GLOBAL VALUE ADVISORS
A Division of Moody Aldrich Partners

Emerging Markets
First Quarter 2020
COMMENTARY

Global Value Advisors is an investment boutique specializing in long-only international and global equities. GVA is a value investor and its research shows that companies that generate positive Free Cash Flow and return capital to shareholders outperform the market. GVA uses a disciplined methodology to isolate an advantaged subset of the universe and then applies fundamental research to identify companies with sustainable Free Cash Flows to maintain their assets, finance their growth and return capital to shareholders.

Total Returns (Net of Fees)	Q1
GVA Emerging Markets	**-31.3%**
MSCI Emerging Markets Index	-23.6%
Value Added	**-7.7%**
MSCI Emerging Markets Value Index	-28.0%
MSCI Emerging Markets Growth Index	-19.4%

Regional Indices	Q1
MSCI China	-10.2%
MSCI Korea	-22.5%
MSCI Taiwan	-19.1%
MSCI India	-31.1%
MSCI Emerging Markets Small Cap	-31.4%

The first quarter of 2020 was one of the worst on record for stock market performance as the global coronavirus pandemic ravaged markets. Stocks were down 15% to 30% across regions and capitalizations. Growth's rout over Value continued in March and YTD global Value underperformed global Growth by a massive 11.4% (MSCI ACWI Value Index -27.1% vs MSCI ACWI Growth Index at -15.7%). For comparison, the two worst years of the TMT bubble (1998 and 1999), saw Value underperform Growth by 17% and 16% respectively. If the YTD 2020 trend continues at this pace, Value would underperform Growth by 46% for the full year.

The spread was almost as severe in Emerging Markets with Value underperforming Growth by 8.7% YTD (MSCI Emerging Markets Value Index -28.0% vs MSCI Emerging Markets Growth Index at -19.3%). Specifically during the month of March, we saw extreme Growth outperformance vs Value for global, international small caps and emerging markets respectively (6.4% for MSCI All Country World Index, 5.5% for MSCI All Country World ex-USA Small Cap Index, and 4.0% for MSCI Emerging Markets Index).

During the quarter, size mattered as larger caps outperformed smaller caps by 8.4% in March and 9.9% YTD, measured by the MSCI ACWI Large Cap and Small Cap Indexes.

GVA Emerging Market Review

The GVA Emerging Market strategy returned -31.3% (net) in the first quarter of 2020 versus -23.6% for its benchmark, the MSCI Emerging Markets Index.

Underperformance in March was driven by a relatively even combination of poor allocation and poor stock selection. Energy was the largest sector detractor in the month, where we are overweight and saw poor stock selection. Communication Services also saw a large performance drag, due to both the strategy's underweight position and poor stock selection. This more than offset strength in Industrials. In terms of country exposures, China was the largest negative, where the strategy is underweight and saw poor stock selection.

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As is often the case in severe drawdowns, smaller market capitalizations were penalized in the market rout. We recently published an Investment Insight titled "Covid-19 Market Meltdown and Bear Market Dynamics", which is available on our website.

The large cap dominance in the quarter was a headwind for the portfolio, which is currently finding better value in smaller cap companies, with a weighted average market cap of $5 billion versus $59 billion for its benchmark. More detrimental to the strategy's relative return, was the 8.7% year-to-date underperformance of Value versus Growth.

The relative underperformance was within expectations, as growth significantly outperformed value and large cap outperformed mid and small caps by a wide margin. GVA's portfolios are designed to slightly outperform during modest growth periods and significantly outperform during value led markets. GVA expects to underperform during extreme growth led periods and Q1 2020 was the most severe growth/value divergence in history. During the month of March alone, growth outperformed value by 4.0% within the MSCI Emerging Markets Index.

Market Positioning

Key attributes of GVA's holdings are strong balance sheets, high and consistent free cash flow generation, and cheap valuations. GVA's holdings typically do not rely on debt or equity to finance their businesses. The average dividend for the portfolio is 9.3%, which is fully covered by free cash flow. All of these attributes should be favorable in periods of heightened market volatility. Despite high levels of market uncertainty and limited earnings visibility in the short term, we believe the strategy's holdings are well positioned to weather the downturn.

As a reminder, country and sector weights are residuals of GVA's bottom up stock selection process, which identifies companies with advantaged fundamentals and cheap valuations. We pay close attention to sector and country positioning, but recognize that over time 88% of added value has been derived from stock selection.

The largest regional overweight is Russia, where the strategy has a 13% weighting vs the benchmark at 3%. Although we are not making a macro-bet on Russia, GVA's process is identifying companies with strong fundamentals trading at depressed valuations. One of the strategy's largest positions is in Lukoil, which operates a leading exploration and refining business in Russia. Although the stock is off roughly 35% YTD, we have been adding to the position. The company is a low-cost producer (Russian producers are Free Cash Flow breakeven at $15 per barrel) and will likely emerge in a stronger competitive position when oil prices rebound off the bottom. Lukoil has very low levels of debt on the balance sheet, with net debt/equity at 4%. FCF yield is 27%, shareholder yield is 22%, and PE FY1 is 8x.

The strategy's second largest regional overweight is Turkey, with a 10% portfolio weight vs less than 1% for the index. Similar to Russia, GVA's process is finding good value in the region. Erdemir is GVA's largest position in Turkey. Erdemir is the nation's largest iron and steel producer. Although the industry is suffering from a sharp global slowdown in steel consumption, Erdemir is well positioned to weather the downturn and benefit from the recovery. The company's vertical integration and market share leadership give it a cost advantage over peers. Erdemir's strong balance sheet provides downside protections if the global recession drags on longer than expected. The company is sitting on 3 billion TRY in net cash, or 1% of the market cap. FCF yield is 27%, shareholder yield is 22%, and PE FY1 is 6x.

Performance Outlook

GVA's key competitive advantage is its exclusive focus on companies within what we have identified as an "advantaged subset". Our research shows that investing in companies with the following attributes leads to significant outperformance over time. As a reminder, GVA's process identifies companies that have four key attributes:

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1. High and sustainable Free Cash Flow – over a market cycle and likely to continue.
2. High and sustainable Shareholder Yield[1] – over a market cycle and likely to continue.
3. Strong balance sheet.
4. Valuation in the cheapest 20% of the strategy's universe and undervalued due to non-structural, short-term factors.

GVA invests in businesses that demonstrate constrained capital allocation focused on shareholders through dividends, buybacks and debt reduction (what we call Shareholder Yield). GVA prefers steady, mundane businesses where we don't pay up for growth and those with flexibility to internally finance operations without the need to access debt or equity markets.

GVA's core financial metrics typically help protect the portfolio during market declines. During a downturn, investors usually rotate to companies with strong fundamentals (steady free cash flow). Companies with high and consistent free cash flow have more financial flexibility than their peers. GVA's average free cash flow yield of 19% is more than 3x the benchmark at 6% and well ahead of the strategy's peer group average.

Balance sheet safety becomes critical in a downturn. As a preemptive measure, companies with overleveraged balance sheets are excluded from GVA's investment universe. Debt covenants are limits put in place by lenders to help increase the likelihood that loans will be repaid. The most common debt covenants are debt/EBITDA and interest coverage (EBIT/debt interest). Note that both of these metrics are tied to earnings, which usually decline to varying degrees during a recession. Investors closely monitor how probable a company is to violating their covenants, which is one of the first signs a company is headed towards bankruptcy. GVA's debt covenant ratios are strong, due to high EBITDA generation. The portfolio's average net debt/equity ratio is 9%, which is well below the index at 14% and the strategy's peer group average.

Valuation is also a key metric that investors monitor in a downturn. High flying growth and momentum stocks are often hit hardest, particularly as a downturn drags on. Investors generally refocus attention on the valuation of businesses. GVA's portfolios can only pick from stocks in the cheapest 20% of the strategy's universe and disciplines eliminate style drift. The portfolio's average PE FY1 ratio is 6, compared to the benchmark at 12x.

During the first quarter of 2020, companies with positive free cash flow and positive shareholder yields outperformed the market, which is consistent with GVA's historical research. Unfortunately for the strategy's positioning, Q1 2020 also saw market outperformance of expensive (i.e. growth) stocks and large cap stocks within GVA's advantaged subset. So while GVA advantaged subset outperformed, the strategy's tilt toward cheap and smaller caps was out of position during the sharp selloff.

The closest comparison we have for future performance of the strategy is looking at the last time the market experienced extreme growth outperformance, as we are seeing today. The TMT bubble is the best example of this. Going back to 1998, GVA's Global Equity backtest has a longer data set than GVA's Emerging Markets backtest. In 1999, growth outperformed value by a massive 16% and GVA's Global Equity model portfolio underperformed the index by 9%. Following this underperformance was five consecutive years of double digit alpha generation (excess returns of 39%, 29%, 23%, 25%, and 22% respectively)[2].

We remain confident in GVA disciplines to guide the strategy through this difficult time. The strategy will continue to only own companies in GVA's defined advantaged subset of the market. The strategy's holding have solid balance sheets and are valued in the cheapest 20% of the market. We are actively adding to holdings that have been oversold. History suggests that the strategy's positioning will be rewarded over time.

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Top 3 Performers in Q1 2020

Lonking Holdings Limited (3339-HK)
Lonking Holdings manufactures construction machinery equipment in China. China was the best performing country vs the MSCI EM index in the quarter. The worst of the COVID-19 crisis in China appears to be behind us and additional stimulus measures are expected. Lonking's 2019 earnings reported on March 26th, showed robust growth. More importantly, management saw demand ramp back up to normal levels and is now looking for 20% revenue growth in 2020. FCF yield is 18%, shareholder yield is 9%, and PE FY1 is 8x.

West China Cement (2233-HK)
West China Cement manufactures cement products in China. 2019 results reported on March 30th were ahead of expectations. Daily cement shipments are already back to 70-80% of normal and management expects to reach full demand by the end of April. This leaves West China Cement well positioned for a second-half recovery in 2020. FCF yield is 27%, shareholder yield is 3%, and PE FY1 is 4x.

Formosa Taffeta (1434-TW)
Formosa Taffeta is based in Taiwan and operates three businesses: Textiles, Tire cord fabric, and Petroleum stations. Formosa's FY19 results reported on March 26th showed the 10th consecutive year of positive FCF generation. Taiwan's coronavirus response is among the best globally, due partially to having past experience from the 2003 SARS outbreak. There have been less than 400 total COVID-19 cases and only 6 deaths reported in Taiwan to date. As a result, Taiwan was one of the top performing countries vs the MSCI EM index in the quarter. FCF yield is 7%, shareholder yield is 10%, and PE FY1 is 14x.

Bottom 3 Performers in Q1 2020

Old Mutual (OMU-ZA)
Old Mutual is one of the largest life insurance companies in South Africa. South Africa is in a state of emergency due to COVID-19 and the economy was already in recession going into 2020, following negative GDP growth reported in Q3 19 and Q4 19. The Rand also depreciated by 22% vs USD in Q1 20, hurting US-based investors. Old Mutual reported FY19 results on March 13th that were slightly below expectations, but operating profits were only down 2% YoY. FCF yield is 22%, shareholder yield is 24%, and P/B 0.8x.

Enauta Participacoes SA (ENAT3-BR)
Enauta Participacoes operates an oil & gas exploration business in Brazil. The company's key startup oil field, Atlanta, continues to show production progress. Unfortunately, this was overshadowed by the collapse in oil prices. Brent oil prices fell by 60% in the quarter to $26 per barrel, due to weak global demand and a supply shock from OPEC. The Brazilian Real also weakened by 24% in the quarter. Enauta's balance sheet is well positioned to weather the downturn, with R$682m in net cash or 26% of the market cap. FCF yield is 17%, shareholder yield is 29%, and P/B is 0.9x.

Absa Group (ABG-ZA)
Absa is a South African diversified bank. FY19 results reported on March 11th were largely in-line with expectations, but this was overshadowed by the weak macroeconomic outlook. Although COVID-19 cases and deaths have been fairly well contained in South Africa (less than 3,000 and less than 50 respectively), GDP growth is expected to remain negative in 2020. South Africa was one of the worst performing regions vs the MSCI EM index in the quarter. GVA sold its position in Absa Group in early April, as the name was kicked out of the model. FCF yield is 24%, shareholder yield is 0%, and P/B is 0.6x.

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Please feel free to contact us with any questions or comments. Thank you for your interest in Global Value Advisors. We look forward to updating you again next quarter.

Sincerely,

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Endnotes:

1. Shareholder Yield = Dividends + Net Buy Backs + Change in Debt
2. Backtest disclosure: Back-tested performance is based on the GVA Proprietary Model (the "Model") which identifies companies with positive free cash flows and positive Shareholder Yields as defined above, excludes companies whose leverage is in the highest 20% of the starting universe, are the cheapest 20% of the starting universe and illiquid companies are eliminated. Foreign exchange is implicit in the total return. The Model assumes it is fully invested with no cash and includes the reinvestment of all income. GVA's Model identifies a subset of the universe with specific attributes and consists of approximately 125-175 stocks. Back-tested presentations may not be relied upon for investment purposes and are not meant to represent actual current or future performance. For more details on the Model please contact info@globalvalueadv.com. Back-tested performance is hypothetical (it does not reflect trading in actual accounts) and securities were selected with the full benefit of hindsight, after their performance over the period shown was known. There are inherent limitations of data derived from retroactive application of a model portfolio. The results may not reflect the impact that any material market or economic factors might have had on GVA's use of the back-test Model if the Model had been used during the period to actually manage client assets. GVA was not managing money during the period tested. Results in back-tests do not guarantee future results. The U.S. dollar is the currency used to express performance. All returns are presented gross of investment management fees, trading costs, and all other costs, expenses and commissions associated with client account trading. As there are no fees or expenses deducted, actual client returns could be materially different.

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For comparison purposes, the GVA Emerging Markets strategy performance is measured against the MSCI Emerging Markets Index.

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