# Emerging Markets

## Second Quarter 2024

COMMENTARY

# Japan's Rising Sun: A New Era of Profitability and Shareholder Returns

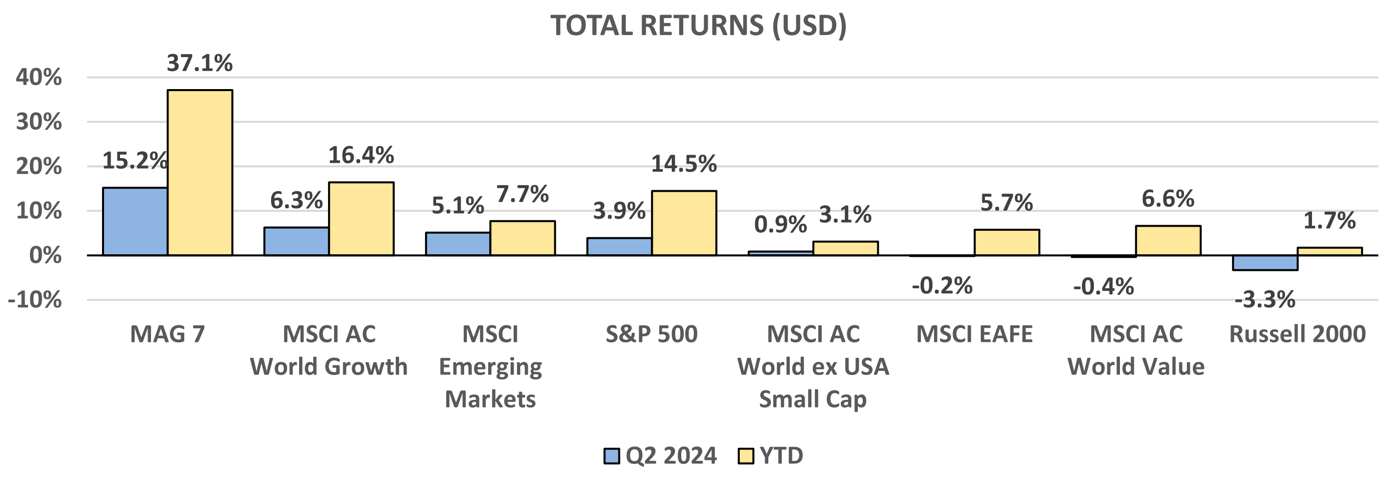
| Total Returns (Net of Fees)[+] | Q2 |
|---|---|
| **GVA Emerging Markets** | **6.5%** |
| MSCI Emerging Markets Index* | 5.0% |
| MSCI Emerging Markets Value Index | 5.1% |
| MSCI Emerging Markets Growth Index | 4.9% |

| Regional Indices | Q2 |
|---|---|
| MSCI China | 7.1% |
| MSCI Korea | -1.2% |
| MSCI Taiwan | 15.1% |
| MSCI India | 12.2% |
| MSCI Emerging Markets Small Cap | 5.9% |

| | GVA Emerging Markets Net Return | MSCI Emerging Markets Net Return* |
|---|---|---|
| 1 Year | 10.0% | 12.6% |
| 3 Years** | -6.1% | -5.1% |
| 5 Years** | -0.7% | 3.1% |
| Since Inception** | 0.2% | 3.6% |

*Benchmark | **Annualized | +Net of fee performance was calculated by retroactively applying the highest model fee for the composite which is the fee new clients would expect to pay based on the early adopter fee schedule (0.60%).

The first and second quarters of the year were strikingly similar to 2023: impressive performance of US growth stocks (mainly the Magnificent 7, which now make up an unprecedented 30% of the S&P 500), and the general underperformance of Non-US, Small, and Value stocks. GVA believes that all three of these trends are overextended and will reverse in the medium term (see Q4 2023 commentary), eventually creating significant tailwinds to our performance.




*Source: Factset. MAG 7 = "Magnificent Seven" stocks – Apple (AAPL), Microsoft (MSFT), Alphabet (GOOGL), Amazon (AMZN), Nvidia (NVDA), Tesla (TSLA) and Meta Platforms (META)*

The macro picture has overall been supportive to equity markets. At the beginning of the year, Wall Street was looking for six rate cuts from the Federal Reserve in 2024. Several high inflation prints resulted in investors lowering those expectations. However, recent CPI figures have once again provided hope that the easing cycle is about to begin. With June CPI coming in well below expectations for the second consecutive month, the odds of the first rate cut coming from the Fed in September have risen dramatically.

Although data can change quickly, the "soft landing" of the US economy currently looks achievable. Economic growth decelerated in the first half, but Q2 GDP came in at a healthy 2.8% and the consumer continues to spend, although at a slower pace. The weakening of the labor market also points to a normalization, for now, rather than an outright recession. All of this has increased investors' confidence of coming rate cuts. The US is not the only easing story, as the ECB, the Bank of Canada, and the Swiss National Bank have already cut. Most economists expect the Bank of England to cut rates for the first time in August.

Although nearly every major central bank appears poised to cut interest rates this year, the Bank of Japan stands out as one of the few developed central banks that remains in tightening mode. The Japanese market has unique characteristics and provides a good illustration of how GVA's process takes advantage of shifts in global market relative valuations.

**Revisiting Japan's investment case through GVA's lens**

The synchronized deflating of 3 speculative bubbles (equity, credit and real estate) that popped in 1990 has led the Japanese economy to one of the longest and most severe investment busts of modern finance. Anemic economic growth and deflationary pressures combined with poor governance, inefficient capital allocation and lackluster profitability have characterized corporate Japan's past 3 decades. Over the period, the Japanese equity market has underperformed the MSCI World index by a staggering 88%.

| | EAFE ex Japan | MSCI USA | MSCI Japan |
|---|---|---|---|
| **5 Year** | 6.9% | 15.0% | 7.0% |
| **10 Year** | 4.5% | 12.8% | 5.9% |
| **20 Year** | 6.5% | 10.3% | 4.6% |
| **Since 1990** | 7.4% | 10.8% | 1.5% |

*Source: Factset*

Similar dynamics can be observed across the different market capitalization categories and styles.

The investment narrative about Japan has been changing over the recent past. The end of deflation (rise in interest rates and wages) for the first time in a quarter of a century constitutes for Japan a game changer. The recent efforts by the authorities to improve corporate governance via a series of drastic initiatives have started to bear fruit and have strengthened the Japanese investment case. Japanese equities have re-rated on the back of these improvements. We revisit here the Japanese investment case.



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## Profitability

For decades, profitability has been Corporate Japan's Achilles' heel. The Japanese ROEs have lagged their international peers' by a substantial margin, and Price to Books have compressed to reflect that. The differential in leverage explains part of it, as Japanese companies have de-levered their balance sheets over the years. But the bulk of the gap in profitability comes from gross margins which will take more time to inflect towards international standards. As a matter of fact, Japanese small caps have recently bridged the profitability gap with their international peers. We show here the ROE and its main components by region. The data exclude financials:

| | Net Income Margin | Asset Turnover | Leverage | ROE | Free Cash Flow Margin |
|---|---|---|---|---|---|
| Japan Small Cap - 2000's | 1.5% | 116.2% | 2.4 | 4.1% | 1.4% |
| Japan Small Cap - 2010's | 2.7% | 105.0% | 2.2 | 6.2% | 1.7% |
| Japan Small Cap - 2020's | 3.6% | 83.6% | 2.2 | 6.7% | 1.7% |
| Japan Small Cap Last 12 months | **4.3%** | **82.4%** | **2.2** | **7.8%** | **3.1%** |

| | Net Income Margin | Asset Turnover | Leverage | ROE | Free Cash Flow Margin |
|---|---|---|---|---|---|
| Ex-Japan Small Cap - 2000's | 3.9% | 85.5% | 2.7 | 9.0% | 0.9% |
| Ex-Japan Small Cap - 2010's | 2.9% | 67.1% | 2.8 | 5.3% | 1.3% |
| Ex-Japan Small Cap - 2020's | 3.6% | 56.3% | 2.9 | 5.8% | 3.5% |
| Ex-Japan Small Cap - Last 12 Months | **3.7%** | **59.0%** | **2.8** | **6.0%** | **3.9%** |

*Source: Factset. Universe is MSCI ACWI ex-USA Small. As of June 2024.*
*Asset turnover measures how much sales a company generates from each dollar of assets it owns. This ratio increases when a company is more efficient at generating revenue with fewer assets, which can indicate effective management.*

Japanese small companies over the past 12 months have delivered much stronger profitability on both an ROE and Net Income Margin basis than their international peers, despite a much lower level of leverage.

Although major improvements in corporate profitability have been achieved in Japan, there are still risks to the overall recovery. Notably, FCF margin improvements in Japan small caps are still lagging compared to their international peers (see table). Japan small companies have also experienced a significant boost in profitability over the last 4 years relative to international peers due to the historically weak yen. This is similar to previous cycles, where a direct benefit to Japan small profitability is seen every time the yen weakens substantially. Conversely, Japan small experiences a drag on relative profitability during extended periods of yen strength (see graph below). We currently have an unfavorable combination of a weak yen with the BoJ slowly raising interest rates. This dynamic creates a risk of yen strengthening in the coming years.



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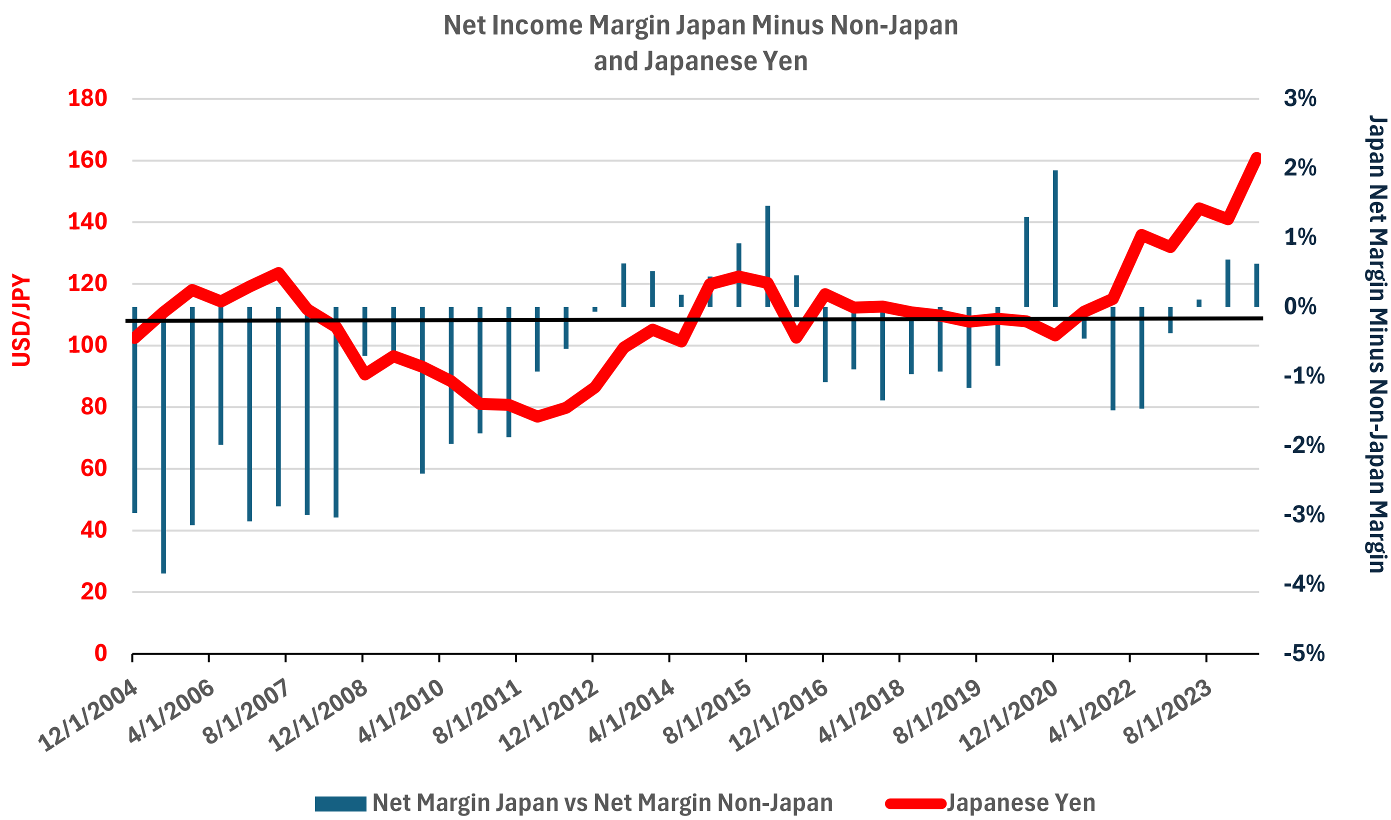



*Source: Factset As of June 2024.*

**Capital Allocation**

Capital allocation has been corporate Japan's other area of frustration for investors, cross shareholdings being the epitome of poor deployment of capital. Cross-shareholding (when companies own shares of each other) can lead to weak corporate governance, market inefficiencies, and stifle competition, hindering economic growth and innovation. Corporate governance guidelines introduced in 2015 as well as recent efforts to bring shareholder value and capital efficiency to the fore, however, are having a clear impact. And that is what has gotten the market participants excited over the past 18 months.

| Japan Small Cap | Annual Dividend Growth | Annual Dividend + Net Buyback Growth |
|---|---|---|
| Last 10 Years | 11.1% | 15.9% |
| Last 5 Years | 7.5% | 14.8% |
| Last 1 Year | **13.6%** | **21.7%** |

| Ex-Japan Small Cap | Annual Dividend Growth | Annual Dividend + Net Buyback Growth |
|---|---|---|
| Last 10 Years | 7.8% | 18.7% |
| Last 5 Years | 7.3% | 10.0% |
| Last 1 Year | **3.1%** | **1.8%** |

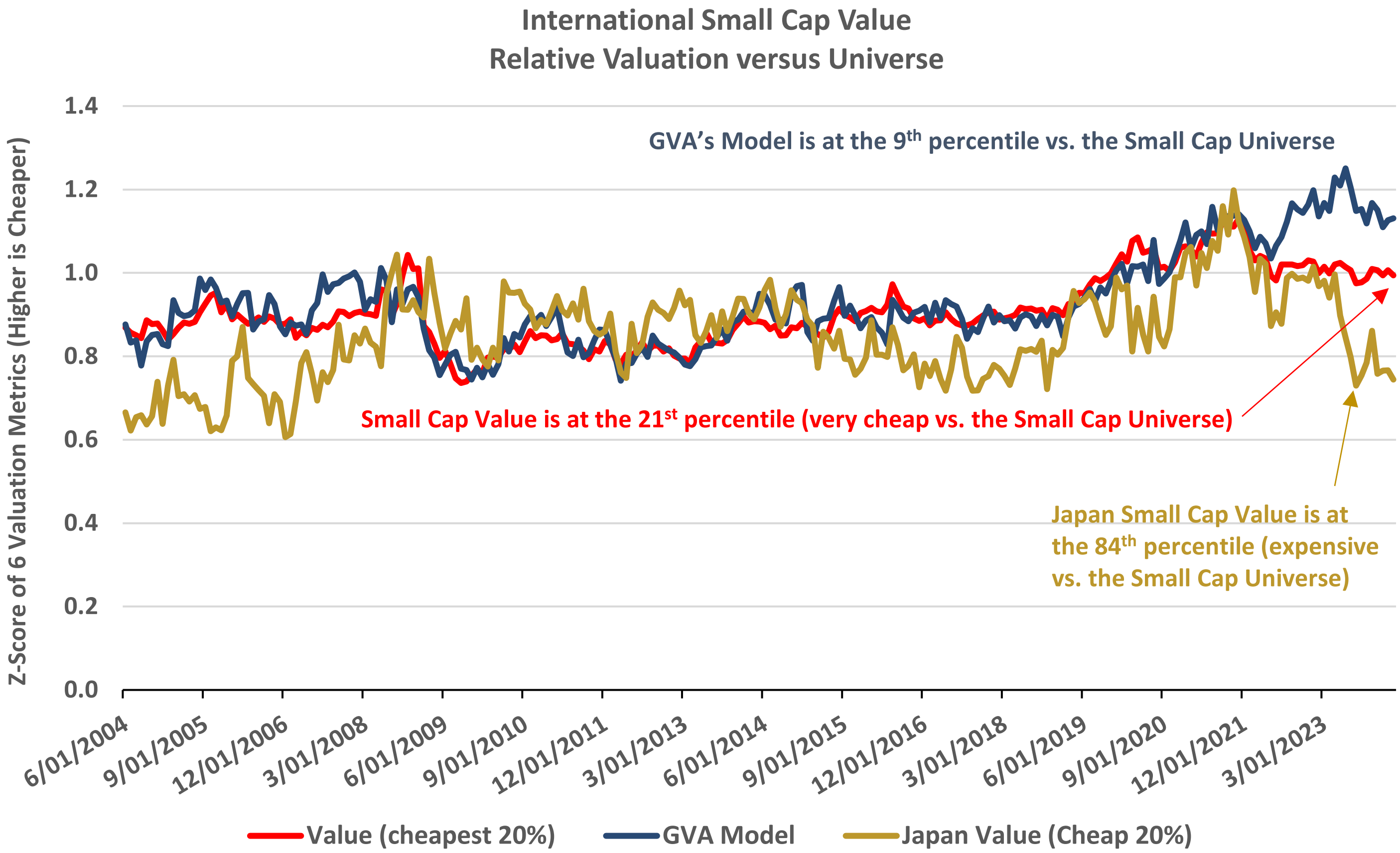
*Source: Factset As of June 2024.*

Japanese Small companies have increased significantly the return to their shareholders via dividend and net buybacks when non-Japanese companies have raised capital to repay their debt and finance part of their dividend payment. This shareholder friendly change in capital allocation has been welcomed by market participants as Japan became the best performing developed market in 2023.

**Valuation**

Japanese small cap value stocks have been particularly compelling from a valuation standpoint for most of the last decade. The strong outperformance since the beginning of 2022 has shifted the relative valuation attractiveness towards other regions. The chart below shows that when analyzing the last twenty years, international small value stocks are currently trading in the 21st percentile of their history (red line). Said differently, international small value stocks are cheaper now than they have been 79% of the time. Honing in on Japan small value (gold line), shows that this subsegment reached its cheapest relative valuation in early 2022, but has since fallen to a less appealing valuation level (84th percentile).

It should also be noted that GVA's model, which emphasizes cheap companies that also generate consistent free cash flow and shareholder returns, continues to trade at a very attractive valuation, at the 9th percentile of its history.




*Source: Factset. Please see back page for disclosures pertaining to the GVA Model*



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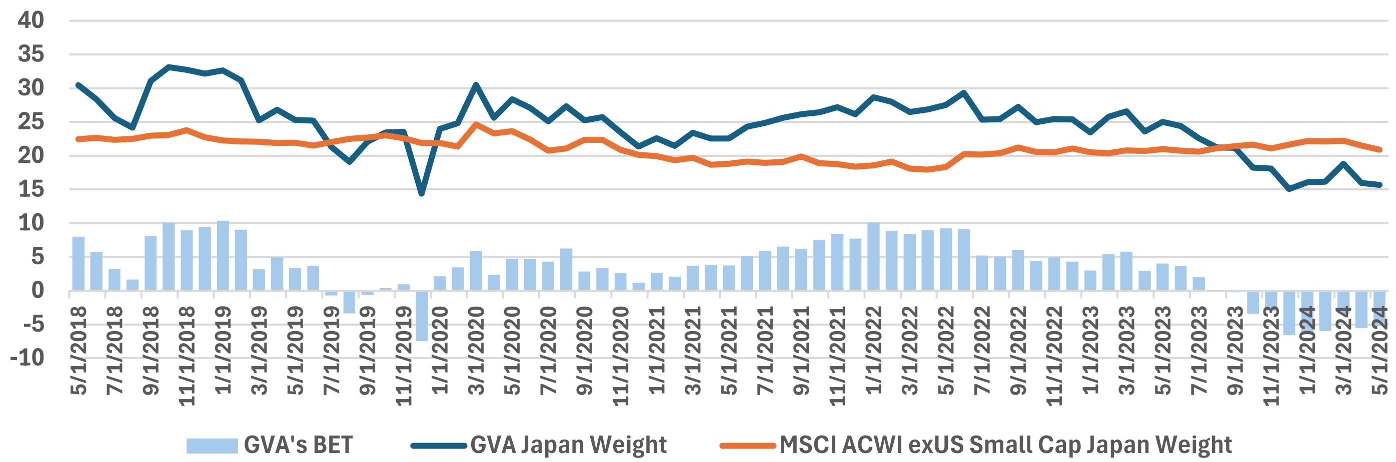
GVA's process has taken advantage of the swings in relative valuation of Japan small value stocks. Our strategy has benefited from being overweight Japan for the majority of the time since our June 2018 inception. The chart below shows GVA's historical Japan weight (blue line) vs its index the MSCI ACWI ex-US Small Cap index (red line). GVA's Japan bet maxed out at roughly 10% overweight in early 2022. After this point, Japan small value stocks started to rally significantly faster than underlying earnings, resulting in more expensive valuation metrics. GVA's systematic process picked up on this changing dynamic and started naturally lowering our Japan bet in the following months. By early 2023, GVA shifted to an underweight position. Although the Japanese market continues to exhibit favorable fundamental tailwinds, the valuation attractiveness has deteriorated.

**Japan Weight**
**GVA International Small Cap Strategy**




*Source: Factset*

In conclusion, the structural improvements in corporate Japan are undeniable. However, these improvements are still ongoing, and we believe there are more benefits to come as companies continue to optimize their operations and capital allocation strategies. GVA's process enabled us to be systematically overweight Japan when relative valuations were cheap and underweight Japan when valuations were less compelling. The key question for investors now is what is already priced into the market. While valuations have increased, the fundamental tailwinds remain strong, suggesting there may still be opportunities for investors to benefit from Japan's ongoing transformation. 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.

**Phillippe Rolland**
**CIO, Portfolio Manager**

**Todd Bassion, CFA**
**Portfolio Manager**

**Matthew Marotta, CFA**
**Investment Research Portfolio Implementation**

**OFFICE CONTACT**

18 Sewall Street
Marblehead, MA 01945

Phone
(781) 639-2750

Fax
(781) 639-2751



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

*Sector weights include exposure to iShares MSCI China A ETF and iShares MSCI India A ETF. ETF exposures are broken out by sector on a look-through basis.

Past performance is not indicative of future results. The U.S. Dollar is the currency used to express performance. Returns are presented gross and net of management fees and include the reinvestment of all income. Net of fee performance was calculated by retroactively applying the highest model fee for the composite which is the fee new clients would expect to pay based on the early adopter fee schedule (0.60%). The annual composite dispersion is an asset-weighted standard deviation calculated for the accounts in the composite the entire year.

The standard investment management fee schedule for new business is as follows: 0.60% in perpetuity on all investments made prior to strategy assets reaching $150 million, thereafter, 1.00% on the first $25 million and 0.90% on all additional funds. Management fees are paid quarterly in arrears. Actual investment advisory fees incurred by clients may vary.

The information presented in the presentation contains analysis of back-tested the GVA Proprietary Model (the "Model") and does not include qualitative analysis or portfolio manager selections. The results shown represent a larger group of stocks than would be included if qualitative analysis was applied. Our Model narrows down our universe to approximately 125-175 stocks and then we conduct fundamental analysis in order to determine inclusion in the portfolio. The strategy being offered includes both the quantitative and qualitative analysis together however performance shown in the back-test only reflects the quantitative portion of analysis as the qualitative analysis cannot be applied retroactively. 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 analysis is hypothetical (it does not reflect trading in actual accounts) and is provided for informational purposes only to indicate historical analysis over the relevant time period. 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. For comparison purposes, the GVA International Small Cap Model performance is measured against the MSCI All Country World ex-US Small Cap Index. Results in back-test do not guarantee future results.

The Model identifies companies with positive free cash flows, that have positive total return to shareholders, 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. 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. The client may experience a loss.