Emerging Markets
Second Quarter 2022
COMMENTARY*

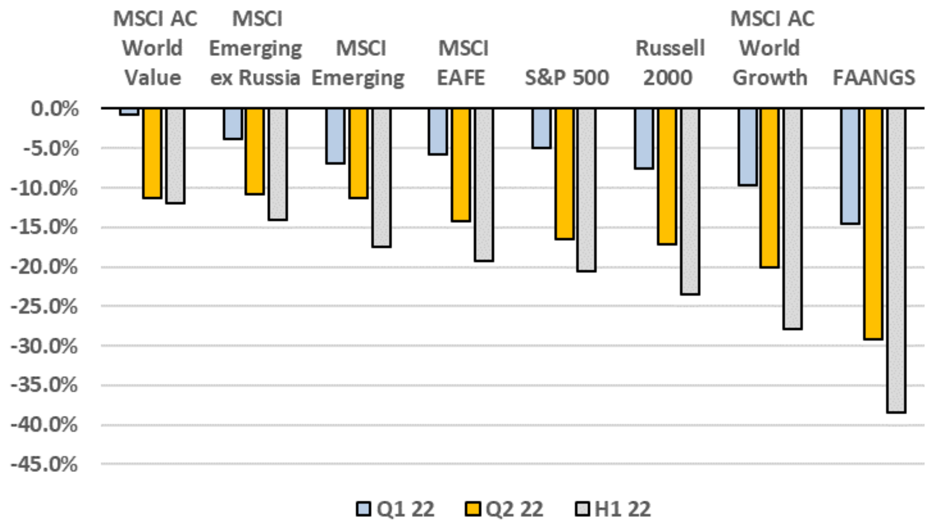
GLOBAL VALUE ADVISORS
A Division of Moody Aldrich Partners

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.

**This commentary has been modified as of November 2023. The modifications were limited to redactions of certain performance-based information that conflict with current regulations and our current policies and a change in referenced GIPS presentations that can be viewed via hyperlink within this commentary. The remaining content remains as originally written.*

The equity market turmoil gathered pace in the second quarter of 2022, as inflation reached a four-decade high, and the Fed confirmed its commitment to get it under control through a drastic rate-hike plan initiated in March of this year. The markets' response was unequivocal, as they recorded their worst first half in 50 years. Although this was no surprise to GVA, overpriced and speculative risk assets were the hardest hit. US growth stocks, which have been the best performing stocks for most of the last decade, were the stand-out underperformers in the quarter among major indices. NFTs, Cryptocurrencies, SPACs, non-profitable growth companies fared even worse. Bitcoin, the largest cryptocurrency in the world by size, registered a 57% decline in the quarter. Cathie Wood's previously high-flying growth fund, ARKK Innovation ETF, declined by 40%.

Total Return in US$



Source: FactSet & MSCI

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The global recovery from the pandemic has been derailed by surging commodity prices, fueled by a war in Ukraine and supply chain bottlenecks from China's lockdowns. Major central banks around the globe are raising rates in sync with the Fed (UK, Europe, Canada, and Australia), resulting in tighter financial conditions. Soaring global inflation is now the #1 focus of central banks. Higher interest rates are aiming to dampen growth and weaken tight labor markets to ease price pressures. Consumers have begun scaling back purchases, and economists have lowered their growth projections. The IMF lowered its 2022 Global GDP growth estimate from 4.4% to 3.6% in April and plans to release a further downgrade in July. Although the early stages of hiking cycles are often accompanied with up markets, this belated tightening cycle leaves no doubt about investors' fear: in its attempt to play catch-up with the curve, the Fed might overreact and trigger a recession. In this context, value outperformed, non-US markets dropped a bit less than the US, and the US dollar strengthened.

As financial conditions tighten, investors shift their focus away from risk assets and back towards companies with strong fundamentals and solid free cash flow generation. GVA's key differentiator is that its strategies <u>only</u> focus on companies with the following attributes:

1. High and sustainable Free Cash Flows
2. High and sustainable Shareholder Yields (dividends, buy-backs, debt repayments)
3. Strong balance sheets
4. Valuation in the cheapest 20%

GVA's research shows that investing in this Advantaged Subset outperforms over time, without taking on additional risk. GVA has no exposure to overpriced growth stocks or other speculative areas of the market. GVA's strategies should provide downside protection in case of unanticipated negative market outcomes, as the average company in GVA's portfolios is quasi debt-free and trades at a significant valuation discount to the market. Companies with strong balance sheets and high free cash frow generation should be well positioned to weather economic downturns and typically emerge in a stronger competitive position, as less capitalized companies are forced to focus on debt repayments.

Small Non-US Value
The Intersection of 3 Compelling Investment Opportunities

As we gradually progress through what GVA believes is a regime change, the following describes the most compelling investment opportunities that are expressed across GVA's portfolios: Value, Non-US and Small.

Value

GVA has written extensively on how value stocks after the Covid crisis reached relative valuation levels only seen in the late 90's, at the peak of the TMT bubble. After 2 bounces, the first one in late 2020, and the second one early 2022, it is often commented that it's too late to join the value recovery, as most of the catch-up has been done. The following graph updated by AQR early May 2022 shows that the recent bounce is minuscule when compared to the 14-year drawdown of the value style:

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GVA believes low-priced stocks will regain their leadership going forward and expects the rise in rates combined with the resurgence of inflation as the backdrop for this perspective. GVA believes inflation will come down thanks to the central banks efforts but will find a new normal higher than the 1.94% average since the Global Financial Crisis (GFC) in 2008. GVA expects that the developed world will use fiscal policies to address decades-long underinvestment in infrastructures as well as to finance the investments necessary to address new challenges (decarbonization, nations' independence and defense etc.). This will create new structural demand for goods and workers whose supply is becoming scarcer (limited natural resources and shrinking workforce), which in turn might move prices up. History suggests that each time inflation rates have crossed the 3% level, value has outperformed significantly.

The current level of cheapness of value and the general political and economic context creates a constructive environment for the value style to outperform in the coming years.

	Annual Inflation	Value Annual Real	Growth Annual Real
1930s	-2.10%	0.96%	6.30%
1940s	**5.40%**	**13.60%**	**4.00%**
1950s	3.50%	17.90%	14.20%
1960s	2.50%	10.90%	7.30%
1970s	**7.40%**	**6.60%**	**-2.40%**
1980s	**5.10%**	**16.00%**	**8.00%**
1990s	2.90%	13.50%	13.00%
2000s	2.60%	4.70%	-3.80%
2010s	1.80%	9.20%	12.10%

Source: Russell Napier "The Solid Ground"; Derived from Fama and French Database

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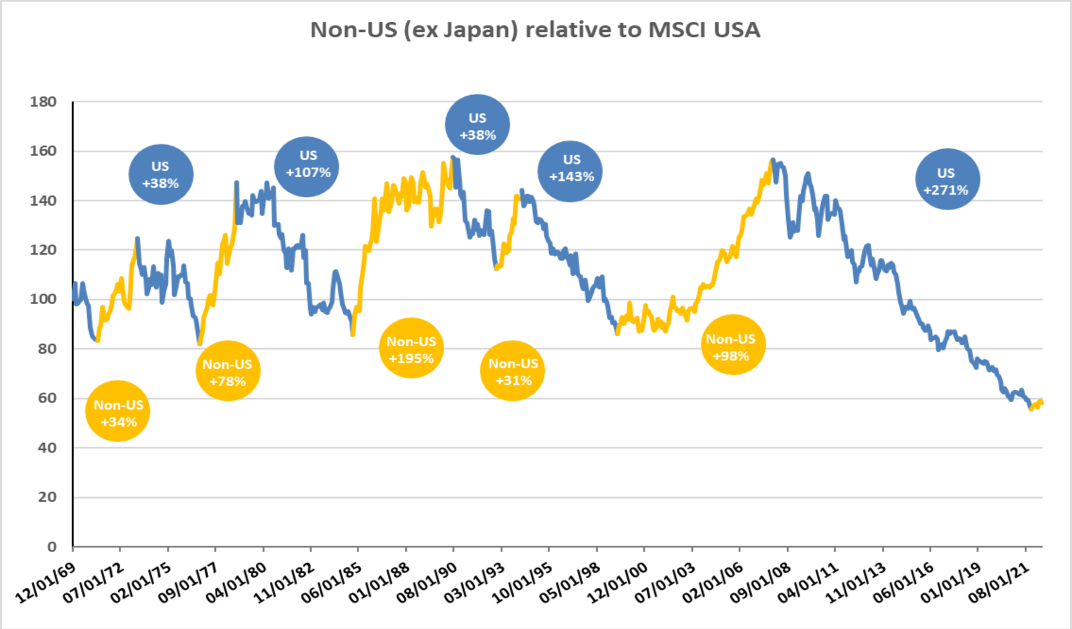
Non-US

The post GFC market environment was characterized by ultra-low interest rates and a significant outperformance of growth stocks; over the same period, the S&P500 delivered a staggering +239% when the MSCI EAFE index returned +75% and the MSCI Emerging index +42%. The following graph tracks the US vs non-US trade over the past 50 years. We exclude Japan from the non-US universe to remove a big source of distortion in the study. Being on the right side of that trade is, of course, invaluable:

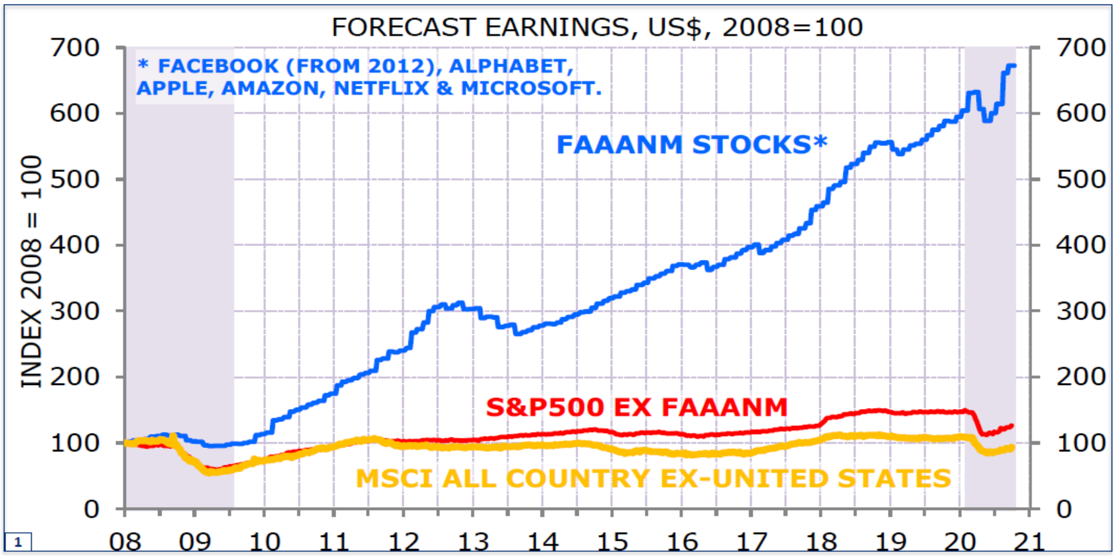
Chart 1:



Source: FactSet & MSCI

If the study stopped in 2016, the US outperformance would seem to be in line with previous rallies. Post 2016, the growth bubble brought the US bull run to uncharted territory. Of note, most of this outperformance is derived from multiple expansion. Apart from the FAAANMs stocks that have compounded unmatched EPS growth over the period, the rest of the US market delivered an EPS growth slightly superior to the one observed in non-US markets:

Chart 2:



Source: Gerard Minack – Minack Advisors

As the current US bubble deflates and its excesses get corrected, GVA believes that the case for non-US markets outperforming the US market going forward is rather compelling.

SMALL

To illustrate how appealing non-US stocks can be, we'll focus here on the most compelling investment opportunity accessible to US investors: emerging small companies. The following table highlights the main elements of the investment case:

As of June 30, 2022	MSCI USA Small	MSCI Emerging Small
Average EBITDA Growth last 10 years	7.5	6.9
Average ROE last 10 years	5.9	6.1
Net Debt/EBITDA	3.0	2.0
Price/Earnings	22.8	13.4
Enterprise Value/EBITDA	12.2	8.9
Dividend yield	1.7	3.3

Source: FactSet & MSCI

When compared to US small companies, Emerging small businesses have delivered similar growth and profitability over the past 10 years. It is worth noticing that when the look back period is expanded to 20 years, Emerging small outpaces US small by 2% in growth and 2% in profitability. Also important, especially when interest rates rise, Emerging small has deleveraged its balance sheet over the period: its net debt to EBITDA stands at 2 times versus 3 for the US small companies.

Despite this, Emerging small has steadily derated versus US small. Remember, the two asset classes traded on par around the Great Financial Crisis. Depending on the valuation metric used, Emerging small trades at a 40% to 50% discount to US small. The same trends also exist in the international developed small universe, although less extreme.

It is worth remembering that here the study looks at the Emerging Small Cap index. When the analysis shifts to the value portion of that universe, valuations discrepancies get even more staggering: emerging small value trades currently on a P/E of 9.9 and a dividend yield of 4.4%! Since 2000, the MSCI Emerging Value index has delivered a US$ return of +12% annually versus 9.6% for the MSCI US Small and 7.8% for the S&P500.

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For a US investor that has benefited from a strong set of returns being invested domestically, Emerging small value stands as a great diversifying opportunity with the lowest correlation with the US equity market as illustrated below:

	MSCI USA Large Cap Growth	*Russell 2000*	*MSCI EAFE*	*MSCI EM (Emerging Markets)*	*MSCI EM (Emerging Markets) Small Cap Value*	*S&P 500*
MSCI USA Large Cap Growth	100%					
Russell 2000	84%	100%				
MSCI EAFE	81%	80%	100%			
MSCI Emerging Markets	70%	71%	87%	100%		
MSCI Emerging Markets Small Cap Value	68%	70%	86%	95%	100%	
S&P 500	96%	89%	88%	75%	74%	100%

Monthly correlations over the past 20 years - Factset

We focused here on the small cap segment of the universe. We observe the same type of dynamics between US and non-US mid caps.

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Value, non-US and small are all potent bets expressed across GVA's portfolios. In focusing its research efforts on a better pool of companies and identifying great businesses at the intersection of these 3 compelling investment opportunities, GVA believes it can deliver superior performance going forward.

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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** This information is presented as supplemental to the GIPS Report, which are available here.

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