Brandes Corporate Focus Bond Fund

Fund Commentary

After bottoming in July, interest rates started marching higher with the pace of increase picking up substantially following the U.S. presidential election on November 8. In the fourth quarter, 10-year U.S. Treasury rates rose by 0.85%, approximately 1.00% higher from July lows.

The primary impetus for increased interest rates appeared to be an expectation that in the wake of surprising election results, the U.S. economy is poised to enter a reflationary environment. This belief seemed fueled by anticipation of increased fiscal spending and tax cuts that may lead to renewed economic activity.

Post-election investors flocked to economically sensitive assets (i.e., those that tend to do well in an improving economy), such as investment-grade and high-yield corporate bonds, and shunned more traditional safe-haven assets such as U.S. Treasuries, agencies, and agency mortgage backed securities (MBS). Most taxable fixed-income sectors delivered negative returns for the quarter. Investment-grade corporate bonds experienced tighter credit spreads that offset some of the impact of rising rates, while the high-yield corporate bond sector was one of the few to post modest gains.

During the quarter, The Brandes Corporate Focus Bond Fund outperformed its benchmark, the Bloomberg Barclays U.S. Intermediate Credit Bond Index.

Positive Contributors

Holdings in economically sensitive areas, such as the energy sector and metals & mining industry were the largest positive performance contributors. Utilities and bank holdings also aided returns.

As was the case during the first three quarters of 2016, the most significant individual positive contributor in the fourth quarter was the Fund's holding in Chesapeake Energy, which benefited from a number of factors, including:

- The company's continued move to rationally and systematically explore all avenues to reduce debt load and ensure long-term survival.
- An asset sale announcement for $465 million during the quarter, bringing full-year divestitures to approximately $2.5 billion versus earlier company guidance of $2 billion.
- Its ability to issue longer-term debt during the fourth quarter as the company commenced a tender offer for near-term bonds for $580 million, 90% of which consists of bonds maturing in 2019 or earlier.
- The continued rise in energy prices, particularly natural gas.

Other energy holdings also boosted returns, including Range Resources, Occidental Petroleum, Exxon Mobil and pipeline company Kinder Morgan.

Additionally, commodity-resource company Cloud Peak Energy added to returns. Cloud Peak is a coal miner operating in the Powder River Basin (Western United States). The company operates some of the industry's lowest-cost mines, as it operates in the lowest-cost mining regions in the country. During the quarter the company took steps to ease refinancing concerns by issuing a tender offer for its nearest term maturity (December 2019) and issuing second-lien notes maturing in 2021. The result of the tender was that Cloud Peak was able to reduce its debt maturing in 2019 from $200 million to $56 million. The company also benefited, post the U.S. presidential election, from the perception that the incoming administration will

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take a more favorable regulatory approach toward the coal industry.

Performance Detractors

As mentioned above, the investment-grade corporate and high-yield market experienced strong performance relative to U.S. Treasuries. The Fund was modestly underweight in corporate bonds during the quarter and Brandes LP has been favoring short-maturity issues. Longer-maturity corporate bonds outperformed shorter maturities leading to a modest drag on performance from the Fund's more defensive corporate-maturity profile.

Select Buy & Sell Activity

Before the election, Brandes LP increased the Fund's weighting in a number of existing holdings that Brandes LP believes have attractive margins of safety, namely Cloud Peak Energy, Sprint Communications, Toll Brothers and Sappi Papier.

In October, Sprint Communications placed a block of their wireless spectrum in a special-purpose entity and issued bonds that are explicitly backed by the value of that spectrum. The new issue saw tremendous demand and was 10 times oversubscribed by the market. A significant portion of Brandes LP's evaluation of Sprint was based on asset coverage basis, with the company's wireless spectrum as the key component. The new issue from Sprint implied a value of nearly $100 billion for its wireless spectrum, or nearly 2.5 times our estimated value. Given the stronger asset coverage implied by Sprint's recent transaction, Brandes LP felt its existing bonds warranted an increased allocation.

After the election, Brandes LP increased the Fund's weighting in a number of financials, including Bank of America, Goldman Sachs and Wells Fargo, as the incoming administration has suggested that it will examine and potentially roll back some of the onerous regulations that have been placed on the financial industry since the Global Financial Crisis.

Additionally, Brandes LP extended its maturity in Chesapeake Energy Corp by six months (August 2020 to February 2021). Brandes LP views the maturity extension as modest especially in light of the changes the company has been able to make to its near-term maturity schedule. Nonetheless, the yield pickup of near 75 basis points to extend the maturity of the holding was attractive, in Brandes LP's view.

Brandes LP did not sell any corporate bonds during the quarter, but had a number of securities mature, including Pitney Bowes, Anadarko Petroleum, USG Corp and Thompson Creek.

Current Positioning

The bond market's technical backdrop remains strong and continues to drive credit spreads tighter than warranted by fundamentals, in Brandes LP's view. With historically unprecedented intervention from the Bank of Japan, the European Central Bank and the Fed, there has been a dearth of yield in the global bond market. At the end of the second quarter there were $10 trillion in global bonds trading at negative yields (Bloomberg: Black Swans and Game Theory: A Post-Brexit Guide to Bond Trading, July 5, 2016)

With near-zero yields particularly acute in Japan and Europe, there has been a dramatic increase in the net purchases of U.S corporate bonds by foreigners. For the five years following the global financial crisis, foreigners were net sellers of U.S. corporate bonds. Net purchases were positive in 2013 and 2014 and experienced a big jump in 2015 and Brandes LP expects that 2016 net purchases will exceed 2015 levels.

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In addition to seeing a considerable increase in foreign money coming into the U.S. corporate bond market, research by Bank of America Merrill Lynch (BAML) suggests that foreign purchases are dipping lower in credit quality and longer in maturity. According to BAML, foreign purchases of higher quality corporate bonds (defined as AAA to A) were 20% in July, down from 40% the prior month. Furthermore, foreign purchases of bonds with maturities exceeding seven years jumped to 85% in July from 45% in June (Bank of America Merrill Lynch: Credit Market Strategist, 8/19/2016)

The highly accommodative monetary policy backdrop appears to have put a safety net under asset values in the eyes of many market participants. One interesting observation around the current market is that bad news in the form of sluggish or disappointing economic data has generally caused yields to decline and equities to rally, while more positive economic data has generally caused yields to rise and stocks to slide as the market fears that the Fed will take off the market's training wheels that have been in place for the past eight years.

In Brandes LP's view, many in the market appear to be stretching their risk boundaries to get any yield in their portfolios. This reach for yield becomes more evident when examining current credit spreads versus their ranges over the past decade. Spreads are nearly uniformly at or near their decade lows and are at these low levels in the face of sluggish economic growth both domestically and globally. In other words, Brandes LP believes that the current fundamental picture does not justify the current credit spreads in many sectors and individual bonds.

Outlook

This is the time of the year when many investment managers and economists will put forth their forecasts for the upcoming year. Many of these predictions are well crafted by intelligent and thoughtful individuals and firms. In Brandes LP's view, however, virtually all the forecasts will not be worth the paper they are crafted on. No one truly knows what the future will bring. At their best, forecasts are educated guesses often based on short-term trends; and at their worst, forecasts are pure speculation, in Brandes LP's opinion.

For example, at the end of 2014 the median forecast for the price of oil per Bloomberg was $70/barrel with a range of $95 to $65/barrel (in U.S. dollar terms) based on the survey of more than 30 economists. The price of oil at the end of 2015 was $37/barrel or 43% below the lowest forecast and 47% below the median forecast. In hindsight, those forecasts were laughable, as most—if not all—were likely anchored to the prior high price. At the time, the oil price had declined dramatically from over $100/barrel, and forecasters did not anticipate or foresee the dramatic downturn in the energy industry that was coming.

Looking back to 2016, how many people can honestly say they accurately predicted that the British would vote to exit the European Union and that Donald Trump would be the next president of the United States?

Even the well-educated and experienced Board of Governors of the Federal Reserve forecast that they would raise rates three times during the course of the year. The first and only increase came on December 14.

As the new year begins, there appears to be more uncertainty than recent years, particularly around the impact that the incoming Trump administration may have on the legislative, regulatory and economic environments. Many have put forth forecasts that posit more infrastructure spending, lower taxes and less onerous regulation of many industries, all of which should be a positive for the corporate bond market. Again the forecasts seem plausible, but keep in mind that if history is any guide, they are likely to be incorrect.

Additionally, there remains considerable uncertainty around Fed policy. Once again, the Fed median forecast

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calls for three interest rate increases in 2017, but the market—again—remains skeptical. At the end of 2016, the market was pricing an approximately 44% chance that the Fed will increase rates at least three times in the coming year.

As Brandes LP embarks on 2017, it doesn't have any forecasts to share, but it does have a number of observations and beliefs that will guide its thinking and investment decisions this year: 1) Brandes LP believes that market valuations remain stretched with yield spreads at or near the tight end of their range over the past decade on most taxable fixed-income asset classes; 2) Brandes LP believes many investors have stretched their risk tolerances in search of higher yields; 3) Brandes LP believes there is greater uncertainty in the market than years past; 4) Brandes LP believes there is also likely to be diminished central bank support as the Fed continues to slowly unwind its historically unprecedented monetary policy; and 5) Brandes LP believes that the combination of tight yield spreads, increased uncertainty and diminished central-bank influence should benefit thoughtful, disciplined and active portfolio management.

Entering this New Year, Brandes LP believes the Fund is defensively positioned across a number of different metrics. Brandes LP favours short-maturity corporate bonds and corporate bonds that exhibit strong, tangible asset coverage in its view. Brandes LP is managing duration towards the shorter end of the Fund's duration controlled range. Brandes LP has a higher allocation to U.S. Treasuries that we will look to redeploy thoughtfully and efficiently—if and when market uncertainty and volatility cause credit fundamentals to become mispriced from Brandes LP's estimates of intrinsic value.

About Brandes LP

In the 40-plus years since Brandes LP was founded, its goal has remained the same: pursue above-market gains to help investors move closer to their long-term investment objectives. Brandes LP believes that its unwavering commitment to value investing will lead it to attractively priced, fundamentally sound companies worthy of inclusion in the Fund.

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Fundamentals

	FUND	INDEX
Average Quality	BBB	BBB
Average Maturity	6.33	4.78
Average Duration	3.43	4.26
Average Coupon	4.23%	3.40%
Average Price	$ 101.88	$ 102.14
Average Yield to Maturity	3.33%	2.72%
Current Yield	4.39%	3.34%

	FUND	INDEX
AAA (includes cash)	26.6	12
AA	5.28	12.5
A	16.32	33.4
BBB	24.63	42
<BBB	27.16	0

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Quarterly Additions/Deletions

Additions
Cloud Peak Enrgy Res Fin 12.00% Nov 01/21
Chesapeake Energy Corp 6.125% Feb 15/21
AT&T Inc 3.00% Jun 30/22
BP Capital Markets PLC 2.241% Sep 26/18
Bank of America Corp 6.875% Nov 15/18
Transocean Inc 4.25% Oct 15/17

Deletions
Cloud Peak Enrgy Res Fin 8.50% Dec 15/19
S&P Global Inc 5.90% Nov 15/17
USG Corp. 6.3% Nov 15/16
Pitney Bowes Inc.
Thompson Creek Metals Co 9.75% Dec 01/17
Chesapeake Energy Corp 6.625% Aug 15/20
Anadarko Petroleum Corp. 6.375% Sep 15/17
Clearwire Communications 14.75% Dec 01/16

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