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Sustainable Value Creation

While many portfolio managers look for high-quality companies, definitions can significantly vary. For Andrew Flynn and Kenneth McAtamney, who are at the helm of the William Blair Global Leaders Fund, high quality means companies driven by strong and sustainable value creation. With a global mandate and a long-term view, the fund looks for companies with clear leadership, internally driven growth, and a sustained competitive advantage.

What core beliefs guide your investment philosophy?

William Blair's global team has been around for a long time; we are beginning our third decade. We have evolved and expanded in this period, but we have remained true to our investment philosophy, which is anchored in quality growth companies.

The prime tenet of our philosophy is the belief that strong corporate performance drives exceptional returns. Across the global team, we aim to identify companies that have sustained a meaningful competitive advantage. We track that advantage in a number of ways, but we focus on companies that demonstrate clear leadership in their business or on companies that grow internally, not through acquisitions. Overall, we look for companies that generate strong and sustained investment returns.

In terms of quality, we used to be more focused on defensive growth, or on default risk and balance sheet quality. Over the last decade, however, our focus migrated toward sustainable value creation. The concept is to track and measure the amount of and the consistency in generating cash flow return on invested capital, as well as the companies' ability to successfully redeploy that cash to the opportunity set.

For us, high quality doesn't mean just companies with low default risk, but means companies that are driven by strong and sustainable value creation. The sustainable value creation is the anchor of our investment philosophy across all the strategies that we manage at William Blair.

What is the importance of price within your strategy?

Valuation is a critical and integral element of our strategy. It is always a balancing act between the quality of the company and its current operating momentum. Of course, companies with strong operating momentum trade at a premium, so we spend a lot of time identifying the opportunity over not just the near term, but also the next three to five years.

We track valuations carefully and have many tools for that purpose. We also evaluate companies based on historical data and, more importantly, relative to the market, the industry, the sector, and even the region.

We are a fundamental shop, driven by our seven different global portfolio managers, and we travel the world to identify great companies. However, we also use systematic, quantitative tools, which guide us with third-party, impersonal, and unemotional information. We've crafted a variety of different systematic models. In the quality model, we moved from pure defensive growth stocks, where we look at earnings quality and balance sheet strength, toward sustainable value creation.

Another important model is our valuation model. It is not difficult to find a lot of great companies out there, but investing in them at a reasonable level of valuation is crucial. The main question is if the operating momentum is stabilizing or improving and what's a reasonable multiple to pay for that.

We have developed and continue to develop tools to identify how extended the valuation might be and what level of risk we should take. When valuation has moved beyond the reasonable balance, we reduce our exposure to a name.

Andrew G. Flynn,
Portfolio Manager

Andy Flynn is a portfolio manager for William Blair's International Small Cap Growth and Global Leaders strategies. Since joining William Blair in 2005, Andy has served as a U.S. industrials and consumer analyst and a non-U.S. consumer, healthcare, and IT analyst. He was also a portfolio manager for the firm's Global Small Cap Growth strategy. Before joining the firm, Andy was a senior equity analyst and portfolio manager at Northern Trust, where he specialized in mid- and small-capitalization growth companies. Before that, he was a senior equity analyst at Scudder Kemper Investments and a research assistant at Fidelity Investments. Andy is a member of the CFA Institute and the CFA Society of Chicago. He received a B.A. in economics from the University of Kansas and an M.B.A. with an emphasis in finance from the University of North Carolina at Chapel Hill.

Kenneth J. McAtamney
Portfolio Manager

Ken McAtamney is a portfolio manager for William Blair's International Growth, Global Leaders, and International Leaders strategies. He was previously co-director of research and a mid-large-cap industrials and healthcare analyst. Before joining William Blair in 2005, Ken was a vice president at Goldman Sachs and Co., where he was responsible for institutional equity research coverage for both international and domestic equity. Before that, he was a corporate banking officer with NBD Bank. Ken received a B.A. from Michigan State University and an M.B.A. from Indiana University.

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What is your definition of "global" and "leaders"?

By "global" we mean our opportunity set. Our mandate is to find the companies that we believe have the highest probability of generating superior and sustainable long-term corporate performance and investment returns, regardless of where they are domiciled. We are unconstrained from a regional standpoint. Our mandate includes the United States, the developed international markets, the emerging markets, and, technically, the frontier markets as well.

Our current weight in the emerging markets is about 8% to 10% of the portfolio. It has ranged from mid single digits up to 25% of the portfolio, depending on the opportunities. Right now we have zero exposure to the frontier markets; over time we may have owned one or two companies opportunistically. We've always found quality growth companies around the globe; we have a lot of experience investing internationally and we want that to be reflected in a global portfolio.

Being a global fund doesn't imply that all of our companies have global businesses. Some of them are indeed global brand names with global end-markets, global supply chains, and global competitors. On the other hand, many of our companies are regional or niche oriented in terms of their geographic exposure, but they have the leadership characteristics that we seek.

By "leaders" we mean the companies with the greatest probability of sustainable superior long-term corporate performance. Most of the strategies at William Blair are focused on quality growth equities. Our portfolios are focused on the top 20% of that quality growth universe. We believe that these companies have the attributes, embedded within their corporate culture, that provide a sustainable competitive advantage. So there is a higher degree of confidence in the future return profile and the growth rate of the company.

These are companies that may actually be early in their corporate lifecycle. They may be smaller-cap companies, but they must have a business model that we believe is superior and sustainable. We explicitly target different parts of the corporate lifecycle, because that approach introduces the leadership characteristics in a diverse array of companies. We can find these leadership attributes everywhere in the world, in every industry, and at every stage of the corporate lifecycle. Our job is to make a selection and build a portfolio that reflects the diversity of that opportunity set.

Would you describe your investment process?

The first element is to downsize the universe from more than 10,000 to about 3,000 companies, starting with the top half in every industry in terms of quality and growth. At each level of our process, there is a good combination of objective, quantitatively defined discipline and highly fundamental, subjective experience and conviction-based approach.

We find the sector expertise, rather than regional expertise, to be more important in the evaluation of a global opportunity set, so we divide our analysts into sectors. Within the sectors, we divide the responsibilities of investment coverage into large, mid-, and small cap to make sure that we focus on all the levels of market capitalization and corporate lifecycle. We empower the analysts to look for the best risk/reward trade-offs between long-term corporate performance and valuation.

That's how we get a smaller universe to implement in the portfolio of leaders. We take the top 20% of our coverage list, assess their leadership qualities, and look for the most timely investments, trying to have a broad and rich reflection in our portfolios.

Regarding individual stock decisions, Andy and I, together with the analyst sector team, evaluate every new potential idea relative to the competitive opportunity set within each sector. We frequently meet with not just the analyst, who presents the potential idea for this portfolio, but also the entire sector team. In that way we get the highest-conviction ideas of our analysts, thoroughly vetted versus their peer set within our own coverage list. Those dialogues tend to be very engaged and spirited. At the end, we believe that we have a fully and globally vetted idea, which has the confidence and support of the entire sector team.

Within the consumer segment, for example, we believe that health and beauty is a highly attractive high-growth area, which has proved more resilient to e-commerce disruption. The opportunity set is really broad as some of the world's leading cosmetic companies are in Korea, while Chinese consumers now represent the biggest and fastest-growing cosmetics end-market.

So we look at cosmetics companies in Korea, Japan, and Europe, and we evaluate the same opportunity in the United States with large cosmetic retailers or manufacturers. There is a global opportunity set of eight or nine interesting, high-growth, high-return companies around this theme. We believe that the best way to exploit the theme is to have coordinated global sector coverage and a portfolio that reflects the best ideas.

What are the key drivers of your research process?

We start with growth from both an industry and company standpoint and we take into account disruption and innovation. We perform deep fundamental analysis, and our portfolio managers travel around the world looking for future pockets of growth, evaluating if that growth is sustainable, and trying to identify it at the corporate level.

We incorporate a lot of historical data, which in reality proves fairly predictive of future growth and returns. The main quantifiable metric that we look for is cash flow return on invested capital. We believe that is the best predictor of a company's ability to sustain its growth into the future.

But we spend most of our time on industry and company analysis, because we have to assess the quality of the management teams, their strategy and ability to execute that strategy, their capital allocation policies, their human resource development, and their relationship with customers and suppliers. We also look at their commitment to innovation and to research and development.

Other important aspects include their relationship with the other stakeholders and the various environmental, social, and governance factors. All these factors need to be vetted from the fundamental research perspective, which underpins everything we do.

Could you cite an example to better illustrate your research process?

We spend a lot of time trying to identify companies that have the necessary return characteristics, niche focus, competitive advantage, and strong management team, because these companies can be tomorrow's global champions. A great example would be Fevertree, a producer of drink mixers based in the United Kingdom that dominates the premium mixer market.

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What makes this business interesting is that it is driving dramatic growth in the premium mixer market. Fevertree accounts for 80% to 90% of the category growth. The company was founded by an individual with a history of identifying attractive, underappreciated brands and investing substantially in them. The business is expanding by 70% in the United Kingdom, its original market, plus 17% in Europe. It is just getting started in the United States, which is a big growth opportunity.

From the perspective of returns, this is a company that engages in product development, but also deploys its assets effectively. So while Fevertree may not be a household name, we believe it has the characteristics, return focus, niche development, and management strength to become a global champion one day. We have been involved with the company for several years across a variety of different strategies, so we've seen the continued success and the market opportunity, while the company is still relatively early in its corporate lifecycle.

How do you construct your portfolio?

Our limits on regional and sector weights range from zero to 2.5 times the benchmark weight. The individual position sizes are restricted to 5% of the portfolio. Our position sizes tend to reflect the company's market cap. We have fewer but larger positions in large-cap names and a greater number but smaller positions in smaller-cap companies.

Our benchmark is MSCI ACWI IMI Index because of our global opportunity set and our exposure across market caps. However, we don't pay too much attention to the benchmark, because we want to build the portfolio around our best ideas, regardless of the sector or regional weights.

The diversity of the corporate lifecycle is another strong consideration since it represents a way to diversify the portfolio risk. We have higher-growth companies with more volatile corporate performance and more mature, lower-growth companies, which are highly cash generative, as well as companies that are in between. That mix of attributes is one of the ways to ensure diversification and provide some risk management within the portfolio.

How do you define and manage risk?

William Blair has done a lot to avoid organizational risks. There is low firm and team risk here, as evidenced by the low turnover of investment professionals and the stability of our organization and investment team. These are critical elements for our clients.

In the portfolio, we manage two primary risks on a day-to-day basis. The first one is the risk of corporate execution or individual security risk. We assess if the company is able to perform and execute as we expect it to. We spend our time evaluating the ability of companies to manage their businesses, including for the best companies out there.

The second risk is aggregate exposure risk, which we take by virtue of our philosophy and style. We assess the risks from macro or investment factor elements that we need to be considerate of. A suite of tools help us evaluate our exposure, both positive and negative, to macro factors and quality. We evaluate the current environment, how expensive high quality is, and whether the market landscape is favorable or not to our exposure to quality.

Not all the risks are necessarily negative; some of them are the risks that we want to take by virtue of our investment philosophy. We do an in-depth job of understanding, quantifying, and measuring the exposures. Then we try to identify how risky these exposures might be and if we are comfortable taking more of them or less. T

William Blair Global Leaders Fund

Adviser	William Blair
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William Blair

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The holdings mentioned comprise the following percentages of the William Blair Global Leaders Fund's total net assets as of 6/30/2018: Fevertree Drinks PLC 0.75%. For a complete list of the Fund's holdings, please visit www.williamblairfunds.com.

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The Fund involves a high level of risk and may not be appropriate for everyone. You should only consider it for the aggressive portion of your portfolio. The Fund's returns will vary, and you could lose money by investing in the Fund. The Fund holds equities which may decline in value due to both real and perceived general market, economic, and industry conditions. International investing involves special risk considerations, including currency fluctuations, higher volatility, lower liquidity, economic and political risk. Investing in emerging markets can increase these risks. The securities of emerging market companies may be subject to greater volatility and less liquidity than companies in more developed markets. Investing in securities of smaller companies tends to be more volatile and less liquid than securities of larger companies. Individual securities may not perform as expected or a strategy used by the Adviser may fail to produce its intended result. Convertible securities may be called before intended, which may have an adverse effect on investment objectives. Investing in smaller companies involves special risks, including higher volatility and lower liquidity. Diversification does not ensure against loss. **Past performance does not guarantee future results.**

Please carefully consider the Fund's investment objective, risks, charges, and expenses before investing. This and other information is contained in the Fund's prospectus, which you may obtain by calling +1 800 742 7272. Read it carefully before you invest or send money. Investing includes the risk of loss.

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