

Brandes Global Small Cap Equity Fund

Fund Commentary

During the quarter, the Brandes Global Small Cap Equity Fund underperformed its benchmark, the S&P Developed SmallCap Index.

Positive Contributors

Select holdings in the real estate and energy sectors were strong contributors to performance. Mexican real estate investment trusts (REITs) Fibra Uno and Fibra Macquarie Mexico lifted returns. These income-oriented securities benefited from the U.S. Federal Reserve's hints that there may be no interest rate hikes in 2019. Oil and gas company World Fuel Services rose over 30% on strong fourth quarter earnings and continued cost improvement.

A number of our consumer staples holdings also aided returns, specifically South Korean beverage manufacturer Lotte Chilsung, U.S.-based Edgewell Personal Care, and Irish cider company C&C Group, which continued to make operational improvements.

Other strong performers included U.K.-based facilities management firm Mitie Group and U.S. biotechnology company PDL BioPharma. Mitie remained on track in its long-term transformation plans, as indicated by its organic revenue growth and reduction in total leverage.

Performance Detractors

While most of the Fund's consumer staples businesses performed well, J Sainsbury was a notable outlier. The U.K. grocer declined amid worry that its planned merger with Asda may not proceed due to regulatory concerns. To assuage these concerns, Sainsbury announced further price-cut commitments in late March. Brandes LP supports the merger and believes it would benefit the company and the entire U.K. food retail market, thus Brandes LP increased its estimate of the company's intrinsic value. Even if the merger does not materialize, Brandes LP believes Sainsbury offers an appealing risk/reward tradeoff given its restructuring program and the upside potential from food price inflation. Brandes LP took advantage of what it viewed as a market overreaction to the merger update by increasing its position.

Holdings in Canada also detracted from returns, most notably mini-conglomerate Dorel Industries. Dorel continued to face weakness in its sports and juvenile products divisions. Additionally, the company recorded a \$500 million impairment loss on goodwill, intangible assets and PP&E (property, plant and equipment). As Brandes LP has noted in the past, while mismanagement has been an issue for Dorel, it does not believe the market is giving enough credit

for the size, quality and diversity of the company's brand portfolio.

Other poor performers included Brazil-based jet manufacturer Embraer, U.S. machinery company Briggs & Stratton, Indian electric utility Reliance Infrastructure and Ireland's Avadel Pharmaceuticals.

Embraer has received sign-off for its deal with Boeing from most of the required stakeholders, including the Brazilian government and shareholders. The deal is expected to close by the end of this year, assuming anti-trust regulators approve. Embraer's shares declined as the company missed revenue and net income forecasts. Nevertheless, Brandes LP's valuation thesis remains positive. Brandes LP views the deal favourably as it crystallizes the value of Embraer's commercial segment ahead of any need for a regional jet volume recovery, partially mitigating the risks related to the capital expenditure cycle of airlines (Embraer's customers). The deal also offsets the competitive threat from Airbus/Bombardier and provides a closer relationship with Boeing, which Brandes LP believes creates an upside potential for Embraer's defense and business jet segments.

Avadel Pharmaceuticals announced that it was shutting down commercialization efforts for its drug Noctiva and restructuring to focus on its sodium oxybate phase III

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Brandes Global Small Cap Equity Fund

clinical trial. Marketed for the treatment of urine overproduction at night, Noctiva was never able to gain traction commercially. The Fund continues to maintain an allocation to Avadel given its cash flow-generating portfolio of injectable products and the option value of the clinical trial.

Select Buy & Sell Activity

The Small-Cap investment committee initiated a position in U.K.-based defense contractor Chemring Group (CHG), U.S.-based communication equipment company Netgear Inc. and Italian luxury eyewear manufacturer Safilo Group.

Founded in 1905, CHG derives the majority of its sales (93% of 2017 revenue) from the defense sector, with space (5%) and commercial (2%) making up the remainder. Even though headquartered in the United Kingdom, CHG's largest market is the United States (48% of 2017 sales), followed by the Middle East (20%), the United Kingdom (16%), the Asia Pacific region and other European countries. The company operates in three product segments: pyrotechnics, countermeasures, and sensors and electronics.

CHG grew rapidly in the 2000s through an aggressive mergers and acquisitions (M&A) strategy. During this period, the company's valuation multiples quickly expanded as the market was captivated by a charismatic chief executive officer (CEO) and his ambitious M&A pursuits that boosted margins and generated appealing returns on

invested capital. However, sentiment swiftly soured after the United States disengaged from its almost decade-long military operations in Afghanistan and Iraq. Rather than being a diversified defense company that could withstand a large retrenchment in U.S. combat spending, CHG suffered when demand for its main product segment was cut in half, driving its operating margin to fall from about 25% of revenue to single digits. Moreover, the M&A legacy left CHG with a high debt burden that became more problematic as profits deteriorated. Since the company's fundamentals peaked in 2011, CHG has halted its M&A activity, removed two CEOs and issued a dilutive rights offering that helped repair the balance sheet. Meanwhile, the stock price has tumbled by over 75%.

Post-retrenchment, Brandes LP believes CHG offers a reasonable valuation on what it sees as depressed fundamentals and is well positioned in a number of diverse, niche end-markets. The company has made commendable strides to improve its balance sheet and has generated attractive free cash flows, which—in Brandes LP's opinion—should improve with better working capital management and stronger demand. Additionally, Brandes LP sees a positive outlook from a potential enhancement in product diversification and operating leverage, as well as a stronger pricing environment. More recently, after years of budget declines, U.S. defense spending has been increasing, a trend that may benefit CHG.

The investment committee exited positions in U.S.-based health care distributor Owens & Minor, Brazilian electric utility Companhia Paranaense de Energia (Copel) and Japanese communication equipment business Denki Kogyo. Additionally, it divested India-based Reliance Infrastructure and Greece-based Grivalia Properties Real Estate Investment Company.

A number of recent developments led to a reconsideration of Brandes LP's investment thesis for Reliance Infrastructure and to the Fund's eventual divestment. Most notably, Reliance sold its Mumbai utility to Adani Transmission during the second half of 2018. The utility had been Reliance's main earnings contributor and was sold to pay down debt. Prior to the sale, Brandes LP's investment case for Reliance Infrastructure was supported by the valuation of its electricity assets, including its stake in publicly listed Reliance Power. Brandes LP also anticipated some upside potential from its significant balance of financial assets. However, the disposal of the Mumbai utility meaningfully reduced Reliance Infrastructure's earnings power and led to a deterioration in the quality of its net asset value, which now consists primarily of financial holdings and contingent assets.

Furthermore, the company went into technical default on a small portion of its debt for a few weeks until it received the proceeds from the utility sale, raising immediate concerns about the liquidity and recoverability of its remaining

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Brandes Global Small Cap Equity Fund

financial assets. Brandes LP's loss of confidence in the company, combined with its poor transparency, triggered the investment committee's decision to exit the position.

Grivalia Properties has been undergoing a merger with Eurobank and its share price appreciated significantly during the quarter. Given the potentially increased risk of the new merged entity and the strong share-price performance, Brandes LP decided to divest its position.

Current Positioning

The Fund's positioning has been relatively unchanged in the last three months. Key exposures remained in Japan and the United Kingdom. Brandes LP also continues to see tremendous value opportunities in emerging markets, which accounted for over 20% of the Fund at quarter end, with holdings in Mexico representing the largest emerging country weighting. The Fund's emerging markets holdings largely comprise conservatively financed businesses that tend to have less economically sensitive cash flow streams, such as those in the consumer staples, communication services and utilities sectors, as well as REITs.

The Fund remained materially underweight to the United States. The Fund maintained a notable overweight in consumer staples and key underweights in more cyclical sectors, specifically financials and materials. With heightened volatility in the fourth quarter of 2018, Brandes LP had started to see opportunities in more cyclical

companies, even adding a few to the portfolio. However, this trend dissipated with the strong run of performance (and expanding valuations) for these sectors so far this year. Information technology and health care are significant underweights as well.

The investment committee is sharply focused on capital preservation and optimizing risk/reward tradeoff in the context of what it considers an expensive market that is late in the business cycle. Brandes LP is confident that its patient and price-disciplined approach is the best way to help clients pursue appealing long-term returns. As of March 31, the Fund continued to have attractive valuation characteristics, in Brandes LP's opinion, trading at 11x earnings and 77% of book value, while offering a 3.0% dividend yield.

There remains significant uncertainty in the global investing environment, whether from trade disputes, the path of interest rates, political concerns, or most recently a lack of clarity with the ongoing Brexit decision. Brandes LP claims no crystal ball to know exactly when and how these uncertainties will resolve themselves, but it believes that in a free market, businesses can adapt. As an active value manager, Brandes LP views market uncertainty positively as it often helps create attractive investment opportunities due to short-term market overreaction.

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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Contribution Analysis (relative to benchmark)

LAST QUARTER

INDUSTRY			
Top 5 Contributors		Top 5 Detractors	
	%		%
Beverages	0.65	Aerospace & Defense	-0.94
Oil, Gas & Consumable Fuels	0.59	Software	-0.94
Personal Products	0.52	Machinery	-0.69
Real Estate Mgmt & Development	0.31	Banks	-0.59
Food Products	0.15	Health Care Equip. & Supplies	-0.57

COUNTRY			
Top 5 Contributors		Top 5 Detractors	
	%		%
Mexico	0.86	United States	-5.71
Japan	0.33	Canada	-1.06
China	0.25	Brazil	-0.49
Ireland	0.13	Germany	-0.49
Philippines	0.12	Switzerland	-0.31

COMPANY			
Top 5 Contributors		Top 5 Detractors	
	%		%
Fibra Uno Admin. SA ORD	0.70	Embraer S.A.	-0.73
World Fuel Services Corp	0.61	Dorel Industries Inc. Cl. B	-0.47
Edgewell Personal Care Co.	0.52	Briggs & Stratton Corp.	-0.35
MITIE Group PLC	0.51	J Sainsbury plc	-0.29
C&C Group Plc	0.45	Avadel Pharmaceuticals Spon ADR	-0.28

LAST 12 MONTHS

INDUSTRY			
Top 5 Contributors		Top 5 Detractors	
	%		%
Oil, Gas & Consumable Fuels	1.13	Household Durables	-1.90
Specialty Retail	0.88	Health Care Equip. & Supplies	-1.56
Beverages	0.82	Real Estate Mgmt & Development	-1.31
Leisure Products	0.34	Multiline Retail	-1.19
Chemicals	0.32	Equity Real Estate Inv. Trusts (REITs)	-1.10

COUNTRY			
Top 5 Contributors		Top 5 Detractors	
	%		%
Japan	0.56	United States	-4.39
France	0.32	United Kingdom	-2.77
Belgium	0.16	Canada	-2.02
Mexico	0.15	Germany	-0.76
Philippines	0.15	India	-0.67

COMPANY			
Top 5 Contributors		Top 5 Detractors	
	%		%
Rent-A-Center Inc.	0.86	Countrywide PLC	-1.34
World Fuel Services Corp	0.67	Dorel Industries Inc. Cl. B	-1.24
C&C Group Plc	0.61	Debenhams PLC ORD	-1.20
PDL BioPharma, Inc.	0.55	Briggs & Stratton Corp.	-1.18
Fibra Uno Admin. SA ORD	0.46	Avadel Pharmaceuticals Spon ADR	-0.95

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Quarterly Additions/Deletions

Additions	Deletions
Chemring Group	Grivalia Properties REIT
Netgear	Reliance Infrastructure
Safilo Group	Denki Kogyo
	Owens & Minor
	Companhia Paranaense de Energia
	Beazer Homes USA

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Published April 25, 2019

