# Brandes Corporate Focus Bond Fund

## Fund Commentary

By some accounts, the first half of 2022 was the worst bond market performance since '88 – that is 1788[1]. Interest rates continued to march higher, equity markets continued to move lower, and inflation readings hit levels not seen since the 1970s. The Federal Reserve (Fed) – which prides itself on offering the markets transparency through forward guidance – leaked to the press two days before their mid-June meeting that a 75bps increase in the Fed funds rate was in the cards when weeks earlier they had guided the markets towards expecting only a 50bps rate hike.

This period can be viewed as a cautionary reminder of one of Aesop's Fables: *be careful what you wish for, lest it come true*. The Fed undertook a herculean effort to slay inflation back in the late-1970s to early-1980s. It remains arguably the institution's greatest monetary policy accomplishment. For the past several decades inflation expectations and actual inflation have effectively been an afterthought.

But in recent years, the Fed - for reasons only known to themselves – started to fret about inflation being too low with scant evidence that destabilizing deflation was an actual threat. I've yet to meet someone who said: "I just wish I could pay more to fill up my car or stock my fridge." The Fed, therefore, set out to raise the level of inflation with an unprecedented accommodative and unconventional monetary policy.

Stable prices were seen as a *problem* by the Fed. However, the problem of allowing something to run too hot is that it eventually requires dousing with cold water.

In addition to the Fed's actions, there are certainly two large contributing factors to the return of inflation to historic levels: the pandemic and Russia's invasion of Ukraine. Nevertheless, the Fed has made several policy errors that were reasonably clear in real time:

- Fed policy is best thought of as a *blunt instrument*, but they believed their unwinding of nearly 15 years of unconventional monetary policy would go smoothly.
- The Fed waited far too long to begin the path of policy normalization. Until late 2021 Fed officials were still calling inflation "transitory". In March their forecasts were for inflation to decline to near 2% by year-end 2022, and they continued their outright purchases of U.S. Treasury and agency mortgage-backed securities (MBS) into that month. This is a case of policy inertia leading to policy error.
- Accommodative monetary policy had gone on for so long, and the Fed had worked to dampen volatility and support the markets over the past 15 years. Accordingly, it seems there was general disbelief by the market when the Fed began to telegraph their pivot to a hawkish stance.
- During their monetary policy experiment, the Fed transitioned from their historical approach of using a model-based framework for administering monetary policy to an outcome-based framework that had the practical effect of putting them further behind the inflationary curve.

As we enter the second half of the year, the Fed is faced with the uncomfortable task of walking a tightrope between corralling inflation that has shown scant evidence of dissipating, without damaging an economic environment that appears increasingly fragile.

## Portfolio Performance

In the second quarter, the Brandes Corporate Focus Bond Fund underperformed its benchmark, the Bloomberg U.S. Intermediate Credit Bond Index.

Holdings in consumer products (Avon Products Inc. & Coty Inc.), food processing (Pilgrim's Pride) and energy (Range Resources Corp.) aided returns.

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Avon Products Inc. initiated a call for our (Brandes LP) holding during the quarter but since the bond indenture did not outline a specific call feature, the company called the bond at a *make-whole call* which effectively allowed them to call the issue after paying a premium to bond holders.

Pilgrim's Pride bonds benefited after S&P upgraded the company from high yield to investment-grade in early June.

Select holdings in information technology (MicroStrategy), banking (U.S. Bank & Goldman Sachs) and telecom (Telecom Italia) detracted from returns.

Term-structure positioning was a positive factor in performance as interest rates continued their march higher. 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.

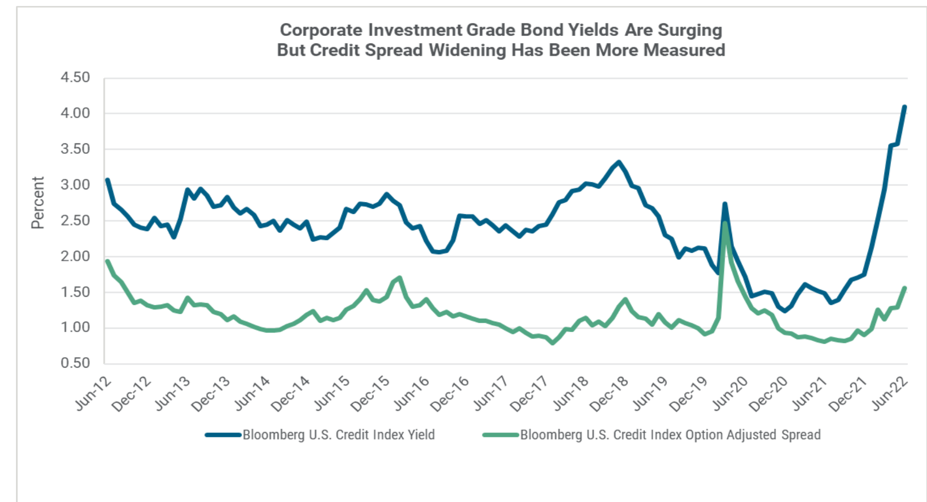
The portfolio added new positions in: Ford Motor Credit (2.70% coupon, maturing 8/10/26, rated Ba2/BB+), Bank of America (4.45% coupon, maturing 3/3/26, rated Baa1/BBB+) and Hess Midstream LP (4.25% coupon, maturing 2/15/30, rated Ba2/BB+).

The portfolio added to existing holdings in Netflix Inc., First Energy Corp. and Charles Schwab Corp.

The portfolio exited its full position in Allison Transmission Inc. (4.75% coupon, maturing 10/1/27, rated Ba2/NR), experienced a full call in Avon Products Inc. (7.00% coupon, maturing 3/15/23, rated Ba3/BB-) and saw a maturity in Continental Airlines in April, as well as a maturity in AT&T Inc. in June.

Overall, while we are starting to see more value come into the corporate bond market, credit yield spreads have not been as volatile as they were in previous episodes of market instability such as 2002 (Enron & WorldCom bankruptcy), 2008 (Global Financial Crisis), and 2020 (COVID pandemic). As the chart below shows, most of the widening in corporate bonds yields has been attributable to the rise in U.S Treasury rates rather than outright weakness in corporate bonds. This reinforces our view that the most prudent approach is to continue to seek value in a measured and deliberate manner.

**Exhibit 1**




As of June 30, 2022. Source: Bloomberg Indices. The Bloomberg U.S. Credit Index measures the investment grade, U.S. dollar-denominated, fixed-rate, taxable corporate and government-related bond markets. It is composed of the U.S. Corporate Index and a non-corporate component that includes non-U.S. agencies, sovereigns, supranationals and local authorities. The U.S. Credit Index Option Adjusted Spread is the difference between the yield of the U.S. Credit Index and the yield on U.S. Treasuries.

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## Outlook

Markets now appear to be exiting a period where valuations were largely artificially propped up by huge injections of liquidity and easy policy by the Fed - not to mention extraordinary stimulus from the federal government. This transition has been painful for virtually every financial asset class over the short-term. In our view, over the last several years fundamentals like cash flow generation, margins and balance sheet positioning have taken a back seat to technical factors like momentum and investor enthusiasm.

Over the longer term, however, we believe that a market where fundamentals largely drive valuations is not only a healthier market, but one where managers focused on finding value through individual security selection have the potential to positively impact portfolio performance.

For a considerable period now, we have attempted to tilt the Brandes Corporate Focus Bond Fund into what we believe is a defensive posture in order to mitigate some of the potential detrimental impact of rising interest rates and widening 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 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.

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.

## 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]Financial Times, July 7, 2022, Datawatch

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# Brandes Corporate Focus Bond Fund

## Fundamentals

| | FUND | INDEX |
|---|---|---|
| **Average Quality** | A | A- |
| **Average Duration** | 3.66 | 4.24 |
| **Average Coupon** | 3.43% | 3.01% |
| **Average Price** | $ 92.02 | $ 94.13 |
| **Average Yield to Maturity** | 5.28% | 4.28% |
| **Current Yield** | 3.74% | 3.20% |

| | FUND | INDEX |
|---|---|---|
| **AAA (includes cash)** | 49.6 | 10.0 |
| **AA** | 0.0 | 8.2 |
| **A** | 7.7 | 37.2 |
| **BBB** | 20.4 | 44.5 |
| **<BBB** | 22.3 | 0.0 |

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## Quarterly Additions/Deletions

| Additions |
| --- |
| Ford Motor Credit (2.70% coupon, maturing 8/10/26, rated Ba2/BB+) |
| Bank of America (4.45% coupon, maturing 3/3/26, rated Baa1/BBB+) |
| Hess Midstream (4.25% coupon, maturing 2/15/30, rated Ba2/BB+) |

| Deletions |
| --- |
| Continental Airlines (5.983% coupon, maturing 4/19/22) |
| AT&T (3.00% coupon, maturing 6/30/22) |
| Avon Products (7.00% coupon, maturing 3/15/23) |
| Allison Transmission (4.75% coupon, maturing 10/1/27) |

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