Investment Team Corner

In conversation with International Large Cap Investment Committee member Jeffrey Germain, CFA

Investment Team Corner: Jeffrey Germain, CFA (Member of Brandes' International Large Cap Investment Committee)

After a period of lackluster performance, international equities (MSCI EAFE) rallied and outperformed their U.S. counterparts (Russell 1000) in the first quarter of 2023. To understand what's behind this positive performance, we spoke with Jeff Germain, a member of Brandes' International Large Cap Investment Committee. Specifically, we asked why Brandes' value emphasis can be an effective strategy for identifying appealing international investments. Jeff has 22 years of experience in the industry, all with Brandes..

The Brandes International Equity Strategy has enjoyed recent outperformance relative to its benchmark as well as the MSCI EAFE Value. It even outperformed the MSCI EAFE Growth Index in the first quarter of 2023. What has driven this return?

The Brandes International Equity Strategy outperformed the benchmark despite value's underperformance in Q1 and it's mainly thanks to the portfolio's idiosyncratic exposures. We build the portfolio from the bottom up, so we're "benchmark agnostic" and invest where we think the best risk/reward potential exists. That can be expressed in large overweights to certain industries, sectors, or countries, while having *no* allocation to others.

So far this year, we saw positive contributions from many holdings in industries where we hold overweights. These are areas where we think there's a lot of value potential and where the risk/reward tradeoff is attractive, such as media, European food retailers, construction materials—especially cement and aggregate companies, and aerospace businesses. Our underweight in information technology, which is often considered a growth-oriented sector, did hurt relative returns a bit. We were pleased with how our technology holdings did in the first quarter, but our underweight to the sector offset their positive impact on relative performance.

You mentioned areas of compelling opportunities for the strategy. Do these areas tend to stay the same or change over time?

> "When the risk/reward profile for a company changes for the better due to short-term or temporary market "noise," we seek to capture that opportunity quickly and initiate a position.

As mentioned, we choose our investments from the bottom up, so our sector and country allocations are primarily a bi-product of this approach rather than a result of top-down decisions. This being said, the overweight and underweight areas of the Brandes international strategy do tend to be dynamic depending on where we see the largest margins of safety (the margin of safety is the discount of a security's market price to its estimated intrinsic value).

For example, a year ago, we had zero allocation to information technology. But as parts of the sector became less expensive, we initiated positions in recent months. We have also added to our exposure to industrials over the past year, although we remain underweight the sector relative to the MSCI EAFE Index. Conversely, our weight to energy companies has materially decreased in the last few years as select holdings appreciated beyond our estimates of their intrinsic value.

As you can see, some changes to the portfolio occur over the course of several years, while others happen fairly fast. We have an inventory of investment candidates that our experienced analysts have vetted and priced. When the risk/reward profile for a company changes for the better due to short-term or temporary market “noise,” we seek to capture that opportunity quickly and initiate a position.

U.S. regional banks have been “big news” recently. How has the banking turmoil in the U.S. affected your view on non-U.S. banks?

> “Based on valuations for non-U.S. equities, and for non-U.S. value stocks in particular, I think there are still tailwinds outside the general economic cycle.

Within the Brandes International Equity Strategy, most of our bank holdings are large-cap European banks. As several U.S.-based banks entered FDIC receivership during the first quarter, we undertook deep reviews of the European banks to assess if their risk profiles changed.

We think the turmoil pertains to certain banking institutions. Many of the troubled U.S. banks had a very concentrated customer base or asset area. This is different from the European banking landscape, in which companies tend to have more diversified customer base and operations. Additionally, U.S. regional banks follow a different, less stringent, regulatory regime than their large money-center counterparts. Meanwhile, the European banking regulations have become stricter over time. Banks in the region have to maintain strong capital levels and pass interest rate stress tests in order to abide by the rules. This has helped many European banks avoid the troubles affecting U.S. regional banks.

Furthermore, the deposits surge in the U.S. during or after COVID was also much greater than in Europe. So, the push on European banks to find places for those deposits wasn’t as big. Many U.S. regional banks seem to have relied a little too much on longer-duration investments, which increased their liquidity risk and made a bad situation turn to worse when customers started to pull out their deposits. We don’t think European banks confront the same risks, but we will keep monitoring the developments. It’s also worth noting that Europe has not increased interest rates as much as in the U.S., so while there remains a risk that deposits could leave as rates increase, the situation is not the same.

Overall, in which economic environments would you expect the portfolio to continue to do well? How may the portfolio positioning help in case of a recession or economic slowdown?

That’s a complicated question. We’re trying to invest over a cycle, to think about the long term, and to not be reactive to what the economic cycle will be in the short term because it’s very difficult to predict. If you compare the portfolio against the MSCI EAFE Index, we are overweight consumer staples and health care. In a recession, companies in those sectors have tended to hold up better than those in others due to their defensive nature.

Meanwhile, the industrials sector represents a sizeable underweight for us and it is an area that tends to be more economically sensitive. In case of an economic slowdown, I can envision a lot of investment opportunities emerging in that sector. Then there’s materials: we don’t have much in mining because the pricing across most commodities has been elevated compared to history. But commodity prices have tended to fall in a recessionary environment, so maybe more opportunities would become available in this sector as well.

So, in summary, why is this is a good time to consider the Brandes International Equity Strategy?

Our starting point is a portfolio of companies that we believe are undervalued relative to our estimates of their true worth or in a relative sense to other parts of the market. Based on valuations for non-U.S. equities, and for non-U.S. value stocks in particular, I think there are still tailwinds outside the general economic cycle.

The portfolio characteristics relate to a single account as of date noted, deemed by Brandes to be generally representative of the strategy. Not every account will have these exact characteristics. The actual characteristics with respect to any particular account will vary based on a number of factors including but not limited to: (i) the size of the account; (ii) investment restrictions applicable to the account, if any; and (iii) market exigencies at the time of investment. Data is updated on a quarterly basis.

The benchmark for the Brandes International Equity Strategy is the MSCI EAFE Index. One cannot invest directly in an index.

The MSCI EAFE Index captures large and mid cap representation of developed market countries excluding the U.S. and Canada.

The MSCI EAFE Value Index with net dividends captures large and mid cap securities across developed market countries, excluding the United States and Canada, exhibiting value style characteristics, defined using book value to price, 12-month forward earnings to price, and dividend yield.

The MSCI EAFE Growth Index captures large and mid cap securities across developed market countries, excluding the United States and Canada, exhibiting growth style characteristics, defined using long-term forward earnings per share (EPS) growth rate, short-term forward EPS growth rate, current internal growth rate, long-term historical EPS growth trend, and long-term historical sales per share growth trend.

The Russell 1000 Index with gross dividends measures performance of the large cap segment of the U.S. equity universe.

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