

Brandes U.S. Small Cap Equity Fund

Fund Commentary

During the quarter, the Brandes U.S. Small Cap Equity Fund underperformed its benchmark, the MSCI USA Small Cap Index.

Positive Contributors

Investments in the health care, energy and real estate sectors were strong contributors.

PDL Biopharma's shares advanced on its share buyback program and its launch of an authorized generic for Tekturna, a medication commonly used to treat hypertension (high blood pressure). Invacare rebounded sharply on renewed optimism in response to issuing its guidance (provided for the first time since its consent decree), and progress made in its multi-year restructuring plan. Eagle Pharmaceuticals also delivered positive returns.

In the energy sector, oil and gas company World Fuel Services rose over 30% after announcing strong fourth quarter 2018 earnings; it continues to improve its cost structure. Companies in the real estate sector, St. Joe Company and Alexander & Baldwin also delivered positive results. Other strong performers included Edgewell Personal Care Co. and electronic equipment company Avnet.

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Performance Detractors

While most of the Fund's health care holdings performed well, Avadel Pharmaceuticals and distributor Owens & Minor were notable detractors.

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

Other detractors included the consumer discretionary and industrials sectors, namely mini-conglomerate Dorel Industries, machinery company Briggs & Stratton, and construction and engineering business Orion Group Holdings.

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 noted in the past, while mismanagement has been an issue for Dorel, Brandes LP does not believe the market is giving enough

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

Information technology companies, mainly Arlo Technologies, Netgear and Sierra Wireless, performed poorly, and the Fund's underweight investment in the sector had a negative impact on relative returns as well.

Select Buy & Sell Activity

The Small-Cap Investment Committee bought regional jet manufacturer Embraer, Arlo Technologies and Avista Corporation.

Embraer is a company Brandes LP knows well, having owned it many times in the past in various portfolios. It is also a cross-holding within other funds. The company is undergoing a commercial joint venture with Boeing on its commercial aerospace assets. The deal values the commercial assets at \$4.75 billion, and Embraer will retain full control of its business jet and defense divisions.

Embraer has received signoff for its deal with Boeing from most 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 it. Brandes LP views the deal favourably as it crystalizes the value of Embraer's commercial segment ahead of any need for regional jet volume recovery, partially



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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 upside potential for Embraer's defense and business jet segments. However, the market reaction has been much more negative, creating a favourable risk/reward tradeoff.

Avista Corp. is an electric and natural gas utility with two reportable segments. Avista Utilities (95% of net income) comprises regulated electric and gas utility operations in the Pacific Northwest (WA, ID, OR and MT), while Alaska Electric Light & Power (5% of net income) is a regulated electric utility in Juneau, Alaska. Brandes LP believes the company is undervalued. At quarter end, Avista traded at a 15% discount to peers on forward earnings and exhibited a price-to-book ratio that was among the industry's lowest. Near-term earnings multiples are comparable to those of similar entities, but Brandes LP believes Avista is earning less than its potential. Brandes LP also believes Avista can improve its return on equity over the medium term, much more in line with the company's operating history.

Notable sales included healthcare distributor Owens & Minor, bank Popular, Inc., insurer American National Insurance Company and pharmaceutical firm Taro Pharmaceutical Industries.

Current Positioning

Other than a swift reversal in the final quarter of 2018, market performance has been surprisingly positive — especially since we're in the later stages of the business cycle when returns typically taper off. On further analysis, Brandes LP found the increase was driven largely by an expansion of multiples in an already-expensive market, rather than from improving fundamentals. As of March 31, margins and the enterprise value-to-sales ratio for the index were near all-time highs. This implies that bloated investor optimism has inflated the prices of many businesses beyond what Brandes LP deems fair values.

Cash levels increased in recent years as it became more challenging to find new investments in an overheated market. Nevertheless, Brandes LP believes pockets of small-cap value remain for discovery. Over the short term in a momentum-driven market, the Fund's conservative positioning may impede results versus the benchmark. However, Brandes LP believes its disciplined, bottom-up stock selection bodes well for the long run. The Fund's cash will enable the investment committee to seize opportunities when volatility increases or the business cycle inevitably turns.

Given the relatively light portfolio activity in the quarter, there has been little change in the Fund's key exposures.

Brandes LP continued to find significant value potential in consumer sectors, both staples and discretionary, offset by a considerable underweight to financials. As patient and price-sensitive value investors with considerable experience navigating portfolios over multiple cycles, Brandes LP remains confident in the prospects of its holdings and the risk/reward tradeoff the Fund offers.

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		INDUSTRY	
Top 5 Contributors	%	Top 5 Detractors	%
Oil, Gas & Consumable Fuels	1.14	Software	-1.14
Personal Products	0.67	Machinery	-0.90
Real Estate Mgmt & Development	0.56	Equity Real Estate Inv. Trusts (REITs)	-0.70
Professional Services	0.26	Construction & Engineering	-0.66
Biotechnology	0.26	Pharmaceuticals	-0.63

COMPANY		COMPANY	
Top 5 Contributors	%	Top 5 Detractors	%
PDL BioPharma, Inc.	0.99	Dorel Industries Inc. Cl. B	-0.64
World Fuel Services Corp	0.98	Avadel Pharmaceuticals Spon ADR	-0.54
The St. Joe Co.	0.67	Orion Marine Group Inc.	-0.53
Edgewell Personal Care Co.	0.65	Arlo Technologies, Inc.	-0.52
Eagle Pharmaceuticals, Inc.	0.57	Briggs & Stratton Corp.	-0.48

LAST 12 MONTHS

INDUSTRY		INDUSTRY	
Top 5 Contributors	%	Top 5 Detractors	%
Biotechnology	2.94	Household Durables	-2.99
Specialty Retail	1.73	Machinery	-1.89
Oil, Gas & Consumable Fuels	1.21	Health Care Prov. & Services	-1.74
Banks	1.02	Software	-1.48
Capital Markets	0.51	Health Care Equip. & Supplies	-1.32

COMPANY		COMPANY	
Top 5 Contributors	%	Top 5 Detractors	%
Rent-A-Center Inc.	1.80	Briggs & Stratton Corp.	-2.08
PDL BioPharma, Inc.	1.56	Owens & Minor Inc	-1.95
OPKO Health, Inc.	1.23	Avadel Pharmaceuticals Spon ADR	-1.83
Fabrinet	0.79	Dorel Industries Inc. Cl. B	-1.63
Evertec Inc	0.73	CSS Industries Inc	-1.31

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Quarterly Additions/Deletions

Additions	Deletions
Arlo Technologies Inc	Popular Inc.
Embraer S.A. ADR	American National Insurance Co.
Avista Corporation	Taro Pharmaceutical Ind. Ltd.
	Owens & Minor Inc

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