

Brandes Investment Partners
International Small Cap Equity Strategy Notes
First Quarter 2024 (January 1 – March 31, 2024)

The Brandes International Small Cap Equity Strategy returned 8.89% net of fees and 9.12% gross of fees, outperforming its benchmark, the MSCI ACWI ex-USA Small Cap Index, which gained 2.11% in the quarter, and the MSCI ACWI ex-USA Small Cap Value Index, which was up 2.40%.

Annualized total return as of March 31, 2024	1-year	5-year	10-year
Brandes International Small Cap Equity Composite (net)	33.96%	12.69%	6.30%
Brandes International Small Cap Equity Composite (gross)	35.12%	13.68%	7.24%
MSCI ACWI ex-USA Small Cap Index	12.80%	6.24%	4.74%

Past performance is not a guarantee of future results. One cannot invest directly in an index. Returns include reinvestment of all dividends and are reduced by any applicable foreign withholding taxes, without provisions for income taxes, if any.

Positive Contributors

Holdings in industrials and communications services helped returns. Among the top performers were aerospace and defense companies Rolls-Royce (U.K.) and Embraer (Brazil), as well as Chinese entertainment firm Boyaa Interactive and Hungary-based Magyar Telekom.

Our aerospace and defense holdings, including Rolls-Royce and Embraer, continued to benefit from the ongoing recovery in passenger air travel that has led to solid revenue growth, expanding profit margins, healthier cash-flow generation, and healed balance sheets. These positive fundamental developments helped confirm our long-term thesis around franchise quality, balance sheet durability, and end-market recovery potential for these holdings. Moreover, record backlogs highlighted—in our view—the appealing long-term secular growth outlook for global passenger air travel in an industry that has historically allowed incumbents to generate attractive returns on capital. Consequently, we revised our intrinsic value estimates for several of our aerospace and defense holdings upward, and believe they continue to offer an attractive risk/reward tradeoff at current valuation levels.

Magyar Telekom appreciated as inflation and geopolitical concerns in Hungary eased. The company recently announced a 15% price increase, which should translate into meaningful revenue growth and potential margin expansion.

Our financials holdings also aided returns, led by Ireland’s AIB Group, Slovenian Nova Ljubljanska banka, Austria-based Addiko Bank, and Japanese Hachijuni Bank.

Additional solid contributors included Hong Kong-based shoe manufacturer Yue Yuen Industrial and food products company First Pacific, as well as Ireland-based convenience foods producer Greencore Group.

Performance Detractors

Significant detractors included several health care holdings such as Spain’s Grifols, France-based Euroapi, and Japanese H.U. Group Holdings.

Biotechnology firm Grifols grappled with multiple declines in its share price following a short seller’s report that questioned the company’s debt and corporate governance practices. In our opinion, the risks highlighted in the report had been largely known, and we maintained our position in the company despite the volatility—albeit now at a lower weighting due to the share-price decline. While we have long been concerned with the company’s elevated financial leverage, we recognize that Grifols has several options at its disposal that can help derisk, including the partial sale of its stake in Shanghai RAAS that is scheduled to close in the first half of this year.

We continue to believe there is potentially meaningful upside in the stock and we are managing the elevated balance sheet risk through allocation sizing. Grifols’ plasma business weathered considerable challenges amid the COVID-19

pandemic, including decreased blood donations and higher costs associated with compensating donors. Today, blood donation volumes are running above pre-COVID levels and collection costs are declining as the pandemic-related supply challenges fade. Admittedly, the free-cash-flow recovery has been slower than anticipated as Grifols has been making substantial investments to expand capacity for future growth. While these investments have weighed on short-term profitability and cash flow, we believe they should be beneficial for the company in the long term as the industry transitions back to the pre-COVID growth trajectory. Furthermore, we appreciate Grifols' competitive position in a consolidated industry with high barriers to entry and long-term secular growth, as well as its business model that should allow it to generate steady free cash flow if the industry returns to equilibrium. Trading at a single-digit multiple of pre-COVID earnings, Grifols appears attractively valued to us.

Beyond health care, other detractors included U.K.-based food retailer J Sainsbury and capital markets company St. James Place.

Select Activity in the Quarter

The small-cap investment committee initiated a position in Canada-based CAE.

CAE supplies simulation equipment and integrated pilot training services to both civil aviation and military customers. Competing in a market dominated by two key players (the other being Flight Safety), CAE boasts the world's largest installed base of full-flight simulators. Over the past 20 years, CAE has diversified into the less cyclical pilot training business, offering training services through a global network of over 250 civil aviation and military training locations across 40 countries. The company derives 40% of its revenues from simulation products and 60% from training and services.

Our coverage of CAE began in 2011, and since then, our assessment of the company's core franchise quality remains unchanged. With its dominant position in flight simulation and pilot training, CAE has historically generated solid free cash flow and healthy returns on invested capital. The company also benefits from its access to attractive financing sources in the form of perpetual zero-cost loans from the Canadian government for research and development initiatives.

It is notable that during the COVID-19 pandemic, CAE took significant steps to strengthen its competitive position and improve industry structure. Firstly, the company leveraged its financial strength to complete a series of opportunistic acquisitions, purchasing nine companies at what we deemed depressed prices. This has helped CAE consolidate end-markets and expand capabilities. Secondly, it restructured its cost base, closing nine plants and removing \$70m in annualized costs that resulted in a 1.5% margin benefit on sales. Lastly, CAE expanded its relationship with mainline airlines, which chose to outsource an increasing share of their internal training needs. To satisfy this new demand, CAE embarked on a heavy capital expenditure cycle over the course of the pandemic that we believe will benefit shareholders in the years ahead.

The opportunity to initiate a position in CAE came as investors have been concerned about recent margin weakness within the defense segment. However, we view these challenges as temporary. Inflation and supply chain pressures have started to ease, and CAE's under-earning, fixed-price contracts are set to expire by 2025. We expect that CAE is positioned to improve its profitability as legacy fixed priced contracts roll over and as new high-margin defense contracts begin to ramp up. Based on the company's guidance, new contracts should earn mid-double-digit margins, compared to the mid-single-digit margins on the legacy fixed-price contracts that were impacted by the pandemic-related cost pressures. At its current valuation levels, CAE represents an appealing risk/reward tradeoff, in our opinion.

Besides the new purchase of CAE, other major portfolio activity included the full sales of China's Weiqiao Textile, Israel-based Taro Pharmaceutical Industries, and Japanese medical device company Fukuda Denshi.

Current Positioning

Allocations from a country and sector standpoint were largely unchanged during the quarter. The strategy maintains large allocations to industrials, consumer staples, and financials, while holding underweights in technology, materials, and consumer discretionary.

Geographically, the strategy continues to have significant exposure to companies in Japan (although underweight relative to the benchmark), the U.K., Ireland, Hong Kong, and emerging markets. It remains underweight Australia and Sweden relative to the benchmark.

As was the case in 2023, while value leadership (MSCI ACWI ex-USA Small Cap Value vs. MSCI ACWI ex-USA Small Cap) provided a tailwind for the strategy in the quarter, it was our stock selection across sectors and countries that primarily drove outperformance. Going forward, we remain optimistic about the portfolio's holdings composition and the risk/reward tradeoff it offers.

For term definitions: <https://www.brandes.com/termdefinitions>

The MSCI ACWI ex USA Small Cap Index with net dividends captures small-cap representation across developed and emerging markets excluding the United States.

The MSCI ACWI ex USA Small Cap Value Index captures small-cap securities across developed and emerging markets excluding the United States, exhibiting overall value style characteristics, defined using book value to price, 12-month forward earnings to price, and dividend yield.

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