Brandes Investment Partners, L. P.
Japan Equity Portfolio Notes
Second Quarter 2016 (April 1 – June 30, 2016)

In the second quarter of 2016, the Brandes Japan Equity Strategy outperformed its benchmark, the MSCI Japan Index, which gained 1.0%.

Positive Contributors

Holdings in pharmaceuticals, specifically **Taisho Pharmaceutical Holdings** and **Daiichi Sankyo**, contributed positively to returns. The strategy's large allocation to **Okinawa Electric Power**, which completed a stock split while maintaining its dividend per share, also added to performance. We appreciated Okinawa Electric Power's effort to improve returns to shareholders and it appeared that the market welcomed the move as well.

Furthermore, a lack of exposure to capital markets and diversified financial services helped returns relative to the benchmark.

Performance Detractors

Our holdings in the machinery sector detracted from returns, most notably **Fuji Machine Manufacturing**, **Komori Corporation**, **Hitachi Koki** and **Sintokogio**. Positions in **Nissan Motor** and **Honda Motor** also negatively impacted returns.

Furthermore, the strategy's continued lack of exposure to telecommunication services hurt performance relative to the benchmark quite significantly.

Select Activity in the Second Quarter

The volatile market created opportunities for the strategy to reduce positions in some of the larger allocations that contributed positively to returns, such as Daiichi Sankyo, Taisho Pharmaceutical Holdings, and **Yodogawa Steel Works**. In addition, we exited our position in electronic parts and ceramic manufacturer **Maruwa**, initially purchased in June 2015, as the share price exceeded our estimate of its intrinsic value.

The investment committee took advantage of the market decline (the MSCI Japan Index fell nearly 15% in Japanese yen terms from late April to late June) to initiate eight positions, a rare occurrence considering the strategy's low historical turnover. The new additions were **Alpine Electronics**, **Fuji Media Holdings**, **K&O Energy Group**, **Nihon Nohyaku**, **Oyo Corporation**, **Tokyo Ohka Kogyo**, **Sekisui Jushi** and **Sumitomo Mitsui Financial Group**.

With the exception of Sumitomo Mitsui Financial Group, which we address below, the new purchases reflect similar themes from the majority of other holdings in the strategy, including:

- *Very strong balance sheets with excess capital*: On one hand, the excess capital can result in low returns on capital and presents a risk of poor capital deployment. On the other hand, however, it can provide a downside intrinsic value protection, in our opinion.
- *They traded below book value at quarter end:* The shares were at levels that provided significant margin of safety based on our estimates of their true worth.

In our view, these companies not only represent undervalued investment opportunities, but also enhance the strategy's diversification as they operate in various industries serving a wide range of end-markets:

- Alpine is a car electronics manufacturer. The company provides equipment mostly to OEMs (original equipment manufacturers), unlike the strategy's other holding in the industry, JVC Kenwood, which focuses on the end-retail market.

- Television broadcaster Fuji Media adds exposure to the national media market, as well as to the real-estate market through its sizeable ownership of prime assets in the Tokyo region.
- K&O Energy produces and distributes natural gas domestically.
- Oyo Corporation is Japan's leading geo-engineering and environmental-engineering services provider.
- Nihon Nohyaku is a manufacturer and developer of agrochemicals.
- Tokyo Ohka Kogyo produces specialty chemicals for LCD (liquid crystal display) and semiconductor equipment.
- Sekisui Jushi is a manufacturer of traffic and road accessories, such as traffic signs and road-safety materials.

Moreover, continuing the trend from the first quarter, the strategy has selectively and slowly increased its bank exposure by adding to existing positions (**Hyakugo Bank**, **Japan Post Bank** and **Kyushu Financial Group**) and initiating a position in Sumitomo Mitsui Financial Group, a company we had owned in the past.

The Japanese financials sector as a whole has been impacted by the Bank of Japan implementing a negative interest-rate policy. While banks will surely suffer from compressed net-interest margins during periods of ultra-low and now negative interest rates, we believe that over the long term, the Japanese economy may improve and interest rates will return to higher levels. However, as the history in Japan has shown, low interest rates can last for a very long time and we cannot predict *when* and *how* the interest-rate increase will happen. We may also be incorrect in our view that it will happen at all. While these risks and uncertainties are present and valid, based on our long-term investment philosophy and the significant margin of safety that these banks currently provide, we believe the risk/reward tradeoff warrants investments in these companies.

Current Thoughts and Conclusion

Amid what appears to be increased pessimism and uncertainty over Japan's economy and currency, we believe the opportunities to find and invest in undervalued securities have significantly broadened, bringing some new excitement for our research analysts, who continue to scour the investment universe. The monitoring list of securities for which the investment committee has placed intrinsic value estimates has expanded, and we have even observed opportunities in industries that had not shown compelling valuations for a long period. The strategy's weighted average margin of safety has increased over the past two years, indicating that the strategy is well positioned to pursue an attractive long-term return potential, in our opinion. While market decline tends to test investors' mettle, we are excited about the increased opportunities.

Most of the companies in the strategy completed their 2016 annual general meetings in June. We are pleased to report that on the provided occasions, Brandes continued to vote against boards of directors that were not majority independent, and against non-independent statutory auditors. For some companies, we voted against dividend proposals due to the low payout ratio in light of the companies' excess capital. We also selectively voted against independent directors whom we felt were not independent enough or did not bring the relevant experience.

We continue to believe corporate governance is a crucial aspect of long-term investing and that proxy voting is a very important tool to send a strong message to companies. In addition to proxy voting, we intend to remain proactive in communicating with the companies that we believe are excessively capitalized. Given the Japanese equity market's decline, deploying excess capital in share buybacks has become a lot more attractive value proposition for the companies and to shareholders. As such, we plan to pass this message along to the companies we hold.

As always, thank you for your business and continued trust.

Diversification does not assure a profit or protect against a loss in a declining market.

The declaration and payment of shareholder dividends are solely at the discretion of the issuer and are subject to change at any time.

Book Value: The total value of a company's assets that shareholders would theoretically receive if the company were liquidated.

Margin of Safety: The discount of a security's market price to what the firm believes is the intrinsic value of that security.

Intrinsic Value: The actual value of a company or an asset based on an underlying perception of its true value.

Net Interest Margin: Interest income generated by a financial institution minus the amount of interest paid to its lenders, divided by average earning assets.

The MSCI Japan Index with net dividends measures equity market performance in Japan.

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