How Being "Purpose-built for Value" Makes Brandes Different

Dear Clients and Friends,

From our beginnings, Brandes has been a reflective investment manager, constantly renewing our bond with our founding principles and periodically reviewing our past communications with the dual goals of staying focused and thinking forward.

Recently, we've taken stock of Brandes Letters from the past several years, the messages affirming our core principles woven throughout them, and the client reactions to them. We think our championing of value investing has passed the twin tests of critical scrutiny and time.

In our experience, it takes commitment to invest consistently through a repeatable process. Brandes has upheld its value investing convictions and has consistently delivered exposure to what we consider value portfolios. In our opinion, being *purpose-built for value* is what makes us distinctive. It's the reason why our investment decisions are not driven by the composition of the benchmarks. We have *not* diluted our approach, though it's more adaptable than often perceived (see the closing paragraph to our October 2021 Letter, *Value Is in the Eye of the Beholder*), nor have we renounced what we stand for to ourselves or to our clients.

Key value investing principles can get lost in translation. While value principles are straightforward in concept, they can be difficult to execute. In this Letter, we will elaborate on why we endeavor not to deviate from a value approach. We will also offer insights into behavioral biases that can undermine disciplined, long-term investing and will discuss in depth the changing market/economic factors that we interpret as favorable to investing with a genuine value orientation. And, finally, we will explain why this could be an ideal time to review your allocation to value investing.

Staying True to Our "Constitution"

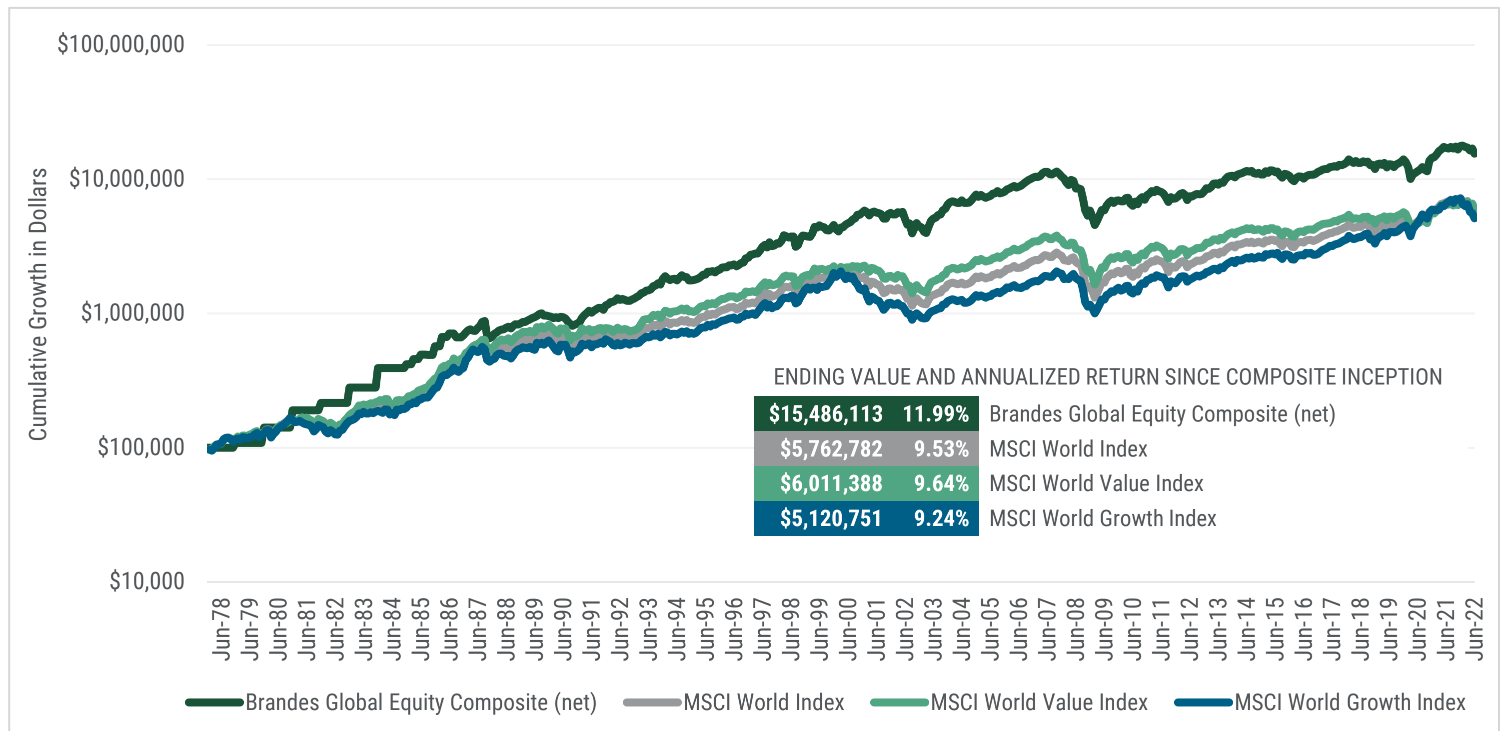
Let us begin with the origins of Brandes as an investing organization and how and why we have committed ourselves to the search for value.

Our "constitution" as a firm is Benjamin Graham and David Dodd's 1934 classic, *Security Analysis*, as well as Graham's 1949 follow-on, *The Intelligent Investor*. Graham and Dodd insisted that there is a profound difference between *deliberate* investing based on careful analysis of business fundamentals and mere speculation. For us, this remains a bedrock truth, and the books established the mindset we regard as the most trustworthy approach to investing.

In our opinion, *Security Analysis* and *The Intelligent Investor* are among those rare texts that continue to speak to audiences long after their publication because they have withstood the challenge of change. Our founder, Charles Brandes, was convinced by the clarity of the arguments about the importance of examining long-term fundamentals and having a "margin of safety" (the discount of a security's market price to an estimate of the security's intrinsic value) especially after he met with the "brilliant…gracious …very formal" author in the early 1970s. At Graham's California home, they conversed about their mutual understanding of what really counts (no pun intended) in investing. Graham later sent a congratulatory letter to Charles on his starting the firm in 1974. (It was featured in the March 2022 Letter, *The Enduring Value of Graham Principles*, on page 2.)

Our consistent application of the value investing style has led to portfolios that have tended to outperform broad-based indices over the long term and have particularly outperformed the value indices in value-led environments (see page 2 of our July 2021 Letter, *Fundamental, Research Driven Investing*, specifically the section under the subhead "The Recent Resurgence of Value").

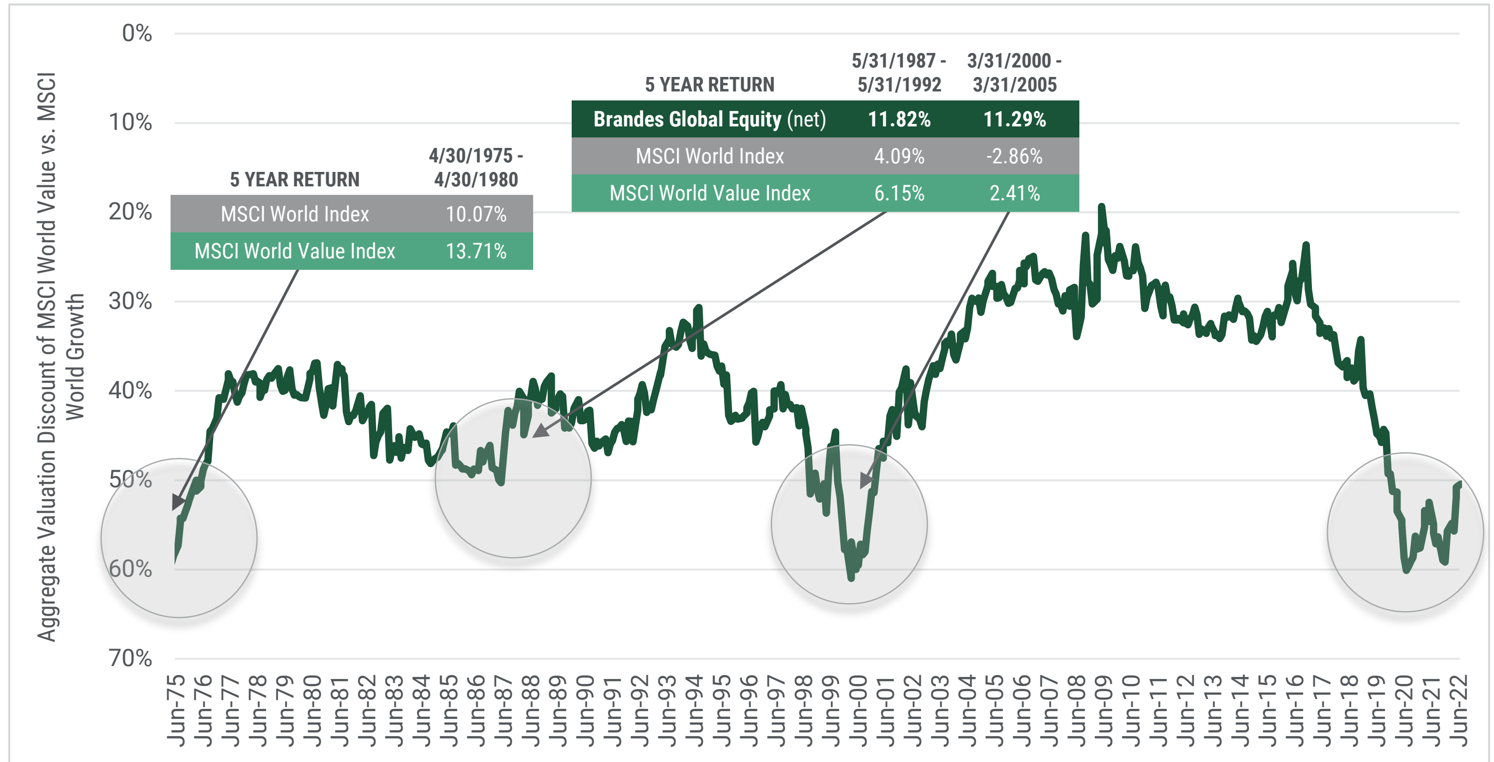
Cumulative Growth of Hypothetical $100,000 Investment



DECEMBER 31, 1977 (COMPOSITE INCEPTION) TO JUNE 30, 2022. Source: Brandes, MSCI. Performance returns net of management fees. Please see the accompanying GIPS® Report. This hypothetical example is for illustrative purposes only. It does not represent the performance of any particular investment. Actual results may vary. Length of period shown is not typical. Past performance is not a guarantee of future results. It is not possible to invest directly in an index. The inception date for the Growth and Value Indices is December 8, 1997. Data prior to this date is the result of back testing performed by MSCI. There may be frequent material differences between back tested and actual performance.

Annualized returns net of management fees as of 6/30/22	1-Year	5-Year	10-Year
Global Equity	-9.53%	4.62%	7.54%
MSCI World Index	-14.34%	7.67%	9.51%
MSCI World Value Index	-6.63%	4.67%	7.62%
MSCI World Growth Index	-22.37%	10.01%	11.04%

Global Value Stocks Relative Valuations
Valuation Relative to Growth Stocks vs. History



JUNE 30, 1975 TO JUNE 30, 2022. Source: MSCI via FactSet. All returns annualized. Past performance is not a guarantee of future results. For each fundamental ratio (Price/Book, Price/Earnings, Price/Cash Flow, Forward Price/Earnings, Enterprise Value/Sales, Enterprise Value/Earnings Before Interest, Taxes, Depreciation, and Amortization), we calculate the average ratio of the MSCI World Value Index and divide it by the average ratio of the MSCI World Growth Index to determine the relative valuation. Aggregate valuation discount based upon the average of each individual metric's valuation discount of the value index relative to growth. Please note that all indices are unmanaged and are not available for direct investment. Brandes performance is net of management fees. Please see the accompanying GIPS® Report. The hypothetical examples are for illustrative purposes only. They do not represent the performance of any specific investments. Actual results will vary.

As a value manager, Brandes undertakes analytical examination of the companies we buy and concentrates on identifying solid financial fundamentals that markets may overlook or ignore. Value investing is not—and has never been—about a search only for low price-to-book stocks to us. It's *not* about being a contrarian for the sake of being a contrarian. It *is about* avoiding competing priorities that can distort sound stock selection.

Around the time Brandes began operating, the "Nifty Fifty" (50 NYSE-listed large-cap stocks dominant in the '60s and '70s) captured the imagination of institutional investors—a situation strikingly similar to the so-called FAANGs (i.e., the large American technology companies Meta [formerly Facebook], Amazon, Apple, Netflix and Alphabet [formerly Google]) over the past several years). Applying value principles, Charles Brandes rejected buying the Nifty Fifty, and today we continue to rebuff what we consider overpriced market offerings.

We acknowledge that some of these can be great companies, but we will not pay more for them than we think they are worth. In a similar and related way, we're also vigilant for and strive to overcome the psychological and behavioral biases that inhibit discerning investing and will discuss them in depth in the next section.

Given that value investing has been out of favor during most of the past decade, the pressure and temptation to 'flex' the definition of value has been intense. However, we have worked hard to embed our self-defining standards into our culture and have committed training resources to impart them to the newcomers and future leaders of our firm. This includes, for example, periodically offering a "Graham Course" to all members of our firm in order to share the wisdom conveyed by Ben Graham in *The Intelligent Investor* and its application by Charles Brandes. We do this to ensure that the style fidelity we seek to preserve lives long into the future and want existing and future clients to have full confidence in Brandes' commitment to being a true value manager.

Seeking to Understand Investor Psychology, Behavior

We are convinced that understanding investor psychology and behavior are important—maybe the most important—elements in successful long-term investing. This applies to our own self-awareness in our selection and decision-making processes, as well as to the direction of educational content we create for our clients. We therefore work to counter emotion-centered biases that might creep into investment decisions, as well as other errors in judgment that can erode rational investing.

Behavioral finance expert and MarketPsych co-founder, Dr. Frank Murtha, with whom the Brandes Institute has worked on various educational initiatives, described other known biases in a March 2019 paper for the Institute: *Five Wealth-Destroying Biases: Where They Strike in the Investment Process and How to Address Them*. These include anchoring, availability, framing, extrapolation (which fits under Prospect Theory) and planning fallacy. It's beyond the scope or focus of this Letter to explore each, let alone others[2] in detail, but we trust you can appreciate that bias can interfere with making an accurate assessment of an investment's inherent worth and a valid case for acquisition or divestment. An important step to dealing with biases is to recognize them. At Brandes and the Brandes Institute, we've done a lot of work studying biases and thinking about how to mitigate them (see the closing paragraph of our March 2022 Letter, *The Enduring Value of Graham Principles*).

In our view, investing based on innate but potentially misleading cognitive biases is an adversary of patient, discipline value investing. Without the diligent process of undertaking fundamental analysis and searching for intrinsic value, it will be hard, in our opinion, to remain committed to the long term when excessive optimism (or "irrational exuberance" as former Federal Reserve Chair Alan Greenspan called it in 1996), heightened uncertainty or unconscious predispositions dominate the markets—as they have many times in the past. Accordingly, we will continue to remind ourselves and our clients about the potential consequences that emotions and biases can bring to any investment approach.

What hasn't Changed? What has? Why does it Matter?

Fundamental, bottom-up investing based on time-tested principles typically does not materially differ from one period to another. Brandes has not departed from them or sought to water down how we apply them. However, our approach is not absolutely rigid: we have adapted our understanding and application of our value-seeking process by deploying intelligent flexibility, as we think Graham would advise.

For example, we have seen a meaningful shift in how value is created over the past 20-plus years, where capital invested in intangible assets, like intellectual property, brands or research and development, has become more prominent. Intangible assets may not always be accurately captured on the balance sheet under current generally accepted accounting principles, and therefore, possibly not reflected in the stated book value of a company.

In today's global economy, stated book value's efficacy as a measure of value has become less useful, especially for a large subset of the investible universe. It is not a metric that we have abandoned completely, but one that is more relevant for our analysis of capital-intensive industries.

For knowledge-intensive industries, we either have to make thoughtful adjustments to book value to reflect economic reality or rely on other metrics that are more indicative of value in those industries.

Technological and competitive disruption has always been a part of value investing, but there is a legitimate argument that the speed and intensity of disruption has increased. The internet has facilitated competitive transparency, the cloud has reduced some start-up costs and moats, and network effects have changed the competitive landscape of a number of industries.

So, no, it's *not* different this time as far as our emphasis on seeking out undervalued companies offering a margin of safety is concerned. However, the circumstances in which that occurs can change—and have evolved. Accordingly, we can and will evolve our approach.

In recent years, we've seen a significant rise of passive or index-replicating funds. Passive investing does not necessarily align allocations with business fundamentals: sometimes capital will flow toward certain companies merely because of their weight in an index. To us, this disconnect from fundamentals can increase the potential for financial bubbles. Most significantly, from our perspective, index investing does not focus on the margin of safety that is at the heart of value investing. In our March 2022 Letter titled *The Enduring Value of Graham Principles*, on page 3, we argue that index-weighted passive investing effectively decouples investing from purposeful choice—money flows to a company *not* because of fundamentals. We further argued that in such situations, money is "*directed*" as opposed to "*invested*." Directed investing can result in speculation and we are very mindful that Ben Graham dedicated the first chapter of The Intelligent Investor to a discussion on the difference between speculation and investing.

Passive investing alone does not account for the sky-high valuations of recent years. Following the Great Financial Crisis, Quantitative Easing (QE) led to record low interest rates being offered as a stimulus to revive economic activity. The sustained low interest rates have helped skew perceptions about risk, reshape financial conduct and reset expectations.

More recently, a global pandemic caused central banks to keep the money taps open to help economies function. However, COVID-19 followed by the Russian invasion of Ukraine, have also reintroduced an awareness of risk, prompting genuine fears and a renewed interest in downside protection. Ubiquitous global supply challenges stemming from the pandemic and aggravated by the prolonged conflict in Eastern Europe have contributed to inflation levels not seen in most national economies in decades and has also resulted in a resurgence in stock market volatility. Some pundits are talking about "stagflation," a condition in which prices rise but employment and gross domestic product growth decline.

As the headline of our August 2019 Letter stated: *Interest Rates—Lower for Longer Not Lower Forever*. At the time, we observed that the record-low rates were likely unsustainable. And now with central banks weighing higher interest rates to help cool down inflation, pervasive geopolitical and economic unease, and accelerating anxieties about the effects of climate change, it's clear to many investors that risks abound. The rise in inflation, specifically, may require a readjustment in thinking because it effectively touches everyone. When you stand in a grocery line expecting to pay much more to keep your family fed or fill your gas tank and shudder, the price-to-value relationship is starkly obvious. It forces you to look for the best deals, i.e., to search for authentic value.

The situation today and for the foreseeable future may inspire some investors to rethink where they place their investible assets. We would argue for investing with a long-term perspective, one that regards sound fundamentals and a margin of safety as essential today as they have ever been.

Owning "Companies for All Seasons"

In a particularly volatile period of turbulent change and unpleasant disruption, we believe investors may benefit from owning a portfolio of "companies for *all* seasons," i.e., those that demonstrate enduring value under a variety of economic and market conditions. And that they should consider avoiding the pricey performers that generate headlines and whose value appears fully recognized (and then some) by the markets. Rather, it is times like we are experiencing when companies the market has seemingly discounted for a variety of reasons may deserve a closer look.

In presenting this line of argument, we make no predictions about future results because forecasts of this nature cannot be made with certainty. At the same time, we cannot ignore recent macroeconomic data that speaks to us loudly and fairly clearly. *Nobody* knows the future direction of the markets, especially given current circumstances, but that is all the more reason for a value investing style—with its emphasis on identifying underestimated resilience and hidden potential in individual companies. It is why the search for value has defined Brandes from its beginnings: as we've said, we're purpose-built for it.

Our responsibility—and our pledge to our clients—therefore, is to stay the course in our detailed, bottom-up research practices and style fidelity, even when it is not "trendy" to do so.

Your opportunity—toward pursuing your long-term financial goals—is to re-explore value in light of the economic/financial conditions we've described in this Letter. Is your allocation to value—that is, to *true* value—where you want it to be?

Ultimately, we ask you to reconsider the value-seeking journey. The conditions are promising because we expect the external drivers described in this letter—high inflation and the potential for higher interest rates to combat it—will likely persist for some time. The indicators are robust and compelling.

Thank you,

Brandes Investment Partners

[1] Source: https://www.brandes.com/docs/default-source/brandes-institute/2019/brandes-institute-five-wealth-destroying-biases

[2] Source: https://www.brandes.com//docs/default-source/brandes-institute/this-time-is-different-behavioural-aspects-of-financial-crises (page 2)

Global Equity GIPS® Report available here.

Book Value: Assets minus liabilities. Also known as shareholders' equity.

EV/Sales: Enterprise value per share divided by sales per share.

EV/EBITDA: Enterprise value divided by earnings before interest, taxes, depreciation and amortization.

Forward Price/Earnings: Price per share divided by earnings per share expected over the next 12 months or next fiscal year.

Price/Book: Price per share divided by book value per share.

Price/Cash Flow: Price per share divided by cash flow per share.

Price/Earnings: Price per share divided by earnings per share.

The MSCI World Index with net dividends captures large and mid cap representation of developed markets. **The MSCI World Value Index** captures large and mid cap securities across developed market countries exhibiting value style characteristics, defined using book value to price, 12-month forward earnings to price, and dividend yield. **The MSCI World Growth Index** captures large and mid cap securities across developed market countries 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.

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