Brandes Emerging Markets Value Annual Report

NOVEMBER 2018

Investment Environment & Opportunity Set

Emerging markets have been sharply out of favor this year, with the Vanguard FTSE Emerging Markets ETF (which we use as an investable index for comparison to active managers) losing 7.7%, after having experienced very strong performance the last two years (up 12.2% in 2016 and up 31.5% in 2017). We are not overly surprised by this given the fickle nature of capital flows into and out of emerging markets, but it has been a disappointing reversal considering the relative cheapness that emerging markets still display relative to the US equity market. Prior to this year, the significant outperformance of growth over value was an additional headwind for Brandes Emerging Markets Value. Year to date through September 30, the MSCI Emerging Markets Growth Index returned negative 10.8%, while the comparable value index returned negative 3.9%. Despite that outperformance by value this year, over the trailing five-year period, it still trailed growth by a wide margin of almost 3% annualized. All this to say that the environment for Brandes Emerging Markets Value has been challenging for several years, in relative terms, absolute terms, and sometimes both. This is not to excuse losses this year, but simply to provide context, which is always valuable, but particularly so when thinking about a strategy subject to two layers of cyclicality (i.e., emerging markets and deep value).

There have been several hot spots in the emerging markets this year, with the most notable being economic/currency crises in Turkey and Argentina (which both impacted the fund negatively), and the trade war between the United States and China. Unlike results in Turkey and Argentina, the resulting damage to China's equity market has been beneficial to the fund, at least on a relative basis, due to the fund's large (nearly 20 percentage points) underweight position in the country compared to the index. As one might expect, the decreased valuations in China have prompted Brandes to increase their research efforts on Chinese stocks. Despite the trade war, Brandes views the Chinese economy as resilient, even with a potential escalation. Brandes EM Investment Committee member Louis Lau stated, "We don't think it's going to be a crisis in China … Over the long term, we see this more as a buying opportunity." Given the material underweight, it's unlikely the fund will suddenly get to the same level of China exposure as the index, but the potential opportunity set is clearly massive, so we expect to see exposure grow in the coming quarters. The range of businesses that have begun hitting Brandes's screens is diverse, ranging from banks to branded foods to industrials, and even technology companies. While they aren't obviously cheap on most metrics, some Chinese Internet companies have suffered declines steep enough to warrant additional research.

Investment Philosophy & Process

Brandes employs a classic deep-value strategy, trying to buy stocks well below their estimate of fair value when the stocks are cheap for either cyclical reasons or due to temporary but addressable problems. The investment team focuses on the fundamentals of companies and their industries in order to develop an estimate of the intrinsic value of each stock they determine to be a potential buy candidate (usually because it has screened cheaply on one or more valuation metrics or is part of a currently unpopular industry, country, or region). The fund will buy a stock when it sells at a significant discount or margin of safety to their assessment of intrinsic value, which is ultimately determined by the Investment Committee (IC).

The firm's idea generation relies primarily on screening for cheap stocks based on common metrics like low price-to-book ratios, price-to-earnings ratios, etc. However, sector team leaders or IC members can direct research projects into areas (geographical or sector-specific) that have seen significant price declines and appear to offer potentially compelling investment opportunities. After identifying a potential investment, analysts will do additional research on

Brandes Emerging Markets Value Top 10 Holdings (9/30/18)	
China Mobile	4.7%
Cemex	4.0%
Embraer	3.1%
KT&G	2.9%
Fibra Uno Administracion	2.8%
YPF	2.8%
Companhia Brasileira de Distribuicao	2.6%
Dongfeng Motor Group	2.4%
Petroleo Brasileiro	2.3%
Hyundai Mobis	2.3%
Total	**29.9%**

Brandes Emerging Markets Value Top Five Sectors (9/30/18)	
Consumer Discretionary	23.4%
Financials	13.5%
Telecom Services	12.1%
Energy	10.4%
Consumer Staples	8.5%
Total	**67.9%**

Brandes Emerging Markets Value Top Five Countries (9/30/18)	
Brazil	17.1%
South Korea	13.9%
China	12.5%
Russia	10.7%
Mexico	10.2%
Total	**64.4%**

Source: Litman Gregory Analytics

the company and build a model to reach an estimate of intrinsic value. The analysts spend significant time studying the industries and regulatory climates in which the companies operate, since the analysts are often looking out a number of years in order to assess what a "normal" and sustainable level of profitability should be for a company. Ultimately, Brandes strives to understand why a company is valued the way it is and assess whether those factors are likely to change over time, which may drive a revaluation of the business in the market. Brandes emphasizes correctly evaluating the business's material drivers of value and recognizes that there is a range in which the "true" business value lies. If they can purchase a stock at a significant margin of safety to their conservative intrinsic value estimate, it should lead to attractive returns over time.

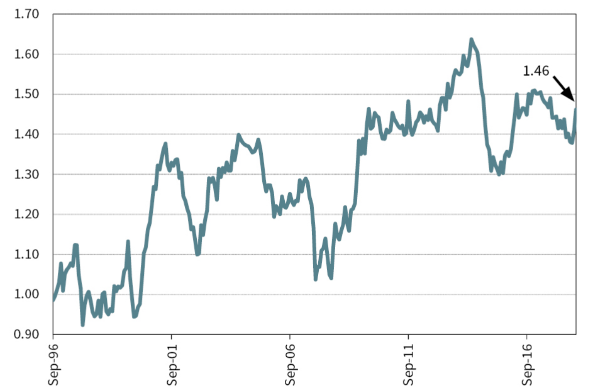
The portfolio is built from the bottom up, based on the individual investment opportunities identified by the analysts and sector teams. However, there are guidelines around portfolio construction to ensure a prudent level of diversification and to reduce risk. Positions are typically under 5% at cost, and the top 10 are usually in the 25%–35% range, with the total portfolio comprising 60–80 positions. Positions are sold when the margin of safety becomes unattractive relative to other opportunities. This can be because the position has appreciated to the point where its market price is close to the intrinsic-value estimate, because the team has better ideas with higher margins of safety, or because the team recognizes it made a mistake and reassesses the business and arrives at a lower estimate of value. The firm does not hedge currency on the view that currency gains and losses average out over time, and that hedging is frequently costly, particularly in many emerging markets.

Portfolio and Highlighted Positions

The portfolio is, as usual, statistically cheap compared to the MSCI Emerging Markets Index. While it's not as cheap as it was in 2015, it's still quite attractively valued. That of course says nothing about timing, but it does imply significant upside when sentiment changes. As of September 30, the fund traded at a P/B of 0.9x compared to 1.6x for the emerging markets index, 9.1x P/E versus 12.8x for the index, and had a 4% dividend yield, which topped the 2.7% yield on the index. Again, the difference in these metrics isn't quite at the level it was a few years ago before the fund went on to return almost 60% cumulatively over the next two calendar years, but it is promising. This should be expected given losses this year, but Brandes's internal estimate of the fund's valuation has declined more than the fund's performance would indicate. At the beginning of 2018, the fund's "margin-of-safety," the high-level metric Brandes uses as one measure of valuation, was in the high-teens to low-20% range. As of the end of the third quarter, the margin of safety was nearly 30%. Importantly, the average quality of the businesses hasn't declined, according to Lau. Although only a rough measure and considered on the margin, Brandes assigns a quality rating to each company it considers, and the distribution of the portfolio by quality tiers has shifted marginally higher since the end of last year. It would be easy to get a dramatically cheaper portfolio by shifting into low-quality companies that deserve low valuations, but that certainly doesn't appear to be the case here.

The portfolio's largest differences from the index remain fairly consistent, namely overweight allocations to Brazil (17% vs. 6%), Russia (11% vs. 4%), and Mexico (10% vs. 3%), and a large underweight to China (13% vs 31%). Partially related to the China underweight, the most dramatic sectoral difference is the fund's valuation-driven underweight to information technology (6% vs. 27%). Positions in Turkey and Brazil have been the main headaches this year, along with Argentine integrated oil and gas company **YPF**, which has understandably suffered due to the country's economic issues and plunging currency. The Brazilian detractors included **Embraer**, the regional jet manufacturer, where the market over-reacted (in Brandes's opinion) to the value placed on Embraer's commercial aircraft unit in the joint venture they are establishing with **Boeing**. Brandes believes the price was reasonable and that the deal is an important strategic victory for Embraer. **Cielo**, a payment processor new to the portfolio this year has also been a detractor, as competition has intensified and the transaction volume has declined in the poor economic environment. Brandes expects that the Brazilian election of more business-friendly candidate Jair Bolsonaro may be a catalyst for improved equity market performance in anticipation of economic recovery.

Relative Strength: Brandes Emerging Markets Value vs. Vanguard FTSE Emerging Markets ETF (10/31/18)**



Source: Litman Gregory Analytics

Although a small allocation overall, Turkish positions hurt the fund quite a bit. This was made more frustrating by the fact that Brandes had started scaling out of these positions (commercial banks and a REIT) based on valuations getting within the range of estimated fair value. They obviously didn't act quickly enough given what happened to the country's stock market and currency (both down over 40%). While the research team had concerns over governance and monetary management, they were clearly caught by surprise by the extent to which Turkish president Recep Erdogan would keep monetary policy irrationally loose when that had not been the case previously. "We were scratching our heads wondering what the Turkish regulators were thinking when inflation was very high and they had zero to negative real interest rates," Lau recalled. After the steep losses, the banks were extremely cheap at around 50% margin of safety. Brandes held onto two of the banks (**Akbank** and **Garanti Bankasi**) that they viewed as higher quality, while selling **Vakif Bankasi**, which is government controlled in addition to having lower-quality assets. The REIT, **Emlak Konut**, is also partially government owned but has a very strong balance sheet and land in prime real estate markets in Turkey, so Brandes views it as a survivor of the downturn with significant medium- to long-term upside.

Performance Analysis & Opinion

Year to date through October 31, the fund has outperformed the Vanguard FTSE Emerging Markets ETF, losing only 14.9% compared to the benchmark's 15.9% loss. The fund has also outperformed over the trailing one year (negative 11.8% versus negative 13.1% for the benchmark). Prior to October when the fund outperformed on the downside, the largest contributors to underperformance had been the fund's relative overweights to Brazil and Turkey and underweight to Taiwan. Despite the style headwinds discussed earlier, the fund has still outperformed the benchmark over the trailing three years (returning 8.3% annualized against the Vanguard ETF's 5.4% return), though it underperformed over the trailing five (negative 0.6% versus positive 0.6%), highlighting again the start- and end-point sensitivity even over reasonable intermediate-term measurement periods. This is to be expected with the Brandes deep-value, benchmark-agnostic style. In any given year (or five), the fund may perform dramatically differently than the index. Over time,

Performance Table (10/31/18)

		Calendar Year Returns					Trailing Returns*				
	YTD	2017	2016	2015	2014	2013	One-Year	Three-Year	Five-Year	10-Year	Since Start of Rec.
Brandes Emerging Markets Value	-14.90%	25.99%	25.74%	-20.34%	-8.68%	5.04%	-11.83%	8.30%	-0.58%	9.85%	6.97%
Vanguard FTSE Emerging Markets ETF	-15.89%	31.48%	12.21%	-15.81%	-0.07%	-4.92%	-13.07%	5.39%	0.62%	7.12%	5.15%

**Start of record Sep-1996. Prior to the inception of the fund, we use the manager's separate-account record. **Prior to the inception of the benchmark, we use the returns of the MSCI Emerging Markets Index.*

Source: Litman Gregory Analytics

this has produced strong returns, with the fund outperforming by over 2.7 percentage points annualized over the last 10 years, and 1.8 percentage points annualized since inception (up 7% versus 5.2%), which translates to a quite significant cumulative return difference (345% against 205%). Of course, we wish that the outperformance was more predictable and consistent, but we believe that value investors get compensated well long term in part *because* of the risk of looking different and possibly underperforming over short and medium horizons.

Our view of the team's advantage remains unchanged. In large part, it is the willingness to take a longer-term view of companies than the market does and to make decisions based on a thorough analysis of current and long-term company and industry fundamentals, rather than short-term noise or temporary, overblown challenges. We believe the fund's flexible mandate, which includes the ability to deviate materially from its benchmark in country and market-cap weightings, will continue to help it add value over time, despite the very painful short-term performance differences it can cause. Brandes has a long history of investing in emerging markets, which is also an advantage relative to newer entrants, and we think they have been thoughtful in preserving their institutional knowledge. They have done this in part by having senior investment professionals sit on different investment committees, and (at a measured pace) rotating new members onto committees so they can benefit from the collective experience of their colleagues. We highlight this aspect here since it is relevant to IC member Doug Edman's retirement at the end of the year. Brandes has been planning for this for over a year and has been transitioning Edman's coverage of energy and materials names to the rest of that team. After internal debate, Brandes has decided not to replace him on the Emerging Markets IC, which will leave the committee with four members going forward, consistent with the range of three to five members on the committees of other strategies. While we thought highly of Edman, we do not view his retirement as a material negative given the large research group and the firm's team-oriented decision-making process.

The fund has had a challenging year, but the investment philosophy and process seem consistent and intact, which we believe will lead to strong results over time. Given the fund's valuation relative to the benchmark, we would expect to see relative performance pick up over the next few years (although we obviously can offer no guarantees). We continue to rate the fund *Approved+*, indicating we believe the fund will perform at least as well, if not in excess of, an index alternative but that we also consider a realistic candidate for upgrading to *Recommended* in the future. We hold the fund across many of our AdvisorIntelligence and third-party model portfolios.

—Jason Steuerwalt, CFA