Some of the most compelling investments over the next decades, in our view, will be in companies that help solve some of society’s thorniest challenges—resource scarcity, chronic health crises, access to clean water and climate change, to name a few. Companies that do this exceptionally well can often put themselves in position to generate robust growth and profitability and reward shareholders over the long term.

Our entire portfolio is built on this philosophy. Our investment criteria have led us to find these solution providers across a variety of sectors, particularly among health care, industrial and information technology companies. It turns out that companies can, in fact, often generate strong business results through products and business approaches that reduce energy and resource consumption, improve health outcomes, mitigate carbon emissions, and offer solutions to our long-term sustainability challenges. Our portfolio’s emphasis on these companies—and our willingness to decouple from our benchmark’s sector makeup to own sizable positions in them—has been a primary driver of our returns since inception.

In this article, we will focus on our strategy’s health care investments, which have generated a 19% annualized return over the past five years ended Sep. 30, 2019, compared to a comparable figure of 8% for the health care holdings in our benchmark, the Russell 1000® Growth Index. Combined with a fairly consistent overweight in the sector over time, our stock selection in health care has driven an outsized proportion of our relative outperformance during that period.

Here we discuss what attracts our interest in the sector, and what drives us away—and show how our choices have impacted our divergence of returns vs. our benchmark.

**SECTOR BACKDROP**

The importance of the health care sector to both society and the global economy is undeniable. Global health care spending is likely to exceed $10 trillion per year by 2022, according to Deloitte’s 2019 Global Health Care Outlook. Unsurprisingly, health care has also grown to become the second-largest sector in public equity markets, representing 13.7% of the market cap of the S&P 500 Index as of Aug. 31, 2019.

The sector is making meaningful strides—notably, in the global fight against communicable diseases, and in innovative biotechnology research that offers hope for curing cancer, rare diseases, and other previously unsolvable medical challenges.

Intractable challenges and obstacles remain: rising (some would say runaway) costs, rapid changes to the models used to deliver care, impacts from climate change and pollution, and massive inequities in access to care. Better health care data comes with the challenge of keeping that data private and secure. Drug pricing is a well-documented issue and few, if any, answers will satisfy all stakeholders. And the regulatory risks facing pharma and biotech companies are often binary in nature—FDA approval can mean billions in revenue, while a failed trial can lead to bankruptcy.

The sector, therefore, presents fertile ground for investors but also contains plenty of danger. Our investment philosophy has always been to start with fundamentally strong companies that we believe are employing smart sustainability strategies to manage their risks, improve their cost structures, and create opportunities for long-term growth. Our approach in health care is no different.

**A DRILLDOWN ON OUR PORTFOLIO**

We generally focus our investments on solutions that we believe can achieve measurable and reliable results. We prefer businesses
that have some control over their own destiny. In health care, these companies often include devices, services, tools or technologies that generate consistent results for customers such as shorter hospital stays for patients, reduced medical waste, higher success rates for medical procedures, or other tangible and (somewhat) predictable outcomes.

We try to avoid companies that, in our view, are excessively exposed to pressures out of their control. In the health care sector, material shareholder value is too often subject to any number of surprises including clinical trial failures, political rhetoric around private/public health insurance, and drug pricing scrutiny. Price volatility is often triggered by these issues, and we find it difficult to justify sizable investments in firms tied to this volatility. We therefore seek to minimize exposure to these issues. (We can’t always avoid these issues entirely, however—for example, portfolio holding UnitedHealth is a well-positioned provider in our view, but it is nonetheless tied to the ongoing debate about universal health care and the potential elimination of private health insurance.)

The table below shows how our “basket” of health care holdings has performed over the past five years, compared to the health care holdings in our benchmark (and the biotech subsector within health care). It is a quick illustration of a meaningful driver of our performance: The biotech subsector takes up more than a third of our benchmark’s health care allocation, but we largely avoid investing in biotech firms. That subsector’s weak performance over the past five years dragged on the benchmark’s returns, but had little impact on our portfolio.

We can take this sector analysis further; the chart on the next page illustrates the breakdown of our health care holdings (in other words, our average weightings in various health care subsectors versus our benchmark. To be clear, we do not aim our investment at particular sectors or subsectors. But our criteria often lead us to specific areas of the economy where businesses are less subject to exogenous risk.

To be sure, our relative avoidance of the pharma and biotech subsectors has hurt us at times during our history when those sectors were outperforming. We can be fairly certain that we will be out of step again at some point in the future when momentum develops behind these and other segments of the health care industry. Cutting-edge drug research continues to produce some truly amazing discoveries, but we find it challenging to base an investment thesis on events that hinge on binary outcomes like regulatory approvals or litigation results. We prefer to invest where we have greater visibility over longer periods of time, and we believe that approach will serve us well.

Importantly, sector allocation is only part of the story—our stock selection has also benefited our returns. We are first and foremost bottom-up fundamental stock pickers; here we highlight several of our holdings that illustrate the kinds of opportunities we like to own:

- **Edwards Lifesciences** is a developer and manufacturer of technologies used to treat structural heart disease. The company’s transcatheter aortic valve replacement is less invasive than traditional open-heart surgery and is approved for patients deemed too high-risk for traditional surgery. This minimally invasive surgery technology effectively increases the probability of survival, reduces the length of hospital stays and readmission rates, and provides patients with a significantly higher quality of life post-surgery. A secondary (but still meaningful) benefit of Edwards’ technologies: reduced time in the hospital for patients means a reduction in waste generated during those hospital stays (an occupied hospital bed generates an average of thirteen pounds of medical waste per day, according to the Environmental Protection Agency). Edwards has been one of our stronger performers over the past year or so, and we believe it has a strong competitive position and the ability to maintain its leadership in its market for some time to come.

- **We view Illumina as a great example of a business model that is on the right side of a health care sector risk, namely drug pricing and regulation.** For a number of years, advances in genomic sequencing have led to incredibly effective drug treatments for small, targeted groups of patients; because of the smaller size of the patient audience for these targeted treatments, prices often have been extremely high. However, costs are gradually coming down in a number of cases, and insurance plans are beginning to cover these treatments thanks in no small part to companies like Illumina who are enabling more effective genomic research. Illumina offers a wide range of tools for large-scale analysis of genetic variation and function. We believe that regardless of the debate over drug pricing, Illumina is in an excellent position because its tools will always be in demand from health care firms who want to improve their research processes. Our investment in Illumina is, we hope, still in its early innings—it has not yet generated the returns for us that we believe it can earn over the coming years.
In our view, Danaher has an especially interesting position in the health care market, due to its leadership position in bioprocessing workflow solutions. As we have noted, biotechnology stocks are volatile, but we believe that the sector offers undeniable growth potential over the next several years, driven by multiple secular tailwinds such as increasing penetration of existing drugs in high-growth markets like China, a rich development pipeline of new drugs and the rise of biosimilar drugs. To meet this demand, many companies are making large investments in bioprocessing equity and manufacturing infrastructure, and we believe that Danaher is poised to be a prime beneficiary of this industry-wide investment activity. As a result, by owning Danaher we believe that we can benefit from the growth of the biotechnology sector, without becoming unduly exposed to the pricing and regulatory risks endemic to the industry.

As a final note, we should mention that a number of our successful investments are not in the health care sector, but their growth has been partly propelled by health care drivers. When we think about the challenges and opportunities in health care, we try not to limit our thinking to the companies that are nominally “in” the health care sector according to GICS or any other classification system. For example, Fortive is the “other half” of Danaher, formed when Danaher divided its portfolio into two businesses. Danaher is now classified as a health care company, and Fortive as an industrial firm, but a variety of Fortive’s solutions are still aimed at the health care industry. Earlier this year, Fortive acquired Advanced Sterilization Products from Johnson & Johnson, giving it a leading position in sterilization and disinfection technology. These products and services help health care customers combat one of the leading causes of hospital readmissions.

Sustainability is complicated; making progress in one sector generally requires contributions from many other corners of the economy. We are finding companies across the entire equity universe that are driving innovation and value in the health care arena, and we will continue to explore the investment opportunities those companies create.
Brown Advisory U.S. Large-Cap Sustainable Growth

<table>
<thead>
<tr>
<th>Year</th>
<th>Composite Total Gross Returns (%)</th>
<th>Composite Total Net Returns (%)</th>
<th>Benchmark Returns (%)</th>
<th>Composite 3-Yr Annualized Standard Deviation (%)</th>
<th>Benchmark 3-Yr Annualized Standard Deviation (%)</th>
<th>Portfolios in Composite at End of Year</th>
<th>Composite Dispersion (%)</th>
<th>Composite Assets ($USD Millions)</th>
<th>Composite Assets ($USD Millions)</th>
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<tbody>
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<td>2018</td>
<td>5.4</td>
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<td>11.6</td>
<td>12.1</td>
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<td>28.4</td>
<td>30.2</td>
<td>10.6</td>
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<td>0.1</td>
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2. The Large-Cap Sustainable Growth Composite includes all discretionary portfolios invested in the Sustainable Large Cap Strategy. The strategy invests primarily in large market capitalization companies with financially and environmentally sustainable business models. The minimum account market value required for composite inclusion is $1.5 million. Prior to 2012, the minimum was $100,000.
3. This composite was created in 2010. Prior to 3/31/13, the strategy was named Large-Cap Sustainability. Prior to 12/31/2011 the strategy was named Winslow Green Large Cap. No changes have been made to the strategy since inception.
4. The benchmark is the 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® Index 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. The Russell 1000® Growth Index and Russell® are trademarks/service marks of the London Stock Exchange Group Companies. An investor cannot invest directly into an index. Benchmark returns are not covered by the report of the independent verifiers.
5. The composite dispersion presented is an equal-weighted standard deviation of portfolio returns calculated for the accounts in the composite for the entire calendar year period. The composite dispersion is not applicable (N/A) for periods where there were five or fewer accounts in the composite for the entire period.
6. Gross-of-fees performance returns are presented before management fees but after all trading commissions, and gross of foreign withholding taxes (if applicable). Net-of-fee performance returns reflect the deduction of actual management fees and all trading commissions. Other expenses can reduce returns to investors. The standard management fee schedule is as follows: 0.80% on the first $10 million; 0.65% on the next $15 million; 0.50% on the next $25 million; and 0.40% on the balance over $50 million. Further information regarding investment advisory fees is described in Part II A of the firm’s form ADV. Actual fees paid by accounts in the composite may differ from the current fee schedule.
7. The three-year annualized ex-post standard deviation measures the variability of the composite (using gross returns) and the benchmark for the 36-month period ended on December 31. The 3 year annualized standard deviation is not presented as of December 31, 2010 and December 31, 2011 because 36 month returns for the composite were not available (N/A).
8. Valuations and performance returns are computed and stated in U.S. Dollars. All returns reflect the reinvestment of income and other earnings.
9. A complete list of composite descriptions, policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.
10. Past performance does not indicate future results.
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