Market and Portfolio Update

During the third quarter of 2019, global markets experienced an increase in volatility as they attempted to digest multiple issues, including an unresolved U.S.-China trade war, heightened uncertainty regarding the U.K. and Brexit and evidence of slowing global growth. The Federal Reserve acted during the quarter to help sustain the economic expansion by cutting interest rates 0.25% each in July and September, which Chairman Jerome Powell termed a "mid-cycle adjustment." As bond yields declined, fixed income investments benefited, generating positive returns. All in all, Brown Brothers Harriman's (BBH) policy portfolios performed well, and we are pleased with the results during another volatile period.

In discussions with clients, we have received questions regarding topics such as increased market volatility and its impact on portfolios, thoughts on how to generate income in a low-yielding environment, the probability of a recession, the impact of the growth in passive investment options and sustainable investing in client portfolios. *InvestorView* sat down with Suzanne Brenner, chief investment officer, and Scott Clemons, chief investment strategist, to discuss these topics and explore how they affect our clients' portfolios.

Investment Returns as of September 30, 2019

Asset Class	3 Months	YTD	1 Year	3 Years*	5 Years*	10 Years*
Fixed Income						
1-3 Year Treasury Bonds	0.6%	3.1%	4.4%	1.5%	1.3%	1.2%
U.S. Aggregate Bonds	2.3%	8.5%	10.3%	2.9%	3.4%	3.7%
Global Aggregate Bonds (USD – Unhedged)	0.9%	6.6%	8.0%	1.7%	2.2%	2.5%
U.S. Municipal Bonds	1.6%	6.7%	8.6%	3.2%	3.7%	4.2%
U.S. High-Yield Bonds	1.3%	11.5%	6.4%	6.1%	5.4%	7.8%
U.S. Leveraged Loans	1.0%	6.8%	3.1%	4.5%	4.0%	5.2%
U.S. Inflation-Linked Bonds	1.5%	8.0%	7.4%	2.3%	2.6%	3.6%
Equity						
Global Equity (ACWI)	0.1%	16.7%	1.9%	10.3%	7.2%	8.9%
U.S. Large-Cap Equity	1.7%	20.6%	4.2%	13.4%	10.8%	13.2%
U.S. Small-Cap Equity	-2.4%	14.2%	-8.9%	8.2%	8.2%	11.2%
Non-U.S. Developed Equity (USD)	-1.0%	13.3%	-0.8%	7.0%	3.8%	5.4%
Emerging Markets Equity (USD)	-4.1%	6.2%	-1.6%	6.4%	2.7%	3.7%
Non-U.S. Developed Equity (Local)	1.8%	16.2%	2.1%	8.8%	6.5%	7.5%
Emerging Markets Equity (Local)	-1.9%	8.1%	0.2%	8.0%	5.9%	6.3%
Long/Short Equity Hedge Funds	-1.1%	8.1%	-1.1%	4.8%	3.5%	4.4%
REITs	7.7%	26.9%	18.4%	7.3%	10.1%	13.0%
Commodities						
Gold	4.5%	14.8%	23.5%	3.8%	4.0%	3.9%
Silver	11.0%	9.7%	15.6%	-3.9%	0.0%	0.2%
Crude Oil	-7.5%	19.1%	-26.2%	3.9%	-9.9%	-2.6%

**Annualized return figures.*
An investment cannot be made directly in any index.
Past returns do not guarantee future results.

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***InvestorView:* We have seen volatility return to the markets in a big way, and it seems like it is here to stay. In particular, clients find it difficult to stomach downside volatility even though they know it is inevitable at some point in the cycle. How should clients think about heightened market volatility?**

Suzanne Brenner: First, I would tell them to try not to worry about mark-to-market volatility. At BBH, we have a fundamental belief that long-term equity ownership of high-quality, cash-flowing businesses purchased at discounts to intrinsic value is the surest way to compound wealth. We think the true measure of risk is permanent loss of capital, and price declines, which are inevitable, simply provide us with opportunities to buy high-quality securities at better prices.

Moreover, it is important to understand that even great long-term investments can be hurt by short-term market fluctuations. Knowing what we own and having confidence in the investment thesis of individual holdings enables us to see through the inevitable drawdowns and let the investments compound wealth over time.

Scott Clemons: Periods of underperformance are often a matter of when, not if. If managers can take advantage of market dislocations that lead to drawdowns in the stock price and redeploy cash into securities that, all else equal, are more attractively priced today than they were yesterday, it is a win-win. To reinforce Suzanne's point, the only way this approach doesn't work is if a client is forced to sell when the price declines. That is why we spend time with our clients to ensure that their asset allocation is aligned with their objectives and risk tolerance and that the account is periodically rebalanced back to its target asset allocation, so we can manage the risk of such a scenario.

***IV*: Fixed income yields are at extremely low levels. In fact, across the world, there are $13 trillion of negative-yielding bonds. Many clients rely on income. What advice do you have for clients who need income in such a low-yielding environment?**

SB: I would caution clients not to reach for yield. For example, while there is additional yield available in the high-yield markets (3.75% above Treasuries, on average), we believe that the risk inherent in these securities is very high. So many investors are chasing yield that spreads on high-yield bonds have been depressed for some years now. Chasing returns through excess credit risk is not a strategy that leads to preservation of capital and growth of wealth. This approach will likely not play out well over time. In fact, we believe that at some point it will trigger the inevitable credit cycle, which, when it turns, will likely offer up very attractive investments.

[O]ur managers invest in the stocks of high-quality companies typically in noncyclical industries; therefore, these portfolios are generally less vulnerable to recessions and market downturns due to their less cyclical nature."

SC: It is also important that clients think about their portfolios on a total return basis, not only how much interest income or dividend yield is generated. In developing the appropriate asset allocation for a client, we ensure that everyone's portfolio meets his or her goals and objectives, which determines the balance of equity and fixed income. This asset allocation is developed with the objective that the portfolio can outpace inflation and meet all current and future expenditures. So, clients who need cash flow should work with their relationship managers to develop a program that provides for regular distributions of capital from the portfolio, not just interest and dividend income.

SB: I would also note that we have been opportunistic in buying bonds for client portfolios when rates have increased to levels that provide adequate risk-adjusted returns. For example, in the middle of 2018, we took the opportunity to increase the allocation to longer-duration fixed income for both taxable and tax-exempt clients. As always, our bond teams are scouring the universe of fixed income securities to identify compelling opportunities for our clients' portfolios.

***IV:* There is a lot of discussion about an upcoming recession. How should we think about that?**

SC: The business cycle is not dead, but the rumors of an imminent recession in the United States are, to paraphrase Mark Twain, greatly exaggerated. Remember that the primary engine of economic activity is personal consumption, and as long as employment is improving, wages are rising and house prices are moving higher, the consumer remains in good shape. This is not to say that things like the trade war with China or concerns about Brexit are meaningless, just that within the context of a strong consumer they pose less risk.

SB: The one thing I would add to Scott's comments is that our managers invest in the stocks of high-quality companies typically in noncyclical industries; therefore, these portfolios are generally less vulnerable to recessions and market downturns due to their less cyclical nature. For example, BBH's portfolios have very little exposure to energy, metals and mining, basic materials, construction and other capital-intensive companies. Although high-quality stocks will also decline with the market, they tend to outperform in times of recession and, given their strong balance sheets and competitive positions, can often take advantage of opportunities to take market share during these periods.

***IV:* There has been a lot of discussion about the proliferation of passive investments. For example, Michael Burry, an American investor and hedge fund manager who made his name during the global financial crisis betting against the housing bubble, recently wrote an article that suggested that passive investments are the next "big short." What are your views on passive investments?**

SC: This is a very involved question that has many facets to it. However, I will try to highlight several points that can help put passive investing into perspective. First, it is important to provide a sense for the magnitude of passive investment options in the market. Did you know that more money is now invested in passive options in the U.S. than in active stock funds? Currently, the market share of passive index-based funds has grown to 51% of the $8.5 trillion being managed in U.S. equity funds.[1] I also find it fascinating that there are over 70 times as many stock market indices as there are quoted stocks in the world.[2] This explosion is huge, and even the late "founder of passive funds," John Bogle, weighed in on some of the unintended consequences of the proliferation of passive investments, particularly corporate governance issues and a lack of an independent pricing mechanism that the market obtains from active management.

With respect to Burry, it is true that he believes that passive investments are the next "bubble" in the markets. To quote him:

> [I]ndex fund inflows are now distorting prices for stocks and bonds in much the same way that CDO purchases did for subprime mortgages more than a decade ago. … In the Russell 2000 Index, for instance, the vast majority of stocks are lower volume, lower value-traded stocks. Today I counted 1,049 stocks that traded less than $5 million in value during the day. That is over half, and almost half of those – 456 stocks – traded less than $1 million during the day. Yet through indexation and passive investing, hundreds of billions are linked to stocks like this. … The theater keeps getting more crowded, but the exit door is the same as it always was.

SB: These are sobering words, and I don't think anyone knows how this will play out when the market has a downturn. However, I am particularly happy at this point in the cycle – having been through the longest bull market in history – to be invested with our roster of high-quality active managers. As you know, we have a more nuanced view than most on active vs. passive investing. While the academic literature often indicates that passive investing is superior to active management, we believe that this research focuses only on a portion of the fund market – that is, on conventional active funds structured in a mutual fund format. Such funds typically are "closet" index funds – they are overdiversified, have high turnover, too closely manage their volatility and tracking error (how closely their returns mimic their benchmark), do not have properly aligned incentives (that is, a sizable portion of mutual fund managers do not have any of their personal wealth in their strategies) and are too big.

In contrast, our managers have the majority of their own net worth invested alongside our clients, prioritize returns over fees and close strategies to new investors to ensure the size of their asset base does not dilute future returns, manage high-conviction, concentrated portfolios and adhere to strict valuation disciplines so they can hold cash when compelling opportunities are not available. Our managers think not only about things that *do* happen, but things that *could* happen, which is exactly the type of thinking we always want, but it is particularly important now.

***IV:* Our final question. There is a lot of discussion these days about sustainable investing. How does BBH think about this topic?**

SC: I think it's important to first focus on the efforts BBH has made at the firm level. Since our earliest days, we have been dedicated to sustainability, which we define as a steadfast commitment to the long-term well-being of our clients, our people and our communities. To that end, we have recently introduced a comprehensive program called Sustainable BBH, which is centered on the positive impact the firm is making through our commitments to diversity and inclusion, employee well-being, environmental stewardship and community engagement, as well as our approach to sustainable investing and supplier selection. While we are proud of the advances we have made, there is still much to do, and as a result, we have established an Executive Sustainability Council to continue our work, including setting program goals and objectives, governing our efforts and measuring our performance.

SB: We all feel proud of the work BBH is doing to continue to make this world a sustainable place for our people, our communities and our clients. On the investing side, we believe that each client's goals and values are at the center of every BBH relationship. Therefore, the only way we can create a plan that can help clients to achieve their sustainable investing goals is to work closely with them to understand their values. Many clients want to incorporate their core values not just in philanthropy and wealth planning, but also in their investment portfolios. For those clients, we offer sustainable investing. Our definition of sustainable investing includes several different things. First, we focus on ESG, which occurs when a set of nonfinancial, environmental, social and governance criteria contributes to qualitative research used to manage risk and identify sustainable businesses in the security selection and portfolio construction process. We believe BBH's investment philosophy naturally aligns with core ESG tenets, as we employ active, bottom-up fundamental research to identify what we believe to be businesses with superior corporate governance, a strong relationship with all stakeholders, policies that lead to a judicious use of resources and management teams with the highest integrity and ethical standards.

Second, for those clients that wish to have their portfolios reflect their social values, we seek to partner with them to first identify what is important to them and then customize portfolios to meet their personal investment criteria. There is no one-size-fits-all solution, and we welcome the opportunity to work with clients to understand their specific socially responsible investment objectives, as they can differ depending on the individual. For example, thoughtful people may have different opinions on social topics, such as nuclear power. Therefore, we work with clients to tailor their approach so that their investment plan meets their unique definitions of success.

Finally, at BBH, we believe that sustainable investing is extremely important, but it is evolving over time. So that we continue to learn and grow, we have formed a working group, chaired by Scott, that includes members throughout the bank and meets regularly to address this ever-changing space. For those that are interested in learning more about our approach to sustainable investing, I would recommend reaching out to your BBH relationship manager.

***IV:* Thank you both for your insights.** ■

[1]Source: Morningstar

[2]Source: Index Industry Association and World Bank.

Past performance does not guarantee future results.

Portfolio holdings and characteristics are subject to change.

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PB-03151-2019-10-21 Expires 10/31/2021 1198_19