



Podcast Transcript

Finding Value in BBB Debt

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Scot Hoffman: Welcome to Dodge & Cox Investment Perspectives, where we take a close look at key themes in our investment portfolios in conversation with our Investment Analysts. I'm Scot Hoffman in Communications. Today we're talking about BBB debt, an area of the corporate bond market that has significantly expanded over the past decade, and one in which Dodge & Cox sees attractive long-term investment opportunities. We'll also discuss how our Global Research team, which brings together our credit analysts in Fixed Income and our Global Industry Analyst covering equities, analyzes the investment merits of a corporate issue. Today, I'm joined by three members of our Investment team. Tony Brekke is a member of the U.S. Fixed Income Investment Committee and leads our Credit Sector Committee. Matt Schefer is a member of our Global Fixed Income Investment Committee and a Credit Analyst. Katie McCarthy is a member of the U.S. Equity Investment Committee and a Global Industry Analyst, whose coverage includes beverages and building products. Welcome, Tony, Matt, and Katie. Thank you for joining me.

Tony Brekke: Thanks, Scott.

Katie McCarthy: Yeah, thank you.

Scot Hoffman: Tony, let's start with you. We recently published a paper titled "Finding Value in BBB Debt: Not All Corporate Bonds are Created Equal." What were the conclusions of the paper?

Tony Brekke: First, there's certainly been significant growth in both the corporate bond market as well as the BBB portion of that market. Nevertheless, we do think that this growth does not represent a systemic risk to the market in general. Secondly, this growth has prompted our team to take a much closer look at our BBB exposures really to make sure that there's nothing looming in there that we're not aware of. Finally, the result of this analysis has given us heightened confidence in the select investments that we've made in the portfolio. In fact, the overall question itself has really emphasized the value associated with the bottom-up, fundamental approach to credit research that we apply at Dodge & Cox and that selectivity amongst the issuers that we hold.

Scot Hoffman: Matt, let's take a step back for a minute. Can you talk us through how the corporate credit market has evolved over the last decade?

Matt Schefer: Sure, Scott. The first thing to note is that the corporate debt market has gotten significantly larger since 2006. The investment-grade bond market, for example, has nearly quadrupled in size, while the BBB corporate market has increased

nearly fivefold. This rapid growth has really been due to a combination of both supply and demand-driven factors. If we just think about the supply side for a moment, by which I mean from the debt issuer's perspective, the low interest rate environment has increased the quantity of debt that a company can comfortably service on an ongoing basis. This has led to more debt being issued, particularly longer-dated debt, which allows companies to lock in lower borrowing rates for longer. We've also seen a quite meaningful pickup in merger and acquisition or M&A activity, and this is also happening for a couple of reasons. Some companies are looking for benefits of vertical integration. We're seeing this in the Health Care sector. Other companies are looking to drive top-line growth and take advantage of cost synergies, and other companies are simply looking to reposition their portfolio based on what they think will be optimal for the future competitive landscape. All of this is happening against a backdrop of low interest rates, which allows bidders to pay higher prices and still pencil out attractive returns. So that's really the issuer's perspective, but it's also important to think about it from the demand side or how an investor is viewing things. And the first thing that stands out here is that there has really been a strong search for yield among investors. Government bond yields are very low for a variety of reasons, and this has pushed investors further out the risk spectrum towards corporate bonds and other assets. We've also seen a secular tailwind for demand for long-dated corporate bonds, and this is particularly from defined benefit pension plans. Companies are increasingly seeking to match their assets and liabilities by investing their pension assets in long-term corporate bonds. And then finally, we have to talk about fundamentals. Investors are doing the credit work and they've realized that many of these companies have a high ability to honor their debts and therefore comfortable investing in quite a few of these companies. This is the reason that we've been adding to select BBB issuers in the Dodge & Cox Income and Global Bond Funds.

Scot Hoffman: In the paper we discussed our views with respect to BBB market fundamentals. Tony, what gives us comfort there?

Tony Brekke: Well Scot, there are really a few things underpinning the credit strength of BBB issuers generally. The first that we point out is the nature of the broad-based growth in the BBB market. Matt alluded to this earlier but a lot of it was driven by mergers and acquisitions. Much of this, not all of it, importantly, not all of it, resulted in big dominant companies getting even stronger. The earnings power and cashflow generation of many of these institutions has grown significantly, as has the value of their assets. So increases in debt should not necessarily be viewed in a vacuum. Second, and as Matt also mentioned, low interest rates were a big part of this. This is how the management teams got comfortable with taking on leverage to get deals done in the first place. So the growth in corporate debt has not been accompanied by commensurate deterioration in companies' ability to service that debt. In fact, it's quite the opposite. Research from Bank of America/Merrill Lynch suggests that the aggregate corporate interest expense as a share of GDP is close to multi-decade lows. So companies have taken on debt but in ways that we think is actually quite comfortable for the broad swath of the BBB market. Furthermore, much of this M&A activity occurred in defensive sectors like Health Care, Telecom, and Cable, Mid-stream Energy. At a high level, these industries are characterized by reasonable revenue and cashflow stability through cycles and importantly, significant fallback options through cost and capital expenditure reductions, potential to reduce dividends, separable assets that we think have value through the cycle, those types of moves that a management team can make to really shore up their balance sheet when they need to. And finally, companies have taken downgrades into the BBB ratings level. But they haven't gone as deep into that BBB sector. So BBB- has really represented a pretty stable portion of that BBB sector of the market, and we think that this provides an additional layer of cushion against downgrades and could actually be quite important should the downside, macroeconomic scenario play out. Finally, I'd point out that after a pretty slow start, we are really starting to see some stabilization in the aggregate leverage numbers as big borrowers are finally, in many cases, following through on deleveraging commitments made a handful of years ago. The median leverage in the investment-grade sector has stabilized in recent quarters, and some of the bigger companies like AT&T, Comcast, Verizon, Anheuser-Busch InBev, which we'll talk more about later, are showing signs of some real progress on this front.

Scot Hoffman: So some pundits are calling for a recession, or at the very least, a slowdown in economic growth. What gives you confidence that the fundamentals will hold up in that kind of environment?

Tony Brekke: First, let's touch on the macro part of that question. Now, a recession is not in our base case, though our expectations for U.S. economic growth looking out over the next couple of years have declined as 2019 has progressed. Downside risk has risen on multiple factors: fallout from overseas weakness, the trade and geopolitical tensions that have characterized markets over the last several months, and our expectation though is that the strength of the U.S. consumer and the resiliency of the Corporate sector will help us avoid outright contraction over that timeframe. Of course, as bond market investors, we're always focused on the downside, and we fully expect some deterioration in credit fundamentals if in fact we do encounter a slowdown. Some issuers would no doubt get downgraded. We just don't think it would result in a wave of downgrades on a level that overwhelms the high-yield market. For one, companies are aware of these issues and have actually been preparing for a weaker growth environment. M&A activity has slowed notably and the upward trajectory of corporate leverage has come to a halt. The big BBB-rated companies have very strong incentives to protect their ratings. There are cost and access to capital reasons for this. Those incentives don't necessarily exist at that single A level. Now this willingness to

defend ratings is also supported by the companies' ability to do so. We've started to see companies play some of these cards through dividend cuts, asset sales, IPOs of separate businesses, and many other examples of ways that companies can utilize their fallback financial flexibility. Examples of these include some of the companies I mentioned a moment ago, but also Kinder Morgan, Kraft Heinz, ConocoPhillips, if we look back a few years. Each of these companies has cut dividends or sold assets to protect their financial profile and support that credit rating. We think that this list will continue to expand, especially if issuers start to get increasingly nervous about that economic outlook.

Scot Hoffman: Matt, what other factors do we consider?

Matt Schefer: One of the things we've discussed within the Credit Research team over the years is that history tells us that downgrade cycles are more closely tied to industry and company-specific challenges. And as an example, we can think back to a couple of the prior spikes in fallen angel activity. In 2001, 2002 we saw downgrades across the Telecom and Merchant Energy sectors. In 2005 it was the autos so it was Ford and GM (General Motors). And in 2016 there was the Commodity sector, so oil, metals and mining. Could we see elevated sector-level downgrades in the future? It's certainly a possibility, but we think the risk is contained and any concurrent spread-widening would likely present buying opportunities for credit selectors like ourselves.

Scot Hoffman: Matt, so why is the Dodge & Cox Worldwide Funds–Global Bond Fund overweight corporate bonds at the lower end of the investment-grade spectrum?

Matt Schefer: Sure. Well I think, Scot, it's important to note that all of the credit work that we do is very much on a company-by-company basis. Our Investment Committee doesn't have a specific target for BBBs or any other specific rating for that matter. Our investment process however does lend itself to investments in the lower end of the investment grade spectrum. Particularly issuers who have a strong, strategic incentive to defend their BBB ratings. This is what Tony was talking about earlier. On an ongoing basis we are looking at the prices and valuations of corporate bonds in the market and comparing them to our assessment of those companies' fundamentals. In environments where valuations are inexpensive, we generally lean into credit by increasing our credit weight. And similarly we reduce our credit weight when valuations appear expensive. Currently in the Global Bond Fund, we have a BBB credit weight in the mid-30% range. Our overall BBB weight however is in the mid-40s as we also own some BBB-rated emerging market local currency bonds. However the risk profile of those holdings is quite different than the corporate bonds that we're discussing today.

Scot Hoffman: Dodge & Cox has an integrated approach to credit research. What does that mean and why is it such an important aspect of our investment philosophy, Tony?

Tony Brekke: Well, Scot, our investment process is truly team-based, starting with opportunity recognition and really, as we work through the entire process of underwriting your credit and making a decision with respect to putting that into the portfolios. By integrated, we're really referring to our equity and credit research resources. We have a group of Industry Analysts. Their industry and company research underpins all of Dodge & Cox's equity and credit investments. On the credit side, there are five of us who focus on things like balance sheet considerations, downside risk and relative value assessment in the fixed income world, which is rather different from the equity investment opportunity set. The Credit and Industry analyst teams work hand in hand to assess the merits of any new investment and pitch it to the rest of the team. We believe that the combination of this integrated approach to credit research, valuation discipline and our long-term investment horizon can reward investors through market cycles. Now, importantly, downside risk analysis is at the heart of this credit research effort.

Scot Hoffman: Matt, how does this approach help us as global bond investors?

Matt Schefer: Well, Scot, there are actually a lot of benefits that come from this global integrated approach. The first is that it broadens our investible universe. We have a pretty comprehensive coverage of the companies that issue investment-grade debt around the globe. Having a robust inventory of current thorough research helps us respond to liquidity opportunities, which, as you probably know, can be episodic in an over-the-counter bond market. And there are many examples of companies that we know well but are lesser known to domestic fixed income investors more broadly, specifically because of our integrated approach. Some of these opportunities have been quite attractive over the years. A second thing to point out is that this team approach allows every individual to specialize in their area of expertise. The Industry analyst team knows their companies inside and out and frequently meets with the senior management teams of the leading companies in their sectors. This helps inform their views with respect to long-term competitive dynamics and also offers insight into long-term strategic plans and capitalization philosophy. Both of these are very important, regardless of whether you're looking at the debt or equity of an individual company. At the same time, the Credit Analyst is able to dive deeply into the financials, ensuring that we have an in-depth knowledge of the capital structure and that we assess access to funding liquidity across a range of scenarios.

Scot Hoffman: Katie, let's bring the equity side of the equation into the conversation. You're a Global Industry Analyst on our

Equity Research team and I know sometimes we own both the debt and equity of a particular company. Other times we may own one but not the other. What do you see as the most important tangible benefits of integrating our research efforts?

Katie McCarthy: Sure. As an Analyst, there's several benefits to looking at companies through both the equity and debtholders' perspectives. It really enhances our analysis, especially with respect to downside protection in capital allocation. And then it's also a two-way street. We often talk about the role the Industry Analyst plays in the credit process, but the Credit team also supports equity investment decisions. There are several examples when fixed income analysts helped me look at the capital structure and liquidity profile of potential equity investments, including current equity investments in Mattel and CEMEX.

Scot Hoffman: Katie, you just touched on the important concept of downside risk assessment. Tony, if we turn back to you, what are some of the potential drivers of financial distress that you and the rest of the Credit team are emphasizing and how are you looking to mitigate these risks across the portfolio?

Tony Brekke: It's a really important point that you make there, Scot, and as mentioned earlier, downside risk is really at the heart of our credit research effort generally. You know, we're fundamental credit selectors. Our primary emphasis is on the potential for permanent loss of capital, either through default or liability management, some scenario whereby we get less principle back than we invested in this particular company's bonds. Now, we found that there are some common characteristics of companies that are able to avoid financial distress. We look for sustainable moats around the business, but we do understand that these can be challenged over longer periods of time. So it's also important to have a management team and board of directors that recognize the importance of being reasonably capitalized, maintaining adequate sources of financial flexibility and really having a Plan B for maintaining viability through unpredictable macro and capital market environments. Now, this assessment is a key element of our underwriting process. It helps provide conviction at the individual issuer level, particularly lower rated issuers held in the Funds, and has helped us maintain and, frankly, quite often add to positions when it seems everyone else in the market is exiting them.

Scot Hoffman: We talk in the paper about strategic corporate activity, specifically mergers and acquisitions, that it's been a fertile ground for finding value in BBB debt. But it's important to note, I think, that we don't buy every deal. Katie, can you talk us through Anheuser-Busch InBev and why we found that particular deal to be attractive?

Katie McCarthy: Sure. It's one of the largest companies in my coverage. I know the company very well and I've been meeting with management regularly for over ten years now. Anheuser-Busch InBev is the largest global brewer and it's one of the top ten global consumer companies overall. Some of their brands include Budweiser, Corona, and Stella Artois. They had 2018 sales of \$55 billion, with operations in nearly 50 countries, so it's really a large diversified enterprise. A group of investors built the company through M&A, most notably the InBev acquisition of Anheuser-Busch in 2008, and then the ABI acquisition of SABMiller in 2016, which is what we're talking about today. We thought that deal was attractive and specifically the financing to fund that SABMiller acquisition, because number one, it was a large global consumer company with substantial cashflow, and a history of deleveraging after deals. Management also had leverage to pull if deleverage was slower than anticipated, including cutting the dividend, selling assets or listing minority stakes. Given the currency volatility that we've seen in emerging markets, they've actually had to employ all three. And then finally and probably most importantly, due to the deal timing, management had to raise debt at a choppy time in the markets in Q1 2016, and we thought the pricing looked attractive.

Scot Hoffman: How has the Fund's ownership in AB InBev evolved over time?

Katie McCarthy: We made our initial purchase in January 2016 with the SAB-Miller acquisition financing, but we began trimming in May 2016, following good performance and lingering concerns with the deleveraging path and timing. We'd actually fully exited pretty soon thereafter. But then this year we rebought in January 2019. There was a combination of market volatility, company-specific challenges and rating downgrades that resulted in attractive valuation. Again, we've been trimming back recently due to outperformance. Usually we have a long three-to-five-year time horizon, but in this case we were opportunistic based on valuation.

Scot Hoffman: So would you bring us back to where we are today? What's our current investment thesis?

Katie McCarthy: The current thesis is very similar to the initial one in many ways. It's a large cash-generative globally diversified consumer company. The leverage has actually come down to under four times, proforma for a recent asset sale, and management has shown that they will take action if deleveraging is slower than anticipated. And they're currently in a sweet spot in terms of leverage. It's low enough not to be a pressing concern, but it's high enough to reduce the likelihood of short- to medium-term M&A, which is important in a serial acquirer. And the valuation has begun to reflect these positives again though, so that's why we're trimming back a little bit.

Scot Hoffman: So how does our research process work when we've seen a transaction's been announced and we're starting to anticipate the opportunity presented by the financing?

Katie McCarthy: So one of the nice things about M&A related issuance is that you get some lead time before a deal comes. In this case, in the fall of 2015, ABI had announced the acquisition and we knew that the bond deal was coming. I was able to work with the Fixed Income team to complete analysis ahead of time so that we could be ready for the issuance, and then my role was to provide information on the strategy and sources of downside protection. My counterpart in Fixed Income looked at where the deal was likely to price relative to large consumer corporates, both ones that were in our portfolio and ones that we didn't own. We presented all of our findings to the Credit Sector Committee, and overall, we thought that the company had high pro-forma leverage but a clear line of sight to reduce that over time. We also realized that given the scale, they pretty much have to retain their investment-grade rating, as we talked about before. So we believed that they would take actions to reduce leverage if necessary and we spent a good deal of time talking through those potential actions in the Committee meeting. So I think overall, we were able to get the Credit Sector Committee ready in a timely manner so we could be opportunistic when the issuance came in January, and this comprehensive analysis and our ongoing attention to the company's fundamentals enabled us to get back in when the pricing became more attractive earlier this year.

Tony Brekke: So this is an example where we had the luxury of time to prepare for a transaction, but this isn't always the case. An example of that is our reentry into this particular issuer earlier in 2019, where we weren't expecting the transaction. But following the company closely, we were able to respond very quickly without sacrificing any of our research process to implement a decision there.

Scot Hoffman: Ultrapar is another issuer that was held in both the Income Fund and Global Bond Fund on September 30th. Matt, can you walk us through our decision around Ultrapar?

Matt Schefer: Sure, Scot. You know I think Ultrapar is actually a really great example of our integrated global research approach. They are one of the leading gas station brands in Brazil and yet they're a company that most global fixed income investors have probably never heard of. We owned Ultrapar equity for approximately 11 years in the International Stock Fund from 2001 to 2012, and our Industry analyst team has continued to follow the company very closely since then. My own first interaction with the company was back in the spring of 2015, when we met with their CFO in Brazil. I was down there at the time with a number of our Industry Analysts performing some due diligence around Petrobras, one of our other Brazilian holdings. I remember being very impressed by the quality of the franchise and the thoughtfulness of management. Unfortunately, at the time there was really no investible opportunity on the fixed income side. However, around a year and a half later, Ultrapar decided to tap the global fixed income markets to fund an M&A transaction. We were able to act very quickly on this opportunity by combining our Industry Analysts' deep understanding of the country with supplemental work performed by the Credit Research team, including things like assessing degrees of downside protection and thinking about relative value versus the other Brazilian exposures we had in the portfolio. The committee ultimately concluded that Ultrapar was a well-managed, strong franchise that happened to be caught up in concerns over oil prices and Brazil economics and politics. We ended up initiating a position in Ultrapar's 10-year bond at a spread of roughly 400 basis points over Treasuries, which is roughly three times the spread of the investment-grade corporate index at the time. The bonds have performed quite well since then and we've periodically adjusted our positioning and in fact participated in a second new deal from Ultrapar in the first half of this year.

Scot Hoffman: So Matt, when we think about your role as a member of the Global Fixed Income Investment Committee, could you talk us through how the committee's thinking about or factoring in the macroenvironment and the current low-rate environment, and to how we build our bond portfolio?

Matt Schefer: You know, it's worth saying that we build the portfolio on a bottom-up basis, name by name, bond by bond, but we need to be very mindful of the overall macroenvironment that we're in and how all of these individual investments fit together. We rely pretty heavily on scenario analysis for both individual bonds as well as a portfolio level to frame how the portfolio may perform in a wide range of macroenvironments. We also use a number of quantitative tools to help measure our exposure to various risk factors and confirm that the risks we have in the portfolio are actually risks that we think are worth taking. On a regular basis, our committee is looking at credit exposures across the portfolio, both name by name, but also on an aggregated basis, sector by sector, country by country, so on and so forth. And so we compare the level of credit spreads versus fundamentals, and what we want to assess is whether we're happy with current positioning or if changes are warranted. When credit spreads are tight—we mean that compensation for credit risk is low—we typically allocate less of the portfolio to credit and/or we sell out of riskier securities and purchase lower-risk securities. With respect to interest rates, the committee seeks to position the portfolio in a way that it will do well over a multiyear horizon or across a wide range of macro scenarios. We don't want to anchor our forecasts based on any single specific macro outcome. When we're thinking about the outlook for rates, we monitor things like the level of yields currently, the shape of the yield curve, what the Federal Reserve is doing and saying, as well as a variety of other factors. All told, when we look at the current low level of yields in the U.S., we've decided to

position the portfolio relatively conservatively with respect to interest rates in order to limit the negative performance impact if interest rates were to rise from here.

Scot Hoffman: Tony, we've covered a lot of ground here. What does all this add up to?

Tony Brekke: You know, Scot, corporate bonds and BBBs, in particular, have had a really nice run so far in 2019, and security selection within the Fund has been a tailwind to relative returns. So our selections in those sectors have done even better than the market. Nevertheless, we remain pretty optimistic with respect to the total return prospects for a carefully selected portfolio—and I can't emphasize this point enough—of individually selected corporate bonds looking out over the next couple of years. We don't see a systemic type of event associated with the growth in BBB corporate debt that we talked about earlier in the segment. That being said, we do remain vigilant of valuations, again, subsequent to outperformance year-to-date at both the single name and index levels. That's led us to selectively reduce exposure to the Corporate sector through bottom-up initiated trims in the third quarter, and we expect that we'll continue to assess the risk-reward trade-off associated with existing Fund investments, not to mention new opportunities that we're presented with going forward.

Scot Hoffman: Thank you, Katie, Matt, and Tony for sharing your thoughts with us.

Matt Schefer: Sure.

Katie McCarthy: Thank you.

Tony Brekke: Thanks Scot.

Scot Hoffman: And thank you for listening. This podcast was posted in December of 2019. Statements in this podcast represent the opinions of the speakers expressed at the time the podcast was recorded, are not a complete analysis of every material fact concerning any market, industry or investment, and may change based on market and other conditions without notice. The statements are not intended to serve as investment advice or a recommendation to buy, sell or hold any security. Any securities identified are subject to change without notice and do not represent a fund's entire holdings. This podcast should not be copied, distributed, published or reproduced in whole or in part without express permission of Dodge & Cox. This information should not be considered a solicitation or an offer to purchase shares of Dodge & Cox Worldwide Funds PLC or a solicitation or an offer by Dodge & Cox Worldwide Investment and its affiliates to provide any services in any jurisdiction. The views expressed herein represent the opinions of Dodge & Cox Worldwide Investments and its affiliates and are not intended as a forecast or guarantee of future results for any product or service. To obtain more information about the Funds, please refer to the Funds' prospectus at dodgeandcoxworldwide.com.

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