Dodge & Cox Funds®

Video Transcript
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2016 Equity Review

Charles Pohl: 2016 has been an extraordinary year. We want to begin by thanking all of our shareholders for their continued confidence in Dodge & Cox. All of our Funds outperformed their benchmarks in 2016 on a relative basis and also performed well on an absolute basis. We are honored by the fact that Morningstar has nominated three of the Funds for their prestigious Manager of the Year Award. The International Stock Fund, the Income Fund, and the Balanced Fund all received nominations and we're especially pleased that the Balanced Fund was named the winner in its category.

Diana Strandberg: You know, Charles, these extraordinary results in 2016 were accomplished with the same people, the same process, and largely, the same portfolio as we had during the challenging period in 2015 and the beginning of 2016. In fact, we leaned even more into areas of investor skepticism like Financials in early 2016, which really highlights how important it is to have the long-term view and the ability to stick with our investment convictions.

Charles Pohl: It's really an illustration of something you've talked about in some of these videos previously, which is the value of patience and persistence, because we own some of these names that were challenged in '15 and early '16 but we stuck with them because we had conviction and we had done our homework and we thought we understood them well, and even added to them, as you pointed out, and then eventually there was a very large payoff in the second half of the year.

Diana Strandberg: No, it's true. Some of the largest detractors became the largest contributors in the portfolio. And it is important not only that we have a long-term view and the ability to persist with our convictions, but it's important and we're gratified that our investors also have a long-term view and can stay the course with their investment choice.

Charles Pohl: And what were some of the areas that were particularly challenged in '15 and early '16, but helped us out so much in the latter part of '16?

Diana Strandberg: Well we'd have to continue the conversation we had last time around value underperforming so significantly. And what I mean by "value" is the less expensive cohort in the market. The constituents are going to change over time, but when we came into 2016 and certainly by the end of the first half, the biggest constituents of value were financial services stocks. The belief of low interest rates persisting for longer is a big earnings headwind to financial services companies, as well as more economically sensitive stocks like Energy and Materials, Industrials, with concerns around the global economic picture, and emerging markets, generally. We saw a big outperformance in the value part of the market, so Financials, Energy, Materials, Industrial stocks contributed handsomely to the Funds' returns.

Charles Pohl: And some of the areas which have become very popular and done well in '15 and early '16, such as the so-called bond substitutes, the Utilities, the REITs and some of the Consumer Staples, were areas that we were very underweight-no Utilities, no REITs, and minimal exposure in the Consumer Staples, and those underperformed quite significantly in the second half.

Diana Strandberg: No, that's true and, you know, obviously as valuations change, we'll reassess where long-term investment opportunity lies.

Charles Pohl: As you mentioned, Diana, the Financials are a big part of the story in 2016. For a number of years since the Financial Crisis, they have been especially challenged by low interest rates, ongoing litigation expenses, regulatory costs, and they've responded by aggressively reducing expenses and exiting some lower performing businesses. And so as we've done our research on them, it became increasingly clear to us that in a more normal environment that we'd eventually return to, these could be very high-earning business franchises. And they were selling at quite inexpensive prices.

Diana Strandberg: No, it's true. We think that many financial services companies are far better positioned in an improving environment than the market's giving them credit for. For example, in our portfolio holdings like Schwab, BofA or UBS would be cases in point where managements have taken action to focus the business, improve the cost base, improve capital and very attractive valuations. UBS is a great example. We have a management team that has restructured the investment bank and significantly bolstered the wealth management business. They've cut costs dramatically and it's hard to see because they've had a run-through of higher compliance costs to meet a more stringent regulatory environment, but also large litigation expenses for legacy issues. And those should largely be in the rear-view mirror now.

Charles Pohl: And UBS should be one of the big beneficiaries of higher interest rates because they have a very large deposit base that will allow them to benefit from rising rates and a higher return on the asset side. And Diana, where are we finding some of the most compelling opportunities today?

Diana Strandberg: Well, you know, as valuations change, we'll look across the market and across the world and we're seeing a lot of long-term opportunity in the Health Care sector. We added meaningfully to a handful of our existing pharmaceutical holdings. Novartis would be an example, and AstraZeneca. Bristol-Myers is a new holding in the Stock Fund and Global Stock Fund.

Charles Pohl: And with all of the pharmaceuticals, we've seen significantly lower valuations. They underperformed in 2016 but in Bristol-Myers' and Astra's case, we also see some exciting opportunities in the immuno-oncology space, the potential to develop some drugs that will make some real progress in curing cancer.

Diana Strandberg: That's true. And also, driving revenues and cash flow for these companies. We believe that the volatility in the current environment is creating attractive opportunities for active managers, like Dodge & Cox, who can take a long-term view and retain a value focus. And while overall market valuations are reasonable, we're finding opportunities in less expensive companies and we can see that if we compare the valuation of our Equity portfolios to those of the overall market.

Charles Pohl: Because our portfolios are all selling at valuation discounts to the market averages. And we see special opportunities in some of the names that will benefit from rising interest rates, as we spoke before. The Financials, we'll continue to be overweight there, and some of the other Materials and Energy stocks that will benefit from rising interest rates in a stronger global economy. Also, our overweight in the emerging markets names should benefit from better economic growth. So, we have a reasonably positive outlook for the future, for our portfolios.

Diana Strandberg: A single quarter or even a year is too short a period to really judge the success of our approach in bottom-up, value-oriented with a high active share.

Charles Pohl: Right, we have a philosophy of being long-term investors, but we think that our shareholders in our Funds are served by taking a long-term perspective as well. In fact, there've been a number of studies that have shown that the returns that investors in mutual funds realize are actually much lower than they would be if they took a longer-term perspective and engaged in a buy-and-hold strategy as opposed to trading in and out of funds, which is what many people do. Looking forward, we believe our portfolios are well positioned for rising interest rates and stronger global economic growth. Again, we want to express our gratitude to the Funds' shareholders for their confidence in Dodge & Cox. Our strategies require patience and persistence and we thank you for yours.

Dodge & Cox Funds SEC Standardized Average Annual Total Returns as of December 31, 2016: Stock Fund: 1 Year +21.27%; 5 Years +17.00%; 10 Years +5.93%; Global Stock Fund: 1 Year +17.09%; 5 Years +13.18%; Since Inception (May 1, 2008) +4.78%; International Stock Fund: 1 Year +8.26%; 5 Years +7.98%; 10 Years +2.11%.

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