Spanning the Globe for Value

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The global equity market can still provide value to investors who know how to find it. Research shows that a low starting valuation is a significant factor in return generation. By combining that factor with a long-term view and a focus on governance, value investors can build a portfolio of risky assets that has an acceptable risk–reward profile.

At Dodge & Cox, we are bottom-up fundamental investors; that is, we construct our portfolios one company at a time. We have a long-term investment horizon with low turnover. Our average holding period is seven years, so we think of ourselves as part owners of a company. We tend to look contrarian even though that is not what we set out to be. We are also value investors who see the world very differently from most other investors, even though we are all looking at the same information.

I will begin by talking about what being a value investor means and then discuss how important valuation is to long-term returns. I will end with five case studies that should help illustrate the world as seen through the eyes of a value investor.

What Being a Value Investor Means

The value investor’s starting point is valuation, and at Dodge & Cox, we look at it from many different angles. There is always a range of possible outcomes for any investment, so we want to buy things cheap enough to embed what could go wrong and not pay a lot for what could go right. Several metrics are useful in judging valuation: price relative to earnings, revenue, cash flow, and asset value.

Low valuation in a company typically means that something is going on that worries investors. Many—but not all—cheap companies are cheap because they should be. It is important to determine whether all necessary information about a company’s long-term fundamentals is adequately incorporated, which requires a lot of research. Value investing is not for the faint of heart. There will almost always be news describing how bad things are and falling share prices that indicate how wrong we are.

Fundamental research on individual companies builds conviction and staying power; such research is the cornerstone of everything we do at Dodge & Cox. Our aim is to build a comprehensive view of a company, so our equity and fixed-income teams collaborate. The equity team does the corporate credit analysis for our fixed-income portfolio; the fixed-income team helps the equity team estimate a company’s downside and its access to liquidity, which is essential when dealing with companies under stress.

We assess the fundamentals—a company’s business franchise, management expertise, growth opportunities, and financial condition—to understand what we are buying; that understanding is essential. Information from a variety of sources creates a 360-degree view of the company, and a scenario analysis can be used to develop a range of possible outcomes.

A long-term view like ours puts us in the mindset of being a part owner of the company. Furthermore, it is impossible to time the bottom or the top. Nudging into a position allows us to revisit and retest theories and to build staying power. Value investors need to have a keen focus on structure and governance. Performing a stakeholder analysis enables us to understand whether our interests are aligned and whether we are likely to get the benefits of our hard work.

People invest—that is, give up current consumption—to increase their future consumption. In other words, investors are trying to build their resources in real terms. Thus, our task is twofold. We must (1) play defense (avoid permanent loss) and (2) play offense (avoid loss of future purchasing power). By having in-depth knowledge of each investment, acting with experience and perspective, maintaining a valuation discipline, making incremental changes to the overall portfolio, and diversifying, we can mitigate the...
risk of permanent loss. At Dodge & Cox, we try to mitigate the risk of lost purchasing power by investing in equities with a long-term mindset, remaining fully invested, and keeping fees and turnover low. Risk, however, cannot be completely eliminated. The manager’s job is to stack the probability of a positive outcome in the clients’ favor as much as possible.

No one likes volatility—that is, the possibility that assets are worth more or less at any given time. Yet, volatility as part of a long-term investment strategy can be an opportunity for patient investors because they can make tactical adds and trims. Figure 1 illustrates how volatility behaved over different periods of time. The one-year rolling monthly return line has high peaks and deep valleys over the 1970–2012 period. Contrast that against the much smoother line that marks the 10-year rolling monthly returns and shows that volatility was mitigated over time.

The odds of achieving a positive return increased as the holding period lengthened. The frequency of positive returns over a 1-year holding period was 72%, whereas the frequency of positive returns over a 10-year holding period was 99%, and it increased to 100% for 15- and 20-year holding periods. The average annualized return was 11.7% for a 1-year holding period and 10.7% for a 20-year holding period. The minimal give-up in return for holding over longer horizons seems to be compatible with an acceptable risk–reward balance.

Governance and structure are very important for long-term investors. Good governance is not achieved by completing a checklist, and it is not a function of where a company is domiciled, be it domestic or international, in a developed market or an emerging market. In fact, one of our best experiences with governance has been with Ultrapar, a Brazilian company whose management returned capital to shareowners because it could not make acquisitions at attractive enough prices. One of our biggest disappointments was with a French company, in which the goals of the employees and lenders were placed ahead of those of the shareowners.

Evaluating all the fundamental factors of each company—such as board characteristics, corporate structure, reputational checks, capital allocation, transparency, shareholder protections, and enforcement—and tapping into available resources—such as legal

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Figure 1. MSCI EAFE Rolling Monthly Net Total Returns, 1970–2012

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<tr>
<th>Rolling Monthly Net Total Return (%)</th>
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<tbody>
<tr>
<td>100</td>
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<td>75</td>
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<td>-50</td>
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<tr>
<td>70 72 74 76 78 80 82 84 86 88 90 92 94 96 98 00 02 04 06 08 10 12</td>
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1-Year 5-Year 10-Year

Note: Returns include reinvestment of dividends and are in U.S. dollars.

Sources: Based on data from Bloomberg and MSCI.
counsel and private investigators—help us address the following four governance questions:

- For whose benefit is the company being run?
- Who are the other stakeholders, and what do they seek to gain?
- Where are we in line in terms of positive and negative outcomes?
- Under what circumstances can our position in that line be changed?

Governance is a complex issue with many moving parts. It is important to take the necessary time to analyze it in the context of the company.

Value investors often appear to be contrarian because they are typically investing where others are not. A low valuation usually indicates something is amiss, but a lot of uncertainty hovers around the specifics of the situation and its outcome. So, the fundamental questions to ask are, What is already priced in, and what opportunities could emerge? It is impossible to time the bottom or the top, so value investors live with being early and need to be persistent. We start small and nudge the position up over time as merited. In hindsight, this strategy usually results in our having a large weighting at or near the bottom when it is hardest to build conviction.

### The Importance of Valuation

To illustrate the importance of valuation in investing, let me propose two scenarios. Imagine that, as the investor, you get to choose one piece of information before making an investment. The first option is to know the starting valuation but have no insight on what is going to happen over time in terms of earnings, cash flow, GDP growth, and so on. The second option is to have perfect knowledge about future revenues, earnings, margins, GDP growth, and so forth, but no knowledge of the starting valuation.

Another way to explain the point would be to use Gregory Trevertton’s framework and ask, Are investors in the business of solving puzzles or solving mysteries? A puzzle has an answer, and the answer is dependent on the quantity and the quality of the information available. A mystery is completely different. A mystery is about ambiguity and uncertainty; no single answer suffices. Many outcomes are possible because multiple factors are continuously interacting. Information can be helpful, but only to a point. The key to framing a mystery is to interpret the available information. The quality of the framing rests with the quality of the framer: Experience and judgment matter.

Investors are in the mystery business. The object is to determine if Company X is a good investment. Although it is helpful to make estimates of Company X’s future revenues, earnings, margins, and so forth, the objective is not to make sure you have perfect accuracy about the future. No one can. The objective is to determine what information is already incorporated into the price. The lower the starting valuation, the easier the investment decision will be because the investor can get away with being less right about the outcome. We believe an investor should choose the first option: knowing whether the starting valuation is appealing.

At Dodge & Cox, we have confidence in the importance of the starting valuation based on the outcome of a quantitative study we performed. We ran univariate and multivariate regressions for the period of 1970–2011 to examine which variables were significant drivers of long-term equity returns. We looked at GDP growth, inflation, earnings growth, and valuation using the trailing price-to-earnings ratio (P/E), normalized P/E, cyclically adjusted P/E, and dividend yields as our independent variables.

We used 1-, 3-, 5-, and 10-year local currency and U.S. dollar MSCI EAFE Index total returns as the dependent variables and got some striking results. Figure 2 shows the starting earnings yield (earnings-to-price ratio), which is consistently and significantly correlated with the long-term 5- and 10-year local currency and U.S. dollar equity returns (the chart includes only the 10-year return).

In contrast, there is a lot of noise in the short term, as Panel A in Figure 3 illustrates. The data points for the one-year returns look like a swarm of bees. Panel B plots the same data for 10-year returns and indicates a strong relationship between starting P/E and 10-year return. Lower starting valuations are associated with higher subsequent 10-year returns, whereas higher starting valuations are associated with lower 10-year returns. Starting valuation—in particular, starting P/E—is the most powerful variable that we studied, and it has the added benefit of being observable and easily measured.

A very strong but surprising relationship exists between market returns and GDP growth. Markets lead GDP growth, not the other way around. Markets are discounting machines. They move before GDP growth, or lack of it, becomes apparent. Knowing how the macro picture might affect company fundamentals is important, but the company’s valuation tells us a lot more about future returns, which is what we are trying to achieve.

### Case Studies

The following five case studies provide a good cross section of real-life investing experience drawn from our portfolios. As tempting as it was, I
did not select our hero stories. My goal with these case studies is to illustrate three things: (1) what is priced in, (2) how we framed the mystery, and (3) how we built conviction and staying power despite pessimism and uncertainty.

Each of the five case studies has a moral, or takeaway. In order, the takeaways are the following:

- Something perceived as really risky might not be if it has an attractive starting point.
- The more skeptical investors are about an issue, the less important that issue becomes to the investment’s return.
- Sometimes the baby is thrown out with the bath water.
- Opportunities can be missed when a “wait and see” approach is used because it is impossible to get the timing exactly right.
- A wide range of outcomes can be rewarding as an investment.

**Case Study #1: The Fear Trade.** The last 10 years, characterized by bouts of both euphoria and terror as well as low nominal and real returns, have been a lost decade for equity investors. It was only the third decade in the last 130 years that wrought such agony and pain; the Depression and the demise of the Nifty Fifty marked the other two excruciating periods for equity investors.

Today, neither the global economic news headlines nor the market’s volatility is encouraging. Over the past 40 years, trading days with price moves greater than 3% (positive and negative) in the MSCI EAFE occurred fairly infrequently until 2008. Over the past five years, volatility has increased enormously; in fact, investors view the current market as a new type of regime—a risk-on/risk-off market.

Making investment decisions in a fearful market is easier when the questions—what is safe and what is risky—are framed as, What is priced in? **Figure 4** shows valuation metrics for so-called safe assets: 10-year U.S. Treasury bond yields and 2-year German bund yields are shown in Panel A and the real price of gold is shown in Panel B. Ten-year U.S. Treasuries are at an almost sixty-year nominal low and are negative in real terms, and two-year nominal German bund yields are near zero, having dropped into negative territory during 2012. Deutsche Bank Securities published a study that shows U.S. 10-year yields are at a post–U.S. Revolutionary War low.

In contrast, looking back over roughly 100 years, the real price of gold in dollars is quite high, rivaled only by the highs hit in late 1980 and early 1981. The picture would look the same for gold over the last 200 years and, when compared with the British pound, over the last 500 years. The price of safety in today’s market is quite high.

Risky assets, such as global equities, present a different picture. Their valuations are attractive on a lot of metrics. Two in particular that are

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**Note:** E/P is earnings yield, and EPS is earnings per share.

**Sources:** Based on data from Bloomberg and MSCI.
illustrated in Figure 5 are dividend yield in Panel A and forward P/E in Panel B. The MSCI World dividend yield is currently 2.8%, which is below the average of 3.0% for the last 42 years (1970–2012) but still attractive relative to bonds. Likewise, the MSCI World forward P/E is now 12 times compared with the average since 1988 of 16 times.

Another encouraging fact is that today, the global ratio of net debt to equity has been at the low end of its range since 1990. The global return on capital employed and the global free cash flow yield are also near their peaks since 1990. As a whole, global companies have reduced their debt burdens, improved their returns on capital, and boosted their cash flows. Companies are facing the same uncertainty investors are facing and positioning themselves to better withstand a murky future.

Our assessment is that it is time to overcome the fear of investing in equities. Starting valuations are attractive, company fundamentals are strong, and the markets have priced in a lot of pessimism. We are enthusiastic equity investors today.

Case Study #2: Pharmaceuticals. By investigating a specific industry—in this case, pharmaceuticals—we can gain another perspective on the issues involved in value investing. Many investors believe growth is dead in the pharma industry. Ironically, the more investors think this is the case, depressing valuation, the less we need to depend on this growth to drive investment return.

The price-to-sales ratio of the S&P 500 Index health care sector has dropped steadily from a high in 1998 of 5 times to its current level of just over 1 times sales. Over the same period, from 1994 to 2012, the weighting in health care stocks has
steadily risen in our domestic portfolio. Starting at less than 5% in 1994, it rose to more than 25% in 2008 and is now just under 20%. Our weighting in pharmaceuticals relative to the industry’s representation in the S&P 500 is more than 2.5 times.

For the first 17 of my 25 years at Dodge & Cox, we were significantly underweight in pharma. Premium valuations reflected a lot of optimism about the industry’s growth prospects, in large part because the consensus wisdom was that pharma companies were innovative. We try to make a distinction between a company’s ability to do well and its need to do well to get a good investment return from the starting valuation. We were not finding a lot of investment value in pharma, so we were underweight the industry. But in the last decade, growth expectations for pharma companies have been rebased in light of tougher FDA approvals, health care cost scrutiny, patent cliffs creating big profit holes, large-scale M&A not necessarily adding value, and declining R&D productivity. By 2005, the consensus view was that growth is dead at big pharma.

During this time, we started to build conviction that this out-of-favor industry held value. We had been researching these companies all along—after all, good reasons for not investing in certain

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**Figure 4. Valuation Metrics for 10-Year U.S. Treasuries, 2-Year German Bunds, and Gold**


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Dec/53 Dec/63 Dec/73 Dec/83 Dec/93 Dec/03

**B. Gold, 1920–2012**

<table>
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<th>Real Gold Price (USD)</th>
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<tr>
<td>2,000</td>
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<td>1,750</td>
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<td>250</td>
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Dec/20 Dec/30 Dec/40 Dec/50 Dec/60 Dec/70 Dec/80 Dec/90 Dec/00 Dec/10 Dec/20

*Note:* The real price of gold is expressed in current dollars, using the U.S. CPI Urban Consumers Not Seasonally Adjusted Index.

companies and industries are just as important as good reasons for investing—but we picked up the pace. We started by looking at the downside. We made multiple trips to Washington, DC, to talk to policymakers and get a sense of how they were framing the issue of health care costs. We met with commercial payers around reimbursement. We met with competitors and disrupters, including biotech and biosimilar companies, and interviewed scientists, doctors, and consultants to get a handle on issues around R&D productivity and FDA approvals. We took trips to emerging markets to gauge whether there was an intellectual property threat, a growth opportunity, or both. We were working to determine if the valuations could go lower and if the current valuations were cheap because they should be or because all available information was not yet incorporated.

One way we framed this mystery was to look at R&D productivity. Table 1 shows the cumulative pharmaceutical R&D spent for each year and the number of drug approvals in that year. From 1991 through 2005, R&D spending increased sixfold as the number of approvals began to drop. The culprits were higher research costs and fewer approved drugs; productivity was declining. Investors were understandably very skeptical about growth and about the prospects of individual drugs. The more skeptical investors became about pharma’s growth prospects, the less important those prospects were as a factor in our investment return.

Our focus was not on forecasting the prospects of each drug because great uncertainty surrounds what an individual drug is worth. For example, Pfizer was as surprised as anyone at the widespread acceptance of LIPITOR, one of the most successful drugs of all time. So, rather than try to determine a specific drug’s prospects, we framed the mystery by asking, What does the company’s stock valuation say about the drugs it has in its current revenue line? We knew how long the current drugs had until patent expiration, so we did a discounted present value to determine what we were implicitly paying for that future...
revenue stream. Starting valuations of 8 or 10 times forward earnings implied that we were not paying that much for future growth and, in some cases, were even getting it for free. At the same time, pharmaceutical companies were generating massive cash flows that they used for dividends and buybacks; the flip side of a bloated cost structure is that management can cut costs to offset earnings headwinds.

There was compensation for being patient if we were early. And we were. R&D spending continued to climb, productivity continued to decline, and valuations continued to fall. Because timing is impossible to predict, we kept reviewing and revising, always keeping that long-term view, and asking ourselves if the company is a better investment with the new, lower price. Are the long-term fundamentals intact, or has something significantly changed? We thought that pharma was becoming a better and better investment, and we were slowly building a bigger stake in the industry. By 2010, we had accumulated a big overweight in pharma—about 6% of the S&P 500 compared with 14% of our domestic portfolio. Since 2009, R&D spending has leveled off, and more recently, the number of drug approvals increased. This turn of events, as well as other factors, gives us some optimism about the industry’s growth prospects.

Emerging market sales, which now represent about 20% of total industry sales, are growing at a compound annual growth rate of 13% and are estimated to be 30% of total industry sales by 2016. This growth stems not only from new products and new scientific breakthroughs, but also from increased consumption by the 50 million people projected to join the middle class each year. Valuations have improved to about 11–13 times forward earnings and stocks have outperformed: Investors’ worst fears have not materialized. We remain overweight in pharmaceuticals because relative valuations are still low and the growth outlook is improving. Relative free cash flow is about as inexpensive as it has been in 60 years; P/Es are low and cash flow is high. It is hard to find another industry in which companies can be bought at 11 times forward earnings with about 4% yields that have a nontrivial possibility of developing new products with high gross margins over the next five years. Consequently, we remain quite enthusiastic about the fund’s pharma holdings.

Case Study #3: Europe. This case study is an example of throwing the baby out with the bath water. Even with the troubles facing Europe, European companies can present good value. I am certainly not trying to argue that the European macro outlook is better than it is. Europe is important: It accounts for about a quarter of global GDP and global market cap.

As a result of the problems in Europe, valuations are low. However, at the same time, company fundamentals have improved. Balance sheets are strong, profitability is high, and free cash flow yields are attractive. In a world where P/Es are low and cash flows are high, Europe is still cheaper. In fact, European margins are not back to their former peak levels. Thus, we are well positioned as investors when we buy European companies that have low starting valuations and high cash flows. We are getting compensated to hold these stocks in our portfolio and wait for better times.

Figure 6 shows the MSCI Europe Index’s P/E, dividend yield, price-to-cash-earnings ratio, and price-to-book ratio (P/B) from 1970 to 2012. For each metric, the current level is historically attractive. Figure 7 offers a picture of the strong fundamentals of European companies. Each of the measures—net cash on balance sheet, net debt-to-equity ratio, net income margin, and free cash flow—is currently, and estimated to continue to be, attractive on a historical basis since 1982.
Net income margins are expected to return close to 2007 highs by 2014, and free cash flow yields are estimated by 2014 to equal or exceed highs reached in 2004–2005 and 2010.

Let me make a further point about throwing the baby out with the bath water. The Dodge & Cox International Stock Fund (ISF) is 42% invested in European-domiciled companies, but three-quarters of the companies that make up that 42% generate the majority of their revenues outside of Europe. For example, Luxembourg’s Millicom International Cellular derives most of its revenues from its mobile networks in Africa and Latin America, and France’s Lafarge generates about 60% of its revenues in the emerging markets. I could name many other similar situations.

Obviously, our officially published country weightings in Europe are overstated in terms of actual exposure. About 18% of the ISF is invested in companies that have significant revenue exposure to Europe. Where a company is domiciled does not tell the whole story of where it does business. We are taking advantage of the opportunity to buy European companies that have global reach and are trading at low valuations because of European macro concerns.

The macro side of the equation is also an important piece of our analysis. We talk to economists and central bankers and coordinate with our fixed-income team to keep an eye on currency and the sovereign debt auctions, but we are primarily looking at individual companies, as is evident with our next case study.

Figure 6. MSCI Europe Trailing Valuations

![MSCI Europe Trailing Valuations](chart)

Sources: Based on data from Morgan Stanley and MSCI.
Case Study #4: Koninklijke Philips Electronics NV (Philips). The first three case studies have dealt with the market, an industry, and a region, respectively. This case study focuses on a company and illustrates how we, as bottom-up investors, spend most of our time: looking in depth at a company to understand the drivers of its success or failure.

Philips is a global leader in three business lines: health care, such as ultrasounds; home health care, such as the Norelco shaver and Sonicare toothbrush; and lighting. We see Philips as a low-valuation turnaround story. It is cheaper than its peers on a number of metrics, including the ratios of enterprise value to sales and enterprise value to EBITDA. Enterprise value to sales is lower than 1 times, while its EBIT margin is just above 6%, but we expect both to improve over the next two years. Disappointing profitability is definitely a problem that plagues Philips, and investors lack visibility about its earnings power.

That said, we think the long-term outlook for Philips is better than many investors expect. Philips was essentially a serial restructuring story. The company has slimmed down to its core businesses, which are attractive and undervalued. Fixed costs of about 4–5% of company sales are being permanently cut. Although past management made several expensive deals in 2007 and repurchased Philips stock at high prices, a new management team is now buying back stock at cycle-low prices and avoiding large deals.
Management has dramatically changed the company’s footprint by exiting a lot of capital-intensive, volatile businesses—such as semiconductors and TVs—and is increasing R&D spending to about 7% of sales. In key product areas, such as patient monitoring and lighting, Philips is taking market share from strong competitors like General Electric.

Our models indicate rising earnings, rising revenues, rising margins, and rising cash flow as end markets recover and cost savings are realized. We see Philips becoming much more focused on the three businesses for which it is a global leader. The company has a very strong balance sheet and good cash flow and is using those strengths to reward owners. The company has bought back about 40% of its shares since 2004 and is currently halfway through a €2 billion share buyback. The dividend has increased from €0.14 a year in 1995 to €0.75 a year in 2012, which represents a 3.75% yield\(^2\) on the stock.

Investors are being paid to be patient. We see greater alignment of management and long-term owners in the future. The company has replaced or reassigned more than one-third of its top 200 managers, stating that tenure is less important than hitting targets, and has changed the

\(^{2}\)As of 31 October 2012.
compensation system to only reward those who achieve their objectives, awarding shares rather than options.

**Case Study #5: European Banks.** The final case study is about European banks. I am calling it the perfect storm, the trifecta for a value manager. Looking at valuations, investors are downright hostile about European banks. The situation for European banks is highly uncertain with a wide range of possible outcomes. It is an excellent example of the challenges value investors often face in making the decision to invest and stay invested.

Downside potential has to be acknowledged. We have the same view of the euro crisis as most people. We think that the European Union will muddle along with low growth and dire headlines for a long time, but at the end of the tunnel, we see a lot of upside. The outcome is not symmetrical. The upside is significant if things are not as bad as investors fear. So in the ISF, what has given us the courage to gradually increase our weighting in European banks these past three years?

**Figure 8** plots the P/B and price-to-tangible-book ratios for European banks from 1986 to 2012. Both metrics have returned to their 2008 levels. Price-to-book ratios are lower today than they have been 95% of the time over the past 25 years. The lowest-quintile European banks punch 2.5 times their benchmark weight in P/B terms. They are

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**Figure 7. European Company Fundamentals (continued)**

![Figure 7](image-url)

**C. Net Income Margin, 1982–2014e**

**D. Free Cash Flow Yield, 1982–2014e**

*Note:* Data exclude financials sector and are from MSCI’s European universe. Data for 12e and 14e are estimates.

*Sources:* Based on data from IBES, Morgan Stanley, MSCI, and Worldscope.
cheap. Discounts to tangible book value are high, which indicates that investors are worried about book value being written down and the banks not earning their cost of capital. The low valuation reflects widespread investor sentiment that the European banks are deteriorating businesses.

We see signs that some fundamentals are improving. The core Tier 1 common equity capital ratio is about 10% today and has increased significantly from five years ago, when it was around 6–7%. During those five years, the banks have raised capital, deleveraged, sold assets, and increased earnings.

Asset growth has been modest, with total assets increasing an estimated 8% from 2008 to 2012. The banks have secured much more stable sources of funding composed of a higher proportion of deposits (estimated increase of 21% from 2008 to 2012) and a lower proportion of wholesale funding. Tangible shareholder equity has increased an estimated 81% from 2008 to 2012. Although investors have been skeptical about the value of some of the regulatory stress tests, we do see that greater scrutiny has inspired action.

We built conviction in our position on European banks through extensive bottom-up research, deep dives into company and industry issues, and collaboration with our fixed-income team. The financial crisis affirmed two things for us. The first is how important it is to work with the fixed-income team, which helps us identify the price signals in the bond market that are good early warning signs of trouble. The fixed-income team can also provide insight into liquidity, under what terms and conditions banks can or cannot access markets. The second thing we learned in the financial crisis is how important it is to talk to regulators and policymakers. We have made trips to Europe to talk to, among others, the Bank of England, European Banking Authority, and European Central Bank to better understand how they think about the euro, the eurozone, European banks’ capital ratios, lending levels, and so forth.

We also turn our attention to each company’s management, span of control, franchise strength, balance sheet (especially funding and liquidity), and both the level and type of capital. We are doing Basel III look-throughs right now to determine the size of the gap between where a bank is today and where it needs to be to conform to Basel III, how long it would take the bank to close that gap, and importantly, how it stacks up in relation to its European peers.

Staying objective is critical. As humans, we face the risk of becoming wedded, or anchored, to our positions. To combat this tendency, we conduct all-cash exercises, in which we literally get out a blank sheet of paper and write down how we would invest looking forward three to five years. It kind of frees our minds. Then we compare what we have written with where we actually are. It is a good gut check.

We try to mitigate sovereign risk by diversifying our exposure by sovereign nation, central bank, and currency. Our holdings of eurozone banks are modest, only about 4% of the portfolio, but our exposure has increased elsewhere in Europe—in Switzerland and the United Kingdom, for example. In these nations, the central banks are the lenders of last resort, their currencies can adjust to a single country’s issues, and they can print money to satisfy their obligations. We are in the early days yet for our European bank investments. During 2010

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3Deutsche Bank Securities’ European bank universe.
and 2011, European financials detracted from the fund’s absolute results, but in 2012, the sector was one of the best-performing in the portfolio, up 28% year-to-date through 30 November 2012.

Conclusion
The starting point of an investment matters, and that starting point is valuation. Valuation is a key ingredient in long-term returns. A “good” company is not always a good investment. Risk is not simply about playing defense; we also need to play offense to build real returns over time. A long-term view is essential. We build persistence and staying power by retesting and revisiting our investment thesis. For value investors, staying power is an ally. Intensive bottom-up research by our global industry analysts, decision making by an experienced and stable team, incremental portfolio moves, and fully understanding a company’s governance and structure are all elements that give us conviction and build staying power.

This presentation is not a complete analysis of every material fact concerning any market, industry, or investment. Data have been obtained from sources considered reliable, but Dodge & Cox makes no representations as to the completeness or accuracy of such information. Opinions expressed are subject to change without notice. The information provided is historical and does not predict future results or profitability. This is not a recommendation to buy, sell, or hold any security and is not indicative of Dodge & Cox’s current or future trading activity.

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Question and Answer Session
Diana S. Strandberg, CFA

Question: How do you measure and deal with national risk?

Strandberg: We look at national risk from two perspectives. First, we start by understanding the rules of engagement—such as a nation’s legal and regulatory frameworks and how our rights may be affected—in the country in which a business is domiciled. Next, we gain an understanding of where the company is doing business and who the other stakeholders are.

In a lot of countries, the government itself is a stakeholder, either directly (as in China) or indirectly, and may be able to confiscate assets or impose regulation that changes the dynamics of a given situation.

Petrobras is a good example of our approach to this type of risk. The Brazilian government owns over half the company’s voting shares. Prior to our investment in Petrobras in early 2000, the company had been used as a tool in senatorial elections. The correlation between where the company was spending money and which senators were elected was very high.

When we met with Petrobras, new management was coming in and new people were taking the helm of Brazil. The new management really talked like long-term owners of the business, and we felt that they would act as such. In addition, Petrobras was one of the biggest line items for Brazil’s National Treasury, so the Treasury was rewarded if we were rewarded. Our interests were aligned.

Question: How do you avoid the value trap?

Strandberg: There are two definitions of a value trap. One is a company that is cheap because its fundamentals are deteriorating. The more typical definition is a company whose stock price has been falling for a long period of time. It is really hard to distinguish between the two.

The investment policy committee is concerned about two things: Based on a stock’s current price, and irrespective of its price history, what is the upside value relative to the downside three to five years in the future, and what factors help stack things in favor of a positive outcome? Our analysts review the company with a range of income statement, balance sheet, and cash flow scenarios to provide a downside case and an upside case.

We try to determine the drivers of both positive and negative performance so that we can assess the risk-reward trade-off.

Question: Do you hedge or take currency risk?

Strandberg: We do both, but hedging is infrequent. If we disaggregate the 9% annual return that EAFE has clocked over 40 years, we can see that the biggest drivers have been earnings growth and cash flow. Currency is noisy in the short term, but has not added much to return over the long term.

So, we look at currency at the company level and are more focused on the company’s earnings and cash flow. A couple of years ago, we were concerned about the euro and the British pound, and last year, we were concerned about the Swiss franc in relation to the U.S. dollar.

Right now, the Japanese yen is a concern. We do not want our return on a Japanese exporter, for example, to disappear if the yen weakens. In this case, we will modestly hedge.

Question: How many names do you have in your portfolio?

Strandberg: We have 90 names in the ISF today, and the typical range is 70–100 names.

Question: How important is liquidity risk in stock selection?

Strandberg: Liquidity is not really a big factor in our decision making. Our strategy has never rested on our jumping in and out of names. But let me reframe the question. You can get any liquidity you want. The question is, at what price?

We are very price sensitive. There is no such thing as a good company or a bad company. We distinguish between good investments and bad investments. We are long-term investors and can take the long-term view. I certainly cannot point to a time in my career when I knew that the answer was to sell or buy an entire stock position. Our strategy has always been to move very slowly.

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