

2023 Annual Global Fixed Income Review

JANUARY 2024

Alka: Welcome to Dodge & Cox's 2023 Global Fixed Income Investment Review. My name is Alka Singal, and I'm a Client Portfolio Manager here at Dodge & Cox. It is my pleasure to be joined by my colleague Matt Schefer, a member of the Global Fixed Income Investment Committee, as well as a Credit Analyst. Thank you for joining, Matt.

Matt: Hi Alka, happy to be here.

Alka: So for the next 20 minutes, we'll provide an update on three things. First, the global fixed income market backdrop. Second, the Global Bond Fund's strong performance across its three pillars of investment, which are global credit, interest rates, and currencies. And then finally, our outlook for the global fixed income markets and for the Global Bond Fund. Matt, before we jump into specifics, do you have any key takeaways for our listeners when reflecting on 2023? And can you just remind our listeners of the key philosophy of the Global Bond Fund?

Matt: Sure, happy to do so. I would say at a high level, what the Global Bond Fund is trying to achieve is really an attractive rate of return for our clients over a three- to five-year investment horizon without taking an undue amount of risk. And we go about doing that by looking at a very broad, in our view, investment universe of global credit, global currencies, and global interest rates. In terms of takeaway messages for today, I'd really point you to two things. The first one is that if we reflect on the past, 2023 was a great year for global fixed income markets overall and for the Global Bond Fund in particular, and we're very proud of that. Then on a forward-looking basis, I'd say that we are quite optimistic about the outlook from here, with a universe of credit, currencies, and interest rates to invest in, we think there are ample opportunities for investors going forward.

Alka: Great. Well, let's start talking about the global macro backdrop. Heading into 2023 and heading out of 2022, it seemed like recession was really at the forefront of everyone's mind. What happened?

Matt: Yeah, I think that's a fair characterization. Over the course of 2022, inflation was quite elevated and central banks, including the Federal Reserve (Fed), were increasing interest rates quite aggressively to combat that. And so as we rounded out the year, markets were grappling with the fact that monetary policy had been tightened significantly and yet inflation was still high, well above target in most countries. So there was a genuine fear, I think, amongst many

market participants that in order to bring inflation down sustainably, central banks would need to push the economies around the world into recession.

Alka: And then what did we see actually happen in 2023, maybe starting with interest rates?

Matt: I'd say overall, in 2023, things have turned out better than what many market participants had expected. Inflation has, in fact, come down in the United States and in a number of countries around the world. It doesn't mean that we're back at target and the work of central banks is over, but overall we'd say sentiment is generally better. And many central banks, including the Fed, are talking about easing monetary policy, or in some countries, have even begun to do so. This is really important, I would say for interest rates, as you know, expectations of monetary policy are a key driver of longer-term rates around the world. And so, I'd say it's interesting when we look at the U.S. on a year-over-year basis, the 10-year [U.S.] Treasury yield started and ended 2023 at 3.9%.¹ But over the course of the year, as fundamentals evolved, as market expectations evolved, interest rates went over a pretty wide range of levels trading down as low as call it, 3.25%, and as high as 5% over the course of the year.

Alka: Yeah, it certainly was a very volatile year when it comes to U.S. interest rates. What did we see outside of the U.S. in other key emerging and developed markets?

Matt: I would say it really varied by country, depending on what was going on with their own inflation and growth dynamics. There are certainly some markets where interest rates rallied quite significantly. In Brazil, for example, 10-year yields declined by over 200 basis points² (bp) year-over-year, so a pretty substantial move. Some Eastern European countries also saw large yield moves over that time. That's not to say that interest rates declined everywhere. Looking at Japan, for example, which continues to be a bit of an outlier from a monetary policy perspective, the 10-year yield actually increased from 0.4% to 0.6% year-over-year.

Alka: Moving on to credit, what were some of these knock-on consequences of the rate environment on global corporate spreads?

Matt: I'd say overall, global corporate spreads performed quite well during the year. Industrials typically outperformed Financials. Lower-rated securities generally outperformed higher-rated securities, at

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least in the portions of the market in which we focus. But it's not to say that it was a smooth ride all the way, even though year-over-year it was quite a significant improvement in credit valuations. If you think back to the spring, there were a number of U.S. regional banks that had failed in part due to the interest rate volatility in the selloff in interest rates that we saw. We also saw the failure of Credit Suisse in Europe in the spring, as well. So credit spreads did have their ups and downs throughout the year, which actually provided us with some interesting opportunities throughout the year to adjust our portfolio positioning.

Alka: Moving to mortgages, can you talk a little bit about what happened with mortgage valuations throughout the years and where there may have been more pockets of opportunities?

Matt: Yeah, so the mortgage space is an interesting one for us. As we trimmed credit, there's always that question of "Okay, where do you put the money to work?" and oftentimes we use U.S. Treasuries as a lower risk, lower return portion of the portfolio. Agency³ mortgages are also an interesting place for us from that perspective. The Agency mortgage space—this is Fannie Mae and Freddie Mac mortgage-backed securities (MBS), so effectively a U.S. implicit government guarantee—is a really interesting space for us, and overall it performed quite well during the year. However, valuations are still quite interesting to us. And the reason for that is, you know, there are a number of major players in that market who have pulled back in recent periods. So the Federal Reserve, for example, who have been purchasing a lot of mortgage-backed securities is no longer doing so. A number of banks as well that had been active in that space have pulled back in their activity. And so overall, we think the valuations are interesting; and, in that lower risk, lower return portion of the portfolio, we think these stack up quite nicely.

Alka: So we've covered global interest rates, we covered global credit, and then we also talked about mortgage valuations. That leaves us with our third pillar, which is currencies. Generally, the U.S. dollar depreciated last year, but can you give us some color around individual either regions or currencies and what happened in the currency market?

Matt: So on a trade-weighted basis,⁴ what you've said is correct. The U.S. dollar depreciated by about 2% or so in aggregate, but there is very wide dispersion I would say, from country to country. As bottom-up, active investors like ourselves, these periods are really ripe for us for identifying opportunities. If we look at what transpired over the year, for example, several Latin American currencies were amongst the best performers in the world. The Colombian peso, for example, strengthened by about 25% year-over-year, and the Mexican peso strengthened by about 15% year-over-year.⁵ Both of these are sizable holdings within our Fund, and I think what they have in common is that they started the year with undervalued exchange rates, attractive levels of real interest rates, and they had some idiosyncratic benefits throughout the year as well. That's not to say that every currency did well. The Japanese yen, for example, is one of the weakest performers during the year, and the yen had depreciated by approximately 7% year-over-year.

Alka: All of these factors—generally falling rates, particularly toward

the latter end of the year, falling credit spreads, mixed results in currencies—that all just led to strong performance across global fixed income markets. If you go to slide six that outlines the performance for the Global Bond Fund, you can see [the] really strong performance that Matt alluded to earlier of 12.3% for the year.⁶ Also strong performance for the broad market [Bloomberg Global Aggregate Bond Index⁷ (USD Hedged)] at 7.15%, but really, you know, significant outperformance of our strategy by 5.2%. If you look at the calendar-year basis, you'll see, we have generally consistently outperformed the benchmark. And more importantly, if you look at an annualized basis in the chart below, you will see very strong returns on a relative and an absolute basis, which accounts for some of those periods where you saw interest rates rise very significantly, such as in 2022. Matt, is there anything else that you would elaborate on when looking at the performance of the Global Bond Fund?

Matt: Yeah, I would say you've summed it up quite well. I think we're really proud of the track record of the strategy. Maybe just the one thing I'll point out is a 12.3% return in isolation for 2023 was quite nice. It's important to realize this wasn't just kind of necessarily a one-off in the Fund's history. We've had about a 12% return, plus or minus, in three out of the past five years, which I think is a testament to our ability to navigate through different market environments. And obviously those returns compound quite nicely over time, leading to our more than 5% annualized return over the past five years.

Alka: When we look at that 12.3%, can you talk about what were the building blocks of that return, if you think about it from an attribution perspective across rates, currencies, and spreads?

Matt: Yeah, so I'd say the reassuring thing for us is that it wasn't a single investment or a single investment theme that contributed to the year's strong performance, but rather it was the interest rate, credit, and currency exposures that all contributed positively over the year. Coming into the year, the Fund had a yield-to-worst⁸ of 6.9% to start, and so with kind of a nice income cushion to begin with, that was a real nice tailwind in terms of overall absolute performance. As we break down the 12.3% across those three dimensions, duration⁹ and yield curve was by far the largest contributor at about 6.2 percentage points. A lot of that is captured in that starting yield-to-worst that I referenced earlier, just the day-to-day accrual of income in the Fund. On top of that though, as interest rates were volatile and we did adjust our interest rate positioning, over time that provided an additional boost in the form of price appreciation as interest rates came down, particularly toward the fourth quarter of the year.

Moving on to credit,¹⁰ which was about 4.8 percentage points out of that 12.3, credit performed very well. As I had mentioned at the outset, we have a very carefully selected set of credits within the portfolio that generally performed well across the board. And so when you combine the incremental yield that we earned by owning corporate bond securities with that spread tightening that we saw, that produced a pretty nice return from the credit sleeve.

Then finally on the currency side, a 1.6 percentage point return. In general, as we had mentioned, you know, most currencies appreciated against the [U.S.] dollar over the years, so that was a nice tailwind

there. And when we look at the specific currencies we owned, some of our largest exposures were some of those Latin American currencies that performed the best. It's not to say everything worked out in the portfolio, but on net, were very happy with the broad contribution of performance that we saw.

Alka: Yeah, and this is especially nice given that currency has been a headwind somewhat recently given the overall strong [U.S.] dollar. It's great to see that all three pillars were firing last year. So you alluded to trimming credit earlier in our discussion. Could you just summarize what are some of the key portfolio changes that occurred last year as the Committee employed its bottom-up valuation focus?

Matt: 2023 was, I'd say, another busy year for our Investment Committee. To start off thinking about credit, taking you back maybe a little bit further, we had added to credit by about 13 percentage points in 2022 as we saw a number of opportunities across the market. In 2023, I'd say we continue to like actually many of those companies from a fundamental perspective, but when we look at the market pricing, as the market has become a lot more optimistic around the economic outlook, we no longer thought that balance between valuations and fundamentals made sense. And so we ended up reducing the credit exposure in 2023 by about 12 percentage points year-over-year. So more or less similar size to the add we had in the prior year. Overall, I would say Industrials securities typically outperformed Financials given some of the bank-specific stresses that we've seen, and so the bulk of our trims were in the non-financial area of the market. Similarly, we saw long duration credit securities perform perhaps the best relative to other duration buckets during the year. And so many of our credit trims, especially most recently, were in these longer-duration credit securities that we feel are most vulnerable in the event of a widening of spreads going forward.

Alka: Great. With that 12% reduction, you mentioned attractive MBS valuations earlier in the investment review. And just so everyone knows, we did add over 9% to Agency MBS, primarily lower-coupon mortgages, just at compelling valuations. Maybe we can move on to duration and talk about what we did not just in the U.S., but also outside of the U.S.

Matt: Certainly, I'd say duration was another interesting story for the year, just given how topical interest rates were and how large some of those fluctuations were in the level of rates. Net net, I'd say we added about a year of duration to the Fund, extending to about 5.4 years overall. And what I think was interesting for us is if you had looked back over time at the Global Bond Fund, our duration posture historically had been predominantly in the United States as well as what I'd say was a very select number of emerging markets where we thought real yields were attractive. As we've seen global yields normalize or rise over the past few years, that opportunity set for us on the interest rate side has widened as well. And so we've actually been able to add duration to quite a few developed markets overall. Just to give you a quick example, German interest rates, I think 10-year German interest rates were still negative as of the start of 2022 and yet reached a high of close to 3% toward the end of 2023. And so that was kind of an interesting opportunity for us to look at and reevaluate our duration posture, which had historically been

having effectively zero duration exposure to Germany for the past few years. So as rates rose, we were able to reevaluate that, and actually take on a small amount of duration going forward.

Alka: With respect to currencies, while the net change was very little, what happened underneath the hood?

Matt: There was certainly a lot going on there, and we come about all of our investments on a bottom-up basis. So as we look at currencies, it's not "Do we have a view on will the dollar go up or down?", but it's very much about looking at each individual currency around the world on its own merits and relative to its own valuation and deciding what to do. What we've seen over the past year actually, was that there were a number of interesting opportunities for us in the developed market side. So we added to places like the Australian dollar, the Norwegian krone as well, and actually increased our developed market currency exposure to the highest it's been in quite a few years. Conversely, I would say there were a number of emerging market currencies that we no longer found as attractive as we had in the past. The Mexican peso, which had been one of the year's best-performing currencies, we were able to trim back slightly. We were able to reduce our exposure to a place like Indonesia, as well. So all in all, I think we continue to find a lot of interesting opportunities. That doesn't necessarily mean that the currency weight will move significantly one way or the other, it could also be a mix shift as we saw in 2023.

Alka: And the weight of our currency exposure was around 76% to the U.S. dollar and 24% to non-[U.S.] dollar currencies at year end. Just a reminder that we do employ a hedged mindset when we think about our currency exposure. Pulling it all together—if you are following along on the slides, this is slide nine—if you look at the Global Bond Fund at year end, the yield-to-worst was attractive, as Matt stated previously, at 5.6%¹¹ and the duration was 5.4 years, which is actually almost close to the highest level of duration the Fund has had since its inception, which speaks to how much conviction our Committee does have in interest rates and interest rates generally falling over our investment horizon. Matt, what else would you really point out on this page as it pertains to portfolio structure?

Matt: I think this page does a great job of slicing and dicing the portfolio across a couple of different dimensions, but what I would really emphasize is that we go about constructing our portfolio very much on a bottom-up basis, investment by investment, around the globe. When we put all of that together, we've tried to balance diversification across sectors, across rating buckets, across currencies, as well as making sure that our best ideas on a risk-adjusted basis have the largest weights. Overall, I'd say we do not anchor on any specific macroeconomic scenario, but we aim to have a portfolio that can perform well across a wide range of macroeconomic environments. And so when we look across this portfolio, it has a mix of corporate bonds, and government bonds, and securitized products. It is predominantly investment grade, but has some interesting below investment-grade opportunities. It takes currency risk, but in a size that we think is manageable overall for the Fund. So we're quite optimistic about the prospects from here going forward.

Alka: So Matt, any closing thoughts on the portfolio and our outlook?

Matt: I would say overall, we're quite optimistic about the outlook from here. As we've talked about, we have a team of experienced analysts who really go through the world very carefully in helping construct this portfolio and uncover opportunities for our clients. So as we look across the strong, in our view, starting yield-to-worst of this strategy, coupled with the opportunities we're seeing within credit, the opportunities we're seeing within currencies, and the opportunities we're seeing within rates, we feel quite good about the outlook for the years to come.

forward to speaking with you soon.

Alka: Thank you very much for that, Matt. We also want to thank our listeners for your interest in our investment review. We're grateful for the confidence that you've placed in Dodge & Cox, and we look

The Global Bond Fund - Class I SEC yield calculated for December 31, 2023 was 4.98% using net expenses and 4.91% using gross expenses. This material must be accompanied or preceded by the Fund's [prospectus](#).

Dodge & Cox Global Bond Fund — Class I SEC Standardized Average Annual Total Returns as of December 31, 2023: 1 Year 12.31%, 5 Years 5.12%, 10 Years 3.56%. Fund and Index standardized performance is available on our [website](#).

Global Bond Fund's Ten Largest Positions (as of December 31, 2023): U.S. Treasury Note/Bond (9.8% of the Fund), Fannie Mae (7.5%), Freddie Mac (7.5%), Japan Government (3.6%), Brazil Government (3.4%), Mexico Government (3.0%), Norway Government (2.7%), British American Tobacco PLC (2.4%), Petroleos Mexicanos (2.1%), and Prosus NV (2.0%).

1. Unless otherwise specified, all weightings and characteristics are as of December 31, 2023.
2. One basis point is equal to 1/100th of 1%.
3. The U.S. Government does not guarantee the Fund's shares, yield, or net asset value. The agency guarantee (by, for example, Ginnie Mae, Fannie Mae, or Freddie Mac) does not eliminate market risk.
4. As measured by the Trade-Weighted U.S. Dollar Index, which measures the value of the United States dollar relative to other world currencies.
5. The use of specific examples does not imply that they are more or less attractive investments than the Fund's other holdings.
6. All Fund performance results are for the Global Bond Fund's Class I shares.
7. The Bloomberg Global Aggregate Bond Index is a widely recognized, unmanaged index of multi-currency, investment-grade fixed income securities. Bloomberg calculates a USD hedged return by applying one-month forward rates to seek to eliminate the effect of non-USD exposures.
8. Yield to maturity is the total rate of return anticipated for a bond if it is held to maturity, assuming all interest payments are made on schedule and the original principal amount is repaid.
9. Duration is a measure of a bond's (or a bond portfolio's) price sensitivity to changes in interest rates.
10. Credit refers to corporate bonds and government-related securities, as classified by Bloomberg.
11. Please see page 9 of the slide deck for details.

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