# BBH Partner Fund – International Equity

*Quarterly Fund Update / 1Q 2022*

For the first quarter ended March 31, 2022, the BBH Partner Fund – International Equity (the "Fund") returned -12.26%. Over the same period, the MSCI EAFE Index[1] (the "Index") returned -5.91%.

Select Equity Group, L.P., the Fund's sub-adviser, assumed management of the Fund on February 24, 2017. Since that date through March 31, 2022, the Fund has generated a net annualized return of +8.24%, outperforming the Index's annualized return of +7.02% by approximately +120 basis points[2] ("bps") per annum, and a net cumulative return of +49.76%, outperforming the Index's cumulative return of +41.35% by approximately +840 bps. Since the Fund's inception on April 1, 1995 through March 31, 2022, the Fund has generated an annualized return of +5.58%, outperforming the Index's annualized return of +5.02% by approximately +56 bps, and a net cumulative return of +415.05%, outperforming the Index's cumulative return of +242.22% by approximately +17,280 bps.

**Performance**
**As of March 31, 2022**

| | Total Returns | | Average Annual Total Returns | | | |
|---|---|---|---|---|---|---|
| | 3 Mo.* | YTD* | 1 Yr. | 3 Yr. | 5 Yr. | 10 Yr. |
| **Class I** | -12.26% | -12.26% | -11.18% | 7.28% | 7.83% | 6.56% |
| **MSCI EAFE Index** | -5.91% | -5.91% | 1.16% | 7.78% | 6.72% | 6.27% |

Class I: Total Expense Ratio (%): 0.68

* Returns are not annualized.

***Performance data quoted represents past performance. 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. For the most recent month-end performance, call 1 (800) 625-5769.*** *Fund shares redeemed within 30 days of purchase are subject to a redemption fee of 2.00%.*

Sources: BBH & Co. and MSCI EAFE

## Introduction

International equities declined in the first quarter of 2022 with stock market performance and investor sentiment dominated by macroeconomic headwinds. While the valuations of our portfolio holdings were impacted by broad-based market weakness, we observed the fundamental performance of our companies to be very strong during the quarter, and we are confident in our businesses' outlooks for the remainder of 2022 and beyond. The equity market performance of our portfolio versus the MSCI ACWI ex US Index[3] was, in some respects, a tale of two halves during the period (broadly characterized as pre- and post-outbreak of the Russia/Ukraine conflict).

- In the first six weeks of the quarter, markets were driven overwhelmingly by mounting concerns about inflation; our holdings were swept up by broad-based selling pressure on all growth companies. From the beginning of the first quarter through February 10, 2022, the MSCI ACWI ex US Index was flat overall – falling just -0.4% – but with significant dispersion by sector in a stark continuation of the rotation trade that characterized 2021. Gains were concentrated among Energy, Materials and Real Estate stocks, as well as Financials (mainly banks) and Communication Services (mainly telecommunications). The sectors in which we typically invest – those for which we have identified companies with predictable long-term growth, high returns on invested capital and well-established competitive barriers – were the worst performing of the MSCI ACWI ex US Index during that same time frame: Information Technology, Healthcare, Consumer and Industrials. Our portfolio had already fallen by -6.1% on a net basis, nearly -500 bps worse than the MSCI ACWI ex US Index, in the first few weeks of the quarter through January 21st. Notably, at that early stage of the quarter, the vast majority of our companies had yet to provide any commentary on their latest quarterly earnings or on their full-year forward outlooks, reinforcing our view that our holdings' share-price performance was being driven by these top-down sector and macro factors with little regard to their fundamental business performance.
- In the last seven weeks of the first quarter, following the news flow that emerged around February 10th that a Russian invasion of Ukraine was likely imminent, the MSCI ACWI ex US Index fell -5.1% (and was down closer to -12% through mid-March) in a risk-off flight from equities. While some areas of the market were down disproportionately (notably, European equities, broadly, and Consumer Discretionary shares, specifically), we noted with interest that Energy and banks actually underperformed the broader MSCI ACWI ex US Index following

[1] The MSCI EAFE Index is designed to represent the performance of large and mid cap securities across 21 developed markets, including countries in Europe, Australasia and the Far East, and excluding the US and Canada. The Index is available for a number of regions and market segments/sizes and covers approximately 85% of the free float-adjusted market capitalization in each of the 21 countries. The Index is not available for direct investment.

[2] A unit that is equal to 1/100th of 1% and is used to denote the change in a financial instrument.

[3] The MSCI ACWI ex US Index represents large and mid cap securities across 22 developed-market countries (excluding the US) and 25 emerging-market countries. The Index covers approximately 85% of the global equity opportunity set outside the US. The Index is not available for direct investment.

the invasion. As we discuss later in this letter, the Russia/Ukraine conflict amplified inflationary pressures globally, leading to spikes in consumers' food and energy costs, while weighing on the outlook for eurozone economic growth and consumer confidence. If the prevailing macro bet from late 2020 through early February 2022 was that the global economy was poised for a sharp multi-year rebound from the pandemic-fueled recession, the Russia/Ukraine conflict caused investors to rapidly and radically rethink their top-down views on what the next few years might hold in store for the global economy.

We do not make macro bets. Our investment philosophy has always been to identify companies that make their own luck in a variety of different geopolitical and macroeconomic environments and to own shares in those companies when their valuations represent significant discounts to our estimates of their intrinsic values[4] based on their strong and growing free cash flows (FCF). During the first quarter of 2022, our portfolio companies reported financial results in which they grew their revenues 17% and operating profits 26% on average versus the prior-year period. As of this writing, the majority of our companies have now reported their financial results (including the impact of Russia/Ukraine) for the first quarter of 2022. Again, they delivered average year-over-year (YoY) growth in revenues and operating profits of 17% and 32%, respectively. Our portfolio has no direct exposure to Russia or Ukraine; in aggregate, those two countries represented just 1% of our companies' profits in 2021.

| Top 10 Companies<br>As of March 31, 2022 | |
|---|---|
| Brookfield Asset Management Inc | 4.7% |
| CRH PLC | 4.2% |
| Safran SA | 4.2% |
| Alcon Inc | 3.6% |
| Fidelity National Information | 3.6% |
| JD.com Inc | 3.2% |
| Keyence Corp | 3.1% |
| AIA Group Ltd | 3.1% |
| Constellation Software Inc | 3.0% |
| ASML Holding NV | 2.9% |
| **Total** | **35.5%** |

Reported as a percentage of total portfolio. Holdings are subject to change.

Given concerns about the macroeconomic outlook for Europe, we would highlight that our portfolio companies generate nearly 80% of their revenue outside of the eurozone (with our top 15 holdings overwhelmingly generating profits in North America and Asia). Our European companies tend to be global businesses with diversified revenue streams, and we have no exposure to the eurozone industrial sectors (e.g., chemicals, cement, steel and automakers) that are most vulnerable to spiking energy input costs. We have reviewed (and revised, where necessary) our near-term earnings forecasts for every company in our portfolio in light of the Russia/Ukraine conflict. Even assuming a fairly draconian scenario for European economic activity, our portfolio ended the quarter trading at approximately 30%-35% upside to our estimate of fair value – a level we regard as highly attractive relative to our average historical portfolio upside of near 15%.

With our portfolio companies demonstrating strong and resilient performance and with their share prices down significantly, we have been taking advantage of the equity market sell-off as buyers into market weakness. We have initiated or added to our holdings in a number of businesses that we regard as among the highest-quality companies in our investible universe. As concerns mount about global growth and investors consider the possibility of another recession, we take comfort in the fact that our businesses have proven their resilience in challenging economic environments of the past. Specifically, our current portfolio holdings in aggregate grew their revenue, operating profits and FCF in each of the last two recessions (2008-2009 and 2020-2021).

## Performance Review

In the first quarter of 2022, we had three positions that contributed more than +0.20% each to the Fund's gross performance, one of which contributed more than +0.50%. Conversely, we had 26 positions that detracted greater than -0.20% each, 11 of which detracted more than -0.50% each.

Our top contributor to performance in the first quarter was **Thales** (HO FP), a leading European supplier of defense applications, including radar, sonar and other communication systems. Thales also provides mission-critical flight avionics and cybersecurity solutions to the broader aerospace industry. We have been studying the Company for nearly five years as part of our broader research on the aerospace aftermarket value chain. Defense represents slightly more than half of Thales's sales and about two-thirds of profits with the majority generated by European customers. This regional focus has allowed Thales to benefit from increased European budget allocations to defense spending following Russia's 2014 invasion of Crimea, enabling consistent mid-single-digit organic revenue growth and high-single-digit growth in operating profit and cash earnings per share.

We initiated our current position in Thales in the second half of 2020 at a moment when its shares had been left behind in the broader post-pandemic equity market rebound; we believed that the Company was well-positioned to benefit from recovering post-pandemic commercial aerospace activity. Thales entered 2022 significantly undervalued, in our view, trading at less than 8x EBITDA and a FCF yield of 9%-10%. During the first quarter, shares rallied in the aftermath of Russia's invasion of Ukraine, which is likely to catalyze further prioritization of European defense spending. In recent years,

[4] SEG's estimate of the present value of the future cash flow that a business will generate over its remaining life.

European nations have spent approximately 1% of GDP on defense budgets, below the symbolic NATO target of 2% and well below the US's spending level of 4% of GDP. As investors reappraised the future outlook for Thales's defense business amid an ongoing recovery in commercial aerospace, its shares appreciated +48% (in USD) during the quarter, contributing over +70 bps to the Fund's performance. Despite this valuation rerating, we believe the shares continue to trade meaningfully below our estimate of their intrinsic value, and Thales ended the quarter as one of our 15 largest holdings.

A large detractor from our quarterly performance was **Inditex** (ITX SM), which we wrote about after adding meaningfully to our position during the third quarter of 2021. As a reminder, Inditex is a Spanish specialty apparel maker and retailer that owns fast-fashion leader Zara, among other brands. Inditex is differentiated by its world-class supply chain and inventory fulfillment process, which allows it to turn designs into on-the-shelf products in three to five weeks versus the industry average of six to 10 months. Inditex further benefits from its strategy of sourcing 60% of in-store sales from factories and suppliers in nearby "proximity markets" (e.g., Spain, Portugal and other countries in Europe), unlike the majority of the Company's Western competitors that source the vast majority of their products from China and Southeast Asia. Prior to COVID-19, Inditex had compounded revenue, operating profit and EPS at high-single-digit rates with high-teens operating margins. Not surprisingly, the pandemic weighed on Inditex's results; when we profiled the business two quarters ago, revenue was rebounding, and Inditex's Europe-based supply chain had helped the Company avoid the widespread supplier bottlenecks in Asia that have been plaguing rival retailers for much of the past year. Accordingly, we viewed Inditex as a likely market-share gainer, as global apparel spending recovered from the depths of the pandemic.

During the first quarter of 2022, Inditex reported strong financial results, including 35% growth YoY in same-store sales. Unfortunately, Inditex is also one of the companies in our portfolio that is *most* exposed to the economic aftershocks of the Russia/Ukraine conflict. The Company generates more than 65% of its sales from Europe with a strong presence in emerging Eastern European economies; Russia and Ukraine collectively represented approximately 10% of the Company's profits in 2021. Most of its stores there have been closed, and it remains to be seen whether they will be able to reopen in the future. Inditex shares declined -32% (in USD) during the quarter, detracting approximately -80 bps from the Fund's performance.

### Portfolio Developments

At the end of the first quarter, our portfolio's valuation represented approximately 30%-35% upside to our estimate of fair value, compared with approximately 20%-25% upside last quarter. Our portfolio ended the quarter trading at a 4%-5% FCF yield, an attractive level given our expectation that those cash flows should grow at double-digit rates for many years to come. For reference, over the past 10 years (from 2011-2021), our portfolio companies have grown their revenues and cash earnings at CAGRs of 11% and 12%, respectively. We finished the quarter with roughly 3% of the portfolio in cash, down slightly from 4% last quarter, while owning positions in 49 companies – unchanged since last quarter. Our 15 largest positions at quarter end represented 50% of the portfolio, while our 20 largest positions comprised 60%.

During the quarter, we added significantly to our position in **Keyence** (6861 JP), a leading Japanese robotics and factory automation technology supplier that we have studied for more than a decade. Keyence sells a variety of tools used by manufacturing customers to make production processes more automated and efficient, including machine vision, sensors, 3D printing and laser marking. Overall factory automation is estimated to be just 25% penetrated today in the US and even lower abroad. We estimate the factory automation market will grow in the high-single digits going forward, driven by rising labor costs (which factory automation helps offset), more affordable automation tools and improved functionality and integration. Over the last 10 years, Keyence has grown revenue, EBITA and cash earnings per share at compound rates of 11%, 12% and 14%, respectively, with best-in-class operating margins of more than 50%. Because most of Keyence's sales are product-related, however, they are generally non-recurring and, therefore, vulnerable to economic cyclicality; from FY 2019 to FY 2021, Keyence's revenue declined -8% with many customer operations temporarily shuttered by pandemic-related lockdowns. Despite this near-term disruption, the ensuing supply-chain challenges have further highlighted the need for factory automation technology.

In Q1 2022, Keyence reported quarterly results in which its revenue and operating profit grew 38% and 48%, respectively, versus the prior-year period. Importantly, given persistent global supply-chain bottlenecks, Keyence's direct sales model and centralized procurement give the Company better visibility than competitors into demand trends. In the most recent quarter, Keyence shipped an astonishing 95% of products on the same day they were ordered. Combined with strong pricing power and relatively low raw material inputs (as evidenced by greater than 80% gross margins), this has allowed Keyence to better navigate current supply constraints and take share against a backdrop of strong demand for factory automation technology. Once Keyence laps its elevated post-COVID-19 recovery growth rates, we expect the business to grow revenue at low-double-digit rates going forward and to further expand operating profit margins, improving upon what is already one of the best financial profiles in our investment universe. During the quarter, despite outstanding results, Keyence's shares declined in tandem with broad-based weakness in Information Technology stocks, giving us an opportunity to add to our position with shares trading more than 40% below our estimate of intrinsic value. Keyence ended the period as one of our 15 largest holdings.

## The Investment Environment

With companies and consumers grappling with soaring inflation around the world, equity markets have come under pressure as investors – cognizant that central banks remain massively behind the policy curve – have begun to discount increasingly imminent normalization in monetary policy. At the start of the year, base rates in the US, UK and eurozone stood at 0.25%, 0.25% and -0.50%, respectively. Just a single quarter later, market expectations for one-year forward base rates have increased from 1.0% to 2.6% in the US (i.e., the equivalent of eight 25 bps rate hikes), from 1.2% to 2.2% in the UK and from -0.4% to 0.0% in the eurozone. In the first quarter, 10-year sovereign yields rose by 83 bps in the US (the proxy for the global risk-free rate) to 2.34%, by 64 bps in the UK to 1.61%, by 82 bps in France to 1.06%, by 73 bps in Germany to 0.55% and by 87 bps in Italy to 2.04%. As of the time of this writing, the 10-year yields in all of these countries have continued to rise, approaching or surpassing the recent peaks reached in 2018.

Against this backdrop, investors have now also had to contend with the economic and financial fallout from Russia's invasion of Ukraine. Russia is a relatively small country in economic terms, contributing just 1.7% to global GDP (only slightly larger than Spain). Nevertheless, supply and demand disruptions caused by the invasion and subsequent economic sanctions have materially impacted a number of important commodity markets and supply chains. Energy price inflation—previously on course to stabilize on a YoY basis halfway through 2022 – has reaccelerated: Brent crude oil rose +65% from December 31, 2021 to a March 8th peak of $128 before ending the quarter at $108 (still up +70% YoY). Meanwhile, European natural gas ended the quarter at €42 – up nearly sevenfold since March 2021 – and exerted upward pressure on natural gas prices globally (with the USD price rising +51% during the quarter). In addition, Russia and Ukraine account for roughly one-quarter of global wheat exports. The conflict has caused the UN Food and Agriculture Organization Food Price Index to rise to a new all-time high of 160 points (versus the 2014-2016 average of 100), which is consistent with YoY inflation of 34%. The energy and food price shocks – arriving on top of another quarter of hotter-than-expected inflation prints across the developed world – caused consensus estimates for year-end 2022 CPI to rise sharply: from 4.4% to 6.2% in the US (where a tight labor market risks a protracted wage-price spiral), from 4.0% to 6.6% in the UK and from 2.5% to 5.6% in the eurozone.

With hindsight, it has become tragically clear that Europe's drive for sustainability caused it to severely underappreciate the value of energy security. In 2020, the EU imported 58% of the energy it consumed, mostly in the form of crude oil, coal and natural gas. Russia was the dominant source of all three, accounting for 41% of imported natural gas, 27% of oil and 47% of coal. The EU imported 155 billion cubic meters of piped natural gas from Russia in 2021 (of which one-third traversed Ukraine), about twice the amount received in the form of liquefied natural gas from the rest of the world. In 2021, when prices were significantly lower than they are today, the EU spent an average of €99 billion per year on Russian energy – far more than Russia's defense budget of $66 billion. Having thus emboldened Russia to invade Ukraine, the EU is left facing a terrible Hobson's choice: end imports of Russian energy immediately (at the cost of an instant recession) or live with the reality that it is directly funding Russian atrocities.

In economic terms, the Russia/Ukraine crisis is not regional but global. It has raised inflationary pressures and disrupted trade flows, both of which were already deteriorating before the conflict. It has also resulted in economic policy being weaponized in the form of unprecedented sanctions (including the seizure of two-thirds of the reserves of a major central bank). There is no easy fix. The EU's newly released plan, which targets a two-thirds reduction in Russian gas purchases before the end of this year, is likely unrealistic. Meanwhile, a sustained conflict interrupting multiple agricultural harvests in Ukraine could trigger famine in much of Africa and the Middle East. The potential for profound disruptions to supply chains and the prices of basic necessities is very real. Against this backdrop, there are signs that the crisis may result in a stronger, more unified EU, less reliant on the US for defense and on Russia for energy. Meanwhile, the world continues to watch as China ponders the implications of the West's robust support for Ukraine after having previously committed to a "no limits" economic and geostrategic partnership with Russia. All in all, the global geopolitical fundamental outlook is now far more uncertain than it was just one quarter ago, and the cone of outcomes is wide.

While painful in the short term, equity market volatility is giving us an opportunity to add to the compounding power of our portfolio at the most attractive prices we have seen in years. We pair our top-down analysis of emerging macro risks with ongoing, deep bottom-up fundamental analysis of the companies in our investible universe. We believe our businesses have de minimis risk of permanent capital impairment thanks to clean balance sheets, strong profit margins and limited cyclicality. We expect that most will thrive relative to peers in this choppy environment. In particular, given heightened inflationary pressures, we have always prioritized pricing power in defining what constitutes a high-quality company worthy of long-term investment. We admire businesses that have a proven track record of achieving positive price increases over time (net of any rise in input costs) thanks to differentiated, highly valuable product and service offerings from which their customers find it difficult to switch to a lower-priced alternative. Our companies are not low-value, "cost-plus" price-takers; most have limited exposure to the rising price of commodity labor and materials input costs, instead generating high profit margins through strong intellectual property borne from years of proprietary research and development expenditures and/or sales intimacy with the unique product and service needs of their customers. As in past environments characterized by macroeconomic pressure and/or recession, we expect that the market's risk appetite will eventually resume and that it will likely favor companies whose profitability and cash flows have proven far more resilient than their share prices. We thank you for entrusting us with your capital, and we will continue to work diligently on your behalf.

**INDEX DEFINITIONS**

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.

## RISKS

Investors in the Fund should be able to withstand short-term fluctuations in the equity markets in return for potentially higher returns over the long term. The value of portfolios changes every day and can be affected by changes in interest rates, general market conditions and other political, social and economic developments.

Foreign investing involves special risks including currency risk, increased volatility, political risks, and differences in auditing and other financial standards. Prices of emerging markets securities can be significantly more volatile than the prices of securities in developed countries and currency risk and political risks are accentuated in emerging markets. The Fund is 'non-diversified' and may assume large positions in a small number of issuers which can increase the potential for greater price fluctuation. The Fund also invests in derivative instruments, investments whose values depend on the performance of the underlying security, assets, interest rate, index, or currency and entail potentially higher volatility and risk of loss compared to traditional stock or bond investments.

Asset allocation decisions, particularly large redemptions, made by BBH&Co., whose discretionary investment advisory clients make up a large percentage of the Fund's shareholders, may adversely impact remaining Fund shareholders.

**For more complete information, visit www.bbhfunds.com for a prospectus. You should consider the fund's investment objectives, risks, charges and expenses carefully before you invest. Information about these and other important subjects is in the fund's prospectus, which you should read carefully before investing.**

Shares of the Fund are distributed by ALPS Distributors, Inc. and is located at 1290 Broadway, Suite 1000, Denver, CO 80203.

Select Equity Group, L.P. acts as the sub-adviser to the Fund.

Brown Brothers Harriman & Co. ("BBH"), a New York limited partnership, was founded in 1818 and provides investment advice to registered mutual funds through a separately identifiable department (the "SID"). The SID is registered with the U.S. Securities and Exchange Commission under the Investment Advisers Act of 1940.

**Not FDIC Insured** **No Bank Guarantee** **May Lose Money**