Brandes Corporate Focus Bond Fund

Fund Commentary

The fixed income Interest rates continued their march higher during the third quarter, particularly for longer maturity bonds. In fact, the 10-year U.S. Treasury yield rose 60bps more than did the two-year Treasury yield during the period. The story of the quarter and of the year continues to be the fight by the Federal Reserve (the Fed) to get inflation under control.

At the Federal Open Market Committee meeting in September the Fed – as most expected – held the fed funds rate steady in what we could characterize as a *hawkish pause*. While the Fed held rates steady, they intimated that there is likely one more hike coming for the fed funds rate. With the release of their Summary of Economic Projections (SEP), the Fed also revised their projection of GDP growth upward for this year and next, cut their forecast of the unemployment rate for the next two years and pushed out the expected timeline to hit their 2% inflation target until 2026. While the Fed paused rate hikes at the September meeting, nevertheless their messaging was clearly *hawkish*.

In our (Brandes LP) view, coming into the third quarter the market appeared to be too complacent regarding the possibility that inflation would stay *stickier* for longer or possibly even reaccelerate. The Fed started raising rates in March 2022 in an effort to cool the economy and tame inflation, yet since that time:

- Unemployment is unchanged.
- The Financial Conditions Index shows easier conditions than when they started raising rates.
- After some moderation in 2022, housing prices are again trending upward.
- Energy costs are higher.
- The Baltic Dry Index – a measure of commodity shipping costs – has experienced a sharp rise recently that should translate into future higher transportation surcharges.
- More recently there have been several large labour strikes – UPS, UAW, Writers' Guild (screenwriters), SAG_AFTRA (actors) and Kaiser Permanente (the largest ever U.S. healthcare strike) – all of which will likely feed into wage inflation.

We believe that the market has been of the mind that as inflation has been heading lower then it must continue to head lower. As evidence, at the end of the second quarter the market was pricing in nearly 150bps in rate cuts expected for 2024. After the rise in rates in the third quarter, the market is now anticipating nearly 100bps in rate cuts in 2024. While that is now more in-line with the Fed's SEP median of 50bps in rate cuts next year, it remains more optimistic than the Fed's indication. There are multiple data points, however, that suggest the *last mile* of inflation reduction will likely be *bumpy* at best.

In the credit markets, both investment grade and high yield bonds posted strong returns relative to U.S. Treasury securities. As we illustrated last quarter, the yields offered by corporate bonds are near the highest we have seen in nearly 15 years, which has led to considerable optimism about the asset class. A closer look, however, indicates that the rise in yield on corporate bonds is largely attributable to the increase in Treasury yields rather than a cheapening of overall credit spreads. The corporate market appears to be *priced for perfection*. Accordingly, we believe caution is warranted when allocating to the sector.

Portfolio Performance

In the third quarter, the Brandes Corporate Focus Bond Fund delivered positive absolute returns and had positive relative performance versus its benchmark, the Bloomberg U.S. Intermediate Credit Bond Index.

Term-structure positioning was a positive factor during the quarter. After the sharp drop in yields in March related to stress in the regional banking system and concerns over debt ceiling negotiations, U.S. Treasury yields continued their march higher as those specific concerns faded and the market started thinking interest rates could be *higher for longer*.

We moved the duration of the portfolio from 80% of the benchmark's duration to 85% towards the end of February. Near the end of September, we moved the duration of the portfolios to 90% of the benchmark's duration.

Within corporate bonds, performance during the period was led by corporate bond holdings in information technology (MicroStrategy and Meta) and telecom (Telecom Italia).

Select holdings in banking (U.S. Bank, Citibank and Bank of America), healthcare (Tenet Healthcare) and Energy (Range Resources) modestly detracted from performance.

Portfolio activity was modest during the quarter. The portfolio added one new position in a secured bond from Transocean Inc. (8.75% coupon, maturing 2/15/30, rated B2/B). Transocean is one of the largest global offshore contract drilling services providers for oil and gas. The company has a modern fleet of rigs, including 28 ultra-deepwater floaters that drill in waters as deep as 12,000 feet and eight harsh-environment floaters that can drill in subarctic waters like the North Sea. Top customers include Petrobras, Shell and Chevron.

Transocean's challenges over the past few years have been elevated capital expenditures, a looming debt maturity wall and a depressed market for offshore drilling. However, we believe all three challenges have largely been addressed as new drill rigs have been delivered and paid for, debt maturities are more modest and the market for offshore drilling has materially improved. The industry supply of modern drill rigs is down 50% since 2014 and Transocean owns approximately 35% of the modern fleet. Additionally, the bond we purchased is secured by five specific drill rigs, giving us a solid measure of asset coverage in our view.

We sold our full position in Continental Resources (4.375% coupon, maturing 1/15/28, rated Baa3/BBB-) as the bond's credit spread traded through our estimate of its fair value.

Outlook

As we head into the last quarter of the year, yields in the fixed income market are at levels that we have not seen since mid-2009 – nearly 14 years. The caveat, however, is that the excess yield spread that investors receive for owning corporate bonds or mortgage-backed securities implies a market that is priced close to perfection in our view.

As we mentioned last quarter, illustrating that "perfection pricing," we note that by the end of the quarter we have more credits in the portfolio (or actively monitored) that we view as closer to their sell targets than we have credits that are close to our internal buy targets.

One of the *storm clouds* that the corporate bond market may have to navigate soon is the increased interest costs facing most companies as they attempt to refinance debt coming due over the next few years. Nearly 25% of investment grade and high yield corporate market bonds have less than three years until maturity.

We looked at the difference between the average coupon rate and the average yield-to-maturity for both the investment grade and high yield corporate markets as a rough proxy for the expected increase in interest costs. According to Bloomberg as of the end of the third quarter, the difference for the investment grade corporate market was 1.91% and for the high yield market it was 2.64%. To add further context to the potential shock corporate treasurers are about to experience, is that since 2010, in an extended period of declining interest rates, that spread has been negative except for two brief periods: in late 2018/early 2019 and at the height of the COVID pandemic.

This potential headwind facing the corporate market, in our view, highlights the importance of robust, long-term focused, fundamental research as we move forward.

There appears to be palpable excitement about fixed income among investors. We share much of this optimism as overall yields in the portfolio are the highest they have been since 2009. Our main caution, however, is that we believe it is important to remain disciplined in what one buys. Higher yields are welcome for long-term savers and investors, but a potential burden for companies that have lived and survived for the better part of the past 15 years on near zero rates.

The takeaway in our view is that deep, measured, fundamental research is essential as we move forward in an environment where idiosyncratic risks appear to be on the rise. We believe it's critical to be patient in adding to a portfolio: to not just know *what* you own but *why* you own it.

For a considerable period now, we have attempted to tilt the Brandes Corporate Focus Bond Fund into what we believe is a defensive posture to mitigate some of the potential detrimental impact of rising interest rates and widening yield spreads. We believe that this remains a risk. Accordingly, the portfolio continues to favour shorter-maturity corporate bonds and those that we believe exhibit strong, tangible asset coverage. While we made a modest extension to duration in the quarter, we are still managing duration approximately 10% shorter than the portfolio's benchmark. We have a meaningful allocation to U.S. Treasuries and if market uncertainty and volatility continue to cause credit fundamentals to become mispriced relative to our estimates of intrinsic value, then we will look to redeploy some of those Treasury holdings thoughtfully and effectively to take advantage of opportunities.

As we move forward, we believe prudence dictates that we continue our search for value in a measured and deliberate manner while continuing to tilt the portfolio to what we believe is a relatively defensive posture.

We remain optimistic about the prospects for the Brandes Corporate Focus Bond Fund.

About Brandes LP

In the 40-plus years since Brandes LP was founded, its goal has remained the same: pursue above-market gains to help investors move closer to their long-term investment objectives.

Brandes LP believes that its unwavering commitment to value investing will lead it to attractively priced, fundamentally sound companies worthy of inclusion in the Fund.

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Fundamentals

	FUND	INDEX
Average Quality	A-	A-
Average Duration	3.52	3.95
Average Coupon	4.43%	2.52%
Average Price	$ 90.47	$ 91.43
Average Yield to Maturity	7.01%	5.84%
Current Yield	4.90%	3.85%

	FUND	INDEX
AAA (includes cash)	36.4	9.7
AA	1.5	8.1
A	12.5	38.5
BBB	19.7	43.7
<BBB	29.9	0.0

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Quarterly Additions/Deletions

Additions	Deletions
Transocean (8.75% coupon, maturing 2/15/30)	Continental Resources (4.375% coupon, maturing 1/15/28)

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