Question: How did global equity markets perform during the first half of 2017?

Diana Strandberg: Global equity markets got off to an exceptionally strong start in the first half of 2017 fueled by earnings growth. The S&P was up 9.3%, its strongest first half since 2013. The EAFE was up 13.8% and emerging markets up 18.4%, which put those six-month returns in almost the top quartile of all six-month returns since 1970 for the EAFE and since 2001 for emerging markets. This is a marked turnaround from the past three, five, and ten years, when the S&P handily outperformed international markets because of growing earnings and rising valuations. Over a 10-year period the S&P 500 has returned 7% a year. In contrast, international earnings have not rebounded to the same extent as they have in the U.S. since the global financial crisis. Over a three, five, and 10-year period, earnings have been flat to down, depending on the time period. And so with flat to down earnings, even with rising valuations, the headwind of a strong U.S. dollar together combined to make international returns pretty lackluster. For example, over a 10-year period international markets returned 1% a year in contrast to the S&P’s 7% a year. Today we have reasonable valuations. Global equity markets are at roughly 16 times earnings. The S&P’s at the higher end at almost 19 times earnings. Developed international markets are almost 15 times earnings, emerging markets a little over 12 times earnings. But we would note that the disparity in valuation between the U.S. and international markets is wide today. We see continued economic growth, gradually rising interest rates in the U.S. and possibly in Europe, and moderately increasing inflation fueling earnings growth across the globe. And we continue to find attractive investment opportunities with good earnings and cash flow prospects over a three- to five-year investment horizon.

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

Charles Pohl: The Stock Fund returned 6.8% versus 9.3% for the S&P 500, and 4.7% for the Russell Value Index. The International Fund returned 14.5% in the first half versus 13.8% for the EAFE Index. The Global Fund returned 10.9% in the first half versus 11.5% for the MSCI ACWI Index. The Fund was helped by the performance of its emerging markets holdings and again, like the other Funds, hurt by its exposure in the Energy sector and also its lack of ownership of some of the high valuation Internet names such as Facebook and Amazon. Overall, all three Funds would benefit from stronger worldwide economic growth, and we believe that the outlook for economic growth is very positive.

Question: What is Dodge & Cox’s debate on Energy?

Diana Strandberg: We continue to vigorously debate the investment thesis for energy companies. Oil is down over 60% from its highs in 2014 and 16% year to date to $45 today. The real question is whether unconventional sources of oil, notably U.S. shale, can continue to increase production at current prices, or whether we’ll need to see higher prices to increase supply to meet growing demand. To put the numbers in context, we consume about 97 million barrels of oil a day around the world. And that is growing about 1% a year, or about one million barrels. The key growth drivers are transportation in emerging markets. For example, China’s already the globe’s largest car market with 27 million vehicles sold last year in comparison to 17 million in the U.S. And the economy is growing much more rapidly than the U.S. economy for example. Existing fields deplete as the oil is produced at a rate of about 2 to 3% of global supply, so about two to three million barrels a year. The simple math, over five years demand is likely to grow five million barrels and supply is likely to decrease ten to 15 million barrels. At today’s low prices, there’s very low cap ex levels. Almost no new projects are being approved. We think shale can continue to grow but we’re skeptical of its ability to grow to meet the gap between supply and demand. Already, return on capital levels are very low on most U.S. shale projects. We think that this supply and demand gap points to higher prices longer term, and we have been nudging our energy weighting higher. More recently, we added to Anadarko Petroleum. We think that the management has incredible capital discipline and they have a track record of earning really attractive return on capital on their projects. And they have a very good position in low-cost shale. We’ll continue to look
Question: What is your investment thesis for Pharma?

Diana Strandberg: Pharma is about 13% of the Stock Fund and about 14% of the International Stock Fund, compared to 8% of their respective benchmarks. And what we think is attractive are the long-term growth prospects. You have aging populations in the developed world and increasing wealth in emerging markets and we find as people become wealthier, they want to become healthier. On top of which then you have R&D investments, which could yield innovative new treatments. So we've built a portfolio of individual companies that together give us exposure to attractive therapeutic areas, like immuno-oncology for example through our holdings in Bristol-Myers, AstraZeneca, and Roche. We think pharma companies in general have high growth, high margins, solid balance sheets, and prodigious cash flow. Now there are risks. There's always the possibility that a promising new drug fails, or we see pricing pressure from pharmacy benefit managers. Yet, at 16 times earnings, we think that valuations are attractive when we weigh risk and reward. So we think Pharma is attractive on an absolute basis, and it's also attractive on a relative basis when we compare it to other parts of global markets—consumer staples, for example, where we have significant underweights in our equity portfolios. We think pharma's more attractive at 16 times earnings compared to consumer staples valuations of 20 to 22 times earnings, and we'd note they lack the right-hand innovation potential.

Question: Why do the Funds remain overweight Financials?

Charles Pohl: Well the first reason is that they have generally very low valuations and that attracts us as a value manager. The banks and the insurance companies, but especially the banks, have been hurt by very low interest rates caused by aggressive central bank monetary policies and increased regulation in the post-2008 period. Many of the banks have gone through extensive restructuring and they've been recapitalized, so now they have very strong capital ratios and are considerably more efficient than they were pre-financial crisis. We see that the extraordinary monetary policies that have been followed by a number of the central banks in the developed world are beginning to come to an end. This has been signaled by the Federal Reserve in the United States and by the Bank of England, and we're beginning to see signs that the ECB may be moving in the same direction. This is likely to result in higher interest rates, which will benefit the banks, and we're also seeing an improving regulatory environment, particularly in the United States and in the UK. This combination of somewhat higher interest rates, improving economic outcomes, and an improving regulatory environment has already begun to show up in better earnings and restructuring and better earnings for companies that we own, such as the Bank of America. We've also seen a number of risks, particularly in Europe, that have been taken off the table. There's better economic growth in the Eurozone; a number of economic indicators have turned up recently. We've also seen in Italy, which had a number of banks that were in serious trouble, some of those situations have been resolved in a very constructive manner. And this has benefited holdings of the International Fund such as UniCredit, a major Italian bank, which has also benefited from recapitalization and extensive restructure. In France, we've seen an election outcome, which I think the market has viewed very favorably with a pro-growth government being elected, and this has benefited particularly the holdings of the French banks that we have, BNP and SocGen. In general, we see better economic growth going forward, both in the EU and in the United States and rising interest rates, and we think that will benefit the Financials as a whole.

Question: What opportunities are you finding in Chinese internet companies?

Diana Strandberg: We own four Chinese internet companies, comprising about 5% of the Global Stock Fund and roughly 7.5% of the International Stock Fund. And when we weigh valuation and fundamentals, we think that the valuations are attractive in light of their exceptional growth prospects. What's driving this growth is high GDP growth in China. You have a large, fast-growing economy, penetration increases of internet services more broadly, and then the potential to leapfrog traditional ways of doing things. So for example, we own JD.com, the largest online retailer and second largest e-commerce company. We think that online retail has the potential to not only grow much faster than in the U.S. but it could be a much larger portion of total retail sales. The fast economic growth, the transition from an industrial to a consumer-led economy, and then the fact that bricks and mortar retail is less developed in China raises the possibility that consumers jump straight to online retail. In the portfolio, we also own a position in Tencent through our ownership in Naspers. Naspers owns 34% of Tencent and that represents a very large piece of Naspers’ market cap. Tencent is China’s leading internet company. It works in social media platforms and digital content services, so they have dominant positions in online and mobile gaming, payments, social media, as well as digital advertising. We own Baidu, China’s largest search engine company. They have 70% traffic share and 80% revenue share. And then the newest addition to the portfolio is 58.com, China’s leading online classified company. Each of these is in the portfolio on its own merits, as we think about not
only valuation and fundamentals, but a careful look at governance as well. In each instance, we have owner operators who have significant portions of their wealth tied up in shares of the company, which we think aligns their interest with those of long-term owners like ourselves. And we would note that if history is any guide, the share price movements at each of these companies reflect more the individual company risk and opportunities than a single risk exposure.

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

**Charles Pohl:** Well equity market valuations have risen over the past year and while we think that return expectations should be more modest going forward, we still have confidence in our portfolio. World economic growth has been weak post-2008, but we see signs that it's improving, particularly in Europe. Earnings growth in the United States has been quite strong and interest rates, while still low in historical context, we think may rise going forward. The portfolio will benefit from strong economic growth and rising rates. We remain overweight in the banks, in energy, and in the pharmaceutical healthcare area and we have confidence in our portfolio longer term.