

# BBH Partner Fund – International Equity

Quarterly Fund Update / 3Q 2018

## Introduction

BBH Partner Fund – International Equity (the “Fund”) gained +2.46% on a net basis in the third quarter of 2018, while the MSCI EAFE Index<sup>1</sup> gained +1.35% in the period. Year to date through the first nine months of 2018, the Fund has gained +4.17% on a net basis while the MSCI EAFE Index has fallen by (1.43)%. International equity markets remain volatile. As we wrote in our last letter, our portfolio has held a relatively high cash balance over the last three to six months given our concerns that macro risks have been building in an environment of relatively high valuations. We were generally very pleased with the earnings results our companies reported during the quarter, as our businesses demonstrated their resilience in a challenging environment. Economic growth is slowing in many parts of the world, even as inflationary cost pressures are building. We have been concerned that the US administration’s escalating trade war would likely further dampen the global growth outlook and that equity prices would not likely prove immune in that scenario.

While this letter reviews the Fund’s performance over the three months ending September 2018, most readers will no doubt be aware that global equity markets plummeted at the end of the third quarter. During the month of October, both the MSCI EAFE Index and the Fund fell by more than (8)% in value. We look forward to providing a detailed update in our next letter on how the Fund’s positioning has evolved following the recent market sell-off. At a high level, we have been actively deploying capital in October and November. Valuations across our opportunity set are now more attractive than at any point since we took over management of the portfolio in February 2017. As sellers into strength for much of the last twelve months, we are now buyers into weakness having built up a sizeable cash balance precisely in anticipation of this kind of environment.

## Portfolio Contribution

We were generally pleased by the breadth of the portfolio’s returns in the third quarter of 2018. In a volatile but broadly flat market in Q3, the Fund owned 34 positions that contributed positively to returns, while 12 positions generated a negative return. In the third quarter, 19 positions contributed 0.1% or more to performance, while only eight positions detracted (0.1)% or more.

Our largest contributor to performance in the third quarter was Adidas, the German maker of branded athletic footwear and apparel. Adidas began the quarter as one of the Fund’s five largest holdings, and its share price gained nearly +13% in Euros (+12% in USD) during the period, contributing 51bps<sup>2</sup> to the Fund’s return in the period. We commented in our most recent letter that “we continue to marvel at the share price volatility of our investment in Adidas, about which we have written on numerous occasions.” Under new CEO Kaspar Rorsted, Adidas continues to gain market share from its competitors around the world – particularly in the large US market – while significantly improving its profit margins after years of operational inefficiency under previous management. In the most recent quarter, the company once again grew revenue more than 10% while growing operating profits 17% and cash earnings-per-share by 20%. Impressively, this growth was delivered against a very difficult prior year comparison, and the

Performance As of September 30, 2018							
	Total Returns		Average Annual Total Returns				
	3 Mo.*	YTD	1 Yr.	3 Yr.	5 Yr.	10 Yr.	Since Inception
<b>Class I</b>	2.46%	4.17%	6.03%	10.63%	5.12%	5.74%	5.43%
<b>MSCI EAFE Index</b>	1.35%	-1.43%	2.74%	9.23%	4.42%	5.38%	4.95%

Class I Inception: 10/25/2002 Class I: Total Expense Ratio (%): 0.73  
 \* 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. 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%.*

*Class I commenced operations on 10/25/2002. Total return information for Class I shares from 10/24/2002 to 6/7/1997 is that of Class N shares and from 6/6/2017 to 4/1/1995 is that of the BBH International Portfolio. Class N's and predecessor Fund's performance has been adjusted to assume that all charges, expenses, and fees which are presently in effect for Class I were deducted during such periods, as permitted by applicable SEC staff interpretations.*

*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, excluding the U.S. and Canada. The Index is available for a number of regions, market segments/sizes and covers approximately 85% of the free float-adjusted market capitalization in each of the 21 countries.*

Sources: BBH & Co. and MSCI EAFE

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<sup>1</sup> 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 U.S. 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.

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

improved margins came despite the company's normal step-up in marketing spending in conjunction with the soccer World Cup. We were also encouraged to see inventories actually lower on a year-over-year basis despite the strong revenue growth; management continues to maintain a healthy degree of product scarcity in the channel (despite strong demand), which is contributing to greater full-price sell-through and, accordingly, higher gross margins. As of quarter-end, Adidas shares have risen roughly +27% (in EUR) year-to-date and +40% (in EUR) since we initiated the position less than two years ago. While still attractive, Adidas now trades at a somewhat lower discount to its intrinsic value after its recent rally. We trimmed the position into strength during the quarter, and it is no longer one of the Fund's ten largest positions.

Our largest detractor from performance in the second quarter was Alibaba, the operator of the largest ecommerce platform in China. Its share price declined (11)% in USD in the third quarter, with about half the decline coming prior to its August earnings release and the rest of the decline transpiring in September after its results had already been digested. Total revenue grew by a staggering 61% versus the prior year period, including a number of fast-growing but loss-making businesses still in investment mode (such as Cloud Computing) as well as a number of recent loss-making acquisitions that Alibaba has completed to expand its logistics and delivery capabilities. However, the company earns the vast majority of its profits from its core business (keyword advertising and sales commissions related to products purchased on the Taobao and Tmall websites), which grew both revenue and operating profit at rates of more than 30% year-over-year. The non-core investments weighed on reported Group earnings – with total underlying operating profit +9% year-over-year and free cash flow +15% for the period – and a delay in the long-awaited IPO of ANT Financial (the privately-held Chinese payments and financial services behemoth of which Alibaba owns roughly one-third) gave investors another reason to fret. Still, Alibaba shares were broadly unchanged in the week that followed its earnings release and there was no other significant company-specific news in the quarter. In our view the share price weakness during the period was predominantly attributable to a broader “risk-off” shift in US investor sentiment towards technology companies generally and Chinese equities specifically, rather than to any factors unique to Alibaba. Of the 15 largest US-listed Chinese Internet/technology companies by market capitalization, all but two saw their share prices end lower in the third quarter, with an average decline of (18)%. Alibaba's shares exited the quarter trading at 70-75% of our estimate of the company's intrinsic value, and we took advantage of share price weakness to add meaningfully to our position in the Fund.

### Valuation & Portfolio Changes

As of the end of the third quarter, our portfolio of companies traded roughly 15-20% below our estimates of intrinsic value, broadly unchanged from the previous quarter. We continue to rotate capital dynamically to the most attractive risk-reward opportunities in our universe. In total, the Fund purchased six new positions during the third quarter and exited five positions. The Fund began the most recent quarter holding 15% of the portfolio in cash, and we ended the quarter targeting a similar cash balance (while our actual cash balance was just over 12% as of the final day of the quarter, that balance had increased to roughly 15% by the end of the first week in October as some of our working orders gradually completed). The Fund owned 41 stocks at the end of the third quarter, and we remain relatively concentrated in our highest-conviction ideas. Our fifteen largest positions at quarter-end represented just over 50% of the Fund, while our twenty largest positions collectively represent nearly 62% of the Fund.

During the quarter we initiated a new shareholding in ASML, a Dutch niche supplier to the semiconductor industry that we regard as an outstanding business. In 1965, Intel founder Gordon Moore observed that the number of transistors in a dense integrated circuit tends to double every two years; this trend, dubbed “Moore's Law,” became the golden rule of electronics. With approximately 80% global market share, ASML is the dominant maker of lithography equipment, the products in the semiconductor value chain that make possible the very “feature shrink” that Moore's Law describes. Thanks to ever lower-cost, more-powerful micro-electronics, more products become “connected” every year such that semiconductors tend to be a mid-single-digit growth market over time. ASML has grown its revenues at nearer a high-single-digit rate annually over the last decade and nearer mid-teens over the last five years, as it has gained share of industry capital expenditure budgets and enjoyed pricing power thanks to its leadership in mission-critical products. Unlike its customers, ASML enjoys operating profit margins well above 20%, is highly cash-generative and enjoys outstanding returns on capital employed. Amazingly, ASML's share of the lithography equipment will almost inevitably approach 100% over time; its two legacy competitors in Japan have notified customers that they will not pursue the next-generation technology roadmap for lithography equipment on which those customers' long-term product strategies depend. However, the semiconductor industry is highly cyclical and somewhat notoriously unpredictable. We typically have little to no portfolio exposure to this industry as a result. In the past quarter, after a torrid 18-month period of industry growth, most participants in the semiconductor value chain began to report softening demand including double-digit order declines in some cases amidst reported deferrals in customer capex projects. ASML shares fell nearly (20)% in local currency off their highs in less than two months during the quarter, once again providing us an attractive entry point to own this high-quality business at a significant discount to its intrinsic value.

We also initiated a new position during the quarter in Sika, a company that we have admired and studied continuously for more than a decade. Based in Switzerland, Sika is a leading provider of specialty chemicals and materials for building and construction end-markets as well as adhesive materials for a range of industrial end-markets. The company's products are not commodity materials; used for bonding, sealing, damping, reinforcing and protecting, they are often additives to a broader structural solution that make the product stronger and/or more effective. Sika derives approximately half its revenue from emerging markets, where penetration of these high-value materials is typically well below developed-market levels. Sika has operated in most of these developing economies for so long, and relies on local managerial talent to such a significant degree, that it is typically regarded as a local domestic player by its customers in those markets. Over time, Sika has demonstrated a consistent ability to innovate, gain market share from smaller-scale local players as well as less focused global competitors, and to pass volatile raw material cost inflation in the form of higher prices. Over the last decade, Sika has grown its revenues at a mid-single-digit rate organically while tuck-in acquisitions have brought local-currency revenue growth nearer to 9% annually. The company enjoys mid-teens operating profit margins, strong free cash flow conversion, and exceptional

returns on equity and capital employed. Sika has recently emerged from a multi-year governance struggle and reestablished its independence after an unsuccessful hostile takeover attempt from French building materials company St. Gobain. With the distraction behind them, Sika management now has a relatively full pipeline of acquisition targets, and we believe that accretive capital allocation is likely to accelerate in the years ahead.

As markets remain volatile, we have opportunistically added to some long-term holdings on weakness while trimming other positions into strength. We added significantly to our stakes in German healthcare company Fresenius, Irish construction materials company CRH, and Spanish fast-fashion apparel giant Inditex in the quarter, each of which detracted from performance in the quarter even as our view on intrinsic value remained broadly unchanged. We reduced our stakes in Canadian information services provider Thomson Reuters, British-American payment services provider Worldpay, and Canadian convenience store operator Alimentation Couche-Tard after each benefited from strong share price performance in the third quarter.

### The Investment Environment

Throughout 2018, as we have written in our previous letters, we have been concerned about rising geopolitical and macroeconomic risks. We noted last quarter that “we believe investors are reevaluating the ‘risk’ component of their ‘risk-reward’ analyses” in light of this backdrop. Several particularly thorny controversies – chief among them US-China trade prospects, fading global economic growth momentum, elevated political risk in multiple countries, and monetary normalization – are moving closer to denouements, but the cone of outcomes remains wide. As investors focused on long-term earnings power and selecting from an approved list of proven and resilient high-quality businesses, we are not at all put off by this. Our goal, as ever, is to understand the top-down issues, consider the range of possible outcomes, manage exposure to tail risk, and faithfully execute our bottom-up research process. However, it does mean that the shelf life of our current macro views is likely to be short.

First, by initiating and escalating a trade war with China, we fear that the United States has made a potentially grave policy error. Rather than unite its allies to bring China to heel for its egregious WTO violations, it has instead picked fights with them, hobbled the World Trade Organization (“WTO”) by blocking appointments to its judicial review board (which will render it incapable of issuing rulings within a year), and isolated itself while the rest of the world presses ahead with trade liberalization. We are increasingly convinced that neither China nor the US will deescalate, which means the emergence of a second cold war is a possibility that must be considered. This would be far more economically damaging than the original one. The US and China account for 24% and 15% of global GDP, respectively, with China projected to surpass the US in the early 2030s. China’s \$12 trillion GDP is already ahead of the US in purchasing power terms (\$23 trillion, vs. \$19.5 trillion). Frankly, we think it is too early to handicap the aggregate economic consequences of a US-China trade war. Such analysis is highly subjective and beyond our core competence, which is to assess the sustainable earnings power of individual businesses. According to the most recent International Money Fund (IMF) analysis, however, the proposed US tariffs and second-order impacts would leave global GDP 0.4% below the IMF’s long term (2023) baseline, with China a little over 0.5% below and the US almost 1% below. We suspect that the surprisingly severe US economic outcome under the IMF’s analysis is not yet discounted by US markets which fell over (7)% off of year-to-date and all-time highs through the end of October, while Chinese markets, at more than (30)% below their YTD highs in local currency, have clearly baked in a far more bearish scenario.

Second, as we foreshadowed last quarter, the global economy is slowing and decoupling after a period of unusually synchronized growth in 2016 and 2017. The IMF has cut global GDP growth estimates by 0.2% since April for 2018 and 2019, leaving both years at +3.7% (the same as 2017). Whereas countries accounting for 75% of global GDP experienced accelerating growth last year, only 47% will do so this year and just 32% in 2019. Developed world growth is expected to slow from +2.4% this year to +2.1% in 2019 before converging to “trend” growth of +1.5%. The US is expected to sustain above-trend growth for longer – thanks to pro-cyclical stimulus unprecedented this far into a cyclical upturn – but in two to three years its growth will likely succumb to the reality of a shrinking working-age population, a potential 3.5% Fed funds rate (based on current guidance), and the drag from federal debt at more than 90% of GDP along with a 5% fiscal deficit. Eurozone expectations have fallen to +2.0% growth this year and +1.9% next year (a deceleration from +2.4% in 2017). The UK, mired in Brexit uncertainty, continues to struggle with growth of around +1.5%, while Japan is growing nearer +1.0% at present. Emerging markets are in aggregate expected to sustain last year’s +4.7% growth this year and next, but with significant variations among them (EMEA weakest, Asia strongest, and Latin America dependent on the success of reforms in Brazil and Mexico). Notably, China’s growth is slowing but not collapsing. At +6.5% year-over-year, its Q3 GDP grew at the slowest rate since the crisis. However, the culprit was not trade fears but rather a sensible and overdue combination of (i) fixed-asset investment at all-time lows, and (ii) financial deleveraging undertaken in the first half of the year. Both of these will partially reverse in the second half of 2018 as the Chinese government starts to ease fiscal and monetary policy to mitigate the impact of the trade war. Admittedly, China’s massive debt problem remains unresolved, as evidenced by a new report from S&P estimating the size of local government off-balance-sheet finance vehicles at 50% of GDP. However, unlike the US, China has more than enough levers to pull to sustain GDP growth for the foreseeable future; the IMF estimates China’s long-term trend growth rate at +5.6%.

Third, over the last three months we would characterize political risks as having moved from “elevated” to “potentially systemic.” In the UK, a “hard Brexit” remains a very real possibility if parliament rejects the deal being negotiated by Theresa May (and Labour intends to vote against it) and no other action is taken. As of this writing, May claims that the deal is “95% negotiated,” but the concessions she is having to make look increasingly likely to push the Conservative party’s Brexiteer wing to oust her as Prime Minister (and they have the votes to do so). In Italy, the new coalition government of left- and right-wing populists has set a 2019 budget with a 2.4% fiscal deficit based on unrealistically high growth expectations. The EU Commission has rejected this as too close for comfort; as of this writing, Italy is refusing to back down, which has the potential to flare up into another Eurozone

crisis. Brazil has just elected as President a right-wing strongman. While markets have right cheered the failure of the Workers' Party (PT) to retain power (given its catastrophic record of corruption and economic mismanagement), investors are perhaps relying too much on the credentials and reputation of Bolsonaro's likely Finance Minister who advocates the kind of pension and public sector reforms that Brazil desperately needs. Bolsonaro himself has no executive experience, and his refusal to appoint members of opposition parties to key government positions will make it challenging to secure the 60% majorities in both houses required to pass the necessary constitutional amendments.

Finally, having earmarked the fourth quarter of 2018 in previous letters as a likely milestone in monetary regime change, we were not surprised to see the market's sudden attention to rising US rates and bond yields. The December rate hike, if Federal Reserve guidance is confirmed, would mark a 200 basis point increase in two years. At 2.9%, the 2-year US Treasury now yields significantly more than the S&P 500 (2.1%) and the MSCI World Index (2.6%). Corporate credit spreads, in our view, remain unsustainably low, particularly in the Eurozone where they have been forced down by soon-to-end ECB buying. We would not be surprised to see a seizure in the corporate bond markets over the next few years, originating in the US, Europe, or China. Issuance has soared, credit quality is deteriorating, Quantitative Easing (QE) has suppressed the natural credit cycle but is reversing, interest rates and bond yields are rising from historically low levels, aggregate corporate margins are peaking, and a refinancing wave is coming (with roughly 65% of current bonds outstanding in the US and Europe and 85% in China maturing within five years). To make matters worse, much of this debt is held by ETFs and mutual funds with daily liquidity. The ingredients for a credit crisis are there, though that is probably a topic for another letter.

As discussed earlier, we have responded to an environment of mounting macro risks by holding a cash position of approximately 15% over the past six months and by concentrating our equity exposure into our highest-conviction ideas. A core part of our investment research process is to study in depth how the companies in our universe fared during the last several recessions. The Fund's largest holdings at quarter-end are businesses that meaningfully grew cash flow between 2007 and 2010 despite the historically difficult global recession and financial crisis in the intervening years. We will continue to invest the Fund in businesses we are happy to own with a five-year view, regardless of the macro environment. We typically find that in broad-based equity market sell-offs – such as the one in which we find ourselves at the time of this writing, we have an opportunity to deploy our cash balances by putting capital to work at very attractive prices and upgrading the quality of the portfolio in the process. We look forward to sharing in greater detail in our next letter exactly how we endeavored to implement that playbook in the fourth quarter of 2018. As ever, we aim to provide our investors with long-term maximization of total return, primarily through capital appreciation.

Top 10 Companies As of September 30, 2018	
AIA Group Ltd	5.5%
Compass Group Plc	4.8%
Nestle SA	4.4%
Fresenius SE & Co KGaA	4.2%
Alibaba Group Holding Ltd	4.1%
Capgemini SE	3.8%
Air Liquide SA	2.9%
Seven & i Holdings Co Ltd	2.8%
Ferguson Plc	2.7%
Brookfield Asset Management - CI A	2.6%
<b>Total</b>	<b>37.6%</b>
Reported as a percentage of total portfolio. Holdings are subject to change.	

On February 24, 2017 (the "Effective Date"), Select Equity Group, L.P. replaced Mondrian Investment Partners Limited and Walter Scott & Partners Limited as the Fund's sub-adviser and assumed the day-to-day management of the Fund's portfolio. Additionally, the name of the BBH International Equity Fund was changed to BBH Partner Fund - International Equity and Class N Shares of the Fund were redesignated and renamed Class I Shares. Following the Effective Date, the rights, privileges or expenses of existing Class N shareholders are the same as the rights, privileges or expenses of Class I shareholders.

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 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.

#### RISKS

International 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.

**For more complete information, visit [www.bbhffunds.com](http://www.bbhffunds.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 1100, Denver, CO 80203.

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