Brandes Corporate Focus Bond Fund

Fund Commentary

Boxing great Mike Tyson once said: “Everyone has a plan until they get punched in the mouth.” The swift repricing of fixed income markets in the first quarter, the likes which we have not seen since the 1970s, appeared to knock the Federal Reserve (Fed) and many investors on their heels.

During the quarter, the Fed was forced to quickly pivot from their plan of slowly and methodically winding down the most accommodative monetary policy in their history, to aggressively updating their forecasts for future rate hikes and balance sheet reductions.

In mid-December the Fed released its closely watched “dot plot”[1], which pegged the median forecast for the fed funds rate at 0.81% for year-end 2022 and 1.65% for year-end 2023. The updated March dot plot pegged the median fed funds rate at 2.05% for year-end 2022 and 2.81% for year-end 2023. This represents an abrupt upward shift in just three months and is particularly interesting in the context of the Fed’s view that the long-term normalized fed funds rate is 2.5%. The updated dot plot forecasts imply that the Fed believes that they will have to aggressively tighten above the projected long-term normalized rate to tame inflation. That’s a considerable about-face from the transitory narrative that dominated their thinking for the better part of the past two years.

Market expectations abruptly changed as well. Last quarter we (Brandes LP) highlighted the disconnect between the Fed’s forward interest rate guidance and market expectations, noting that market expectations for the terminal fed funds rate were much lower than Fed guidance. As the market reset future expectations guided by the newly hawkish Fed, rates swiftly moved higher to levels not seen in several years.

After two years of a global health pandemic, during this quarter the world has had to grapple with the worst outbreak of European military violence since World War II. Navigating monetary policy through this turbulent time has undoubtedly been a difficult task, but history will likely show that the Fed has simply waited too long to begin policy normalization and hence has run the risk of falling well behind the curve on inflation. Many commentators (including ourselves) have made this accusation, and we finally feel like we’re no longer the old man yelling at the clouds when it comes to expressing concerns about inflation.

We’ve previously accused the Fed of being guilty of policy inertia and we’ve hoped that inertia would not lead to a policy error. It increasingly looks like the Fed has indeed made a policy error with its continuation of unprecedented stimulus well after the initial shock of the pandemic receded. As a result, taming inflation while achieving a soft landing for the economy has become decidedly more difficult and could lead to additional market volatility.

Portfolio Performance

In the first quarter, the Brandes Corporate Focus Bond Fund posted negative absolute returns, but had positive relative performance versus its benchmark, the Bloomberg U.S. Intermediate Credit Bond Index.

Holdings in energy (Range Resources & Occidental Petroleum), information technology (MicroStrategy) and healthcare (Tenet Healthcare) aided returns.

Select holdings in banking (U.S. Bank) and food processing (Pilgrim’s Pride) detracted from returns.

Term-structure positioning was a positive factor in relative performance as interest rates rose sharply. The portfolio was positioned near the bottom of its duration-controlled band during the quarter, helping to mitigate the impact of rising rates on a relative basis.

The portfolio added new positions in Mauser Packaging (7.25% coupon, maturing 4/15/25, rated Caa3/CCC), Charles Schwab Inc. (5.375% coupon, perpetual, callable 6/1/25, rated

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Baa2/BBB), Citigroup Inc. (4.40% coupon, maturing 6/10/25, rated Baa2/BBB) and Methanex Corp. (5.125% coupon, maturing 10/15/27, rated Ba1/BB).

We believe that the Charles Schwab bond that we purchased is a good example of a situation where the distinctive structure of the security presents an attractive value opportunity. This bond is a junior subordinated security – it ranks lower in the company's capital structure. It pays a fixed-rate coupon until June 2025; if the bond is not called in June 2025, it will become a perpetual security, and its coupon will revert to a floating rate based on the 5-year U.S. Treasury rate plus 4.97% - with a quarterly reset. The reset rate will be at a yield spread that is similar to where low-quality high yield bonds generally trade.

The distinctive feature of this bond is that if Charles Schwab chooses not to call the security in June 2025, the company does not have the option to call it again for an additional five years. At today's interest rates the coupon would reset to nearly 7%. Given the relatively high cost of a coupon reset and the limited flexibility offered to the company for future calls, we believe that this bond is best treated as a bullet security with a 3-year maturity.

Charles Schwab issued this bond in April 2020 during the early stages of the pandemic, which we believe is the likely explanation of why the bond's structure is not representative of the strong underlying credit quality of the company. As a result, this represents an attractive value opportunity to us.

The portfolio also added to existing positions in Coty Inc., MicroStrategy and Netflix.

The portfolio exited our full position in Occidental Petroleum (3.50% coupon, maturing 6/15/25, rated Ba1/BB+), experienced a full call in Range Resources (9.25% coupon, maturing 2/1/26, rated B1/BB-) and saw maturities in Microsoft Corp. and ExxonMobil.

Outlook

From a total return perspective, the performance of virtually the entire fixed income universe was quite painful during the first quarter. Interest rates moved up swiftly from a very low base, leading to negative returns across the fixed income spectrum.

As we begin the second quarter, higher yields in the market and in portfolios can help cushion some of the impact if we are in the midst of secular change to a higher rate environment. With any investment, and in particular fixed income, time horizon is important. In the short term, interest rate increases can cause negative total returns. However, over a longer time horizon, higher rates can allow a diversified portfolio to reset to a higher level of income that a portfolio can generate.

For a considerable period now, we've attempted to tilt the Brandes Corporate Focus Bond Fund into what we believe is a defensive posture in order to mitigate some of the detrimental impact of higher interest rates and wider yield spreads. The portfolio continues to favour shorter-maturity corporate bonds and those that we believe exhibit strong, tangible asset coverage. We are managing duration toward the shorter end of our duration-controlled range. We have a substantial allocation to U.S. Treasuries and if recent market uncertainty and volatility continues 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.

During the quarter we found several new bonds that we believe meet our criteria as attractive value opportunities and market volatility provided chances to add to a number of securities that we currently own.

As we move forward, we believe prudence dictates that we continue our search for value at the margins while continuing to tilt the portfolio to what we believe is a relatively defensive posture.

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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.

[1]Bloomberg, Federal Reserve, 12/15/21 and 3/17/22

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Fundamentals

	FUND	INDEX
Average Quality	A	A-
Average Duration	3.62	4.34
Average Coupon	3.24%	2.95%
Average Price	$ 98.29	$ 98.37
Average Yield to Maturity	3.55%	3.22%
Current Yield	3.30%	3.01%

	FUND	INDEX
AAA (includes cash)	48.6	9.7
AA	0.0	8.1
A	10.0	37.2
BBB	18.1	45.0
<BBB	23.3	0.0

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Quarterly Additions/Deletions

Additions
Mauser Packaging (7.25% coupon, maturing 4/15/25, rated Caa3/CCC)
Charles Schwab Inc. (5.375% coupon, perpetual, callable 6/1/25, rated Baa2/BBB)
Citigroup Inc. (4.40% coupon, maturing 6/10/25, rated Baa2/BBB)
Methanex Corp (5.125% coupon, maturing 10/15/27, rated Ba1/BB)

Deletions
Occidental Petroleum (3.50% coupon, maturing 6/15/25, rated Ba1/BB+)
Range Resources (9.25% coupon, maturing 2/1/26, rated B1/BB-)
Microsoft Corp (2.40% coupon, maturing 2/6/22)
ExxonMobil Corp (2.40% coupon, maturing 3/6/22)

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on the BRIDGEHOUSE INDEPENDENT PLATFORM