direct and indirect loyalty (and lock-in) from multiple constituencies in the payment ecosystem: merchants, cardholders, banks, and other processors. For a competitive platform to succeed, this disparate set of parties would essentially have to move in concert – a prospect that we believe is highly unlikely. Also important to Mastercard's competitive positioning and its natural shielding from customer and supplier bargaining power is the fact that the networks claim only a very small share of the total fee stack for card-based payment transactions, which makes them a less-likely target for pricing pressure.

We view Mastercard's core business as being attractive for the growth and competitive positioning described above, but we believe the Company is also particularly well positioned for opportunities that could represent additional earnings upside. Mastercard has made significant investments in technologies that enable business-to-business (B2B) transactions, which represent a global market that is multiples of the size of PCE. While some parts of the B2B market will likely be slow to evolve, we do believe that the inefficiency of traditional methods of payables management will be increasingly addressed by modern solutions, and Mastercard's card- and automated clearing house-based technologies can thus gain traction over time.

Regarding valuation, our perspective is that the durability of electronic payments growth and the incremental opportunities related to B2B payments are not fully captured in Mastercard's current stock price. We have a high level of conviction about the Company's ability to sustainably grow cash flows at strong rates for the next several years. We made our initial purchase in the shares at the end of May.

In early April, we received shares of Alcon Inc. upon completion of its spinoff from Novartis AG at a ratio of one Alcon share for every five shares of Novartis that we owned in Core Select. Alcon is a global leader in the ophthalmological medical device industry, offering a full suite of eye care products within two complementary businesses: Surgical (56% of sales), which consists of implantable products (intra-ocular lenses), consumables (surgical kits), and equipment; and Vision Care (44% of sales), which consists of contact lenses and over-the-counter ocular health products. Alcon's prescription drug business remained with its former parent Novartis. Alcon is headquartered in Switzerland, but it has a global operating footprint and a large functional presence in the U.S., and its shares are listed in both countries.

We believe Alcon represents a strong fit with our Core Select investment criteria, and we believe that focus and execution will continue to improve as a standalone public company. Alcon has a strong heritage of product quality and differentiation, good service levels, and trusted relationships with eye care professionals, but during the first few years of its ownership by Novartis, a series of operational missteps and inadequate investment led to a span of poor performance, which then sparked a key management change (the installation of Michael Ball as CEO) and a comprehensive turnaround beginning in 2016. The turnaround plan broadly consists of three phases that will continue through at least 2021. First, Management is working to "fix the foundation" by appropriately funding promotion and market support, reinvigorating the Company's research culture and making fundamental improvements in systems and capital planning. The second phase is meant to follow through on the first phase, with tighter business execution, further product investments, new launches and higher levels of marketing. In the third phase, Alcon hopes to reach a steady state of highly productive pipeline conversion, continued market expansion and growth in directly adjacent businesses and sales channels.

Alcon's turnaround plan is comprehensive and ambitious, but we believe that it has made a substantial amount of progress in the last two years, and the remaining objectives are attainable. The CEO role has now passed to David Endicott, a healthcare industry veteran and Alcon's former COO. We believe he and his surrounding senior management team have now set and communicated a credible operating plan. At a broader level, we believe the industry opportunity in ophthalmology is highly favorable given aging populations, broadening diagnosis and treatment, and lifestyle changes that are affecting eye health (e.g. screen exposure). Importantly, Alcon's business has relatively low exposure to reimbursement pressures, in our view, given the cash-pay nature of the Vision Care side of the business and the high level of medical necessity and patient benefit on the Surgical side. Alcon's near- to intermediate-term profitability will be dampened by costs related to the separation from Novartis and ongoing investments being made as part of the strategic plan, but we expect that the Company will be able to reach strong and sustainable levels of margins, returns on capital, and cash flow productivity within its first few years as a standalone company. After receiving shares in Alcon in early April, we added to our position later in the month.

Along with our new purchase of Mastercard, the Alcon spin-off, and the additions to Linde and Alphabet noted above, we also added to our existing holdings of **Celanese Corp., Henry Schein Inc.,** Allegion, and **Unilever NV** during the quarter.

In April, we continued trimming and ultimately exited our remaining positions in Liberty Global PLC, Discovery Inc., and Qurate Retail Inc. We had significantly cut each these holdings earlier in the year in reflection of our concerns regarding the long-term range of business outcomes for some parts of the media sector. While each of these Companies have formidable assets, accomplished leadership teams and important roles in their respective markets, we came to a view that disruptive industry forces could materially impair the full-lifecycle values of each business, and as such, the stocks no longer met the threshold level of certainty that we aspire to have in our portfolio holdings. During the quarter, we also trimmed our positions in **PayPal Holdings Inc.** and FleetCor as their valuation levels approached the upper end of our intrinsic value ranges.

At the end of the quarter, we had positions in 29 companies with 54% of our assets held in the 10 largest holdings. As of June 30, Core Select was trading at 90% of our underlying intrinsic value estimates on a weighted-average basis, which was five percentage points higher than the prior quarter due to the rise in equity prices across the portfolio. We ended the quarter with a cash position of 2.6%, which was down slightly from the prior quarter level as our purchases more than offset our trims and sales (and equities outperformed cash).

Commentary

Equity markets are now in their eleventh year of an expansion that began in 2009, and many familiar patterns that have characterized the bull market seem to keep repeating themselves. Most notable among these patterns is the market's seesaw response to any perceived directional changes in central bank policies. In the low-growth environment of the last several years, we have noted that the global economy has become 'asset-driven' in the sense that valuation levels of equities, fixed income, and real estate have continued to inflate, but similar increases in the costs of wages and other inputs in the production economy have not kept pace. Because asset prices are inherently sensitive to interest rates and credit growth, there is of course simple logic to the market's responses to central bank positioning, but we continue to be concerned by the potential mismatch in the perceived strength of the asset economy versus the realities of the production economy. Credit growth that is not accompanied by sufficient growth in the income necessary to service it has the potential to create problematic imbalances that may be difficult to reconcile.

As always, we take note of these market-level considerations not as a means to make timing calls in our investments, but instead as contextual points that underwrite our awareness of price risk and the importance of maintaining high standards for business quality in our portfolio holdings. The approach we use for Core Select focuses on long-term ownership of competitively differentiated, well-run, conservatively financed companies that are likely to earn excess returns on their capital as they continue grow over time. We believe that owning a portfolio of such companies at discounts to our appraisals of their intrinsic value best positions us to compound capital while also providing downside protection.

Concerning the matter of the ongoing trade dispute between the U.S. and China, the situation continues to evolve, and we cannot hazard guesses as to its ultimate resolution. After reviewing the individual exposures of our Core Select companies, focusing specifically on their end markets and supply chains, we concluded that first-order impacts throughout the portfolio are relatively modest, but not absent. Our larger concern would be the potential for global economic disruption and a material slowdown in growth if trade relationships deteriorate further. While such a scenario would present clear risks for equity values, we believe that the resilience of demand for the products and services offered by our companies could help mitigate the impact on our portfolio.

As a final note, we wish to inform you that Marla Sims, an analyst on the Core Select team, has left Brown Brothers Harriman & Co. as of the end of June. We are grateful to Marla for her many years of service and we wish her well. Marla's responsibilities within the Media and Consumer sectors have been absorbed by other members of the Core Select team.

We appreciate your continued interest and support, and we look forward to providing further updates on our companies' progress in the second half of 2019.

Sincerely,

Michael R. Keller, CFA
Portfolio Manager

Representative Account Equity Weighting As of June 30, 2019	
Common Stock	97.4%
Cash and Cash Equivalents	2.6%
Total	**100.0%**

Representative Account Portfolio Characteristics As of June 30, 2019	
Composite Assets (mil)	$2,590.3
Number of Securities Held	29
Average P/E	22.2
Average Market Cap (bil)	$126.2
Turnover (Rolling 12-Months)	15.78%

Exclude cash equivalents

Composite Risk Statistics As of June 30, 2019	
Beta	0.79
Alpha	1.83%
Tracking Error	4.92%
Upside / Downside Capture	86.0% / 82.4%

Risk statistics are reported gross of fees and are based on trailing 60 months

Representative Account Sector Weighting As of June 30, 2019	
Communication Services	12.9%
Consumer Discretionary	2.7%
Consumer Staples	16.4%
Energy	0.0%
Financials	15.5%
Health Care	14.9%
Industrials	10.5%
Information Technology	20.5%
Materials	6.6%
Real Estate	0.0%
Utilities	0.0%
Total	**100.0%**

Reported as a percentage of portfolio securities.

Representative Account Top 10 Companies As of June 30, 2019	
Oracle Corp	7.2%
Berkshire Hathaway Inc	6.8%
Alphabet Inc	6.6%
Comcast Corp	6.0%
US Bancorp	5.2%
FleetCor Technologies Inc	5.0%
Copart Inc	4.6%
Novartis AG	4.3%
Zoetis Inc	4.1%
Linde PLC	3.8%
Total	**53.6%**

Reported as a percentage of total portfolio.

Holdings are subject to change. Totals may not sum due to rounding.

Price/Earnings (P/E) ratio is a company's current share price divided by earnings per-share.

Turnover ratio is the rate of trading in a portfolio; higher values imply more frequent trading.

Contribution figures are presented gross of fees and do not include cash and cash equivalents.

Opinions, forecasts, and discussions about investment strategies represent the author's views as of the date of this commentary and are subject to change without notice. References to specific securities, asset classes, and financial markets are for illustrative purposes only and are not intended to be, and should not be interpreted as recommendations.

Purchase and sale information provided should not be considered as a recommendation to purchase or sell a particular security and that there is no assurance, as of the date of publication, that the securities purchased remain in a fund's portfolio or that securities sold have not been repurchased.

RISKS

The strategy is 'non-diversified' and may assume large positions in a small number of issuers which can increase the potential for greater price fluctuation.

Data presented is that of a single representative account ("Representative Account") that invests in the strategy. It is the account whose investment guidelines allow the greatest flexibility to express active management positions. It is managed with the same investment objectives and employs substantially the same investment philosophy and processes as the proposed investment strategy.

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Gross of fee performance results for this composite do not reflect the deduction of investment advisory fees. Actual returns will be reduced by such fees. "Net" of fees performance results reflect the deduction of the maximum investment advisory fees. Performance calculated in U.S. dollars.

The Composite is a fully discretionary, fee-paying accounts over $5 million that invest in a portfolio of approximately 20-30 companies with market capitalizations greater than $5 billion that are headquartered in North America, as well as in certain global firms located in other developed regions. This strategy is benchmarked to the S&P 500 Index.

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IM-06634-2019-07-19 Exp. Date 10/31/2019