DODGE & COX®
WORLDWIDE FUNDS

Question: How did global equity markets perform in 2017?

Diana Strandberg: Global equity markets were strong in 2017. With international markets outpacing the S&P 500. The MSCI emerging markets benchmark was up over 37%. The MSCI EAFE up 25%, and the S&P 500 up almost 22%. And this was a pivot point relative to the past ten years, when international markets significantly lagged the U.S. market. The MSCI EAFE was up 1.9% per year over the 10-year period, in contrast to the U.S. 7.8% per year. And those results included the very strong results of 2017. The key reason was earnings growth. U.S. companies had growing earnings, whereas in the MSCI EAFE benchmark earnings declined over a 10-year period. And then the dollar was strong against foreign currencies, which provided a further headwind to international investors. In 2017, the tables turned. International earnings grew 21% and the U.S. dollar weakened 9% against a broad index of major currencies, and that fueled international returns being stronger than the U.S. market. Globally, growth continues to outpace value, and so we continue to find numerous opportunities within the universe. Currently, the disparity of valuation between the S&P and international markets remained wide. The S&P 500's trading at 20 times forward earnings, the MSCI EAFE at about 15, and the emerging markets at about 13 times earnings. because the composition is somewhat different between the U.S. market and the international indices. The U.S. market, the S&P 500, has a higher weighting of internet and technology stocks, which are currently at premium valuations. And the international markets have a higher weighting of financials and materials stocks, which traditionally have below-market valuations.

Question: How have the Funds performed in this market environment?

Diana Strandberg: The Stock Fund, the Global Stock Fund, and the International Stock Fund had good nominal returns in 2017, though they lagged their benchmarks. The U.S. Stock Fund was up 17.6% compared to the S&P 500's 21.8% return in 2017. The Stock Fund did, however, outperform the Russell 1000 Value Index, which was up 13.7%. There were two main reasons that the Stock Fund lagged the S&P 500. The first, is there are a handful of Internet and technology companies, known as the FAANGs—Facebook, Apple, Amazon, Netflix, Google—that significantly outperformed. They were up collectively 50% in 2017. We own only Google of the group. Now they're a shining example of the difference between a good company and a good investment. We agree these are great companies, and they've had excellent growth. Their valuations are at a significant premium and we believe that their growth then has to continue to be excellent to justify these valuations. There's little room for disappointment. We continue to evaluate these companies to see if there's investment merit because we think it's important to have conviction not only in where we choose to invest but where we choose not to, and our viewpoint might change as valuation and fundamentals shift. Our overweight and stock selection in Energy was the second main reason for our underperformance against the S&P 500. Energy was one of the worst performing sectors of the market, down 1%, and our holdings underperformed the sector. My colleague, Bert Bangayan, one of our global energy analysts, will be joining us to talk about our views and positioning in the Energy sector. Industrials were another detractor. Emerging markets were a bright spot in the portfolio. 17 companies comprising 26% of the portfolio were up substantially during the year. Turning to the Global Stock Fund, up 21.5%, the performance drivers were largely the same as those for the Stock Fund and the International Stock Fund. We do want to point out that with a weaker dollar, our hedges against some of our portfolio exposure to the euro, the Swiss franc, and the Chinese renminbi were a headwind to performance in 2017. We're a value oriented, bottom-up investor and there's a risk of being early in identifying investment value. That's a fancy way of saying prices can still go down after we make an initial investment. We try to mitigate this risk by moving incrementally and continuing to evaluate our investment thesis against changing conditions. Where we reaffirm our view and build conviction, we'll continue to lean in, and Energy is a case in point in 2017.

Question: What happened in Energy during 2017?

Bert Bangayan: Oil prices rose but energy stocks didn't perform as well. The price for oil for immediate delivery went from \$57 to \$67, or up about 18%. But longer-term expectations for oil prices didn't rise as much. For example, the price for oil delivered three years in the future was only up 3% during the year.

Question: So despite underperformance, where are we finding opportunities in Energy?

Bert Bangayan: Using our three-to-five-year time horizon, we think Energy's a very attractive area of the market for a couple reasons. First, we think the external environment will be very favourable for energy companies. Going forward, we think demand growth will be very healthy, and with the low level of investments in new projects over the past three years, that supply and demand balance should become even tighter, which would be favourable for oil prices. Second, as bottom-up investors, we are finding selected opportunities where valuations aren't fully reflecting this improvement in fundamentals that we see over the long term. In the exploration and production industry, for example, we think companies like Anadarko, Stat Oil, and Suncor have a good combination of excellent assets, strong management teams, and reasonable valuations. We are also overweight the oil field services sector in companies such as Schlumberger and Baker-Hughes GE. Revenue for these companies has fallen by about half since the peak in 2014, but we think there's significant earnings rebound potential, as upstream companies start to reinvest in their businesses to help offset decline rates and grow production.

Question: What is our investment thesis for Suncor Energy?

Bert Bangayan: Suncor is a Canadian oil company, with most of its production coming from mining oil sands. We think the company's a good example of a management team that's really taken advantage of the cycle. So when oil was above \$100, the company resisted the urge to increase capital spending. Instead, they returned capital shareholders through buybacks and built-up cash on the balance sheet. During the downturn, this allowed the company to play offense. For example, they increased their ownership stake in an oil sands asset called Syncrude at a very attractive valuation. We also like the resource base, which can produce for decades at very low decline rates and with little exploration risk. Over the next few years, we think the company can grow production at very attractive rates and we think the company can generate attractive free cash flow at a wide range of oil prices.

Question: Where is Dodge & Cox finding opportunities?

Diana Strandberg: In 2017, as valuations changed in equity markets, we made a number of incremental bottom-up investment decisions that cumulated into broad portfolio moves. We trimmed Technology and Financial Services holdings and we broadly added to Healthcare, especially Pharma and Energy positions. In addition, as the U.S. market is at a valuation premium to the international markets, these bottom-up decisions also resulted in our tilting toward international holdings in the Global Stock Fund. Non-U.S. companies are now 57% of the Global Stock Fund compared to 41% for the MSCI World. Tech was the best performing sector of the market globally. Tech was up 38% in the MSCI World Index. Absolute and relative valuations rose. If we were looking two years ago, technology stocks traded in line with the World Index at 16 times earnings. Today, they're at a premium at 19 times earnings compared to 17 times for the World Index. We responded to these rising absolute and relative valuations by trimming and selling some of our Technology holdings. An example in the Stock Fund, the Global Stock Fund, would be selling DXC and another example would be selling VMware. We trimmed significantly our holding in Samsung in the Global and International Stock Funds. In addition to Technology, we also trimmed back our Chinese Internet exposure in both the International Stock Fund and Global Stock Funds with trims to Tencent through our holding in NASPERS, Baidu, JD.com, and we sold our position in 58.com. So where are we adding? We made pretty meaningful adds to our Healthcare, particularly Pharma weighting across our equity portfolios. Steve Voorhis, our global pharmaceutical analyst, will be joining us to talk about our views on Pharma and portfolio positioning. Our adds to Pharma increased our weighting. We also added to Energy, which is roughly 8% of each of the equity portfolios. The portfolio weighting didn't change over much, because the underperformance of the stocks counterweighed our adds.

Question: Why are the Funds significantly overweight the Pharmaceutical industry?

Steve Voorhis: To start with, we think valuations in the Pharmaceutical industry are compelling. Our holdings in the sector sell for about 16 times earnings today, which is a substantial discount to the market overall, for companies that we view as stable businesses with strong balance sheets and resilient cash flows. In comparison, the Consumer Staples sector, which is an area where the Funds are very underweight, as we think quite similar characteristics, but sells for 20 times earnings.

We think the reason for the low valuations in the Pharmaceutical sector is concern among investors about regulatory change in the U.S. We've seen that really come into play since the election campaign in 2016, when both presidential candidates were talking about how they would reduce drug prices if they were elected. We spent a lot of time studying this issue, including trips to Washington, and trying to really understand who the key players are, what the changes that might happen could be, and what the likelihood of those changes happening is. And we've come to the conclusion that meaningful change in the regulatory or legislative front is quite unlikely. We think that private payers, PBMs and managed care companies, have been exerting real pressure on pricing and that's likely to continue, but it's a manageable threat for the industry. On the other hand, innovation for the industry has clearly been improving. FDA approvals on new drugs are on the upswing and that includes some real breakthroughs, like what we've seen in immuno-oncology, where companies are coming up with real improvements for patients that are making a real difference. Emerging markets are also doing very well for the drug companies, as are the markets for vaccines and consumer healthcare products. And so in total, we think of this as an industry with some very strong businesses that are generating good growth and trading at very reasonable valuations.

Question: Why did the Funds recently reestablish a position in GlaxoSmithKline?

Steve Voorhis: As always, when looking at new investments here at Dodge & Cox, we look to the downside case first: what will happen to the value of our shares if things don't work out well for the company. In the case of GSK, we think the downside is mitigated by a few factors. First of all, a very diversified business model, where they're not only strong in pharmaceuticals but also have strong businesses in vaccines and consumer products, by a strong balance sheet, and importantly, by a low starting valuation. We then turn to the base case: what happens to us as investors if things work out roughly as we expect for the business. In the case of GSK, we think that means probably moderate growth in revenue and earnings, which, when combined with a 6% dividend yield, should give us pretty good returns as investors. And then lastly, but importantly, in the upside case, if the money that GSK is spending on R&D is able to actually generate important new products, then we think we could have a real benefit not only to earnings at GSK, but also the valuation multiple applied to those earnings. Importantly, the company has a new management team led by a new CEO, Emma Walmsley, who's hired in a number of other senior executives, including a new head of R&D, Dr. Hal Barron, who we think gives us a real chance at seeing that improvement in the R&D output of the company, and really energising the company more broadly. And so as we look to that downside, base case and upside set of scenarios, we think GSK is an interesting opportunity. It may be worth noting that this is, GSK is new to the portfolio this year, but it's not new to Dodge & Cox overall. It's actually a company that we held through 2015, when we sold it based on concerns over both growth and valuation. Over the next two years, we continued following the company and the underlying operations of the business actually did pretty well, better than we had expected that they might. But despite that, the valuation continued to fall even in a rising market. And so as Diana referred to in her discussion about the FAANGs, we continue following companies very closely, even when we're not shareholders of the company. And so in the case of GSK, we continued meeting with management, meeting with competitors, staying abreast of what the important developments at the company were. And so as the valuation continued to go down in the case of a steady business, we were able to take that idea back to the Investment Committee for consideration quite promptly. And importantly, because we have very low turnover among the Investment Committee members here, people on the Investment Committee were quite familiar with the company. They remembered it very well from when we had owned it, and so were able to have, I thought, a very in-depth discussion about the changes and the differences at GSK, and how the relative opportunity had changed since we sold the company in 2015.

Question: What are your thoughts on current equity market valuations and the outlook for the Funds?

Diana Strandberg: Starting point matters to long-term returns, and from today's starting point of higher valuations, especially in the U.S., we have a more tempered view of long-term equity returns. We think earnings and cash flow will be important drivers of market returns and the U.S. dollar is going to be an important factor for international equity returns. That said, we remain enthusiastic about our portfolios. We're continuing to find numerous opportunities at attractive valuations and our portfolios overall have a lower valuation than the overall market. Our approach as a bottom-up, value-oriented investor requires patience and persistence. We hope that investors will take a long-term view in which to assess the success of our strategies. And we thank you for the confidence you've placed in Dodge & Cox.

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