

Corporate Credit: An Opportunity on a Global Scale

July 2009

Introduction

Bond markets have been driven to the forefront of many investors' consciousness recently. This unusual position for a historically conservative asset class is largely the result of unprecedented events in financial markets that emerged during 2008:

- distress in the mortgage and asset-backed sectors;
- the meltdown in liquidity in the corporate debt market in the second half of 2008 and the related dramatic widening in spreads;
- the concerns over counterparty risk and misuse in the Credit Default Swap ("CDS") market.

The first of these events was discussed in the Brandes Institute paper *Structured Products: Asset Backed Securities – Opportunities Resulting from Systematic Mispricing*¹. This study delves into the other two developments; we look at the increased perception of risk in the bond markets and, specifically, at how this may translate into both cyclical and secular opportunities for potential future returns.

This study has three sections:

- **Spreads.** An analysis of the current wide spreads in the corporate credit sector and of the potential returns if those spreads revert to their historical averages at some time in the next several years.
- **Global Opportunity and CDS Development.** An analysis of the current state of development in the CDS market and the risks inherent in these instruments, plus a perspective on how structural change may allow investors to benefit more easily from the underlying advantages of using CDS in a portfolio.
- **Importance of Income.** An analysis of income's contribution to total returns over extended periods and the current relevance for investors in terms of potential returns and risk reduction.

I. Spreads

The panic in credit markets in 2008 led to both a dramatic reduction in market liquidity and to the widening of the spreads between corporate bond yields and those of comparable maturity Treasury issues. The level of spread widening is unprecedented in recent financial history. Investment grade corporate spreads reached over 6% in late 2008, compared to their long-term average of 2% (between 1920 and 2008), according to Barclays Capital data. In addition, high yield (below investment grade) spreads exceeded 18%, compared to the average of 5.3% between 1994 and 2008 (as far back as data is available). Exhibits 1 and 2 show how the 2008 spread-widening compares with the most recent 10-year history.

Given recent spread widening, investors appear to be concerned with two particular scenarios:

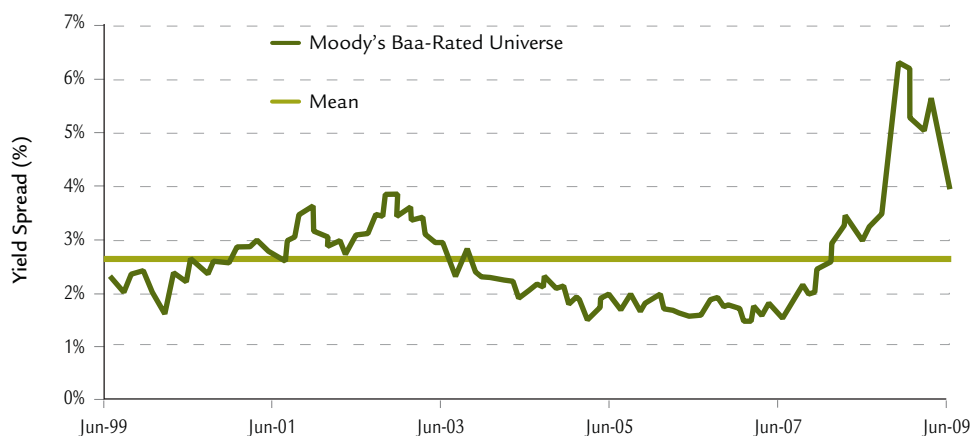
- If U.S. Treasury yields go back up, possibly due to increasing inflation or inflation expectations, then not only Treasuries, but also all bonds would likely fall in price.

¹ This paper was published in August 2008. Like all Brandes Institute research, it is available at www.brandes.com/institute.

- Corporate bond and other credit spreads are wide historically because the market is anticipating some of these bonds will default, and so eventual returns would be reduced.²

This section demonstrates that even if U.S. Treasury yields rise and some corporate bonds default (which should in fact be expected), credit spreads prevailing today are still wide enough, despite the narrowing since year-end, that we believe the opportunity to make excess returns over Treasuries is still compelling.

Exhibit 1: U.S. Corporate Investment Grade Bonds* Yield Spread to Treasuries
(6/30/99 – 6/30/09)**



* U.S. investment-grade corporate bonds are represented by the Moody's Baa-Rated universe, available via FactSet, using data provided by Thomson-Reuters and the Federal Reserve Board. This universe includes U.S. corporate bonds with a minimum Baa rating, as defined by Moody's. **Yield spread to Treasuries is the difference between the quoted yield of U.S. investment grade bonds to a comparable U.S. Treasury. Past performance is not a guarantee of future results. Source: FactSet; data as of 6/30/09.

² There are other concerns surrounding the fixed income markets, particularly in the United States. Some analysts argue that the appetite for U.S. Treasury bonds will wane due to a variety of issues: institutional investors reaching maximum weightings permitted by policy guidelines for this asset class; concerns about the U.S. Government maintaining its fiscal credibility and the AAA-rating on its debt; political considerations that may prompt non-U.S. countries to curtail their level of investment; the attractiveness of other, high quality debt securities; the impact of liability-driven investing programs; and the potential inflationary effects of recent U.S. Government spending programs. In addition to inflation and default expectations, there are related questions about the magnitude and timing of spread movements and global liquidity. For the purposes of this paper, we assume that U.S. Government bonds retain their AAA-status and do not default.

**Exhibit 2: U.S. Corporate High Yield Bonds Yield Spreads to Treasuries*
(6/30/99 – 6/30/09)**



*Yield spread to Treasuries is the difference between the quoted yield of a U.S. high yield corporate bond to a comparable U.S. Treasury. Past performance is not a guarantee of future results.

Source: FactSet; as of 6/30/09.

Such large spreads reflect market participants' concerns that these expected yields-to-maturity won't be achieved for many of the securities in these indices. Future defaults, with accompanying low recovery rates, appear factored into these market prices and would be expected to reduce future returns.

Higher-than-average defaults are probable in today's economic environment. Some investors have expressed concern that default rates could be as bad as in the Great Depression. For example, Moody's has estimated that speculative grade (i.e., high yield) default rates may reach 16% before year-end 2009, a level in excess of the 15.4% that marked the *peak* in the Great Depression.³ Leaving aside the point that today's market problems (and hence the likely outcomes) are different from the 1930s, the specter of "Depression pricing" is one that haunts a broad range of investors, and this may well contribute to their reluctance to move back into the market. A simple example can confirm that bond market participants are not just pricing in "Depression-level" defaults, but may be anticipating *higher* defaults than even occurred in that era.

The "Brandes Bond Calculator" is a spreadsheet that allows users to choose the number of years for their time horizon, input current spreads and the level to which users expect them to revert, and then calculate the hypothetical annualized return over that time horizon. This illustration uses the spreads as of June 30, 2009, and assumes a 3-year horizon for these spreads and the 10-year Treasury yield reverting to its long-term average. The illustration uses a portfolio with sector composition and corresponding yields-to-maturity equal to those in a hypothetical portfolio focused primarily on corporate bonds.⁴ See Exhibit 3. Note that while the illustration uses segment weightings and yields from an actual portfolio for this hypothetical example, the future returns do not include the potential for additional added-value that could result from active management over the subsequent period.

³ Moody's Refunding Risk and Needs for U.S. Speculative-Grade Corporate Issuers, 2009-2011.

⁴ The "hypothetical" portfolio is based on the Brandes Corporate Focus product. The Brandes Corporate Focus product invests primarily in corporate bonds, but may also invest in government and agency bonds, as well as mortgage and asset-backed securities. The strategy has a minimum average credit quality of BBB- and is benchmarked against the Barclays Capital U.S. Intermediate Credit Index.

Exhibit 3: Hypothetical Portfolio Characteristics

	Percentage of Total Portfolio	Weighted Average Yield to Maturity
High Yield	47.9%	14.5%
Investment Grade	47.5%	8.4%
Government Related	4.6%	2.5%
Total	100.0%	11.1%

This is a hypothetical example intended for illustrative purposes only. It does not reflect the performance of any particular investment. The effects of taxes and other investment expenses are not considered. Actual results will vary.

Source: Brandes Investment Partners, as of 6/30/09.

Exhibit 4 suggests that the bond market appears to be pricing in default levels that are even higher than Depression-era levels. The default levels assumed in Exhibit 4 are 1.5% for investment grade, and 15.4% for below-investment-grade securities. These are equal to the highest level ever reached in data going back to 1920. During the 1930s, the average default rates were 0.7% and 5.8% for investment grade and below-investment-grade with individual year highs of 1.5% and 15.4%, respectively. The comparison is not quite “apples-to-apples” for below-investment-grade since before the emergence of the high-yield sector in the 1980s, the below-investment-grade segment did not have the broad representation of issuers that it does now. As a result, it is likely that the average credit quality of that whole segment was somewhat nearer to investment grade than is the case now.

Exhibit 4: Hypothetical Bond Calculator Illustration – Current Environment and 3-Year Assumptions

	Current	Assumptions Over Three Years	
		Target	Annual Default Rate
10-Year U.S. Treasury Yield	3.5%	4.8%	0.0%
Investment Grade Spread vs. Treasuries	4.0%	2.3%	1.5%
Non-Investment Grade Spread vs. Treasuries	9.8%	5.4%	15.4%

This is a hypothetical example intended for illustrative purposes only. It does not reflect the performance of any particular investment. The effects of taxes and other investment expenses are not considered. Actual results will vary.

Source: Brandes Investment Partners, BondEdge, as of 6/30/09.

However, tilting the balance back toward conservatism, the bond calculator assumes that these default rates occur in *each* year over that 3-year timeframe. These default assumptions are therefore worse than actually occurred in the Great Depression, reflecting high default rates for an extended period. Even under the assumption of these conditions, the hypothetical portfolio still produces an annualized return of 3.8%, which is 1.7% ahead of 10-year U.S. Treasuries. See Exhibit 4A. This implies that current corporate bond yields are pricing in even worse default rates than the ones in this example.

**Exhibit 4A: Hypothetical Bond Calculator Illustration –
Annualized Returns Over A 3-Year Period Given Assumptions in Exhibit 4**

	Annualized Returns
Hypothetical Portfolio*	3.8%
Treasuries	2.1%
Difference	1.7%

* This is a hypothetical example intended for illustrative purposes only. It does not reflect the performance of any particular investment. The effects of taxes and other investment expenses are not considered. Actual results will vary. Source: Brandes Investment Partners, BondEdge, as of 6/30/09.

The next exercise is to test how high default levels would have to go in this scenario in order to eliminate any excess return over U.S. Treasuries. For the same hypothetical portfolio, over the same 3-year horizon, default rates would have to climb to 2.0% and 19.0% for *each* of those three years for investment grade and below-investment-grade, respectively, for the simulated returns from that portfolio to drop just below returns for U.S. Treasuries.

To summarize, current credit spreads are so wide that mean-reversion (or a return to “normal” as defined by long-term averages) over a 3-year horizon still may have the potential to produce returns that are both positive in absolute terms and that exceed the expected return on 10-year Treasuries.

II. Global Opportunity and CDS Development

Note that although the example above is based on U.S. bonds, this is a global opportunity, as corporate spreads have widened worldwide. To expand the opportunity set and increase diversification, there is a strong case to be made for looking globally, not just in the United States, and not just within the corporate sector, but among asset- and mortgage-backed securities, as well. However, for the purposes of this paper, we largely confine our comments to U.S. investors and the U.S. corporate sector.

For a U.S. investor, owning a global portfolio of non-government credit securities involves managing local interest rate risk and duration, currency risk, and the practical issues of custody and settlement in various jurisdictions. If the goal is primarily to take advantage of opportunities in credit spreads (either the current wide spreads or through ongoing, issue-specific credit analysis), then there may be a simpler way that avoids many of the elements described above.

That approach would be to use CDS. The CDS market has been castigated in the media as being either the cause, or at least a symptom, of the current financial meltdown. For the sake of clarity (and sanity), it is important to set out first what is a CDS instrument and then examine the rewards and risks of using these.

Simply put, a CDS is a contract that allows one party to trade the credit risk (i.e., risk of default) of an issuer (such as a corporation) with another party. So an insurance company in the business of providing credit insurance would be one natural user of CDS contracts. In market terminology, the party that takes on the credit risk is “selling protection” to the other party. Put another way, the CDS market is like the futures market in which every open contract has two sides, a buyer and seller.

What makes CDS an interesting alternative to the corporate cash bond market is that a corporate bond essentially has two components. One component is a “cash bond” with maturity and duration characteristics and a coupon equivalent to the risk-free government rate (i.e., a Treasury bond with no default risk). The other component is the option-adjusted credit spread over that risk-free rate. That second component is broadly equivalent to “selling protection” on that issuer through a CDS contract. So a corporate bond can largely be replicated by owning a Treasury bond of equivalent duration plus selling protection via a CDS on that issuer. (We use “largely,” not “completely,” because a CDS instrument itself has duration, so the combination with a Treasury bond will modify somewhat the duration of the combination).

Why is this of interest? Because if the investment strategy is to isolate and take advantage of opportunities in credit spreads, as opposed to making decisions on yield curves, duration, currencies, or other macroeconomic factors, why not consider building a portfolio of CDS contracts to take advantage of specific opportunities on a global basis?

To understand why this straightforward and potentially effective tool has become tainted with the “toxic asset scandals,” some historical background may be useful. The CDS market had a notional size of around \$180 billion in 1997 (as reported by Moody’s in 2008). By 2007, the CDS market had grown to a very substantial \$62 trillion. By comparison, at the end of 2007, the market capitalization of the world equity markets as measured by the MSCI All-Countries World Index was \$32 trillion. Note that notional size of the CDS market is not the same as the capital at risk: with each contract “selling protection” there is an offsetting contract “buying protection.”

Moody’s estimated that at the end of 2007, the notional \$62 trillion CDS market had capital at risk (or “replacement value”) of \$2 trillion – admittedly smaller, but still a substantial amount. Moody’s analyst Alexander Yavorsky explained, “Unlike the cash bond market, in which credit losses result in a permanent loss of value, the CDS market, in its entirety, is a ‘closed system’ where the losses of one party ultimately equal the gains of another.”⁵

That point also illustrated the weakness of the CDS market, at least until now. Historically, there has been no central clearing system to absorb counterparty risk for CDS, and so each contract has been written on a one-to-one basis. For example, for the corporate credit investor mentioned previously, each CDS would have needed to be negotiated and written with a counterparty, typically an investment bank or insurance company. To the extent that a few counterparties dominated trading, there was substantial counterparty risk for investors separate from any investment risk that they had knowingly undertaken. In early 2008, market participants became increasingly concerned (and, as it turned out, rightly so) about counterparty risk. Central banks, industry bodies, and leading investment banks started initiatives to centralize market settlement to eliminate counterparty risk.

⁵ Kerr, Duncan. “Counterparty Failure Poses Highest Risk to CDS Market.” www.efinancialnews.com. May 29, 2008.

The goals of these initiatives included:

- standardizing contract terms and documentation
- reducing the notional amount outstanding by offsetting equivalent contracts, leaving just the net amount outstanding
- creating one or more central clearing houses to eliminate counterparty risk

The International Swaps and Derivatives Association (“ISDA”) is pushing for changes in settlement and dispute resolution documentation. A major ISDA initiative in April 2009 (the “Big Bang Protocol”) standardized auction settlement procedures, aspects of the contracts (for example coupon levels), and set out to improve liquidity and methods of dealing with defaults.

A major reduction in notional amounts is underway. ISDA estimates suggest that the notional amount outstanding has more than halved over the last year to around \$28 trillion as of March 20, 2009, based on Depository Trust & Clearing Corporation (“DTCC”) data – and this is expected to decline further. The largest segment of the market is based on contracts on single issuers (54% of contracts outstanding), with the balance made up of index-related contracts, according to the DTCC.

We believe the third goal, to create centralized clearing, is an essential building block for a less risky system. Progress has been made, and the goal may now be in sight. The Intercontinental Exchange started clearing CDS contracts in the United States in March 2009. CME Group, the Chicago-based derivatives exchange, also announced plans to compete in this market. European regulators and market participants appear reluctant to let U.S. clearing houses control European CDS business, so there are initiatives to create one or more European clearing houses during 2009. The initial emphasis appears to be on clearing CDS contracts based on indices of corporate credit, but then are expected to move to individual corporate CDS contracts (single-issuer CDS).

Since the financial system went into crisis in 2008, the CDS market frequently has been targeted in the media as a cause of collapses in the insurance or banking sector. Like many financial instruments, CDS can be misused (and certainly can be misunderstood), but if appropriately constructed and regulated, we believe these instruments can play a very effective role in the development of the financial markets. If current efforts to “regularize” the sector continue on track, it is possible that during 2009 both U.S.- and non-U.S. based CDS instruments may be used by investors to pursue their objectives with a much greater comfort level than they have had in the past. This may be true not only in the context of long-term structural change, but also in terms of the more immediate potential for credit spreads to narrow in the short to medium term as outlined earlier in this paper.

III. Importance of Income

The first section of this study focused on the opportunity available due to the high credit spreads currently prevailing in U.S. fixed income markets. Despite the potential for default, yields are so high that the income generated by these bonds may give investors a reasonable expectation of positive results. Although this opportunity is particularly evident in 2009, investors generally have tended to underestimate the importance of income in their investment programs.

A 2004 research study by the Brandes Institute, “Examining the Income Component of Total Returns” found that over longer time horizons (for example 20-year periods), the income component tended to produce a greater contribution to historical total returns than did capital movements.

Fixed income portfolio returns can be broken down into three components. First is the income component, a second is the impact of price movements due to the change in the yield curve (“capital component”), and the third is an “active credit/risk” component which includes returns from investing in credits other than risk-free government securities, as well as returns from active management (including issue selection). Over periods of more than five years, the Brandes Institute study showed that the capital component tended toward zero; in other words, yield curve-driven price moves tended to even out over time. For the average of all 5-year rolling periods over the 1926 to 2003 period, the capital component of returns on U.S. government bonds represented only about 3% of total returns, with income comprising 97% of that total. (Over 20-year rolling periods, the capital component was slightly negative and income accounted for more than 100% of total returns.) History thus suggests that for long-term investors in fixed income, the driving forces behind returns have been the income component plus any active credit/risk component. See Exhibit 5.

The change in investors’ attitudes about the importance of income arguably may be more pronounced in the equity markets than in fixed income. The study found that income was a substantial component of equity returns, even for time horizons of only five years. Over all the rolling 5-year periods in the Brandes Institute study (covering 1926-2003), dividend income comprised an average of 43% of total U.S. equity returns. However, this number increased to 63% of returns if the rolling time horizon was extended from five to 20 years, reflecting the compounding effects of reinvested income.

Most investors today came of age during an era when dividends were considered secondary to potential capital movements (if indeed they were considered at all). However, this era may be an aberration in a historical context. For example, in the Institute study, if rolling 5-year periods were restricted only to 1995-2003, then the component of dividend income dropped to 17% (compared to the 43% average for the whole 1926-2003 period).

Exhibit 5: Income Component of Total Returns (average of all rolling periods, 1926-2003)

	5-Year Rolling Periods	20-Year Rolling Periods
U.S. Equity	43%	63%
U.S. Fixed Income	97%	102%

Past performance is not a guarantee of future results. Rolling periods represent a series of overlapping, smaller time periods within a single, longer-term time period. A hypothetical example is the 20-year time period from 12/31/82 through 12/31/02. This long-term period consists of 16 smaller five-year “rolling” segments. The first segment is the five-year period from 12/31/82 to 12/31/87. The next rolling segment is the five-year period from 12/31/83 to 12/31/88, and so on.
 Source: Brandes Institute, as of 12/31/03.

This downplaying of the importance of dividend income may now be coming to an end. By the end of 2008, for the first time since the 1950s, the dividend yield on equities had risen above the yield on long-term U.S. government bonds. Of course, it is important to be aware that U.S. government bonds are backed by the full faith and credit of the United States, whereas the declaration and payment of stock dividends are solely at the discretion of the issuer and are subject to change at any time.

At the end of March 2009, the so-called “reverse yield gap” had re-emerged in the United States. At that time, the dividend yield on the S&P 500 Index was 3.5%, which was higher than the 2.7% yield on 10-year Treasuries. However, that reverse yield gap disappeared during the second quarter. By June 30, the S&P 500 Index dividend yield fell to 2.4%, which was lower than the 10-year Treasury yield of 3.5%. The reverse yield gap persists in Europe. On June 30, the 4.4% dividend yield on the MSCI Europe Index was above the Eurozone representative 10-year German “Bund” yield of 3.5%. The existence of the reverse yield gap sparked the cult of the equity in the 1960s, based on the thesis that the lower equity yield was justified by the greater dividend and capital growth potential in equities. It’s possible that its elimination during part of 2009 may only turn out to be a temporary side-effect of the depressed level of equities in the early part of the year. Even so, it may be a catalyst for a sea-change in investor attitudes toward the importance of income, and its role in generating long-term returns.

To what extent have investors’ recent experiences been consistent with the long-term historical patterns of income “dominance?” Exhibit 6 provides some evidence that may explain why the current generation of both equity and fixed income investors give less weight to the importance of income than did earlier generations.

Exhibit 6: Income Component of Total Returns (average of all rolling periods, 1926-2008)

	5 Years	20 Years
U.S. Equity	*	22%
U.S. Fixed Income	52%	65%

* Five year equity returns were negative, so income effectively represented over 100% of total return. Past performance is not a guarantee of future results.
 Source: Brandes Institute, as of 12/31/08.

For equity investors during the 20-year period ending 2008, income represented only 22% of total returns, about one-third of the average level for all rolling 20-year periods in the 1926-2003 period. Even for fixed income investors, the equivalent 20-year statistic was 65% – low compared with the longer rolling period average of 102%, a consequence of the bull market in bonds prevailing since the early 1980s. Over the shorter term, the five years ending 2008, the income proportion for fixed income was as low as 52%, a level only reached twice in the 73 rolling 5-year periods from 1926 to 2003 (both those instances occurred in the 1930s). The 5-year equity number ending 2008 is distorted by the negative total return on equities for that period.

Most investors today have little practical experience in an environment where income is a more significant component of their potential return than capital gains. The recent reversal of the reverse yield gap between equity and fixed income may or may not be a temporary phenomenon, but the powerful effect of reinvested income is one that investors should consider factoring into their strategies.

SUMMARY

The corporate bond markets offer a set of opportunities in 2009 that are different from prior investing eras, given three factors with both secular and cyclical elements:

- Credit spreads have recently been at extremely wide levels, and even after a narrowing of spreads in the first half of 2009 are still well above historic averages. Even factoring in default rates at peak Depression Era levels over each of the next three years, plus a rise in Treasury bond yields, we believe investors still may have the potential to capture positive relative and absolute returns from corporate bonds.

- The mechanisms for investing in corporate credit are undergoing a structural change that may make it easier and less risky for investors to identify and own credit exposure to a wider range of issuers worldwide. Credit default swaps acquired a “toxic” reputation in 2008, but (partly as a consequence) structural changes are taking place in central clearing, settlement and regulation that may make these attractive instruments for long-term investors.
- In recent years, investors have grown accustomed to income being a secondary component of their returns compared to capital moves. As such, many may be reluctant to own investments supported by high income potential. They may be more accustomed to trying to predict the next big market move. However, it may be that the investing environment in 2009 provides the financial analogy of the proverbial “bird-in-the-hand.”

Past performance is not a guarantee of future results.

The MSCI All Country World (ACWI) Index is an unmanaged, free float-adjusted market capitalization weighted index designed to measure equity market performance of developed and emerging markets, including the United States. This index includes dividends and distributions, but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

The S&P 500 Index is an unmanaged, market capitalization weighted index that measures the equity performance of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large cap segment of the market, with approximately 75% coverage of U.S. equities, it can also be a suitable proxy for the total market. This index includes dividends and distributions, but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

The Merrill Lynch U.S. High Yield Master Index tracks the performance of U.S. dollar-denominated, below-investment grade corporate debt publicly issued in the U.S. domestic market. Qualifying securities must have a below investment grade-rating (based on an average of Moody’s, S&P and Fitch) and an investment grade-rated country of risk (based on an average of Moody’s, S&P and Fitch foreign currency long-term sovereign debt ratings). In addition, qualifying securities must have at least one year remaining term to final maturity, a fixed coupon schedule and a minimum amount outstanding of \$100 million. Original issue zero-coupon bonds, “global” securities (debt issued simultaneously in the eurobond and U.S. domestic bond markets), 144a securities, pay-in-kind securities and toggle notes qualify for inclusion in the Index. Perpetual and fixed-to-floating rate securities also qualify provided they are callable within the fixed rate period and are at least one year from the start of the floating rate period. Taxable and tax-exempt U.S. municipal, dividends received deduction (“DRD”)–eligible and defaulted securities are excluded from the Index.

The MSCI Europe Index is an unmanaged, free float-adjusted market capitalization weighted index that is designed to measure equity market performance of the developed markets in Europe. This index includes dividends and distributions net of withholding taxes, but does not reflect fees, brokerage commissions, or other expenses of investing.

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