Brandes Investment Partners
U.S. Value Equity Strategy Notes
Second Quarter 2023 (1 April – 30 June 2023)

The Brandes U.S. Value Equity Strategy rose 5.77% (gross of fees) in the quarter, outperforming its benchmark, the Russell 1000 Value Index, which appreciated 4.07%.

Positive Contributors
Several holdings in health care helped performance meaningfully, led by health care distributors **Cardinal Health** and **McKesson**, as well as hospital operator **HCA Healthcare**. All three companies reported robust results and favorable earnings guidance. HCA saw demand for its services surpass pre-COVID levels as discretionary procedures recovered, while McKesson raised its long-term growth targets amid increased utilisation and encouraging product sales.

Other solid contributors included technology-related holdings, most notably semiconductor equipment manufacturer **Applied Materials**, technology equipment manufacturer **Flex**, and internet firm **Alphabe**t. Many technology-related companies rose in the quarter on optimism about the progress in artificial intelligence as well as the potential recovery in the semiconductor cycle.

Performance Detractors
Detractors from relative performance included health care holdings **CVS Health** and **Pfizer**, as well as energy distribution company **World Kinect Corporation**.

CVS, which owns health insurer Aetna, saw its share price decline along with other health insurance companies as elevated volumes of non-urgent surgeries triggered concerns about increasing costs. However, given that health insurers can relatively quickly reprice their policies based on the costs they incur, we feel the negative sentiment and depressed multiple on our estimate of CVS' normalised earnings provide an attractive opportunity for longer-term investors.

Additionally, some noteworthy performers in 2022, including industrial firm **Textron** and oil company **Chevron**, declined slightly and hurt relative returns in an up market.

Select Activity in the Quarter
We initiated a position in outsourced software services provider **SS&C Technologies**.

SS&C is a leader in the growing market of software-enabled outsourcing services for financial companies. The company offers services such as fund administration, trading, and portfolio analytics to a variety of clients, including asset managers, banks, and insurance companies. It is the world's largest fund administrator for alternative investments with over U.S.$2 trillion of assets under administration and is the largest third-party mutual fund transfer agent in the United States and United Kingdom.

As client workflows are typically built around the software, SS&C has enjoyed excellent customer retention and attractive upselling opportunities. Based on our analysis, the company should likely see growing long-term demand as fee compression within the financial services sector drives more and more firms to outsource their often-complex legacy services. Additionally, SS&C has been a successful acquirer. These acquisitions have historically allowed for cost improvements and access to new products and markets that the company can cross-sell into. Most recently, SS&C acquired a process automation firm, Blue Prism, which focuses on productivity improvement utilising digital workers (a software robot) across a variety of business processes.

Despite its appealing business model with high recurring free cash flow, SS&C trades at what we consider an attractive valuation and discount to the overall U.S. market (Russell 1000). We believe that the company is well equipped to continue improving its margins through growth and productivity improvements, and that the shares represent a compelling risk/reward tradeoff.

Other major activity included the divestments of **Loews Corporation** as well as two long-time software holdings in the portfolio, **Microsoft** and **Oracle**. We exited these positions as they reached our estimates of their intrinsic value.

In our view, Microsoft is a great example of our value philosophy and the benefits of patience and ignoring conventional market narratives. We first bought the company over 15 years ago when its stock price languished following the hangover from the 1995-2001 tech bubble and later from poor consumer reception to its Vista operating system. After paring and adding a few times during the first several years of our holding period, we significantly increased our position in 2011, making Microsoft our largest holding. At the time, the market was concerned about the company's poor positioning in many consumer-facing businesses, especially in the emerging mobile phone business as Apple had begun to dominate with its iPhone. Microsoft was also perceived by the market as old and boring due to its focus on traditional enterprise computing and its stock hadn't really gone anywhere for a decade-plus.

Over the last decade, Microsoft's valuation finally started to climb as the company successfully migrated its enterprise business to the cloud and the market finally began to appreciate the strength of its enterprise business instead of focusing on its less important consumer business. As market sentiment improved, the large margin of safety evident in the share price declined, and we began to pare our position. (The margin of safety is the discount of market price to our estimate of the security's intrinsic value.) We continued to pare our position in 2020 and 2021 because of how the business fared during the pandemic. After declining in 2022, the stock price appreciated notably again this year, leading us to divest our position. While we very much appreciate Microsoft's capability in artificial intelligence, at its current valuation that strength does not appear to be lost on the market. Throughout our holding period, Microsoft's free cash flow more than doubled and its enterprise value to free cash flow expanded fivefold since 2011—from what we considered a depressed multiple of 8x to a much more optimistic level of closer to 40x today, a staggering increase for a company of its size.

Year-to-Date Briefing

The Brandes U.S. Value Equity Strategy rose 4.80% in the six months ended 30 June 2023, slightly underperforming its benchmark, the Russell 1000 Value Index, which rose 5.12%.

Technology-related businesses—both within the technology and communication services (e.g., internet companies) sectors—represented the best performing firms within the Russell 1000 Value Index. Our overweight and stock selection in this area aided returns relative to the benchmark, with notable performers including Applied Materials, Flex, Micron, and Alphabet.

Other contributors included **FedEx**, financial firms **Fiserv** and **OneMain**, and health care companies Cardinal Health and HCA Healthcare.

As oil prices declined from their elevated levels a year ago, energy holdings **Halliburton**, Chevron and World Kinect weighed on performance. Additionally, a few holdings gave back some of their 2022 performance, including CVS Health and **Cigna**.

Other detractors included a few large money-center and super-regional banks that declined in the first quarter amid the industry turmoil that was brought on by the failure of SVB Financial, First Republic and Signature Bank and affected mostly smaller regional banks. Note that our bank holdings are concentrated primarily in the larger money-center banks that not only command what we consider strong deposit franchises, well-capitalised balance sheets, and solid underwriting, but also have benefited from the deposit flight from troubled community and regional banks.

Current Positioning

As of 30 June 2023, we were significantly overweight technology companies relative to the Russell 1000 Value Index, as the sector only accounted for approximately 9% of that index (vs. more than 25% for the broader Russell 1000 Index). Although we feel the technology sector is generally quite expensive and we have trimmed or sold a number of our holdings, we believe our current investments are more attractively valued than the sector overall as well as the broader market.

We also maintain an overweight to the financials sector, in which our exposure has been mainly to large money-center and trust banks. While it is not unusual for these banks to trade at a discount to the broader market index, our analysis shows that their current valuation discounts are greater than historical averages and that any potential recession has been more than factored into their share prices.

Furthermore, we continue to hold an overweight to health care as we consider it as one of the few defensive sectors with enough controversy to be attractively valued. In contrast, other traditional defensive sectors, such as consumer

staples, utilities, and real estate, represent some of our larger underweights. Many companies in these sectors appear expensive to us as market participants seem willing to overpay for their perceived defensiveness in the event of a recession.

As a reminder, while the above discussion focuses on our sector weightings, our stock selection is based on a bottom-up, fundamental analysis and our sector allocations are a by-product of those individual company decisions. We believe the differences between the Brandes U.S. Value Equity Strategy and the broader U.S. market continue to make it an attractive complement to more index-like or growth-oriented alternatives.

There has been a large return dispersion among sectors within the broad market (Russell 1000 Index) this year, with technology-related companies—not only those in the technology sector, but also in communication services (i.e., Meta Platforms) and consumer discretionary (i.e., Amazon)—up while the rest of the market was largely flat. As most of these businesses fall under the growth category, their stock-price appreciation has led to a widening valuation divergence between the value and growth indices. As of 30 June 2023, value stocks (MSCI USA Value) again traded at some of the largest discounts to growth stocks (MSCI USA Growth) since the indices' inception across a variety of valuation metrics, including price/earnings, price/cash flow, enterprise value/sales. These larger-than-average discount levels have historically portended attractive returns for U.S. value stocks over the long term. We are optimistic about the potential of value stocks in general and believe the Brandes U.S. Value Equity Strategy is well positioned given its historical tendency to outperform the Russell 1000 Value Index when it outperforms the Russell 1000 Index.

Enterprise Value: Market capitalisation plus debt, minority interest and preferred shares, minus total cash and cash equivalents.

Enterprise Value/Sales: Enterprise value divided by annual sales.

Enterprise Value/Free Cash Flow: Enterprise value per share divided by free cash flow per share.

Free Cash Flow: Total cash flow from operations less capital expenditures.

Normalised Earnings: Earnings adjusted based on economic cycles.

Profit Margin: Net income divided by revenues.

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

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

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

The Russell 1000 Value Index with gross dividends measures performance of the large cap value segment of the U.S. equity universe. Securities are categorised as growth or value based on their relative book-to-price ratios, historical sales growth, and expected earnings growth.

The MSCI USA Value Index captures large and mid cap U.S. securities exhibiting overall value style characteristics, defined using book value to price, 12-month forward earnings to price, and dividend yield.

The MSCI USA Growth Index captures large and mid cap U.S. securities exhibiting overall 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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