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Brandes Investment Partners
Global Balanced Strategy Notes
Second Quarter 2019 (April 1 – June 30, 2019)

The Brandes Global Balanced Strategy declined 0.1% (gross of fees) in the second quarter, underperforming its blended benchmark, the World Balanced Index, which is composed of 70% of the MSCI World Index with net dividends and 30% of the FTSE U.S. Broad Investment Grade Bond Index. The benchmark rose 3.8% for the quarter.

Performance Detractors
Notable detractors included several of our U.K.-based holdings, namely tobacco company **Imperial Brands**, retailer **Marks & Spencer Group** and grocer **J Sainsbury**.

After being one of the top performers in the first quarter, Imperial saw its shares decline amid increased market concern about its slowing sales growth. Trading at less than 7x earnings and offering a dividend yield of higher than 10% as of June 30, the company remains an appealing opportunity to us.

Sainsbury had to drop its bid to merge with Asda after antitrust authorities blocked the deal, which would have resulted in the U.K.'s largest grocery chain. As we mentioned in our notes last quarter, we were supportive of the deal, but it was not the crux of our investment case. We had owned the shares before the deal was announced, and at the current share price we believe the company offers an even more attractive risk/reward tradeoff. While Sainsbury has been hurt by negative sentiment toward the deal fallout and a weaker consumer-spending environment due to the uncertainty around Brexit, it has the potential to improve its margin. Additionally, following the share-price decline, Sainsbury now trades at less than 10x earnings (as of June 30) and its market valuation is roughly equal to the value of the real estate it owns, representing a compelling value proposition, in our opinion.

Other detractors included Japan-based automaker **Nissan Motor**, Finland-based communications firm **Nokia** and U.S.-based gas engine manufacturer **Briggs & Stratton**.

Briggs & Stratton reported weak earnings, in part due to some temporary business issues from Sears' bankruptcy and the drought in Australia and Europe. The stock price has dropped over the last year. However, we believe the market has overreacted to some of the temporary issues. Additionally, the company has made significant investments over the past few years, hurting its free cash flow. We see these investments weighing less on cash flow over the next year and we hold the view that the company offers an attractive investment opportunity. At quarter end, Briggs & Stratton shares traded at a low single-digit price-to-earnings multiple on depressed earnings. The company maintains a strong competitive position in power equipment and should benefit if single-family housing starts continue to improve.

Positive Contributors
Equity and credit markets continued their strong year-to-date rally, with the S&P 500 Index recording its best first-half return since 1997 and the high-yield market posting its best first-half performance since 2009. At the same time, the yields on U.S. Treasury securities declined steeply as the U.S. Federal Reserve signaled a pivot in its monetary policy stance. With market expectations shifting to multiple interest-rate cuts this year, the 10-year U.S. Treasury yield declined to 2% at quarter end.

As a result, our fixed-income holdings in U.S. Treasuries aided returns during the period as interest rates declined.

Key equity contributors included a number of U.S.-based holdings, such as financial companies **Citigroup**, **PNC** and **Bank of America**, as well as software maker **Microsoft**.

Citi has a strong capital position and with its clean pass at the end of the quarter of the Comprehensive Capital Analysis and Review (i.e., a stress test of financial companies' capital-reserve adequacy and internal strategies for managing capital), it said it will continue to return excess capital to shareholders. The company announced a dividend increase and a share buyback of more than $17 billion over the next year, which is expected to generate close to a 14% shareholder yield. At quarter end, Citi shares traded near tangible book value and we believe the company continues to offer an attractive margin of safety, and therefore it remains one of the strategy's largest holdings.

A number of non-U.S. holdings also boosted returns, including France-based industrial company **Schneider Electric** and multi utility **Engie**, as well as U.K. advertising agency **WPP** and Brazil-based telecommunications firm **Telefonica Brasil**.

Select Activity in the Second Quarter
The Global Large-Cap Investment Committee divested its position in Brazil-based utility **Companhia Paranaense de Energia** (Copel), which appreciated to our estimate of intrinsic value, in part aided by the Brazilian equity market's strong performance over the past 9 months. Copel's dividend yield dropped to 3% after the stock price advanced.

The committee purchased additional shares in U.S.-based pharmaceutical distributor **Cardinal Health** (4% dividend yield) and U.K.-based Imperial Brands (10% dividend yield) following declines in their stock prices, as we believed the companies' valuations and dividend yields remained attractive.

Year-to-Date Briefing
For the six months ended June 30, 2019, the Brandes Global Balanced Strategy advanced 4.6%, underperforming its blended benchmark, which rose 13.8%.

Many of the key contributors year to date were similar to those from the second quarter, including U.S. firms Citigroup and Bank of America, as well as Schneider Electric, Telefonica Brasil and WPP.

Additionally, our fixed-income holdings of U.S. Treasuries aided performance as yields have declined sharply given increasing expectations of an interest-rate cut by the Federal Reserve.

Significant detractors were also similar to the ones from the second quarter, led by U.K. holdings Imperial Brands and J Sainsbury, as well as Briggs & Stratton, Nokia and Nissan Motor.

Additionally, Brazilian regional jet manufacturer **Embraer** hurt returns.

Current Positioning
At quarter end, the Brandes Global Balanced Strategy exhibited more attractive valuations, in our opinion, and a higher equity dividend yield than the MSCI World Index.

Allocations to emerging markets, the United Kingdom and France represented the largest overweights (versus the benchmark), while the United States remained our largest underweight position.

From an industry/sector perspective, the strategy held key areas of exposure to pharmaceuticals, oil & gas, banks and capital markets, while maintaining significantly lower allocations than the benchmark in industrials, materials and technology.

The Fed appears to be having a difficult time weaning the markets off a decade of extraordinary stimulus. Many investors enthusiastically cheered the Fed's latest policy pivot and the prospect of lower interest rates. The important question, however, is whether the Fed is ultimately doing more harm than good, with a propensity to prop up the markets at any hint of volatility or negative sentiment.

For the near term, it appears that market technicals continue to take precedence over fundamentals. Yield spreads on most taxable fixed-income assets remain close to the tightest levels in some time. Credit spreads per unit of leverage suggest that caution is warranted. Nonetheless, the markets continued to rally.

Value Investing Update: Why Is the Style Still Relevant Today?
As value stocks continued to struggle relative to their growth counterparts year to date and over the last 10 years, some have questioned the validity of value as an investment style. The MSCI World Value Index underperformed the MSCI World Growth Index by more than 800 basis points year to date and by over 300 basis points annualized in the 10 years ended June 30, 2019.

While the magnitude of value's recent underperformance is nothing new (it was worse in the late 1990s), the extended period has been by far the longest in the last 40 years. Thus, it is only natural for investors to question if value is still relevant.

Value's prolonged underperformance has led to increased sell-side reports and news articles proclaiming the "death of value." These reports, similar to those prevalent during the late '90s technology bubble before value's big run of outperformance, cite several factors which have contributed to value's recent underperformance: 1) quantitative easing by central banks worldwide, which has led to record low interest rates; 2) the dominance of technology companies, which have boosted the performance of growth indices while diminishing "mean-reversion;" and 3) diminished importance of book value, a key metric in valuing companies, most notably as pointed out by Warren Buffett earlier this year.

- *It is important to define how we view value investing.* We use a variety of valuation methods in our attempt to buy businesses for less than our estimates of what they are worth. We believe this method is the best way to help clients pursue their long-term investment goals. With the advent of passive indexing and the increasing use of quantitative and factor strategies, value is now most commonly defined as buying stocks trading at low multiples, with price-to-book (P/B) seeming to be the most popular multiple. Historically, the P/B ratio may have been a good proxy for businesses trading at a discount to their estimated true worth, and still may be for some asset-intensive businesses like financials or utilities. However, we believe that the relevance of the P/B ratio has declined for many industries as companies increasingly add value through investments in research and development and intellectual property, investments which aren't sufficiently recorded on the balance sheet. Moreover, while passive value indexes and quant value funds may do a fine job at identifying companies with low multiples, in our work we look to discern what is simply cheap versus what we would consider to be undervalued, or selling for less than what it's worth.

- *Other common arguments for value's demise have been the relatively weak economic environment of the past decade and accommodative monetary policies by central banks worldwide, which have led to the current low interest-rate environment.* Mathematically, given the lowering of interest rates and more difficult growth environment, it makes sense that investors would "pay up" for growth and that the multiples on high-growth stocks (i.e., those of companies with the higher expectation of robust earnings growth) would move up as their future cash flows have a much higher duration. But most sectors with stretched valuations or even bubbles have historically been born out of solid arguments that just became excessively applied. How much higher should these distant free cash flows be valued? What if interest rates don't continue declining in perpetuity? And even if interest rates were to continue to decline, history has witnessed several periods when value has outperformed in a declining interest rate environment when valuation spreads are extended, as they are today.

- *The rise of disruptive giant technology companies has threatened a variety of industries and therefore ended companies' reversion-to-the-mean potential.* We agree that powerful technology companies are increasingly disrupting several industries, reducing or eliminating the ability of these industries to "mean-revert." However, we consider it our job as active value managers to differentiate between those industries whose fundamentals are being disrupted, from those who are only experiencing stock price disruption. In some cases opportunities arise if the market overreacts to the threat of disruption, and when our work suggests the market underappreciates the discounted company's moat or durability in the sell-off. Interestingly enough, the argument that, in total, disruptive technology is dramatically impairing the fundamentals of "value" companies is even suspect. When looking at the long-term expected earnings per share growth of the constituents of the MSCI World Value Index and the MSCI World Growth Index, we find that the growth differential has been fairly constant over the past 15 years.

As a result of the headwinds to value over the past decade, there are increasingly few true value managers—as many have migrated to more quality or growth-oriented strategies. Looking at Morningstar data on U.S.-based funds' net value exposure as of March 31, less than 6% of global and international equity mutual funds have more than half of assets under management exposed to the value style, meaning that more than 94% of funds are more than 50% exposed to growth stocks.*

We believe that if more managers give up on value or migrate to different strategies, this could set up well for style-pure value managers such as Brandes. Ultimately, current valuations remain the most important drivers of future returns, in our opinion. On a sector neutral basis, value stocks are currently priced at the largest discount in our firm's history, larger than during the technology bubble.** Going forward, we believe this bodes extremely well for value and our investment strategy in particular, since we have historically done better than value indices in general when the style had outperformed.

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We remain committed to building and holding value portfolios for our clients in all market conditions, and appreciate the trust you have placed in us.

We believe the current positioning of the Brandes Global Balanced Strategy bodes well for the long term.

Thank you for your continued trust.

*Source: Morningstar, as of March 31, 2019. Universe includes global open-end mutual funds, exchange traded funds, smart beta, dividend, tactical, low-volatility, currency hedged, passive, index and quality funds.

**Source: Alliance Bernstein Global Quantitative Strategy; published March 28, 2019. Based on median trailing P/E ratio of the most expensive and cheapest quintiles. Data as of the end of 2018.

Basis Point: 1/100 of 1%.

Book value: Assets minus liabilities. Also known as shareholders' equity.

Cash Flow: The amount of cash generated minus the amount of cash used by a company in a given period.

Dividend Yield: Dividends per share divided by price per share.

Enterprise Value: Market capitalization plus debt, minority interest and preferred shares, minus total cash and cash.

Federal Funds Rate: The interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight.

Free Cash Flow: Total cash flow from operations less capital expenditures.

Margin of Safety: The margin of safety for any security is defined as the discount of its market price to what the firm believes is the intrinsic value of that security.

Price/Book: Price per share divided by book value per share.

Price/Tangible Book: Price per share divided by tangible book value per share.

Price/Earnings: Price per share divided by earnings per share.

Sell Side: The part of the financial industry involved with the creation, promotion, analysis and sale of securities.

Share Buyback: The re-acquisition by a company of its own stock.

Tangible Book Value: Book value minus intangible assets (e.g., goodwill).

The declaration and payment of shareholder dividends are solely at the discretion of the issuer and are subject to change at any time.

The S&P 500 Index with gross dividends measures equity performance of 500 of the top companies in leading industries of the U.S. economy.

The MSCI World Index with net dividends captures large and mid cap representation of developed markets.

The MSCI World Growth Index with gross dividends captures large and mid cap securities across developed market countries exhibiting growth style characteristics, defined using long-term forward earnings per share (EPS) growth rate, short-term forward EPS growth rate, current internal growth rate, long-term historical EPS growth trend, and long-term historical sales per share growth trend.

The MSCI World Value Index with gross dividends captures large and mid cap securities across developed market countries exhibiting value style characteristics, defined using book value to price, 12-month forward earnings to price, and dividend yield.

The World Balanced Index (rebalanced daily) is composed of 70% MSCI World Index with net dividends and 30% FTSE US Broad Investment Grade Bond Index. The MSCI World Index captures large and mid cap representation of developed markets. The FTSE US Broad Investment Grade Bond Index tracks the performance of U.S. dollar-denominated bonds issued in the U.S. investment-grade bond market. Prior to April 1, 2015, the World Balanced index was composed of a 50 percent allocation to each benchmark in the blend. Brandes Investment Partners believes the rebalance of the benchmark's allocation better represents the Global Balanced strategy's asset allocation to equities and fixed income.

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