Brandes U.S. Equity Fund

Fund Commentary

In the third quarter, the Brandes U.S. Equity Fund underperformed its benchmark, the S&P 500 Index.

Positive Contributors

Notable contributors included several health care holdings, led by pharmaceutical firms Pfizer and Merck, hospital operator HCA Healthcare and pharmacy benefit manager Express Scripts.

Pfizer's stock price increased on improved results from its drug pipeline and increasing market optimism about future medications. Despite its noteworthy appreciation during the period, the stock trades at only 12x earnings. Merck also realized strong results and benefited from growing optimism about its pharmaceutical pipeline; several of its cancer and HIV treatments received new use approvals in the United States, China and Europe.

HCA Healthcare rose after reporting strong earnings results from patient and revenue growth that exceeded market expectations.

Express Scripts' share price grew after its proposed acquisition by health insurer Cigna passed an antitrust review by the U.S. Justice Department; the company expects the deal will close by the end of 2018.

Other contributors included electronic manufacturing service company Fabrinet and fuel distributor World Fuel Services; both rose after posting strong earnings results.

Performance Detractors

The most obvious detractors from performance were the Fund's holdings in the financial sector, primarily trust banks State Street and Bank of New York Mellon, as well as Wells Fargo. State Street's share price declined after the company announced its intention to acquire investment data and analytics software firm Charles River Systems. While the acquisition was considered fairly expensive in Brandes LP's opinion, it believes the market overreacted in the short term as the purchase largely makes sense from a long-term strategic viewpoint.

Wells Fargo reported an improved net interest margin, but earnings fell short due to a one-time tax expense and a reduction in loan volume.

Other detractors included ad agency Omnicom Group, homebuilder Taylor Morrison and media company Twenty-First Century Fox. Along with other global ad agencies, Omnicom's stock was lower amid concerns around slowing growth. Twenty-First Century Fox's stock price was reduced after the bidding war between Disney and Comcast ended at the beginning of the quarter when Comcast bowed out after Disney's $71-billion bid in June.

Select Buy & Sell Activity

In a fairly light quarter for portfolio activity, the investment committee took a new position in Johnson Controls, a leading global supplier of heating, ventilation and air conditioning (HVAC), fire and security products and services, as well as automotive batteries. There were no full sells.

Brandes LP reviewed Johnson Controls as the stock had underperformed the market noticeably over the last three years, declining to what now seems to be an attractive valuation at just 12x forward earnings. The company appears well-positioned in most of its end markets but seems to have been run inefficiently.

The market has apparently taken a negative view since Johnson Controls' late 2016 merger with Tyco because the combined entity is still trying to achieve synergies to improve its margins and bring them closer to its peers. Additionally, the market seems fixated on the potential long-term threat of electric vehicles to the company's traditional car battery business. Brandes LP agrees this transition will have a negative long-term impact for Johnson Controls

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because there is little to no need for traditional car batteries in electric vehicles which means less revenue and profit, while future technological development and competition is uncertain. However, Brandes LP thinks the market is punishing the company excessively in the short term since most of its revenue relates to after market battery replacement, which is sustained by the one billion-plus combustion-engine vehicles now operating globally. It will likely take decades before most vehicles in operation are electric and after market replacement battery sales begin to fall off.

While the company's HVAC business has lost some market share during the past few years, newly released products should likely help it gain some back. Overall, Brandes LP thinks this is a well-positioned business that trades at an attractive valuation with upside potential from integrating the Tyco acquisition and improving its margins through cost synergies.

The Fund also acquired two floating rate preferred securities, from Goldman Sachs and Morgan Stanley. These securities offer a floating rate dividend of 4% and trade at a discount to par value at quarter end, delivering attractive income in a rising rate environment.

Current Positioning

In Brandes LP's view, the Brandes U.S. Equity Fund exhibited more attractive valuations than the S&P 500 Index at quarter end.

As of September 30, the Fund's largest relative overweight positions were in the financials and health care sectors. The most obvious underweight positions were in technology, industrials, as well as consumer staples and discretionary sectors.

At quarter end, the planned Global Industry Classification Standard (GICS) sector reclassifications occurred. GICS created the newly termed "communications services sector" (formerly "telecommunication services") and changed some company categorizations, primarily in the technology and consumer discretionary sectors.

As a bottom-up fundamental manager, this recalibration had no direct effect on Brandes LP's portfolios. However, it has altered some of Brandes LP's key underweights relative to its benchmark. With the reclassification of Brandes LP's entertainment and media holdings into the communication services sector, its portfolios are now materially underweight in consumer discretionary companies.

While the consumer discretionary sector accounts for over 10% of the S&P 500, it is mostly driven by Amazon. The company accounts for about one-third of the sector weight and together with the technology sector, the consumer discretionary sector is up more than 20% year-to-date. The Fund continues to be relatively underweight compared to the technology sector, although this situation has decreased slightly as technology now accounts for 21% of the S&P 500; previously, it was over 25%. In the new communication services sector, the Fund's holdings are about equal with the S&P 500, where this sector accounts for 10% of the index. The Fund remains underweight in diversified telecommunications and overweight in the media industry.

Market dynamics constantly present challenges and opportunities. This is why Brandes LP adheres to a disciplined process of stock selection based on fundamental, detailed research. Brandes LP anchors its allocation decisions in a bottom-up investment approach that seeks the most promising return. Brandes LP is always focused on company valuations and margin of safety because it believes this is the prudent approach to pursue growth for your assets over the long term.

Brandes LP believes the current positioning of the Brandes U.S. Equity Fund bodes well for the long term.

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	%
Health Care Prov. & Services	1.23	Tech. Hardware, Storage & Periph.	-0.80
Pharmaceuticals	0.72	Media	-0.58
Elect. Equip., Instr. & Components	0.54	IT Services	-0.47
Oil, Gas & Consumable Fuels	0.41	Internet & Direct Marketing Retail	-0.41
Internet Software & Services	0.33	Health Care Equip. & Supplies	-0.35

COMPANY

Top 5 Contributors	%	Top 5 Detractors	%
HCA Healthcare Inc	0.66	Omnicom Group	-0.35
Express Scripts Holding Co	0.61	Microsoft Corp.	-0.26
Pfizer Inc.	0.53	Taylor Morrison Home Corp. Class A	-0.23
Fabrinet	0.50	State Street Corporation	-0.21
World Fuel Services Corp	0.43	Bank of New York Mellon Corp.	-0.16

LAST 12 MONTHS

INDUSTRY

Top 5 Contributors	%	Top 5 Detractors	%
Health Care Prov. & Services	2.03	Internet & Direct Marketing Retail	-2.51
Elect. Equip., Instr. & Components	1.39	Tech. Hardware, Storage & Periph.	-1.95
Media	1.19	Software	-1.25
Pharmaceuticals	1.16	IT Services	-1.13
Banks	0.87	Semicond. & Semicond. Equip.	-1.07

COMPANY

Top 5 Contributors	%	Top 5 Detractors	%
Express Scripts Holding Co	1.39	Microsoft Corp.	-0.54
HCA Healthcare Inc	1.35	Briggs & Stratton Corp.	-0.35
Fabrinet	1.06	McKesson Corp	-0.34
Pfizer Inc.	0.79	Taylor Morrison Home Corp. Class A	-0.29
Advance Auto Parts, Inc.	0.76	World Fuel Services Corp	-0.25

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Quarterly Additions/Deletions

Additions	Deletions
Johnson Controls International plc	
Morgan Stanley	
Goldman Sachs	

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