# BBH Select Series – Large Cap

BROWN BROTHERS HARRIMAN & CO.
140 BROADWAY
NEW YORK, NY 10005

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*The global COVID-19 crisis has taken a tremendous toll on the afflicted as well as their families and communities, and as such, we wish to offer respectful sympathies and earnest hope of recoveries and better times ahead. We also wish to express sincere gratitude and praise for the resolute legions of healthcare workers and frontline responders who have made enormous sacrifices to care for others during such difficult times.*

## Introduction

While capital markets have regained some footing in recent days thanks to outbreak control measures and aggressive fiscal and monetary policy moves launched by the governments worldwide, the COVID-19 pandemic has nevertheless caused enormous disruptions to normal business and consumer activities, which in turn have led to widespread dislocation in asset prices. We do not believe it is yet possible to forecast, or even fully dimension, all of the downstream impacts of the disruptions or the duration of their effect, nor do we believe it would be advisable to hazard guesses. But we do believe that surveying some of the contextual elements of this market correction can help investors maintain a 'through-the-cycle' perspective, which is critical to good decision making and adherence to fundamental principles. We offer some of our observations along those lines in this commentary.

## The COVID-19 Correction of 2020: what's different this time?

Every market correction has its own unique attributes. This one is notable for the fact that it has roots in multiple sources, each of which is adversely interacting with the others. First, as to the pandemic itself, COVID-19 has precipitated a public health crisis of a magnitude we have not seen in generations. Precautionary business shutdowns are in effect worldwide, leading to a dramatic reduction of consumer and business activity. The services-led U.S. economy of our era is simply not compatible with the concept of 'social distancing' or other limitations on human gathering and interaction. These sudden curtailments of ordinary commercial and consumer activities are therefore fanning out across the system, causing reverse multiplier effects.

A second element of the current market correction is the major downward oil price shock that started in February. Normally, lower crude oil prices would benefit consumers and transportation providers (and that may prove to be the case here as normal activities eventually resume), but with the upstream component of the energy sector now constituting a substantial segment of the U.S. industrial economy, there are also significant gross domestic product (GDP) headwinds as well as negative implications for investment and employment in these areas. Moreover, there will likely be additional trouble in the credit markets that feed from the energy sector.

A third notable issue influencing this market correction is the level of public and private debt that underlies nearly all forms of commerce, investment, and public spending in today's highly-financialized economy. Eleven years of excess growth in the money supply has suppressed interest rates and encouraged higher levels of borrowing. In our view, this has left lenders and debt capital markets increasingly vulnerable to downside risk if and when underlying collateral values (both secured and unsecured) negatively react to trends in the 'real economy' (e.g. corporate earnings, unemployment, commercial rental payments), thus presenting the potential for credit support and equity backstops to be eroded. In the 2008-2009 recession, it was consumers who were overburdened with debt. In this cycle, consumer balance sheets are in much better shape, but it is instead businesses that have added significant leverage.

A fourth factor that we believe has contributed to market dislocation is the increasingly large footprint of investment strategies and styles that are directly or indirectly predicated on low volatility, both as a mechanical input in trading and hedging decisions, and also as an underlying structural belief that is based on years of observed data since the 2008 financial crisis. Such strategies were essentially selling 'insurance' against bad market outcomes, rolling the bet forward in ever-greater size, even as compensation for such insurance was diminished. History has repeatedly shown that one-way bets of this sort become dangerous when tail-risk events occur.

Lastly, it is clear that passive investment strategies such as indexing as well as algorithmic and quantitatively-driven approaches today account for a much larger share of trading in the public markets than they did in prior market cycles, and thus their influence in setting short-term asset prices is notably higher. Particularly worrisome among the implications of this shift, in our view, is that the growing influence of tactics such as dynamic hedging, risk parity, and momentum following can create added instability as they all tend to move in the same direction at extremes, limiting the stabilizing influence of human actors in the market and giving false price signals that undermine investor confidence.

### What's NOT different this time?

Having noted some of the unique elements we see in the current correction, we also believe there are several things occurring that echo the patterns of many other sharp selloffs in the past. The overwhelming majority of trading in public markets involves secondary, not primary transactions, and thus the major determinant of quoted asset pricing is the relative eagerness of the parties on either side of each trade. During market corrections, and perhaps particularly in those that result from unanticipated shocks, sudden investor panic can run well ahead of reality. The price setters and price takers (at least those of the human variety, as noted above) begin to act emotionally, and their focus on the return <u>of</u> capital can supersede level-headed, longer-term considerations of the potential returns <u>on</u> capital. When large number of investors are eager to sell assets, or they are *forced* to sell assets in order to raise cash to repay borrowings or meet fund redemptions, they often first look to securities that are easier to sell; i.e. those that have better liquidity or defensive characteristics. This can disproportionately impact the prices of otherwise attractive assets, causing distortions during the early phases of a selloff.

Closely related to the preceding point is the fact that every major market correction exposes the imprudent actions and excesses of the recent past. When prices plummet, undercapitalized, complacent and highly leveraged market participants become exposed for the weaknesses in their risk management, and they are forced out of positions as they attempt to defend their capital. This process adds to downside pressures as the excesses are wrung out, sometimes in dramatic fashion.

Another recurring feature of corrections is a widespread desire to reduce duration. The concept of duration is primarily used as an analytical tool in bond markets, but we believe it is applicable to equities as well, at least as a theoretical expression of the time-weighted proximity of earnings and cash flows. During bear markets, investors' collective desire to collapse duration can lead them to overly discount the future as the uncertainties of the present moment are extrapolated. We see this as a key behavioral error that happens in every market trough. Essentially, all of a company's equity value is driven by future earnings, but the majority of those earnings exist beyond the headwinds of the moment or even the current part of the business cycle; as such, true underlying intrinsic equity value does not logically become impaired in a 1:1 ratio with near-term earnings pressures. The upside of this phenomenon is that disciplined, patient investors can benefit as others succumb to this behavioral error of extrapolation.

Lastly, as we have seen in other periods of market panic and economic distress, governments and central banks can and will intervene to lessen the damage. As with the present situation and the announcements we have seen of late, these interventions can be massive in size and scope, and they can certainly act as a firewall against systemic collapse. However, we believe that the more fundamental driver of periodic financial downturns is the ebbing of economic 'animal spirits' – the aggregation of countless individual human decisions that are based on confidence. Government actions serve a purpose, but it is far from certain that they can accelerate the organic and sometimes-slow processes of rebuilding capitalistic motivation and consumer confidence.

### What is the right approach for equity investors?

Even for long-term oriented equity investors, market corrections can be distressing and disorienting, but we believe it is essential to follow guiding principles and view the selloffs as being natural occurrences within a cycle. Periods of sharp volatility are simply part of owning equities. Because they are ownership interests, not credits, equities do not offer any guarantee of principal, nor do they offer stable pricing over time. The compensation for these attributes comes in the form of potentially higher long-term expected rates of return relative to other asset classes, but the interim path can be erratic as economic trends vary and exogenous factors inevitably arise.

At BBH, we believe that disciplined, long-term equity investing requires not only fortitude, but also a steadfast belief in a simple 'North Star' principle: that the most durable source of capital accumulation over long periods of time is the ownership of well-positioned businesses that are able to grow while also earning rates of return on capital that consistently exceed their cost of capital. This is the formula for true shareholder value creation, and we view it as being axiomatic.

**Even in challenging times, we remain committed to the central tenets of the Fund's approach:**

1. We must always know what we own. We make investment decisions that best reflect our views of individual company fundamentals, supported by bottoms-up due diligence.
2. With our strict set of investment criteria, we maintain very high standards for business quality. We seek resilient, differentiated businesses that have solid cash flows, attractive long-term growth opportunities, prudent approaches to capital investment, strong balance sheets, and capable management teams.
3. We use a valuation-driven approach in constructing the portfolio, looking for divergences between market prices and underlying intrinsic value[1].
4. We view equity investing as business ownership, and thus our returns over time will result from the compounding of underlying business value rather than short-term trading of stocks.

Periods of downside volatility are inevitable in equity investing. Our core objective in the current market correction (as well as in those that will occur in the future) is to keep a steady hand while also looking carefully for valuation opportunities that arise.

Sincerely,

**Michael R. Keller, CFA**
**Partner**
**BBH Select Series-Large Cap Portfolio Manager**

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

Past performance does not guarantee future results.

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.

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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.

International investing involves special risks including currency risk, increased volatility, political risks, and differences in auditing and other financial standards.

**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.**

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