BRANDES
INVESTMENT PARTNERS
COMMEMORATING 35 YEARS

Value Investing: Warts and All

11988 El Camino Real | Suite 500 | P.O. Box 919048 | San Diego, CA 92191-9048 | 858.755.0239 | 800.237.7119 | Fax 858.755.0916 | info@brandes.com | www.brandes.com

In recent years, several companies held in our portfolios filed for bankruptcy. Despite their generally small weightings within our portfolios, the "headline notoriety" associated with these firms has caused trepidation among some of our clients.

Note that our investment process hasn't changed. We have had failures before – and we will have failures in the future. One of the notable differences in recent years is that these failures have involved securities of U.S. companies. Thus, these are firms with which our clients may be familiar – or may have read about in the financial press. In the past, comparable failures typically occurred among non-U.S. firms. These companies were just as "ugly," or had just as many unsightly "warts," but U.S.-based clients often were less familiar with them. They typically didn't hear about them in the media and tended not to have strong, personal convictions about them.

Our willingness to include out-of-favor businesses in our portfolios has long been a part of our investment strategy. In the past, we have held U.S. companies that were "distressed," but later recovered. Although these companies traded below our estimates of their fair values, one of them could have failed with small changes in the broader environment. Were we to change our process to avoid these potential failures, our ability to provide long-term excess returns potentially would diminish.

The risk of business failure or bankruptcy, unfortunately, is inherent in our approach. Businesses often are least attractive to the market and their share prices the most depressed at the bottom of their business cycle, when their prospects look the worst. Value investors search among depressed businesses for what they believe to be underappreciated opportunities with the potential for recovery. As changes in expectations about future prospects are factored in a company's share price movements, small improvements in conditions can cause improvement in share price as fears subside. Conversely, eroding conditions can bring consequences. We recognize the potential for conditions to deteriorate. As a result, we broadly diversify holdings and tend to maintain small allocations to distressed holdings. Our goal is to mitigate adverse influences on the overall portfolios.

Keep in mind that where others see only risk, we may see risk and opportunity. We understand that risks can bring rewards. Often, when we are buying companies that are troubled, clients wonder why we would buy such "risky" firms. If these holdings don't work out, we run the risk of looking rather foolish. If, however, they do work out, clients often wonder why we didn't buy more! "If you knew the stock had so much upside," they ask, "why didn't you buy a bunch more?" Unfortunately, of course, we can't predict which companies will go on to stage a remarkable turnaround and which will go under. But we will take a calculated risk by investing in these opportunities when they present themselves. We believe such investments are essential to our process and long-term success.

As committed students of Benjamin Graham, widely regarded as the father of value investing, we often reflect on Graham's insights posited in his famous book, *The Intelligent Investor*. In the book, Graham states there are

two things investors must do to ". . . enjoy a reasonable chance for continued better than average results."[1] First, "the investor must follow policies that are inherently sound and promising." We equate that with buying companies that we believe to have significant margins of safety – or large differences between our estimations of the true business values and current stock prices. But Graham knew that wasn't enough. He added that investors must follow policies that "are not popular in Wall Street." This advice is echoed by Charles Brandes, founder of our firm, in his book, *Value Investing Today*: "Achieving better-than-average returns depends upon thinking and acting differently than the average market participant."[2]

Undervalued securities generally are not easy to find. They typically are not popular; nor are they comfortable to hold. They often are characterized by escalating bad news, controversy, and risk. The average investor may not think of purchasing them for his portfolio. But acting differently – purchasing what is out of favor and uncomfortable – is inherent to value investing. As Graham summed up in the final sentence of the final chapter in *The Intelligent Investor*, "To achieve satisfactory investment results is easier than most people realize; to achieve superior results is harder than it looks."[3]

When our portfolios experience unfavorable, short-term results, we are sometimes asked whether our process has changed. The answer is no. We retain strict adherence to our value investing principles and remain committed to our proven process. This process has consistently produced sound results over time.

We will stick to value investing – warts and all.

[1] Graham, Benjamin. *The Intelligent Investor: A Book of Practical Counsel.* 4th rev. ed. New York: Harper & Row. 1973. page 13.

[2] Brandes, Charles H. *Value Investing Today.* 3rd ed. New York: McGraw-Hill. 2004. page xi.

[3] Graham, Benjamin. *The Intelligent Investor: A Book of Practical Counsel.* 4th rev. ed. New York: Harper & Row. 1973. page 287.

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