Brandes **believes:**

Japan: A New Dawn in the Land of the Rising Sun

Many investors have a number of concerns about Japan including the nation's:

- Large fiscal deficits
- Growing population of retirees and dwindling working population

While these are legitimate concerns, Brandes believes the markets have largely ignored the following:

- The Japanese government has several fiscal, monetary and public policy options for alleviating current pressures.
- Many Japanese companies have been getting stronger over the past few years.
- Because investor fear has helped drive down prices, Brandes believes Japan may present a unique opportunity to buy quality companies that may be in a much stronger position than they were 10 years ago, potentially at bargain prices.

Brandes believes Japan may present a unique opportunity for the rational, long-term value investor.

One of the more popular trends in the investment world these days seems to be proclaiming the demise of Japan. Given the steady downward trend of the Japanese stock market for the past two decades, last year's devastating earthquake and tsunami and a steadily appreciating yen, many are asking whether a new dawn of fiscal responsibility will break in Japan, or whether economic darkness will soon envelop the Land of the Rising Sun.

A Tale of the Two D's

For those issuing dire proclamations about Japan, the causes for concern center on debt and demographics.

Debt

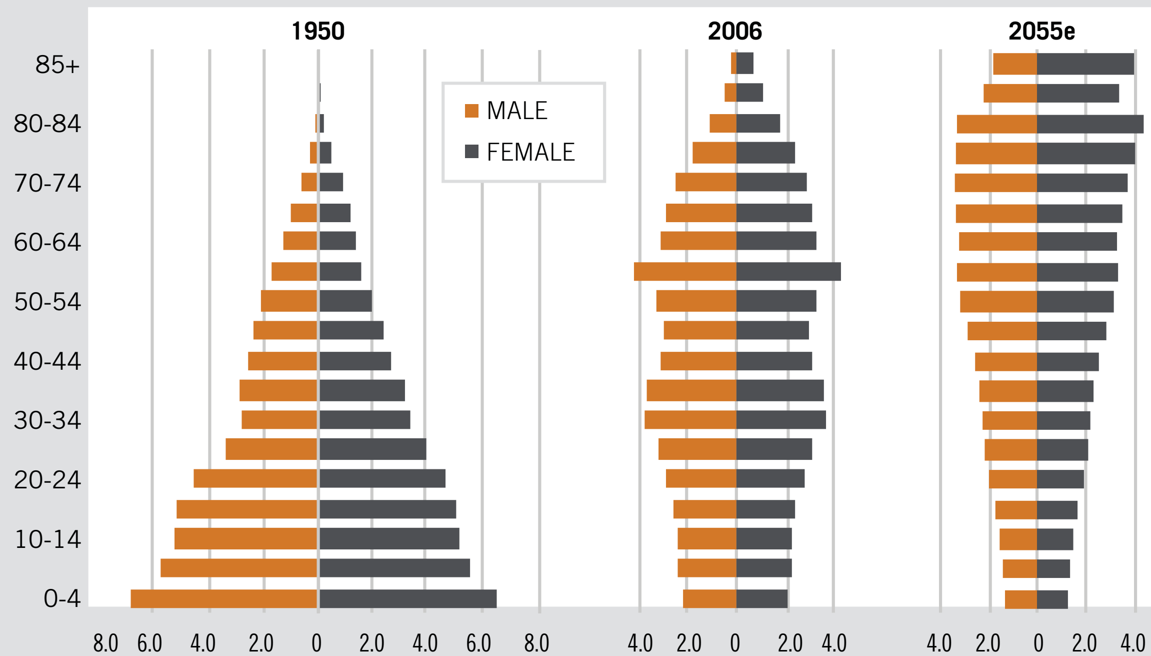
The government economic stimulus programs and bank bailouts that followed the bursting of Japan's economic bubble in 1989 caused the country's government debt to balloon. At more than 225% of gross domestic product (GDP),[1] Japan's government debt is currently the highest in the industrialized world. The debt by itself is not necessarily an issue because interest rates are low and Japanese investors are the largest debt holders,[2] allowing the government to finance its deficits at extremely small cost. However, when combined with the demographic trends in the nation, the government debt situation becomes more troubling.

Demographics

Japan's aging population contrasts starkly with many emerging markets where a young, growing population helps fuel economic growth. A decrease in birth rates and an increase in lifespan due to improvements in health care have created a situation where a growing population of Japanese retirees depends on a dwindling working population, as shown in Exhibit 1.

Exhibit 1: Japan's Growing Population of Retirees

Percentage of Japan's Population by Age, millions of people



Source: National Institute of Population and Social Security Research, 2008. 2055 data is estimated. It should be noted that longer-term, country-specific population projections can be highly variable given the compounding effects of assumptions about future fertility, mortality and migration trends. There is no assurance that a forecast will be accurate. Because of the many variables involved, an investor should not rely on forecasts without realizing their limitations.

Some investors fear that as the large portion of the Japanese population reaches retirement age, Japanese pension funds will increasingly need to sell their large share of Japanese government bonds (JGBs) in order to finance benefits. With fewer domestic borrowers for their debt, the Japanese government would increasingly need to rely on non-Japanese creditors who may demand higher yields to compensate for the country's high debt and low growth. For a deeply leveraged nation like Japan, a slight upward tick

[1] Source: International Monetary Fund (IMF) staff estimates; as of September 2011
[2] Bank of Japan; as of year-end 2010

in the cost of that debt could have a meaningful impact on that nation's ability to service their obligations. Spiraling debt-service costs combined with lower tax revenues caused by a decline in the working-age population could lead to more economic challenges for the island nation.

Japan's Challenges Are Real, but Solutions May Exist

While sovereign debt and demographics pose significant fiscal and social challenges that could result in economic turmoil in Japan, the nation possesses many fiscal, monetary and public policy options for alleviating current pressures.

Fiscal

- **Raise revenue through tax increases**
  At about 17% of GDP,[3] overall tax revenue in Japan is relatively low compared to other developed nations. Enactment of government proposals to gradually raise taxes could provide a stable and robust source of revenue.
- **Reduce government spending**
  Increasing the retirement age and cutting health care costs by increasing co-pays are options already being discussed to help reduce Japanese government spending.

With a variety of policy options at its disposal, Japan does not appear anywhere close to imminent financial collapse.

Monetary

- **Devalue the yen**
  Japan has been less aggressive than the United States and Europe in devaluing its currency, causing the yen to remain stubbornly high. Expanding the government's balance sheet and debasing the currency by purchasing government debt could serve the dual purpose of both supporting the JGB market and weakening the currency, increasing the competitiveness of Japanese companies internationally and making Japanese exports more attractive.

Policy

- **Boost employment**
  While Japan's unemployment rate is relatively low, the labor market still has excess capacity. By raising the retirement age and doing more to increase workforce participation among women—who remain under-represented in the Japanese labor force[4]—a more healthy balance between retirees and labor-force participants may be achieved.
- **Improve productivity**
  At nearly 30% below U.S. levels, productivity per hour worked is much lower in Japan than in other developed nations.[5] By promoting competition and the utilization of new technologies, the Japanese government may be able to encourage improvements in productivity to help spur economic growth.

With a variety of policy options at its disposal, Japan does not appear anywhere close to imminent financial collapse. Given the choice between an explicit default

[3] IMF; as of June 28, 2011
[4] OECD Labor Force Statistics; as of year-end 2010
[5] The Conference Board; as of January 2012

and using these policy options to gradually alleviate a crisis, Brandes believes the Japanese government will opt for the latter and usher in a new dawn of sustainable fiscal policy.

Japanese Companies—A Reason for Optimism

The intense focus on Japan's macroeconomic issues may grossly overshadow what truly matters for many long-term, value investors—the prices paid for Japanese companies.

In the face of a 20-year downward march for the Japanese stock market, Brandes believes a number of factors point to improving prospects for Japanese companies.

- **Japanese companies have been deleveraging**. The deleveraging that followed the bursting of the asset bubble left some Japanese corporate balance sheets relatively strong and the banking system with adequate levels of capital, strong funding, liquidity and good asset quality.
- **Many Japanese companies have substantial amounts of cash.** In fact, the number and percentage of Japanese companies with more than 25% of their market capitalization in cash far exceeds that of any other nation.

Exhibit 2: Many Japanese Companies Are Flush With Cash

Cash Levels of Companies (ex Financials) Larger than $1 Billion USD of Market Cap, by Country

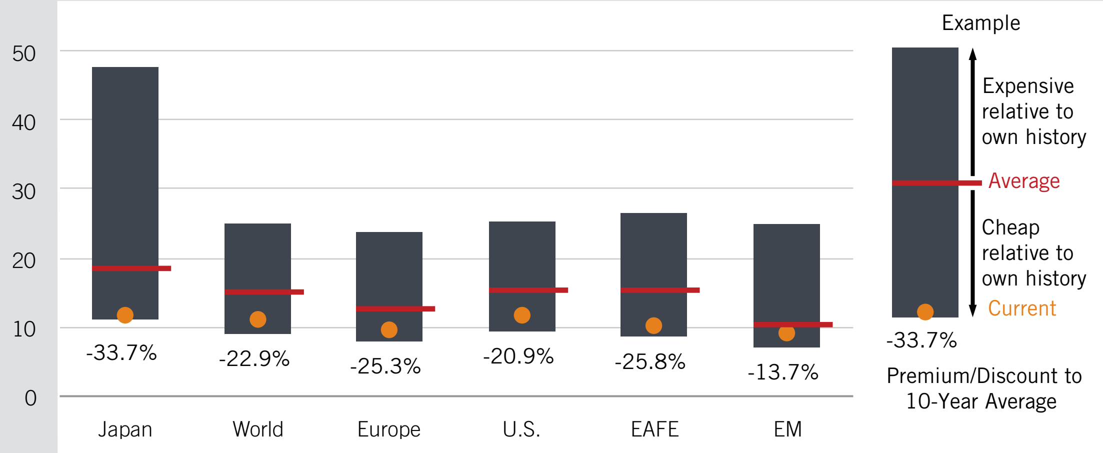
Country	Number of Companies With >25% of Market Cap in Cash	% of Companies With >25% of Market Cap in Cash
Japan	245	52%
United States	170	15%
France	12	41%
United Kingdom	2	5%
Germany	30	30%
Canada	19	10%

Source: Worldscope via FactSet; as of 12/31/2011

- **Some Japanese companies could be more profitable than they seem.** When valuations for Japanese companies are adjusted for the excess cash on their balance sheets, their price-to-earnings ratios (P/Es) tend to be significantly lower, and their returns on equity (ROE) are often higher and in some industries much closer to peers in other markets.
- **More Japanese companies are slowly increasing their focus on shareholders.** An increased focus on managing costs and a ramp-up in dividend payments and share buybacks provide evidence that Japanese companies may be beginning to focus more on shareholder returns.

These improvements, however, have not stopped investors from indiscriminately punishing Japanese companies for the cataclysmic pronouncements regarding Japanese demographics and sovereign debt, last year's natural disaster and an uncharacteristically strong yen. Because of this, the Japanese market is trading at a greater discount to historical averages than the rest of world, as demonstrated in Exhibit 3 on the following page.

Exhibit 3: Japan is Trading at a Greater Discount to Historical Averages than the Rest of the World Range of Forward P/E, 1998-2011



Source: Morgan Stanley, MSCI and FactSet; as of 12/31/2011

Chart Info: Japan is represented by the MSCI Japan Index. The World is represented by the MSCI World Index. Europe is represented by the MSCI Europe Index. The United States is represented by the S&P 500 Index. Europe, Australasia and the Far East (EAFE) is represented by the MSCI EAFE Index. Emerging markets are represented by the MSCI Emerging Markets Index. Past performance is not a guarantee of future results. One cannot invest directly in an index. For definitions of the aforementioned indices, please see the disclosures.

Brandes in Japan

With so many companies trading at attractive valuations, Japan may provide a compelling opportunity for the discriminating investor. Brandes' current exposure to Japan is primarily in defensive industries (pharmaceuticals, telecom and consumer staples), exporters (technology companies and autos) and financials (banks and property and casualty insurance companies). By design, many of these holdings are well-positioned, globally competitive, relevant companies with attractive market positions and clean balance sheets.

A rising interest-rate environment and a depreciating yen would no doubt impact various companies differently. Below are examples of companies in the Brandes portfolios and the impact that a domestic financial crisis could have on their businesses.

- **Toyota (TM):** Toyota, one of world's top auto companies in terms of vehicle sales,[6] derives roughly 73%[7] of its revenue outside of Japan. A depreciating yen should help increase Toyota's profits in dollar terms and the value of the company in yen terms. While part of the benefit of a depreciating yen would be offset by the company's domestic business, we believe the net result would likely be positive given the larger percentage of sales outside of Japan.
- **Seven and I Holdings (S&I):** S&I, the largest retail conglomerate in Japan, is a mostly domestic-oriented company with regard to revenues and costs, but with only a small net debt balance, probably would not be materially impacted by rising interest rates alone. S&I has a large mix of non-discretionary items (food, tobacco) that should prove defensive, and as the leading convenience store operator in Japan, it's possible S&I would gain market share as smaller competitors struggle through any potential economic turbulence.

[6] As of December 2011
[7] As of November 2011

BRANDES INVESTMENT PARTNERS

A Potentially Rare Opportunity

The market has taken a negative view of Japan for many reasons, but borderline hysteria about Japan may be overshadowing what Brandes believes is the unique opportunity the country presents for the rational, long-term value investor—the ability to buy quality companies that, by nearly all measures, are in a much stronger position than they were 10 years ago, potentially at bargain prices.

Market history has revealed, time and again, that despite occasional, even powerful, macroeconomic forces, the best indicator of a company's long-term stock price movement could be derived from the underlying fundamentals of that company, and the price one pays to get them. Today, bearish macroeconomic conditions are keeping many investors away from potentially undervalued, quality Japanese businesses whose fundamentals could be at their most attractive point in over two decades.

Amid the market negativity, Brandes continues to identify undervalued, quality businesses that we believe have the ability to overcome the challenges facing Japan and thrive at such a time that the nation emerges from its economic woes.

The MSCI EAFE (Europe, Australasia, Far East) Index with net dividends is an unmanaged, free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The MSCI EAFE Index consists of 22 developed market country indices. This index often is used as a benchmark for international equity portfolios and includes dividends and distributions net of withholding taxes, but does not reflect fees, brokerage commissions, or other expenses of investing.

The MSCI Emerging Markets Index with gross dividends is an unmanaged, free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of 21 emerging market country indices. This index includes dividends and distributions, but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

The MSCI Europe Index with net dividends is an unmanaged, free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the developed markets in Europe. The MSCI Europe Index consists of 16 developed market country indices. This index includes dividends and distributions net of withholding taxes, but does not reflect fees, brokerage commissions, or other expenses of investing.

The MSCI Japan Index with gross dividends is an unmanaged, free float-adjusted market capitalization weighted index that is designed to measure equity market performance of the developed markets in Japan. This index includes dividends and distributions, but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

The MSCI World Index with net dividends is an unmanaged, free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. The MSCI World Index consists of 24 developed market country indices. This index includes dividends and distributions net of withholding taxes, but does not reflect fees, brokerage commissions, or other expenses of investing.

The S&P 500 Index with gross dividends is an unmanaged, market capitalization weighted index that measures the equity performance of 500 leading companies in leading industries of the U.S. economy. The index includes 500 leading companies in leading industries of the U.S. economy, capturing 75% coverage of U.S. equities. This index includes dividends and distributions, but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

Price/Book: Price per share divided by book value per share.

Price/Earn: Price per share divided by earnings per share.

ROE: Return on Equity - net income divided by common equity.

International investing is subject to certain risks such as currency fluctuation and social and political changes which may result in greater share price volatility; such risks are increased when investing in emerging markets. Additional risks associated with emerging markets investing include smaller-sized markets, liquidity risks, and less established legal, political, social, and business systems to support securities markets. Emerging markets investments can experience substantial price volatility in the short term and should be considered long-term investments. Investments in small and medium capitalization companies tend to have limited liquidity and greater price volatility than large capitalization companies.

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Brandes Investment
Partners, L.P.
11988 El Camino Real,
Suite 500
P.O. Box 919048
San Diego, CA

10242 PUB 0312