BRANDES INVESTMENT PARTNERS

Brandes Quarterly Letter: As Markets Rise, Resisting Status-Quo Bias

FOURTH QUARTER 2017

Dear Clients and Friends,

As we pen this letter in the middle of December, stock markets around the world seem to be reaching new highs almost daily. The S&P 500 Index was up 19% in 2017, and the MSCI EAFE Index, which measures the major international equity markets, was up 25% (as of 12/31/2017). While many investors are undoubtedly happy to see positive absolute returns in their brokerage statements, we are worried that the recent strong performance may be lulling some into a false sense of security and causing them to exhibit *status-quo bias*.

Status-quo bias, also called *regret-avoidance bias*, is a concept based on research conducted by Daniel Kahneman and Amos Tversky, in which they observed that “people feel greater regret for bad outcomes that result from new actions taken than for bad consequences that are the consequence of inaction.”[1]

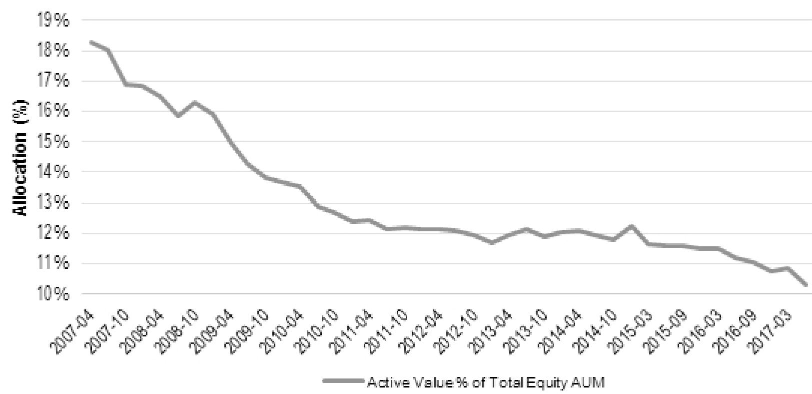
As we travel the world meeting with current and prospective clients, we often have conversations about how active management and value investing have recently done poorly and what needs to happen for this to change. Many appreciate that we are likely at a frothy point of the cycle in most markets as measured by traditional valuations. However, we fear that many are becoming biased in sticking to the status quo and are unable or unwilling to reposition portfolios for what the future may hold.

We have written in previous letters about high valuations, the impact of central bank manipulation of interest rates and general complacency when there is little volatility and markets appear only to go up. None of these concerns have abated. We believe it’s only a matter of time until the benefits of active management become apparent and value stocks start to outperform their growth counterparts again. Of course, what we cannot tell you is exactly when this will happen. While valuations tend to be good predictors of long-term returns, they are rarely accurate for forecasting short-term performance.

Nonetheless, a number of business publications have hypothesized on what may cause a narrowing in the wide dispersion that has developed between so-called growth and value stocks. A recent *Wall Street Journal* article points to a number of potential catalysts that could trigger a change in the value-growth performance cycle, among them being when “over-hyped stocks get too expensive and cheap stocks get too cheap.”[2]

The chart below illustrates the difficult environment. Ten years ago, U.S. investors had 18% of their portfolios allocated to active value equity management. This has fallen by $1 trillion to just over 10% today. We have observed similar trends in non-U.S. markets.

Exhibit 1: Investors Have Less in Value



June 30, 2007 to June 30, 2017 | Source: Morningstar. Active Value represented by Morningstar US open end & ETF and Separate Account & CIT value universes for US and International Equity.

Despite the headwinds, we will continue to beat the drum for active value management. We encourage investors to remember the importance of portfolio rebalancing and to be aware of the potential for status-quo and regret-avoidance biases.

While we are surprised that the current cycle of value-stock underperformance has lasted so long, we are mindful that cycles can both last longer and turn quicker than most people expect—quite possibly when they least expect it. Those of us who recall the peak of the tech bubble in early 2000 may view the market’s subsequent decline at that time as a reminder of how failing to adhere to long-term strategic asset-allocation targets can significantly hurt investors’ financial goals. As we move into the new year, we encourage investors to revisit their equity allocations, particularly as they relate to potential growth vs. value biases, and make sure their portfolios are positioned appropriately for what 2018 has in store.

We thank you for your continued confidence in Brandes and wish you a happy new year.

Regards,

Brandes Investment Partners

[1] “The Psychology of Preferences” by Daniel Kahneman and Amos Tversky, *Scientific American*, 1982. Source: https://www.behavioraleconomics.com/mini-encyclopedia-of-be/status-quo-bias/ Kahneman and Tversky are considered the fathers of behavioral economics/finance. Since their initial collaborations in the late 1960s, they have published about 200 works, most of which relate to psychological concepts with implications for behavioral finance. In 2002, Kahneman received the Nobel Memorial Prize in Economic Sciences for his contributions to the study of rationality in economics. Source: https://www.investopedia.com/university/behavioral_finance/behavioral2.asp?ad=dirN&qo=investopediaSiteSearch&qsrc=0&o=40186

[2] *The Wall Street Journal,* “Investors Finding Little Value in Value Stocks, So Watch for the Rebound,” Nov. 28, 2017

The MSCI EAFE Index with net dividends captures large and mid cap representation of developed market countries excluding the U.S. and Canada. MSCI has not approved, reviewed or produced this report, makes no express or implied warranties or representations and is not liable whatsoever for any data in the report. You may not redistribute the MSCI data or use it as a basis for other indices or investment products.

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.

Past performance is not a guarantee of future results. One cannot invest directly in an index. No investment strategy can assure a profit or protect against loss. The information provided in this material should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any security transactions, holdings or sectors discussed were or will be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance discussed herein. Strategies discussed are subject to change at any time by the investment manager in its discretion due to market conditions or opportunities. International and emerging markets investing is subject to certain risks such as currency fluctuation and social and political changes; such risks may result in greater share price volatility. The Brandes investment approach tends to result in portfolios that are materially different than their benchmarks with regard to characteristics such as risk, volatility, diversification, and concentration. Market conditions may impact performance. International and emerging markets investing is subject to certain risks such as currency fluctuation and social and political changes; such risks may result in greater share price volatility.