GLOBAL VALUE ADVISORS
A Division of Moody Aldrich Partners

Global Equity

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 Global Equity	**-30.9%**
MSCI All Country World Index	-21.4%
Value Added	**-9.5%**
MSCI All Country World Value Index	-27.1%
MSCI All Country World Growth Index	-15.7%

Regional Indices	Q1
MSCI USA	-19.8%
MSCI EAFE	-22.8%
MSCI Emerging Markets	-23.6%

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 its current pace, Value would underperform Growth by 46% for the full year.

GVA is currently overweight Emerging Markets where the spread was almost as severe 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 ACWI, 5.5% for ACWI Small Cap ex-US, and 4.0% MSCI Emerging Markets).

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. Indices broke all-time highs in early February before going through the fastest collapse on record in March, as the world economy came to a COVID-19 induced halt.

GVA Global Equity Strategy Review

The GVA Global Equity strategy returned -30.9% (net) in the first quarter of 2020 versus -21.4% for its benchmark, the MSCI All Country World Index.

Underperformance in March came from a combination of poor allocation effect and poor stock selection. Consumer Discretionary was the largest sector detractor, where we are slightly underweight, but had poor stock selection. Financials were also a significant drag, where we are overweight and saw a negative impact from stock selection. In terms of regional exposures, the strategy's large underweight the US and large overweight Emerging Markets were both headwinds to the portfolio.

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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 dominance of large caps over smaller caps was a headwind for the portfolio, which is currently finding better value in small and mid-cap names with a weighted average market cap of $14 billion versus $160 billion for its benchmark. More detrimental to the strategy's relative return, was the underperformance of Value.

Overall, GVA's -9.5% relative performance for the quarter was disappointing, but in-line with expectations. 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 6.4% within the MSCI All Country World 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 yield for the portfolio is 6.7%, 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 GVA's holdings are well positioned to weather the downturn.

UK housing is one area that has been hit particularly hard by the COVID-19 shutdowns, with most companies in the industry down 50% in the quarter, as homebuilding has been temporarily halted in the UK. GVA's UK homebuilders are market share leaders, with economies of scale and very strong balance sheets (most with net cash). Free cash flow generation for GVA's holdings has been positive for more than a decade. During the Global Financial Crisis, free cash flow took a hit in 2008 and then saw a large rebound in 2009. All of GVA's holdings should survive the current downturn and benefit from pent-up demand when markets reopen. GVA has added to current positions, at cheaper valuations.

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. GVA pays close attention to sector and country positioning, but we recognize that over time 84% of added value has been derived from stock selection.

The strategy's overweight Emerging Markets (EM) is another area that stands out in GVA's market positioning. GVA currently has a 38% weighting in EM versus the index at 12%. Valuation metrics of emerging vs developed markets have widened to a level not seen since 1998. Our model is recognizing this valuation discrepancy and favoring companies with high and consistent free cash flow generation. One of the strategy's largest EM 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 (breakeven less than $5 per barrel) and will 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.

Our underweight the US is the other large regional bet that we are taking in the portfolio. GVA currently has a 21% weight in the US vs the index at 57%. The US has outperformed international markets for the last decade, and valuation spreads have widened dramatically. The PE FY1 of the MSCI USA index now sits at 19x, compared to 14x for MSCI EAFE and 12x for MSCI Emerging Markets. Our valuation disciplines are recognizing this gap and finding better investment opportunities outside the US. We believe that valuation spreads are likely to revert over time, as they have in the past.

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Performance Outlook

GVA's key competitive advantage is its exclusive focus on companies within what we have identified as an "advantaged subset". GVA's 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:

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.

We invest in businesses that demonstrate constrained capital allocation focused on shareholders through dividends, buybacks and debt reduction (what we call Shareholder Yield). We prefer 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 15% is 3x the benchmark at 5% and well ahead of the strategy's peer group.

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 20%, which is well below the index at 67% and the strategy's peer group.

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 8x, compared to the benchmark at 15x.

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's 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. GVA's Global Equity backtest has a longer data set, going back to 1998. 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].

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

Top 3 Performers in Q1 2020

Admiral Group (ADM-GB)
Admiral Group is a UK based auto insurer. Auto insurance is one of the few businesses that potentially benefits from Covid-19, given that fewer cars are on the road. The company also reported strong FY19 results on March 5th. FCF yield is 7%, shareholder yield is 6%, and PE FY1 is 16x.

NTT DoCoMo (9437-JP)
NTT DoCoMo is the leading telco operator in Japan. The company's business model performs well in downturns. 5G service was launched on March 25th. Capex is expected to be flat YoY, as the company cuts back on 4G investments. The Q4 19 earnings release is scheduled for April 28th. FCF yield is 5%, shareholder yield is 10%, and PE FY1 is 17x.

Royal Ahold Delhaize (AD-NL)
Royal Ahold Delhaize is a supermarket operator. The company is based in the Netherlands (22% of sales), but also operates a large grocery business in the US under the brands Stop & Shop, Food Lion, Hannaford, and Peapod (61% of sales). Total US retail sales collapsed by 9% in March, but supermarkets were one of the few bright spots, posting 25% growth. EPS is expected to grow 6% in 2020. FCF yield is 14%, shareholder yield is 6%, and PE FY1 is 12x.

Bottom 3 Performers in Q1 2020

Capital One Financial (COF-US)
Capital One operates a diversified financial business in the US. The sales mix is 65% Credit Cards, 25% Consumer Banking, and 10% Commercial Banking. Capital One is exposed to the roll-over of the US consumer and current recession. The loan exposure is heavily geared towards the consumer vs traditional banks. That being said, the balance sheet is manageable and the company is well positioned for a rebound if the worst is behind us. FCF yield is 22%, shareholder yield is 25%, and PE FY1 is 6x.

Redrow (RDW-GB)
Redrow is a residential homebuilder in the UK. Homebuilders in the UK have been hit especially hard, with most names in the space down around 50% in the quarter. Homebuilding has grinded to a halt, but Redrow is positioned to survive the downturn. The company cancelled its dividend in the short term to preserve cash. The balance sheet is in decent shape with net debt/equity at 33% and interest coverage at 50x. FCF yield is 12%, shareholder yield is 18%, and PE NTM is 5x.

Bellway (BWY-GB)
Bellway is a residential homebuilder in the UK. Homebuilding has been temporarily halted in the UK. Bellway is well positioned to weather the downturn and rebound with the eventual recovery. The balance sheet is strong with net debt/equity at 4% and interest coverage at 45x. The dividend has been temporarily suspended to preserve cash. FCF yield is 9%, shareholder yield is 9%, and PE NTM is 7x.

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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 Global Equity strategy performance is measured against the MSCI All Country World Index.

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