

Brandes Investment Partners
Global Small Cap Equity Strategy Notes
Third Quarter 2024 (July 1 – September 30, 2024)

The Brandes Global Small Cap Equity Strategy gained 9.60% net of fees and 9.78% gross of fees, outperforming its benchmark, the MSCI ACWI Small Cap Index, which was up 8.80% in the quarter. The MSCI ACWI Small Cap Value Index returned 10.05%.

Annualized total return as of September 30, 2024	1-year	5-year	10-year
Brandes Global Small Cap Equity Composite (net)	39.53%	18.70%	9.67%
Brandes Global Small Cap Equity Composite (gross)	40.44%	19.64%	10.58%
MSCI ACWI Small Cap Index	24.62%	9.39%	7.80%

Past performance is not a guarantee of future results. One cannot invest directly in an index. Returns include reinvestment of all dividends and are reduced by any applicable foreign withholding taxes, without provisions for income taxes, if any.

Positive Contributors

Notable contributors included holdings in industrials and health care.

Brazil-based regional jet manufacturer Embraer and U.K.-based aerospace and defense company Rolls-Royce reported improved earnings amid strong demand in their aerospace end markets. Embraer also announced that it will receive a settlement from Boeing for the latter company’s unsuccessful takeover bid, while its stock benefited from recent inclusion in the MSCI Emerging Markets Index.

Within health care, leading contributors included Japanese health care testing services company H.U. Group and Kissei Pharmaceuticals, as well as Spain-based biotechnology firm Grifols. In July, Grifols confirmed that its founding family, which controls 30% of the company, is evaluating a potential joint takeover bid for the entire business with Brookfield, a multinational Canadian alternative investment fund. The structure and pricing of the takeover remain unclear, but the market reacted positively to their proposal.

Other notable performers included consumer staples companies J Sainsbury (U.K.) and Greencore Group (Ireland), as well as U.S. networking products firm NETGEAR. In September, NETGEAR revised its guidance upward after entering into a settlement agreement with TP-Link regarding pending patent infringement disputes. NETGEAR received a \$135 million settlement, and all pending litigation between the two parties will be dismissed. The company also announced an earlier-than-anticipated launch of its 5G mobile hotspot.

Performance Detractors

While much of the Japanese market rebounded following its August decline—which was driven by the sudden volatility in the Japanese yen, Bank of Japan rate rises, and earnings concerns—it was not the case for our Japanese financials holdings. Hachijuni Bank and Oita Bank declined, and our underweight to the country detracted from relative returns.

Select U.S.-based holdings performed poorly as well, notably energy equipment firm Innovex International, consumer products business Edgewell Personal Care, and specialty construction company Orion Group.

Orion announced a \$25 million equity raise, with plans to use the net proceeds for working capital and general corporate purposes which may include debt repayment. The decision to raise capital was driven partly by a delay in Orion’s \$30 million land sale agreement, which has taken longer than expected to close. Additionally, Orion’s balance sheet has been under pressure over the past two quarters due to expanding working capital needs, stemming from a six-month delay on a large U.S. Navy project where Orion is a subcontractor. We believe the capital raise was a prudent move as it provides the company with greater control over its destiny while awaiting the land deal closure and a reversal in the working capital cycle. It should also allow Orion to participate in the upcoming infrastructure cycle inflection mostly intact.

Other detractors included Canadian juvenile and home products company Dorel Industries and Hong Kong's PAX Global Technology. On a relative basis, our underweights in financials and real estate, two of the strongest-performing sectors in the benchmark, detracted from returns.

Select Activity in the Quarter

It was a relatively busy period for the portfolio in terms of buying and selling. The small-cap investment committee initiated positions in several companies: U.K.-based Burberry Group, Mexico-based Bolsa Mexicana de Valores, Brazilian electric utility Neoenergia, and Indonesian noodle company Indofood, as well as U.S.-based packaging company Sealed Air, grocer Ingles Markets, and aerospace and defense company Hexcel.

With a rich history dating back to 1856, Burberry primarily sells apparel and accessories. The company went public for the second time in 2002 after nearly five decades under the U.K. retail conglomerate Gus. Since its re-listing, Burberry has been refining its business model to focus on elevating the brand.

When Gus spun off Burberry, more than half of its revenue came from the wholesale channel. After investing in its retail channel roll-out, almost 80% of the company's revenue is now from direct-to-consumer sales, either through its stores or online—aligning it more closely with its luxury peers. This shift from wholesale to direct retail has been positive for Burberry, as it has allowed the company to better control its brand image, including customer experience and pricing. In addition to the retail channel expansion, Burberry has streamlined its product offerings, concentrating on categories where it has a distinct legacy and brand appeal. Despite a management turnover in 2022, Burberry's core strategy has remained largely unchanged.

In the past few years, the luxury goods industry has lagged the broader global market (MSCI ACWI Small Cap) as concerns about Asia's economic prospects have dampened the outlook for many companies in the industry, including Burberry.

Asia Pacific accounts for more than 40% of Burberry's revenue, with China accounting for about half of that. This is typical for players in the industry as Asia Pacific represents the largest luxury goods market in the world. Recently, a weak Japanese yen and a sluggish Chinese economy have created a challenging environment for luxury goods businesses. However, while the luxury market is sensitive to macroeconomic changes, history suggests that the top luxury brands can still accrue value even during times of low economic growth. For example, it is estimated that the luxury goods market in Japan has continued to grow over the past 15 years even as the Japanese economy contracted (in U.S. dollar terms).

We believe Burberry's issues are temporary in nature and have created a compelling entry point (its stock has declined by over 60% in the past 18 months) for an investment in a company with heritage brand value, resilient financial performance amid topline cyclicality, and a strong balance sheet.

Mexico-based Grupo Bolsa Mexicana de Valores (BMV Group) operates the Mexican Stock Exchange and other cash, listed derivatives, and over-the-counter markets for various asset classes. Founded in 1894, BMV is now the second-largest stock exchange in Latin America. It is the only fully verticalized operation that offers integrated trading and post-trading solutions for multiple asset classes, including equities, fixed income, derivatives, and exchange-traded funds. Additionally, the company provides custody, clearing, and settlement facilities, as well as data products for the local and international financial community.

Mexico's national election in early June led to a sell-off in the country's financial market and a depreciation of the peso. This heightened political uncertainty, combined with perceived limited growth prospects, competition threats, and concerns about high real interest rates in Mexico, has weighed on BMV's outlook. However, we believe that the company's current challenges have been more than reflected in its share price. We appreciate BMV's healthy balance sheet and its history of paying dividends and repurchasing shares, as well as the fact that its business has a franchise that is difficult to replicate. Additionally, the company has been investing to upgrade its technology infrastructure and has grown revenues and profits above inflation despite facing currency, competition, and domestic trading volume headwinds. At its current valuations, BMV represents an attractive value opportunity to us.

Founded in 1946, Hexcel (HXL) is a manufacturer of carbon fiber composite materials and composite engineered structures for commercial aerospace, defense, space, and industrial end-markets. HXL's composites are a key input for a variety of applications, including aerostructures (wings, fuselage, engine casings), primary structures on spacecraft, and carbon ceramic brakes for high-performance cars. About 90% of its revenues comes from aerospace programs (commercial and defense), with HXL active on all modern Airbus and Boeing platforms, as well as over 100 defense programs.

Since the pandemic, HXL has faced industry-wide skilled-labor shortages, supply-chain bottlenecks, and input cost inflation. These challenges have slowed the production ramp on key commercial platforms and compressed HXL's margins as the company operates under fixed-price contracts. Additionally, HXL had increased capacity ahead of the production ramp and thus has been operating at suboptimal efficiency on a substantial fixed-cost base. While these headwinds have started to ease and HXL fundamentals have moved closer to pre-pandemic levels, lingering supply-chain issues in recent months have slowed production on commercial aerospace platforms at Airbus and Boeing, prompting questions about the pace of normalization. The outlook has been further dampened by regulatory hurdles and the Boeing labor strike, though it should be noted that HXL's commercial exposure is primarily to Airbus.

Despite the supply-chain issues starting to alleviate, the market seems to extrapolate HXL's prospects from its short-term challenges, causing its share price to fall. However, we expect the environment to gradually normalize and HXL to resume its recovery to pre-pandemic levels. Among aerospace composite manufacturers, HXL holds a leading market share and is the most vertically integrated player, with strong capabilities throughout the value chain. There is also potential for secular growth from new aircraft designs that will incorporate more carbon fiber content as the industry seeks to reduce emissions. This should bode well for demand for HXL's products in the long term. Furthermore, we appreciate HXL's attractive financial characteristics, including a solid balance sheet, healthy free-cash-flow generation, and an operating culture focused on return on invested capital metrics. At its current valuations, HXL offers an appealing risk/reward to us.

Other portfolio activity included the full sales of Swiss pumping equipment business Sulzer, aerospace and defense company Heroux-Devtek, and U.K. retailer Marks and Spencer.

Year-to-Date Briefing

The Brandes Global Small Cap Equity Strategy gained 26.01% net of fees and 26.63% gross of fees, outperforming its benchmark, the MSCI ACWI Small Cap Index, which was up 11.29% in the nine months ended September 30, 2024, and the MSCI ACWI Small Cap Value Index, which returned 11.25%.

Holdings across multiple sectors drove returns, led by industrials, consumer staples, and consumer discretionary. Leading performers included Embraer, Heroux-Devtek, and Rolls-Royce in industrials, Greencore Group in consumer staples, and apparel company Yue Yuen Industrial in consumer discretionary. Bank holdings AIB Group (Ireland) and Nova Ljubljanska Banka (Slovenia) also aided returns. Geographically, holdings in the United States, Hong Kong, the United Kingdom, Ireland, and Brazil were solid contributors.

Several positions in health care and energy declined, specifically Spain's Grifols, France-based Euroapi, and U.S. Innovex International. Furthermore, our lack of exposure to India weighed on relative returns.

Current Positioning

With the addition of Hexcel and the appreciation of our holdings, the strategy's allocation to industrials increased, and the sector remains its largest exposure from an absolute and relative standpoint. The strategy also maintains significant weights in consumer staples, financials (although underweight relative to the benchmark), and health care, while retaining underweights in technology, real estate, materials, and consumer discretionary.

Geographically, the strategy continues to have meaningful exposure to companies in the U.K., Spain, Ireland, and emerging markets, and a notable underweight to the United States. In our opinion, the differences between the Brandes Global Small Cap Equity Strategy and the MSCI ACWI Small Cap Index make it an attractive complement to other small-cap offerings, especially those that are growth-oriented or passively managed.

Compared to the benchmark, our strategy exhibits lower valuations, while also offering exposure to companies that we believe have strong balance sheets, compelling growth prospects, and a history of durable free-cash-flow generation. Going forward, we remain optimistic about the portfolio's holdings composition and the risk/reward tradeoff it offers.

For term definitions: <https://www.brandes.com/termdefinitions>

The MSCI ACWI Small Cap Index with net dividends captures small cap representation across developed and emerging markets countries.

The MSCI ACWI Small Cap Value Index captures small cap securities across developed and emerging markets countries exhibiting overall value style characteristics, defined using book value to price, 12-month forward earnings to price, and dividend yield.

The MSCI Emerging Markets Index with gross dividends captures large and mid cap representation of emerging market countries.

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