

# BBH Core Select - U.S. Large Cap

## Quarterly Strategy Update / 2Q 2020

Large-cap equities rebounded sharply during the second quarter of 2020, recovering most of the steep declines that had occurred earlier in the year as the COVID-19 pandemic gripped the global economy and damaged investor confidence. To some degree, the market rebound reflected investors' views that the rate of economic decline had reached a bottom, as retail spending, employment levels, production activity, and other indicators bounced back from what had been stunning declines in March. The gradual easing of lockdown restrictions and the concurrent impact of public assistance in the form of stimulus programs and direct transfers appeared to support market sentiment, even as many risk factors related to the shape of recovery and the path of the pandemic itself remained unknowable. Equally influential, in our view, was the massive quantity of unsterilized liquidity injected into markets by the Federal Reserve (Fed) as it not only endeavored to ease credit conditions, but also to overtly influence asset prices with the aim of stoking economic recovery.

All sector groups within the S&P 500 rose during the quarter, albeit with very sizable gaps between the outsized performances of the pro-cyclical sectors compared to defensives. While key measures of market breadth were notably positive, the most influential factor driving the upside in the Index was the performance of the largest technology and Internet stocks, as these companies not only aligned with investors' continued strong preference for growth over value, but also have been viewed as beneficiaries of stay-at-home trends and e-commerce acceleration. While less influential on the S&P 500 Index given their smaller aggregate equity capitalization, companies with lower-quality balance sheets were also among the top performers in the quarter, partially reflecting the beginnings of economic re-opening, but more likely as a downstream effect of the Fed directly purchasing corporate debt.

The S&P 500 Index returned 20.5% in the second quarter but remained down by 3.1% year to date in 2020. By comparison, BBH Core Select Composite ("Core Select" or "the Strategy") rose by 15.9% in the quarter and is down by 6.8% thus far in the year. Over the last five years, Core Select returned 8.3% on an annualized basis, versus 10.7% for the S&P 500.

Regarding the relative performance of Core Select thus far in 2020 and in the last few years, we remain disappointed but not necessarily surprised by our shortfall compared to the S&P 500, given the structural context of growth dominance and narrow market leadership that has prevailed throughout the period. We have consistently prioritized fundamental business quality, economic resilience, and management skill in the selection of our investments. Also, we have maintained prudent sector diversification that does not use Index weights as a guide. We use a balanced approach to valuation that is driven by long-term cash flow modeling and prioritizes a reasonable margin of safety<sup>1</sup> in the prices we pay. Importantly, we do not use superficial 'cheapness' as a selection mechanism or a substitute for qualitative attractiveness, nor do we reflexively avoid superficial 'richness' if a company has durable growth characteristics and sustainable competitive differentiation.

We stand behind the philosophical and empirical tenets that underpin our process and believe it can offer attractive compound equity returns over full market cycles. Nevertheless, we also acknowledge that in the prevailing market environment of the last several years, with widening growth premiums, enormous monetary policy support from central banks, and continued displacement of valuation-sensitive active management by implicitly momentum-oriented trading styles, our performance numbers have not kept pace with large-cap equities as an asset class. Critical self-reflection is an important part of our team's approach, and to that end we have undertaken a review of our process steps and valuation methodologies to determine if we had adopted any structural biases or failed to fully and timely appreciate industry shifts and areas of opportunity. We are committed to making any necessary adjustments as we continue this study, but we will not depart from our core principles of prioritizing quality, knowing what we own, and acting with appropriate care with respect to valuation and underlying factor exposures.

<sup>1</sup> With respect to equity investments, a margin of safety exists when we believe there is a discount to intrinsic value at the time of purchase.

Performance As of June 30, 2020							
	Total Returns		Average Annual Total Returns				
	3 Mo.*	YTD*	1 Yr.	3 Yr.	5 Yr.	10 Yr.	Since Inception
<b>Gross of Fees</b>	15.89%	-6.78%	1.02%	7.18%	8.26%	12.11%	9.62%
<b>Net of Fees</b>	15.61%	-7.25%	0.02%	6.12%	7.19%	11.00%	8.54%
<b>S&amp;P 500</b>	20.54%	-3.08%	7.51%	10.73%	10.73%	13.99%	8.72%

\* 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 composition of the index is materially different than the Fund's holdings. The index is not available for direct investment.

Sources: BBH & Co. and S&P

## Portfolio Contribution

Gains in the second quarter were broadly spread among our holdings, as more than three-quarters of our stocks rose by double-digit percentages, while only one company showed a negative return. Our largest positive contributor in the quarter was **Alphabet Inc.**, our largest holding. Alphabet shares rose by 22%, benefiting not only from a strong rebound among growth stocks, but also from the company's late-April earnings report that featured very strong cash flow production and better-than-expected revenue resilience despite a sharp slowdown in online advertising that accompanied the COVID-19 shutdown. We expect there to be continued pressure in the core Google business as corporate customers moderate their spending due to economic softness, but the efficacy and return on investment (ROI) of targeted and search-based advertising as demand generation tools will remain highly desirable, in our view, helping to blunt the net impact. YouTube advertising revenues, while not immune from economic pressures, contributed positively to growth as the platform continues to gain reach and usage. The company's cloud computing business grew by more than 50% in the quarter, demonstrating the benefit of large recent investments in capacity, features, and go-to-market activity. With \$117 billion in cash and investments at quarter-end, Alphabet's balance sheet remains very solid and offers continued flexibility for capital allocation including share repurchases. Despite the presence of economic headwinds that may persist for the near term, we remain very positive on the key structural drivers of Alphabet's businesses and believe that its continued investments in cloud, hardware, machine learning, and other technologies will reinforce its competitive position and add value for the broader ecosystem of advertisers, application developers, business partners, and consumers.

Other positive contributors in the second quarter included **FleetCor Technologies, Mastercard Inc., Copart Inc., and Dollar General Corp.** Shares of FleetCor, Mastercard, and Copart rebounded from steep declines in the prior quarter as investors anticipated a recovery from the economic disruptions that have impacted each business. While they differ in their business models and underlying drivers, all three are uniquely advantaged, capital-light businesses with significant operating leverage and durable secular growth. As such, we had viewed their first quarter share-price declines as being inconsistent with the likely progression of longer-term value creation beyond the current recession.

Dollar General shares pushed to new highs after a brief dip during the March correction. As evidenced by comparable-store revenue growth that spiked to nearly 22% in the first quarter, the company has been a clear beneficiary of changing consumer behavior during the pandemic period given its in-store assortment of everyday essential items, its diffuse rural market presence, and its low price points. Operating margins expanded in the quarter despite a mix shift towards lower-margin consumables, higher logistics costs, COVID-related expenditures at the store level, and proactive wage increases for workers. Apart from the short-term boost caused by the pandemic, progress in the core business and continued execution on store growth and other key initiatives remain very favorable, in our view.

The Strategy's only performance detractor during the second quarter was **Berkshire Hathaway Inc.**, whose shares declined modestly even as markets rose sharply. Despite the lagging performance of the stock, we believe that the company's overall operating and financial performance has been robust. Moreover, we see the outlook for the Berkshire's key business segments as having improved notably during the quarter. Fundamental trends within the company's insurance operation – which accounts for approximately 45% of pretax profits – remain strong and are likely improving incrementally. GEICO, which generates nearly 60% of the insurance unit's total premiums, is a beneficiary of the recent decline in vehicle miles

Holdings As of June 30, 2020	
Alphabet (Class C)	7.9%
Oracle Corp	5.4%
Berkshire Hathaway Inc (Class A)	5.4%
Zoetis Inc	4.6%
Copart Inc	4.6%
Mastercard Inc	4.6%
Arthur J Gallagher & Co	4.2%
Alcon Inc	3.9%
Fleetcor Technologies Inc	3.8%
Linde PLC	3.7%
Brown-Forman Corp Class B	3.3%
Diageo Plc ADR	3.3%
Dollar General Corp	3.1%
Novartis AG ADR	3.1%
AO Smith Corp	3.1%
Allegion Plc	3.1%
Henry Schein Inc	2.7%
Celanese Corp	2.7%
Colgate-Palmolive Co	2.6%
Nike Inc	2.5%
Waste Management Inc	2.4%
Booking Holdings Inc	2.4%
Baxter International Inc	2.4%
Comcast Corp (Class A)	2.4%
KLA-Tencor Corp	2.1%
Progressive Corp	2.1%
Nestle SA ADR	2.0%
Perrigo Co Plc	2.0%
Costco Wholesale Corp	1.8%
Unilever NV ADR	1.6%
Cash and Cash Equivalents	1.1%

Holdings are subject to change.

driven, which has resulted in far fewer automobile accidents and a pronounced drop in auto insurance loss costs. While driving activity increased sequentially in the second quarter, GEICO's solid levels of underwriting profit are likely to be sustained, in our view. Berkshire's other insurance businesses, which primarily write commercial and reinsurance coverages, will experience material losses related to COVID-19, but not to a degree that could feasibly erode the company's massive capitalization backstop. Critically, in response to pandemic-related losses and other structural pressures, premium rates for commercial and reinsurance coverages continue to rise sharply, which bodes well for the future profitability of those businesses. Apart from insurance, the reopening of the economy, and the resumed pace of activity should contribute to an improvement in the performance of Berkshire's more economically sensitive manufacturing, service, and retail businesses. Recovery in these areas will be complemented by a sharp rebound in Berkshire's large portfolio of public equity investments. The total value of the company's equity portfolio likely increased by more than \$30 billion in the second quarter on a pre-tax basis. This bounce back from depressed levels in March will further enhance Berkshire's already exceptional balance sheet strength and liquidity. The company ended the first quarter with approximately \$130 billion in cash, which we believe positions it very well to navigate and capitalize upon whatever economic and financial conditions arise over the near-to-intermediate term.

### Portfolio Changes and Valuation

In May, we began building a position in **Progressive Corp.**, which we had previously owned in Core Select through 2017. Progressive is a differentiated leader in the U.S. insurance industry, with a strong record of superior growth, attractive underwriting margins, high returns on equity, and consistent product innovation. Having been a market share gainer for multiple decades, the company now stands as the third-largest domestic auto insurer (84% of company premiums) and the largest commercial auto insurer (12% of company premiums), and it has built a small but rapidly growing home insurance line as a complementary offering (4% of company premiums). Progressive has a solid capital position and a float investment program that prioritizes high credit quality and liquidity.

At the industry level, auto insurance aligns well with our financial services investment criteria given that it is an essential product (mandated by law) with inherently 'short-tail' liabilities that reduce the likelihood of large, unforeseen losses. However, the industry is well developed and very competitive, so from our perspective the key investment consideration is whether a sustainable business 'moat' is present. In our view, Progressive's track record of top-tier financial performance reflects consistently strong management and a broad, self-reinforcing set of competitive advantages that are becoming more formidable over time. Success in auto insurance is predicated on a host of critical performance factors – operational efficiency, underwriting selection, product distribution, scale and brand. On each of these dimensions, we view Progressive as a clear industry leader. As the auto insurance industry consolidates, these advantages should allow the Company to strengthen its positions and continue gaining share. In addition, Progressive's newer endeavors in homeowners' and commercial lines can allow it to further leverage and extend its brand, distribution, and differentiated underwriting capabilities.

The auto insurance industry has been a passive beneficiary of the COVID-19 pandemic and its downstream effects. Social distancing, stay-at-home orders, and subdued economic activity have all led to a precipitous drop in vehicle miles driven which, in turn, has resulted in an equally pronounced fall in accidents and loss costs borne by insurers. Consequentially, profitability at Progressive has been and should continue to be very strong in 2020, even after accounting for pandemic-related policy rebates offered to customers. However, the economic impact of the pandemic will also likely lead to slower growth in policies and premiums due to fewer new car purchases, financial strains on some customers, and falling auto insurance rates in response to the decline in loss costs. Fortunately, from a profitability standpoint, combined ratios (a proxy for underwriting margins) are significantly more important than premium growth, and this is where Progressive's differentiated performance is particularly notable. The next critical step for insurers will be to effectively navigate the eventual rebound in miles driven and thus accident activity. Progressive's strong track record of success gives us confidence that it can adapt to changing conditions by altering pricing and underwriting formulas to respond appropriately. Following our initial purchase of shares in mid-May, we made two subsequent additions later in the month.

During the quarter, we also added to our existing holdings of **Celanese Corp.** and **Waste Management Inc.** At recent prices, shares of Celanese continued to discount negative free cash flow growth into perpetuity – a scenario that we believe is unsupported by fact. While the company is currently facing sharp recessionary headwinds, our longer-term focus remains attuned to the structural benefits conferred by its many years of deliberate work to improve its business and strengthen its balance sheet. In comparison to the last global recessionary environment, Celanese now has: (i) greater regional diversity of revenues, (ii) a more extensive Engineered Materials product portfolio, (iii) energy cost per ton of production that is over 30 percent lower, (iv) an integrated model and lower fixed-cost intensity in its Acetyl Chain business, and (v) significantly more diversified demand-side exposure with a larger percentage of sales in more resilient end-markets. The company has produced demonstrably constructive financial results that we believe are durable. Over the past 10 years, Celanese has grown its operating and free cash flows at compound rates of approximately 10% and 30%, respectively, despite relatively modest accompanying rates of growth in revenues and gross profits during the same period. The company has also strengthened its balance sheet, with no long-term debt maturities until the middle of 2021, fully-funded pension plans, a stable investment-grade credit rating, and adequate access to credit markets with currently ample levels of liquidity. Celanese management is singularly focused on factors within its control and is working to maximize cash flow generation and asset productivity during the current downturn

while investing strategically to strengthen its business for the longer term. Despite the material challenges posed by the present environment, we continue to believe that Celanese's advantaged product capabilities and its ability to leverage its global presence and low-cost position in its Acetyl Chain business will create value for its customers and shareholders.

Recent weakness in the price of Waste Management shares gave us the opportunity to build our position. The company has operated well in a low-growth industry setting that was further challenged by economic pressures related to the pandemic. Waste Management's collection and disposal business continued to produce solid organic revenue growth from pricing and volume growth year-over-year in the first quarter, but the balance of the year is likely to see declines as commercial collection, industrial activity, and landfill volumes remain under pressure. Asserting its characteristic discipline and bottom-line focus, the company's leadership has quickly pivoted to cost-saving initiatives and capital expense vigilance that we believe will help bolster free cash flow generation through the period of volume softness. The recycling segment remains severely challenged at the top line by continued declines in commodity pricing, but Waste Management's operational cost discipline and transition to fee-for-service arrangements have allowed it to modestly grow pretax cash flow in this part of the business versus the prior year. While structural challenges remain, we continue to believe that the company has the potential to improve the economics of its recycling business over time. Waste Management maintains a solid balance sheet and liquidity position, with current and forecasted leverage ratios well within covenant mandates and significant capacity remaining under its credit facility.

Overall, we believe the company is well-positioned to manage through the pandemic-driven recession, and the steps being taken to manage costs and capital spending will not compromise its long-term strategic priorities or growth opportunities. Recent developments indicate significant progress towards closure of Waste Management's planned purchase of Advanced Disposal, which we view as a favorable consolidation move that has the potential to add material shareholder value over the long term.

We sourced capital for the purchases detailed above by making modest trims in eight positions: Berkshire Hathaway, Dollar General, **Comcast Corp., Copart, Unilever NV, Brown-Forman Corp., Linde plc, and A.O. Smith Corp.**

At the end of the second quarter, we had positions in 30 companies with 48% of our assets held in the 10 largest holdings. As of June 30, Core Select was trading at 87% of our underlying intrinsic value<sup>2</sup> estimates on a weighted-average basis, which compared to 71% at the end of the prior quarter. We ended the quarter with a cash position of 1.1% (versus 1.3% at the end of the first quarter) as our portfolio purchases modestly exceeded trims, but we remained essentially fully invested throughout the period.

### Commentary

Our investment process is governed by a fundamentally-driven, bottom-up approach that focuses on business quality and valuation sensitivity. However, we also study market structure and the economic setting, and along those lines we count ourselves among the many observers who are unsettled by the seemingly large disconnect between economic conditions and the performance of financial assets. The COVID-19 pandemic undoubtedly has compromised what was already an unbalanced, low-growth macro environment, arguably creating one of the most challenging situations in memory for current earnings power and forward clarity, yet equities in the aggregate have entered one of the most robust valuation regimes in history. Logically, both cannot be correct.

Central bank intervention seems to have entered a realm of outright experimentation, with unprecedented levels of public and private debt purchases distorting discount rates and fueling a massive rise in global borrowing. By design, this activity has emboldened risk-accepting investor behavior, but it remains to be seen whether it can precipitate sustainable recovery in jobs, incomes, and productivity investments that are critical to consumer and business confidence and thus the economic growth needed to support equitable societal outcomes and the service of swelling debt balances. Moreover, monetary policy tools are ill-equipped to address other economic risk factors such as tax revenue shortfalls, saving preferences, skill gaps in labor markets, geopolitical tensions, and trade rancor.

If asset price levels become further detached from fundamental trends, we believe that the appropriate question for investors to be asking is whether the key risk is missing the full upside, or instead accepting insufficient security and straying from core principals of sound investment. Of the two, we believe the latter is potentially far more dangerous to long-term compounding. As such, we remain committed to the patient application of our investment criteria and process, which are guided by business quality, competitive positioning, long-term growth potential, management skill, balance sheet strength, valuation sensitivity, and independent thinking. Long-run equity returns will be driven by the cash flow generation, growth, and capital allocation success achieved by the underlying companies. In our view, there is no other logical or sustainable set of forces that can supplant those elements.

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<sup>2</sup> BBH's estimate of the present value of the cash that a business can generate and distribute to shareholders over its remaining life

We appreciate your continued interest and support, and we look forward to providing further updates on our companies' progress in the second half of 2020.

Sincerely,



*Michael R. Keller, CFA*  
*Portfolio Manager*



Representative Account Equity Weighting As of June 30, 2020	
Common Stock	98.9%
Cash and Cash Equivalents	1.1%
<b>Total</b>	<b>100.0%</b>

Representative Account Portfolio Characteristics As of June 30, 2020	
Composite Assets (mil)	\$2,100.9
Number of Securities Held	30
Average P/E	27.3
Average Market Cap (bil)	\$119.3
Turnover (Rolling 12-Months)	23.94%
Exclude cash equivalents	

Composite Risk Statistics As of June 30, 2020	
Beta	0.87
Alpha	-1.31%
Tracking Error	4.60%
Upside / Downside Capture	82.2% / 91.8%
Risk statistics are reported gross of fees and are based on trailing 60 months	

Representative Account Sector Weighting As of June 30, 2020	
Communication Services	10.4%
Consumer Discretionary	8.2%
Consumer Staples	14.7%
Energy	0.0%
Financials	11.8%
Health Care	19.0%
Industrials	13.4%
Information Technology	16.1%
Materials	6.4%
Real Estate	0.0%
Utilities	0.0%
<b>Total</b>	<b>100.0%</b>
Reported as a percentage of portfolio securities.	

Representative Account Top 10 Companies As of June 30, 2020	
Alphabet Inc	7.9%
Oracle Corp	5.4%
Berkshire Hathaway Inc	5.4%
Zoetis Inc	4.6%
Copart Inc	4.6%
Mastercard Inc	4.6%
Arthur J Gallagher & Co	4.2%
Alcon Inc	3.9%
Fleetcor Technologies Inc	3.8%
Linde PLC	3.7%
<b>Total</b>	<b>48.1%</b>
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 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 largest account as of the end of the most recent quarter that is managed with the same investment objectives and employs substantially the same investment philosophy and processes as the 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. Time Weighted Rate of Return is used to determine performance of a portfolio in a Composite. A portfolio's rate of return is the percentage change from the beginning balance to the ending balance of the period. Capital changes as well as dividends and other income earned during a period are included in the ending balance. Any reinvestment of dividends or other income will be reflected in the beginning balance of the following period. Sub-periods returns are linked to calculate a portfolio return for the period. 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 25-35 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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