Wealth Management
PH&N Investment Counsel

Stu's View

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Investing in the time of COVID

A virtual Q&A with a U.S. growth equity manager, Brown Advisory, LLC

This past week I had a chance to (virtually) sit down with the portfolio management team at Brown Advisory, LLC, which has sub-advised the RBC Private U.S. Growth Equity Pool since June 2012. Brown manages a concentrated portfolio of 30-35 holdings, and follows a disciplined bottom-up investment process, seeking out companies that can produce a 14% or better earnings-per-share (EPS) growth rate over a full market cycle. Their investment process and valuation discipline seek to identify outcomes that are skewed in their favour. The firm's culture and philosophy, which support a shared belief that low-turnover, concentrated portfolios derived from sound fundamental research has resulted in positive investment returns over a reasonable time horizon, relative to the Russell 1000 Growth Index as shown in Table 1.

Table 1. Performance, RBC Private U.S. Growth Equity Pool

All Performance shown gross of all fees and taxes.							
As of May 31, 2020			**Annualized returns**				
	YTD	**1 Year**	**2 Year**	**3 Year**	**4 Years**	**5 Year**	**Since Inception**
RBC PRIVATE U.S. GROWTH EQUITY POOL Series O (Sub-advised, Brown Advisory, LLC)	14.9	32.6	24.4	23.3	21.5	18.7	9.6
Russell 1000 Growth Total Return (CAD)	11.6	28.6	18.9	18.0	19.4	16.9	9.1
Difference (bps)	3.3	4.0	5.5	5.3	2.1	1.9	0.5
Annual returns, as of Dec 31	**2019**	**2018**	**2017**	**2016**	**2015**	**2014**	**2013**
RBC PRIVATE U.S. GROWTH EQUITY POOL Series O (Sub-advised, Brown Advisory, LLC)	34.4	15.9	22.9	(5.1)	28.3	17.2	38.9
Russell 1000 Growth Total Return (CAD)	29.7	7.0	21.9	3.9	25.9	23.7	42.8
Difference (bps)	4.7	9.0	1.0	(9.0)	2.5	(6.5)	(3.9)

Source: RBC Global Asset Management. All performance is shown in CAD for O series, gross of fees and taxes. Performance figures for periods greater than one year have been annualized, and are time-weighted returns, dividends/distributions reinvested. Please see the disclosures at the end of the article for a complete description of the Russell 1000 Growth index referred to in this table.

The lead Portfolio Manager is Kenneth Stuzin. Kenneth is a partner and has managed their large-cap growth strategy since its inception in 1996. Prior to joining the firm, he was a vice president and a large-cap portfolio manager at J.P. Morgan Investment Management in Los Angeles. Previously, Ken worked as a quantitative portfolio strategist in New York, where he advised clients on capital markets issues and strategic asset allocation decisions.

Stu: How is the team managing to communicate with each other with "social distancing"? Has your research process changed at all since the COVID-19 outbreak? If so, how?

Continued on page 2

Investing in the time of COVID

Continued from page 1

Table 2. Portfolio and Index Characteristics

	Portfolio Characteristics	
As of May 31, 2020	**Brown Advisory Large-Cap Growth**	**Russell 1000 Growth Index**
Market Capitalization		
Weighted Average (USD BN)	$239.5	$463.2
Weighted Median (USD BN)	$66.2	$156.1
Est 3-5 Yr EPS Growth	14.7%	14.4%
P/E using FY2 Est	31.5x	24.0x
PEG Ratio (PE FY2 Est./Est. 3-5 EPS)	2.1x	1.7x
Portfolio Turnover (3 years)	20.20%	

Source: Brown Advisory, LLC. All data presented as of May 31, 2020 in US dollars. Est. 3-5 yr EPS Growth calculates the average analyst estimate for earnings per share (EPS) over the next three to five years. P/E using FY2 Est calculates the average Price-to-Earnings (P/E) for the portfolio and index based on earnings (E) estimates over the subsequent two year period. PEG Ratio (PE FY2 Est. / Est. 3-5 yr EPS growth) is defined as the Price-to-Earnings-growth (PEG) ratio, which divides the average Price-to-Earnings (P/E) for the portfolio and the index, to the average analyst estimate for EPS over the next three to five years. It is a measure of how much growth is being priced into the portfolio or index. Portfolio turnover (3 years) is a measure of how often the securities in the portfolio are traded. Portfolio turnover is calculated by taking the fund's acquisitions or dispositions, whichever number is greater, and dividing it by the average monthly assets of the fund for the year. For example, a fund with a 20% turnover rate holds stocks for five years on average. Portfolio characteristics are subject to change.

Brown: Our research process has not changed due to the COVID-19 outbreak. Our investment team is accustomed to communicating while out of the office for travel and are in regular contact via telephone, email and video conferencing. The market volatility caused by the outbreak is presenting opportunities for re-allocation of capital where we have the opportunity to either upgrade the portfolio with holdings that have dropped into our valuation range, or to re-allocate capital among existing holdings where we feel there is better upside, with attention to risk management. We have conducted valuation analyses that "stress test" our holdings against recession-level scenarios, so the volatility is not adding reactive work since our discipline is to be proactive.

Stu: Can you please describe your investment philosophy, and investment process.

Brown: The Brown Advisory Large-Cap Growth Strategy follows a disciplined investment process developed based upon our investment objective to build a portfolio of fast-growing companies where the total risk-adjusted return of the portfolio is optimized to account for both expected earnings-per-share (EPS) growth as well as valuation. We use broad quantitative screens to identify companies with market capitalizations > $2 billion and business models we believe are capable of an absolute EPS growth rate of at least 14% over a full market cycle.

From this list of approximately 250 names, we further narrow the universe and identify securities we wish to evaluate in more detail. Common attributes of companies selected for further research include a large addressable universe coupled with a wide competitive moat, experienced management, proprietary products or services, strong financial condition, and an innovative and adaptable corporate culture.

The backbone of the strategy is a highly collaborative, team-oriented research process which incorporates internal and external inputs in the decision-making process. We believe the greater the diversity of views and information incorporated in evaluating industries and business models, the greater the odds of investment success. Within the due diligence phase of our process, we take a deeper look into specific companies, taking an "inside-out investing" approach to identifying the real drivers of growth.

This entails relying on our internal research team to conduct bottom-up, fundamental research on companies to gain an unbiased view of how specific business models work. The investment team continues the research effort by conducting a competitive analysis and identifying a company's position in the marketplace. All of these steps are necessary inputs to building a financial model used to evaluate both upside and downside price targets for each business under consideration.

This valuation framework is the core of our investment process and is continuously reviewed and challenged to ensure that only our best ideas with the greatest upside potential and least downside risk get into the portfolio. The foundation of the valuation model is a matrix approach of metrics and key ratios, evaluations of the company and both its role in its industry and the condition of the industry overall, and an assessment of the lifecycle of its business. These provide the basic framework for our upside and downside scenarios.

The resulting portfolio typically consists of 30 to 35 positions, ranging from 1.5% to 5% of the portfolio's weight. Because we rely on high-conviction names, the top 10 holdings of the portfolio will typically account for a material portion of the product; between 35% and 40%.

We constantly review the portfolio and seek to mitigate risk. We trim names in accordance with our upside/downside models and a self-imposed "one in, one out" management discipline, meaning that any new name must be better than the existing positions in the portfolio.

Continued on page 3

Investing in the time of COVID

Continued from page 2

Stu: I'm certainly a fan of investment processes that are focused on low turnover and a disciplined risk management process. The fund has seen positive relative performance versus the Russell 1000 Growth Index over the last three calendar years. What were some of the main contributors to your success? What drove the relative underperformance of the fund in 2016?

Brown: Due to our investment philosophy and process, most of any outperformance is the result of stock selection.

Health care was the top contributor in 2019. All of the portfolio holdings made positive contributions in 2019, and Intuitive Surgical was the only underperformer on a relative basis. While the company continues to post solid results, the stock was up more than 23% this year and is up 179% over the last three years.

While health care was the biggest positive contributor in 2018, the portfolio benefited from good stock selection across the majority of sectors. Fundamentally, strong business models generally translated to attractive relative returns.

In 2017, consumer staples was our best-performing sector. Technology was a big positive contributor on both an absolute and relative basis. Digital payment stocks PayPal and Visa were both strong contributors, as each continued to benefit from the shift to e-commerce.

Three significant episodic market rotations summarize the strategy's relative and absolute underperformance in 2016: a) early profit-taking in February, b) the Brexit vote in June and c) the post-election uncertainty in November. The portfolio recovered well after the downdraft during the beginning of 2016 as portfolio fundamentals remained intact and valuations eventually recovered. However, later in June when the Brexit vote riled equity markets, the portfolio was not positioned toward the high-dividend-yielding, low-volatility stocks that drove the benchmark's performance through the third quarter. This shift combined with the weak stock performance of Stericycle and later Bristol-Myers, both of which we eliminated during 2016, significantly attributed to the portfolio's relative mid-year drag. By November, though, we had begun to considerably shrink our relative performance deficit. Gains, however, were reversed by the market's uncertainty with post-election results, which caused our deepest underperformance, primarily attributable to TripAdvisor, Facebook, DexCom and continued weakness in Alexion Pharmaceuticals.

Stu: Capital preservation is important to our clients. When the index declines, we would expect active managers to be able to protect capital relative to a passive investment approach. Can you please describe the sort of market environment where you would tend to outperform your benchmark, and the environment where you may perhaps underperform the benchmark?

Brown: We believe this portfolio has characteristics for potential outperformance in both up and down markets – and historically this has been the case. We continue to feel this trend will continue, as our focus on owning companies that grow their earnings at high and sustainable levels has historically been rewarded in up markets. Our valuation discipline of trying to optimize our portfolio around upside price potential versus downside risk has also served us well in down markets.

We feel the environment in which this portfolio tends to underperform is during a "hyper-momentum" bull market. We are a fundamentally focused product which uses an upside/downside price target discipline to help us maximize potential capital appreciation while minimizing downside price risk. If stocks possess stretched valuations versus company fundamentals – and thus, in our view, pose a headwind to total returns – we tend to trim or sell positions. If the market is in a euphoric state and the only driver to price appreciation is price momentum, we will likely underperform the benchmark until stretched valuations ease.

Stu: When you think about the current environment, investors are trying to draw parallels to the Great Depression, or the 1987 market crash. Are there any periods of history you could draw parallels with today's environment, and if so how could this impact your portfolio construction process?

Brown: There are always some similarities with previous market cycles, and it is not difficult to draw some parallels with previous episodes of turmoil. However, there are still many uncertainties and this will undoubtedly play out in its own way and we need to be careful of making assumptions. Our process has withstood the test of time over the course of more than two decades and now nearly three full market cycles. We have generated outperformance over this time in a wide variety of market conditions. We may react and interpret data specific to this cycle. Our bottom-up models take into account the specifics of a particular industry and the company prospects, but the core of our investment approach does not change based on the current market fad *du jour*.

Continued on page 4

Investing in the time of COVID

Continued from page 3

Stu: That's great to hear your approach has not changed throughout the crisis period. There seems to be a vast amount of news stories, research reports and studies related to COVID-19, and many experts weighing in on how this will, or may end. What are you reading these days? How do you sort through the noise? What does your COVID-19 dashboard/indicators look like today?

Brown: We are constantly digesting information related to the COVID crisis and its economic impact. At this point there is a lot of noise and very little signal, and we don't have a proprietary crystal ball that will tell us what to buy or when this will all end. We are testing our assumptions, being more punitive where it makes sense, and where we think there is existential risk to a business model we will sell it. We have been talking to our company management teams gauging how they are responding to the crisis and where they see opportunities and threats developing.

Stu: In the health care sector, what is your exposure in the portfolio today, and are there any companies in the portfolio that may benefit from the development of a vaccine or particular treatment of COVID-19? If applicable, comment on how long you've held these companies and what your thesis was/is today.

Brown: We do not have any direct biotech exposure as these companies rarely meet our criteria given the binary outcome of their research and financial results. Our health care exposure is primarily in three broad categories: medical devices (DexCom, Inc., Intuitive Surgical, Inc, and Edwards Lifesciences Corp.), tools and diagnostics (Illumina, Inc., Danaher Corporation, and Thermo Fisher Scientific), and veterinary health (Zoetis Inc.). Three of our companies (Thermo Fisher, Danaher, and Illumina) are working to develop testing and or assisting with the development of treatments for COVID.

Stu: Have you made material changes to your holdings since the outbreak of COVID-19? If so, can you provide us with a few examples of changes you made and what the reason(s) were for the changes?

Brown: While we are always focused on owning best-in-breed business models, during periods of high short-term uncertainty, and the concomitant volatility that follows, we have the additional responsibility of keenly focusing on opportunities that come about due to pricing anomalies. It's not just looking for new stocks that come into our price range but also being fairly ruthless in trimming, or selling companies within the portfolio, in order to put more capital into our very best investment ideas, where the market has perhaps overreacted.

To that end, we decided to sell BWX Technologies, Inc., an American power generation company, in order to bulk up our exposure to three existing defense/industrial companies that we think are superior businesses with very strong track records. Roper, Fortive and L3Harris have all received an infusion of additional capital. In times like these, more defensive business models need to exhibit the attributes for which they were purchased. When those companies fail in that effort, it means we have made a mistake in owning them. In the case of BWXT, while the core business is certainly intact, management's decision to diversify into new, unrelated businesses has up to now been a mistake, which is largely responsible for the stock's lack of resiliency in these turbulent markets.

Most recently, we took advantage of the recent market volatility to swap out of our position in TJX Companies Inc. (owner of Winners in Canada) into Lululemon. While nothing at TJX was fundamentally flawed, this was purely an upgrade from one good business model into an even better one. We believe Lululemon has an exceptional business model within the athleisure space. They have complete control over their product distribution, which is rather unique for an apparel company. This gives them a favorable margin structure coupled with a fast-growing top line. When compared with TJX, they also benefit from a higher percentage of sales from e-commerce, which is becoming even more important both in the near and long term.

Earlier in the year, we eliminated our position in online travel (OTA) company Booking Holdings Inc. The OTA industry has become more competitive and more mature, which has led to slowing growth for all participants. Given the prevailing negative backdrop on top of the recent malaise for travel, our confidence in the company's ability to meet our growth requirements for this strategy was severely diminished.

Lastly, we swapped our position in Visa to MasterCard. The two business models are very similar; however, we view MasterCard as a marginally better model going forward. It is growing faster and has executed better internationally, which we believe will be an important driver of growth in the future.

Stu: Most companies today will see earnings growth materially slow over the near term. Do you own any companies that are seeing positive (revenue, earnings) growth in this environment?

Brown: The short answer is yes there are companies that are able to grow revenue and or earnings through this. Microsoft, PayPal, and DexCom Inc. are three good examples but there are

Continued on page 5

Investing in the time of COVID

Continued from page 4

more. We have owned all three of these companies for more than three years.

Stu: So far we have seen these and other technology names hold up well during the bear market. How are you thinking about technology valuations, growth, and your holdings today in light of their performance?

Brown: Technology valuations have crept back and in many cases are higher than they were prior to the COVID crisis. While broadly elevated, they are not at extreme levels especially in light of the strength in the underlying business models for many software companies. Technology is an important sector for us and it is the largest absolute weight in the portfolio, however it is the largest underweight relative to benchmark. We have been trimming back positions as valuations have increased reallocating into other tech stocks such as Genpact, a business service/consulting company, which remains attractive.

Stu: The U.S. Federal Reserve and other global central banks have been reducing interest rates and are firmly in the quantitative easing camp. This has pressured real interest rates lower than they have ever been in modern history. In light of this, how are you thinking about company valuation as real interest rates continue to fall, and expectations for earnings are still generally declining? Are you seeing many buying opportunities today, and if so, in which sector(s) are you seeing opportunities?

Brown: The vast majority of our companies do not have much balance sheet, or financial leverage, so interest rates do not play a big role in our models or our expectations. Said another way there are much more important factors than the discount rate when modeling most of these business. With respect to portfolio positioning we maintain a fully invested portfolio; as such we have to sell something in order to buy another stock. This relative evaluation is imbedded in our investment process and the bar for the next entrant is very high; it has to be better than what we already own. If what we already own is performing well, and doing what we expect, it is unlikely we would swap out of the stock. There are always opportunities and stocks on our wish list that we would love to hold, but it must be a more compelling opportunity than what we already own.

Stu: When you are looking for new opportunities to invest today, what are some of the key indicators, metrics or signposts that you look for in a company?

Brown: The core tenets of our investment philosophy don't change based on the short-term market backdrop. We are constantly looking for companies that can support our 14% growth rate hurdle despite market and economic conditions. We don't require that a business model generate this growth over the next couple of quarters, but over the next several years. This lens helps look past what is happening right now and more to what is likely to happen a year or two from now. That said, it is much easier to avoid certain sectors and industries based on signposts or specific metrics. A good example is energy where we see very little opportunity long term, and without a view on which way the commodity will go we find these stocks uninvestible.

Stu: Please describe your sell discipline (i.e. how you decide when to reduce/sell a stock in the portfolio), and if it has changed at all during the COVID-19 crisis period?

Brown: Our sell discipline has not changed during the COVID-19 outbreak. The decision to sell securities, whether completely liquidating the position or trimming the position, typically depends on following attributes:

1. Fundamentals violate our underlying investment thesis: For example, poor execution or increased competition impede a security's growth rate, a material change in strategy, or compromised ability by management.
2. Market expectations: Valuation considerably overstates the fundamentals and becomes a headwind to total return.
3. Displacement for a better idea: In concentrated portfolios, limited membership creates competition for capital among alternative opportunities. We often refer to this as "Darwinian Capitalism" and enforce the one in, one out discipline.

This has not changed due to the crisis, however we are more keenly focused on the near-term risks to business models and whether or not there is existential risk.

Stu: What are some of the risks U.S. investors face over the next decade?

Brown: Geopolitical risk would likely be at the top of list. The current populist political environment could potentially lead to less rather than more globalization which is a real risk to U.S. investors in particular as U.S. companies have been some of the biggest beneficiaries of globalization.

Stu: What are some of the longer-term themes you may be invested in within the portfolio?

Continued on page 6

Investing in the time of COVID

Continued from page 5

Brown: We have had an overweight to health care in the portfolio for several years. One of the basic themes we look for in health care business models are those that are not only improving patient outcomes, but also reducing the overall cost to the medical system. DexCom Inc. is a great example of this. They make continuous glucose monitors, which are proven to help diabetics better manage their disease, helping them live healthier and more productive lifestyles. It also reduces the chances of a diabetic event leading to hospitalization which is very costly to system, keeping one diabetic out of the hospital would be the equivalent of hundreds of monitors.

Intuitive Surgical Inc. is also a good example. Their robotic surgical system helps reduce infection rates and internal bleeding. This dramatically reduces hospital re-admittance rates which are a big driver of potentially avoidable expense for hospitals. We see direct evidence of this as cost-conscious socialized medical systems are adopting both of these technologies, essentially paying the upfront costs for long-term overall savings.

Update: What we are watching

Over the few weeks, the financial markets continued to hold on to their gains from the March lows. The S&P 500 index has now rallied greater than 40% from the intra-day low on March 23. As we have written before, a combination of liquidity injections from global central banks, significant fiscal support from various governments, a trend of fewer coronavirus cases in previous hotspots, and as the economy begins to reopen, consumer and business spending data seems to support the slow/gradual healing thesis playing out. That is not to say that there is an "all-clear" as the picture remains mixed. Real-time data continues to rebound, but many are slowing significantly in the rate of improvement.

U.S./China trade and currency wars continue on despite what seemed to be a relief period over the last few months. While markets have certainly climbed to new highs before despite the trade wars, the long-term impacts of re-routing supply chains, or on-shoring, need to be considerations for where investors invest their money. We certainly should expect a pick-up in U.S./China trade disputes as the U.S. Federal election in November inches closer by the day.

The markets seem to have accepted that we'll deal with any increased debt load as a result of global central bank relief efforts sometime in the distant future. We do believe that global central banks learned their lessons from previous crises. Providing an abundance of liquidity in a very short timeframe can ensure that financial markets and the economy remain on somewhat stable footings. While lower real interest rates continue to support debt-servicing for higher sovereign debt loads, we should be mindful about any signs of inflation out in the mid-term horizon. The potential for higher taxes down the road to pay for the relief efforts shouldn't be discounted, nor should the belief that we will not see any more money printing by global central banks. Perhaps these risks are for another time, but as disciplined investors we should be mindful nonetheless.

All of this to say, while we remain positive on the long-term outlook for stocks relative to bonds, remaining well diversified on a number of levels in your portfolio, rebalancing the portfolio back to optimal weights for each asset class in a systematic manner, and remaining invested despite the volatility are all legitimate investment principles to stand by, in any market environment.

Please be sure to contact your Investment Counsellor with any questions related to the information we have presented in this article, and related to financial markets and the impact COVID-19 may have on your investment portfolio, at any time.

Be well,
Stu

Wealth Management
PH&N Investment Counsel

Russell 1000 Growth Index: The Russell 1000 Growth Index measures the performance of the large cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000® Growth Index is constructed to provide a comprehensive and unbiased barometer for the large-cap growth segment. The index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect growth characteristics.

S&P 500 Index: The S&P 500 Index includes 500 companies across many sectors of the U.S. economy. The index is weighted by market capitalization so bigger companies make up a larger proportion of the index than smaller companies. The index is designed to measure performance of the broad US economy through changes in the aggregate market value of the largest US companies.