For the first quarter ended March 31, 2020, the BBH Partner Fund – International Equity (the “Fund”) returned -17.93%. Over the same period, the MSCI EAFE Index1 (the “benchmark” or the “market index”) returned -22.83%.

Select Equity Group, L.P., the Fund’s sub-adviser, assumed management of the Fund February 24, 2017. Since that date through the first quarter of 2020, the Fund has generated a positive net annualized return of +3.4%, outperforming the Index’s negative annualized return of -1.1% by approximately +1,440 bps2 per annum. The Fund has generated a positive net annualized return of +3.4%, outperforming the Index’s negative cumulative return of -3.3% by approximately +1,440 bps.

Introduction

The Fund began 2020 conservatively positioned, with approximately 20% of our portfolio in cash and very little exposure to businesses selling into traditionally cyclical end markets. We observed in the introduction to our year-end 2019 Letter that “While the market’s fear of a recession has temporarily faded…many businesses in our universe are back to trading at record highs, and we have been trimming into strength. With…several headwinds to global growth threatening an already lengthy economic cycle, we are well prepared to deploy capital…should the now decade-long period of global gross domestic product (“GDP”) growth give way eventually to another economic downturn.” On Monday, February 24, the world awoke to news that a highly contagious respiratory coronavirus (“COVID-19”), which had infected tens of thousands of Chinese citizens in recent weeks, was beginning to spread rapidly in at least four other countries. The MSCI EAFE Index proceeded to lose roughly one-third of its value over the next five weeks, as the coronavirus became a global pandemic and led to the sharpest and most synchronized global recession in history.

We spent the last five weeks of the quarter actively deploying capital, as most businesses in our portfolio and many of the highest-quality businesses in our investible universe saw their valuations compress dramatically. Our portfolio’s cash balance fell to a low of 4% during the week when the Index hit its lowest levels of the quarter. Concurrently, we engaged the vast majority of our over 50-person Research Team – our investment Analysts, Qualitative Field Research Team, and our Data & Analytics Team – in an exhaustive and multi-faceted effort to understand in great detail the likely path forward for COVID-19; the resulting public health, monetary, and fiscal response from the world’s policymakers; and the near- to mid-term prospects for the companies in which we invest. As of this writing, much remains uncertain about the immediate path forward for the global economy. However, we exited the quarter feeling unreservedly optimistic about your portfolio. We believe that we own many of the very best businesses in the world at valuations more attractive than we have seen in years.

Performance Review

In the first quarter, we had three positions that contributed +0.10% or more each to the Fund’s returns, none of which contributed greater than +0.20%. We had 35 positions that detracted more than -0.10% each during the period, 28 of which detracted greater than -0.20% each.

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, 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. 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.
Our top contributor to performance in the first quarter was Adyen (ADYEN NA), the Dutch global leader in online payment processing. Over the last five years, our Research Team has conducted an extensive study of the non-cash payment-processing industry, a highly attractive value chain characterized by rapid growth, high profit margins and deeply entrenched customer relationships. Adyen develops software and tools that enable merchants (via their e-commerce websites) to accept a wide variety of non-cash forms of payment from customers around the world in a seamless interface. Adyen provides a variety of back-end technology services, including fraud detection and prevention, transaction authorization, and foreign currency translation, ensuring that its merchant customers can sell to the widest possible global audience with minimal risk. Its business model is akin to a tollbooth. Adyen is paid contractually a certain percentage (in basis points) of all revenue a merchant generates online. With more than 90% of its revenue derived from e-commerce (with the balance derived from its “omni-channel” – online and offline – customers’ bricks-and-mortar retail locations), the business is a high-quality, pure-play way to invest in the secular growth of e-commerce.

Adyen’s founder developed one of the industry’s first leading solutions in the early 2000s before selling that business (“Bibit”) to the predecessor company to the UK’s Worldpay (a company we have owned and profiled in past letters). He then started from scratch in the late 2000s aiming to develop a better mousetrap for the same industry based on a superior technology architecture; that company became Adyen. The company is now rapidly gaining share of this fragmented industry, and it already counts as customers many of the largest and fastest-growing companies in the world, including Uber, Netflix, Facebook, Spotify, Etsy, Nike, and the Zara retail chain (owned by Inditex). Over the last five years, Adyen has grown its revenue, operating profit, and cash earnings at compound annual rates of 60%, 80%, and 80%, respectively. Its operating profit margins exceed 50%, returns on equity were 28% last year, and the company earns infinite operating returns due to the low capital intensity of its business model (with negative working capital more than offsetting the low fixed-capital requirements). Adyen began the quarter as a small position, but we added significantly to it on weakness during the global equity market sell-off. The shares subsequently rebounded, contributing +17 bps to performance. Adyen ended the quarter as one of the Fund’s 15 largest positions.

The largest detractor from Q1 2020 performance was Melrose Industries (MRO LN). We noted in the introduction to this letter that we entered 2020 with very little exposure to companies selling to classically cyclical end markets; Melrose is a notable exception. While Melrose is an acquirer, owner, and operator of UK industrial businesses, it is no ordinary cyclical company. We profiled the company just three months ago in our most recent letter, as Melrose was the single largest positive contributor to the Fund’s returns in Q4 2019. As we wrote then, Melrose is a hybrid of an industrial company and a publicly traded private equity firm. Its exceptional management team has a nearly two-decade history of buying undermanaged UK industrial businesses, significantly improving their operations (and thus their profit margins) and then selling those companies to strategic acquirers at many multiples of its original capital investments. Importantly, and unlike traditional private equity managers, Melrose employs relatively little financial leverage in its deals, relying on organic business improvement to drive the majority of its returns. Our investment in Melrose was very much on track until COVID-19 hit, but the manner in which the coronavirus has debilitated the global economy has created a perfect storm for this business for the next six to 12 months.

Melrose’s three most important industrial divisions today are exposed to the commercial aerospace, automotive, and commercial heating, ventilation, and air conditioning (HVAC) sectors. Thanks to COVID-19, air travel has collapsed (pressuring airline original equipment manufacturers [OEMs], soaring global unemployment will dent automotive demand, and would-be acquirers of the company’s commercial HVAC business (which was reportedly actively for sale by Melrose at this quarter) have no doubt diverted all their attention away from mergers and acquisitions (M&A) and toward internal operations for now. With its largest business – aerospace – suddenly facing a downturn significantly greater in magnitude than either the Global Financial Crisis (GFC) or the post-9/11 period, Melrose suddenly finds itself with cash flow and balance sheet concerns that belie the seemingly conservative 2x net debt/EBITDA (earnings before interests, taxes, depreciation, and amortization) leverage ratio with which it entered 2020. While we have great confidence in the operational and transactional expertise of Melrose’s management team – and would note the company already announced a successful negotiation of relief from some of its bank covenants late in the quarter – the business will remain cash-constrained until the airline industry begins to recover from the travel restrictions imposed by COVID-19. Melrose’s shares fell -64% in U.S dollars (USD) during the quarter, detracting approximately -275 bps from the Fund’s performance. Based on our lowered estimate of the company’s fair value due to lower near-term cash flows than previously expected, we believe Melrose’s valuation still represents more than 100% upside today with a multi-year view. We held our investment in Melrose but did not add significantly to the position during the quarter, preferring instead to deploy capital in the many businesses in our universe and portfolio that saw sharp share price declines yet are far less directly impacted by COVID-19 than Melrose.

**Portfolio Developments**

We were extraordinarily active during the first quarter, as we took advantage of the broader equity market dislocation to deploy capital aggressively as markets fell by one-third in a very short timeframe. Stock prices rarely decline with the synchronicity we witnessed over the last few weeks; neither the 1929 stock market crash nor the GFC of 2008-2009 saw equity markets fall as fast as they did during the final weeks of the first quarter of 2020. In a broad-based, nearly indiscriminate sell-off, our portfolio management playbook is clear: (i) become significantly more invested as buyers into weakness and (ii)
upgrade the overall quality of the portfolio by deploying capital only into businesses of the highest quality. We view a market sell-off like the one we witnessed in the last few months as a once-in-a-decade opportunity to buy many of the world’s highest-quality businesses on sale. Accordingly, we ended the quarter with seven new positions relative to three months ago, including a number of businesses that we consider to be among the highest-quality growth companies in the world. We also added significantly to many of our existing holdings as valuations became considerably more attractive.

By mid-March, our cash balance had dropped to just 4% of the Fund and remains at that level (as of this writing in late April) versus approximately 20% in the first week of 2020. As we have discussed extensively in previous letters, the Fund’s cash balance typically moves in inverse relation to the portfolio’s valuation upside to our estimate of our holdings’ intrinsic values. By late January/early February 2020, we estimated that our portfolio was only slightly undervalued based on upside to intrinsic value. By late March, the portfolio’s upside to our estimate of intrinsic value had risen to a peak of more than 40%-45% before markets rebounded somewhat in the final days of the quarter. At the same time, we are painfully aware that the global recession that has only recently begun will likely dwarf the GFC in terms of peak-to-trough GDP declines accompanied by an unprecedented and synchronized surge in developed-world unemployment. The cone of outcomes for the global economy is unusually wide at present. If public health efforts can result in a successful containment of COVID-19 in the months ahead and if fiscal stimulus efforts avert a sustained collapse in the global services sector, then we believe equity markets remain significantly undervalued at quarter-end. If, by contrast, a prolonged economic depression ensues over the 18-24 months before the world develops one or more viable vaccines for COVID-19, we estimate that our businesses are still undervalued but nearer the high end of our historical “normal” range of 10%-20% portfolio upside. This still represents a historically attractive margin of safety - even against conservative bottom-up assumptions for our businesses – underpinning our conviction that we should become significantly more invested into the market sell-off.

We ended the period owning 41 companies, down from 45 holdings at year-end. As we took advantage of the opportunity to initiate a number of new positions in many of our favorite businesses in the world, we simultaneously exited a number of holdings during the quarter for which we regarded the risk/reward to be less favorable in an environment in which suddenly everything was on sale and we could “trade up” from a quality standpoint at very attractive valuations. Accordingly, we continue to be relatively concentrated in our highest-conviction ideas. Our 15 largest positions at quarter-end represented just over 50% of the portfolio, while our 20 largest positions collectively represented more than 60%.

During the quarter, we took advantage of market weakness in March to initiate a new position in Lululemon Athletica (LULU US). Founded in 1998 as a retailer of yoga pants, Lululemon helped pioneer the trend of “athleisure” wear for everyday fashion, building a popular brand that has allowed it to open more than 490 company-operated stores. We rarely invest in retailers, given the ubiquitous competitive threat posed by e-commerce, but Lululemon has developed a formidable moat operating in a somewhat protected category within retail. Athleisure apparel, notably products like sports bras and women’s fitness pants, fit snugly to the body and typically need to be tried on in-store to ensure a proper fit as styles and performance materials continue to evolve. Over the last 10 years, Lululemon has compounded revenue and operating profit at annual rates of 24% and 26%, respectively. During 2019, brand momentum remained strong as the company grew same-store sales 10%, while continuing to expand total store count by 12%. Looking forward, we believe the business can sustain double-digit growth as it has begun a successful expansion into menswear (currently only 24% of the brand) and has a long runway to open more international locations (75% of stores are in the United States and Canada today). Given our long-time study of other high-quality athleisure retailers like Nike and Adidas — whose management has cited Lululemon to us in the past as exemplary retail operators — we have waited patiently for years for the opportunity to buy Lululemon shares at a discount to our estimate of intrinsic value. We were excited to finally take advantage of such an opportunity after the company’s shares sold off nearly -50% (in USD) peak-to-trough along with most other listed global retailers during the quarter. While there is no doubt that Lululemon will experience depressed sales in 2020 due to store closures, the company’s balance sheet is in excellent shape. With zero debt and $1 billion in cash, the company will weather the current storm and may emerge even stronger: The recession will likely force weaker retail competitors out of business, while desirable retail sites may become available on attractive terms amidst the unprecedented ongoing dislocation in the commercial real estate industry. As long-term investors, we believe Lululemon enjoys a long runway for profitable growth once the pandemic passes and its retail stores globally reopen for business.

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3 BBH’s estimate of the present value of the cash that a business can generate and distribute to shareholders over its remaining life
4 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
Lululemon ended the quarter as one of the Fund’s top five contributors during the period, as its share price rebounded sharply in late March from the level at which we initiated our position.

During the quarter, we also seized upon the opportunity to add to our existing position in Partners Group (PGHN SW) during the equity market sell-off. Over the last 10-15 years, our Research Team has continuously studied the alternative asset management industry, a niche value chain we consider to be one of the most attractive in the global financial services sector. Based in Switzerland, Partners Group oversees approximately €80 billion in assets under management (“AUM”) across alternative asset classes including private equity, real estate, infrastructure, and private debt. Approximately 85% of the company’s AUM is invested in locked-up vehicles for 10-12 years, which means the majority of Partners Group’s revenue is predictable and recurring (even in a recession). Its business model is capital-light; most of the expense base is compensation for the investment team, which is inherently variable in nature. We have been greatly impressed with the quality of the management team; they have distinguished themselves through market cycles and over time both as investors as well as operators. Over the last decade, the company’s revenue, EBITA and cash earnings per share (EPS) have grown at compound annual rates of 17%, 16%, and 19%, respectively, while sporting operating profit margins of around 65% and generating a return on equity of 42%.

Relative to some of the other global alternative asset managers we admire, Partners Group has a differentiated and highly effective approach to building and scaling strong client relationships around the world. The company is one of the few global alternative managers set up to operate locally around the world, enabling it to tailor bespoke solutions for clients who have unique requirements for fund domicile, asset class and geography. Partners Group is often one of few, if not the only, alternative asset partners for its worldwide client base, and outside the US the asset allocation industry is underweight alternatives relative to first-moving peers in the U.S. Over the last decade, Partners has compounded AUM 17% annually, as institutional asset allocators turn to them for yield in a world of historic and increasingly low interest rates. Partners Group finds its growth constrained not by client demand but rather by its own ability to hire and train more investment professionals in a disciplined manner. With shares falling by -40% (in USD) from recent highs to intra-quarter lows, Partners Group detracted from the Fund’s return in the period. In our experience, equity markets often are too quick to sell alternative asset managers during periods of market dislocation, fretting about a likely slowdown in near-term revenue from carried-interest profits (a minority of Partners Group’s earnings) and, in some cases, dismissing the business models (wrongly, in our view) as levered equity market proxies. We added significantly to our position on share price weakness, with the shares at one point valued 30%-40% below our estimate of their intrinsic value. Partners Group ended the period as one of the Fund’s 10 largest positions.

The Investment Environment

The breadth and depth of the economic uncertainty we are observing today (at every level: structural and cyclical, macro and micro) are perhaps unprecedented. Based on the exhaustive work of our Analyst, Qualitative Field Research, and Data & Analytics Research Teams over the past two months, we believe that the timing of any country’s economic recovery will be determined by the success of its public health policy. No economic or social policy response can be fully effective while entire populations remain in lockdown. While we have spent considerable time surveying medical experts across the globe on this subject, it has become clear that no one, regardless of expertise, knows precisely when and to what degree current policy actions will turn the tide. While this makes it difficult to opine with any credibility on the global investment outlook for the rest of 2020, it is useful to take stock of what we do know, while remaining as mindful as possible about what we don’t.

As of this writing, day-on-day growth rates of new virus cases, hospitalizations and deaths are generally improving (albeit from tragic levels) in the U.S., UK, and Europe. With the exception of Japan, economic reopening may be feasible within the next few months in developed-world economies, paving the way for monetary and fiscal stimulus to do its job. Japan, however, has been significantly under-testing relative to peer countries (which we attribute to the initial desire to avoid postponing the Olympics as well as to the poorly conceived policy that a positive diagnosis requires hospitalization, even in the absence of symptoms). As of April 13, Japan had completed just 499 tests per one million people (vs. South Korea at 10,214, Italy at 17,334, and even the U.S. at 8,943) and had still not instituted a lockdown. Consequently, the country’s officially reported number of cases, at 7,618, is not credible, and Japan could experience a breakout of U.S. proportions. We also fear that the virus may not yet have done its worst throughout the emerging markets, which lack the public health infrastructure and the economic means to fight back. Daily growth in new cases remains alarmingly high in India, Latin America, Africa, and the Middle East.

As a result of the aggressive monetary policy response and increasing fiscal stimulus, as of this writing the MSCI World Index is back in bull market territory, up more than +20% from its March 23 low. Credit markets have similarly recovered, spurred by the Federal Reserve’s historic decision in early April to begin buying high yield debt. We are relatively optimistic about the short-term outlook for most of the developed world, largely thanks to the magnitude of the monetary and fiscal response. The ongoing recovery in financial markets suggests a similarly benign scenario has already been largely discounted in public equity market valuations. As economies emerge one by one from lockdown, positive sentiment may propel this rally further, but its...
sustainability will ultimately be determined by the medium- and longer-term prognosis. Our chief concern is that a second wave of the virus, catalyzed by an overly hasty reopening of various economies, could occur before clear progress is made on expanded testing and vaccine development.

For this reason, if markets continue to rise, our positioning is likely to become more conservative. Given the unprecedented degree of uncertainty, we are wary of overconfidence. It seems taken for granted, for instance, that a vaccine will be developed in 12-18 months. The fact remains, however, that the fastest vaccine ever developed (for mumps) took four years. While markets have already returned to optimism, we are not out of the woods yet, and Q1 and Q2 earnings results are likely to remind investors of the sobering fundamental impact this pandemic has had — and, in some cases, will continue to have — on the global economy. Our playbook remains unchanged: We seek to have ample dry powder (in the form of a sizeable cash position) when markets are complacent and to deploy that capital aggressively in the event that we see another bout of indiscriminate selling.

The Fund’s objective is to identify, research, and own outstanding businesses from around the world domiciled outside the U.S. with the pedigrees and hallmarks that will be familiar to followers of Select Equity: predictable double-digit earnings growth, high returns on capital, limited financial leverage, and sustainable barriers to competition. We believe our disciplined approach to valuation and insistence on a discount to intrinsic value provide additional protection during falling markets and a key source of upside in rising markets. We are agnostic about country of origin and uninterested in making macro bets.

We have great confidence in our portfolio companies’ abilities to navigate through the uncertain economic environment. The Fund has limited direct exposure to the most volatile and cyclical market segments and low exposure to the bank credit cycle. Within the categories in which we do invest, we are generally diversified among niche companies that often have differentiating secular dynamics. The standard designations of these sector exposures do not always clearly reflect the nature of our businesses. Most importantly, we believe we understand how our businesses will perform in a financial crisis, having watched them navigate the worst economic decline since the Second World War a decade ago. The current recession may in many respects be worse, with countries representing most of global GDP under stay-at-home orders that effectively prevent them from conducting commerce.

Our Analyst Team has worked diligently over the last two months to think proactively, objectively, and creatively about the way each of our businesses will likely navigate the turbulent months ahead. In times like these, we believe our investment philosophy is more important than ever, with its emphasis on businesses selling a highly valued product or service to customers with growing (and often recurring) demand profiles. The quality of our businesses has historically been most evident in periods of broad economic distress. While it is always painful to report a decline in the Fund’s performance, we ended the quarter more confident than we have ever been in the long-term prospects of the companies we own on your behalf. After a multi-year period in which equity market valuations have often been stretched, we are pleased that the Fund ended the quarter trading at a significant, attractive discount to our estimate of its intrinsic value.

Our partnership with clients is the foundation of the Firm. We hope that you and your families remain safe and well in these challenging times. Thank you for entrusting us with your capital; we will continue to work diligently on your behalf.
The Fund seeks to generate attractive returns over time but does not attempt to mirror a benchmark or index. The composition of the MSCI EAFE Index is materially different than the Fund’s holdings.

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

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.

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