International Small Cap

Third Quarter2018

COMMENTARY

Global Value Advisors is an investment boutique specializing in long-only international and global equities. We are value investors, who buy businesses that are undervalued due to temporary, non-structural reasons. We believe in combining the discipline of quantitative investing with qualitative judgement informed by fundamental research. The key idea is companies that generate positive free cash flows and return capital to shareholders outperform the market.

Q3 2018 Total Returns (Net of Fees)	
GVA International Small Cap	**-0.98%**
MSCI All Country World ex-US Small Cap	-1.51%
Value Added	**+0.53%**
MSCI All Country World ex-US Small Cap Value	-0.86%
MSCI All Country World ex-US Small Cap Growth	-2.14%

Regional Indices	
MSCI Japan Small Cap	-0.13%
MSCI United Kingdom Small Cap	-3.86%
MSCI EM (Emerging Markets) Small Cap	-4.21%
MSCI Europe ex UK Small Cap	-0.48%
MSCI Pacific ex JP Small Cap	-1.56%

During the 3rd quarter, the GVA International Small Cap strategy returned -0.98% versus -1.51% for its benchmark, the MSCI All Country World Index ex-US Small Cap. The period saw a continuation of emerging markets underperformance relative to developed markets which was a headwind to the strategy's overweight positioning in emerging markets, specifically in Taiwan, Korea, Russia and Brazil. Value stocks stopped underperforming growth companies during the quarter which benefited the strategy.

As a reminder, GVA focuses on companies that generate sufficient cash flow to maintain their assets, internally finance their growth and return unused capital to shareholders, either directly through the payment of dividends or indirectly through share buybacks or debt repayments. We avoid debt laden companies, cash hoarders (a poor use of capital) and externally financed serial acquirers. Importantly, we ensure style discipline by only purchasing companies with cheap valuations using a blend of standard valuation metrics.

Our outperformance during the more benign environment for "value" stocks in the 3rd quarter reinforces expectations for our strategy compared to our underperformance earlier in the year when growth strongly outperformed value. Despite a poor regional allocation effect, related to our overweights in the UK and emerging markets, our strong stock selection drove our index beating results. Consumer stocks as well as mineral resources stocks showed particular strength over the quarter.

It is important to note, that the fund's assets under management are $4.5 million and transaction costs are a significant headwind at this size. We calculated that in Q3, our net returns would have been 0.3% higher had we managed a $20 million portfolio. Our analysis shows the trading costs normalize above $20 million in the strategy.

Top Contributors

Labrador Iron Ore (Ticker: LID-CA)

The company is a high quality Canadian iron ore producer that is benefiting from current industry dynamics. Specifically, the Chinese environmental clampdown that is seen to be driving iron ore pellet usage to improve furnace efficiency as well as the demand for higher quality iron ore to reduce total energy usage. In its August earnings report, the company confirmed its production target for the second half of the year. The dividend it received at the end of September for its 15% stake in The Iron Ore Company of Canada was substantially higher than expected, which might lead to a higher dividend going forward.

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Radspadskaya (Ticker: RASP-RU)
This Russian coking coal company delivered a very strong set of numbers in August despite some significant reorganizational costs. Volumes grew 22% year-over-year and EBITDA improved 30%. Debt was brought back to zero with the repayment of a loan. The stock trades at 5 times its trailing earnings with a 27% free cash flow yield.

United Arrows (Ticker: 7606-JP)
The company is a retail clothing operator in Japan (100% of sales). The company has performed well in the face of online competition. In August, the company reported strong quarterly results which were ahead of consensus expectations. Same store sales (SSS) grew by a healthy 7% (online saw SSS grow 22% and retail grew 3%) and operating margins expanded to 7.1%. Despite the earnings beat, management reiterated its conservative guidance. The company has strong free cash flow, with a 10 year average free cash flow yield of 7%. Management pays a 2% dividend and buys back shares. Valuation is reasonable with an Enterprise Value/EBITDA at 10X.

Top Detractors

DB HITEK CO (Ticker: 000990-KR)
The company is a Korean based semiconductor manufacturer. The stock underperformed in Q3, despite reporting strong Q2 results in August. DB's stock has been a strong performer over the long term (+15% YTD and 18% 5 year total return compound annual growth rate) and our model sees strong free cash flow, decent capital allocation, a solid balance sheet, and cheap valuation. However, in early October, we decided to sell our position and rotated into a tech peer with better downside protection. We were concerned that DB's fundamentals have peaked as the company is sitting at very high operating margins, supply/demand is tight, and capacity utilization is already at 100%. The semiconductor space has also been bid up on M&A speculation. Semiconductors tend to be a highly cyclical industry and we would rather be ahead of the curve.

Aurelius Equity (Ticker: AR4-DE)
Aurelius is a holding company and turnaround expert that has delivered poor results following the sale of some very profitable businesses in the past year. Its current pool of companies have not yet produced the same level of performance compared to prior holdings. Aurelius reported a loss in the first half of the year with negative free cash flow which systematically triggered an immediate sell of the position.

GAM Holding (Ticker: GAM-CH)
The Swiss asset management company stunned the market this past summer when it announced it was suspending a star fund manager, leading to a surge of outflows from its absolute return bond fund strategy. The company later put up contentious redemption gates to limit the outflows. Last month it announced its compliance officer had quit after just a few months in the job. After the stock price drop and the redemptions, the stock trades at 5.5X its normalized EBITDA. Rumors of a takeover have been circulating in early October. We continue to hold our position.

How Fundamental Research is Used in GVA's Process:

Our competitive advantage is based on our proprietary quantitative process which has a proven ability to identify a structurally advantaged subset of the universe that has outperformed consistently over time. Fundamental research is used to eliminate from this subset the companies that we believe have qualitative problems that most systematic processes do not capture. In order to illustrate the different aspects of the fundamental input in our process, we'd like to walk you through an investment decision we made in Q3 to limit exposure to parts of the real estate sector.

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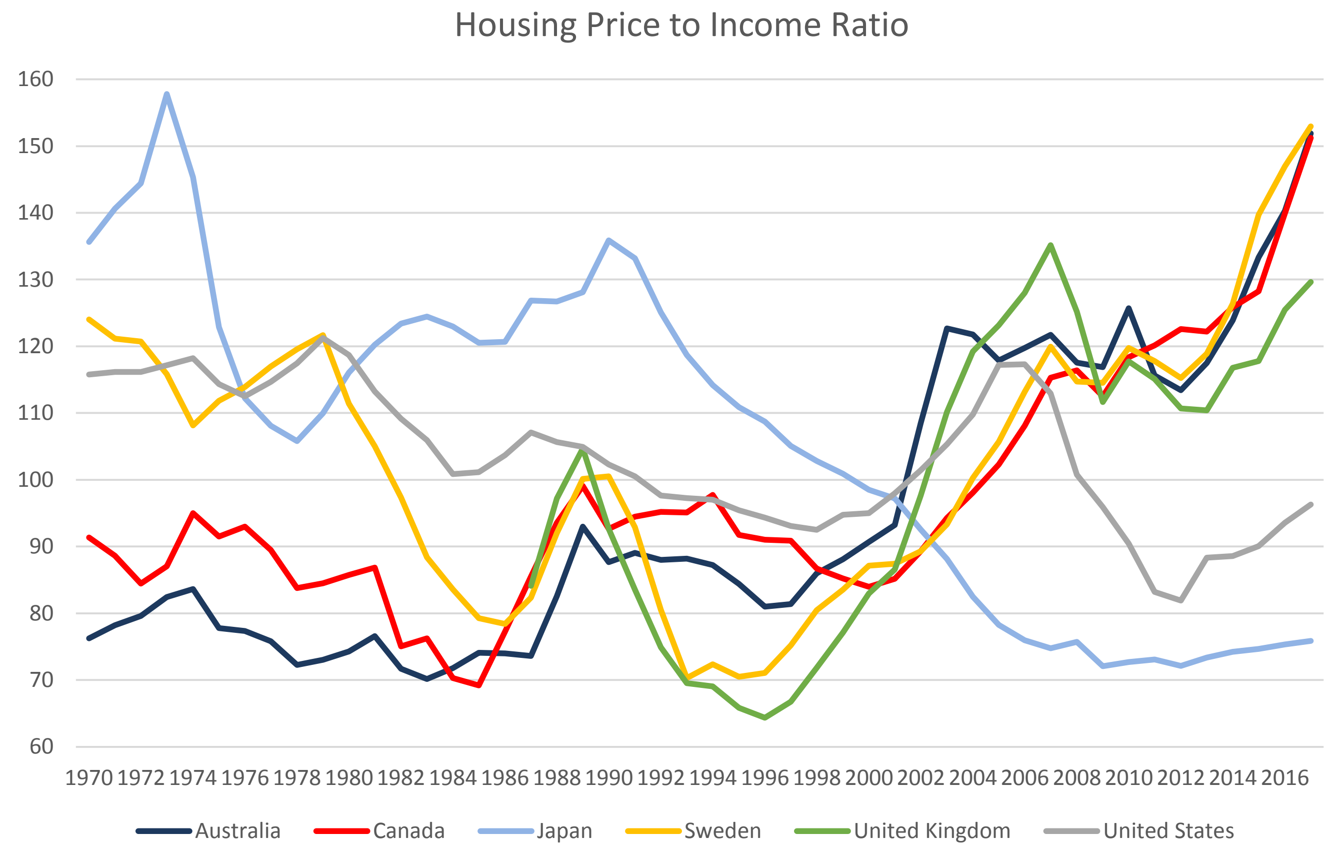
Over the past few quarters the weight of property or property-related stocks has been creeping up in our model. We notice more stocks coming through in British and Swedish housebuilders, Australian mortgage insurance brokers, Australian construction materials companies, and Swedish home-goods manufacturers. The combined weight of this "real estate" related theme approached 20% of our model.

Our fundamental research seeks to identify disruptive elements that may cause the future to be less attractive than the past. We're especially vigilant when speculative bubbles inflate asset prices based on implausible views about the future. Over the last 10 years, the ultra-low interest rate environment has supported property markets globally and some have reached bubble territory. Sydney, Stockholm and London have had some of the most expensive properties values in the world.



Nominal house prices divided by nominal disposable income per head. Net household disposable income is used. The population data come from the OECD national accounts database. The long-term average is calculated over the whole period available when the indicator begins after 1980 or after 1980 if the indicator is longer. This value is used as a reference value. The ratio is calculated by dividing the indicator source on this long-term average, and indexed to a reference value equal to 100.

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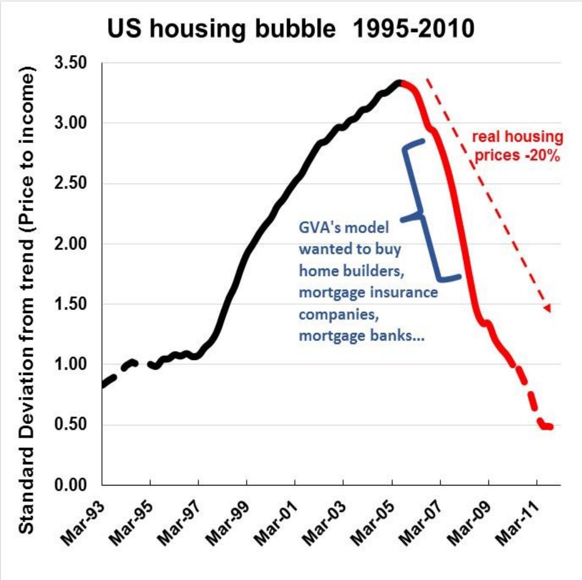
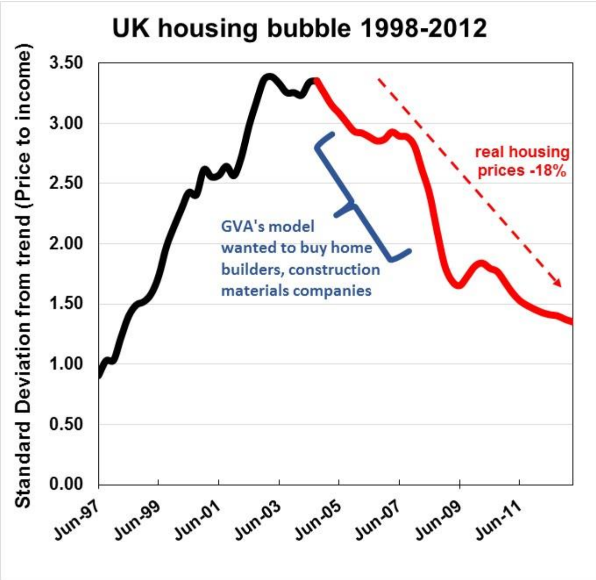
As interest rates have moved higher, stocks exposed to the property theme have generally underperformed and some have come down sharply in price. Some of them are identified by our model since they have low debt, generate strong free cash flows, return capital to shareholders, and have been getting cheaper. History has taught us to be wary in the early phase of a bubble's deflation as backward looking models can be fooled and buy too early. The following graphs show how our model wanted to buy real estate related stocks in the US and UK following peak prices (3+ standard deviations from trend – vertical axis).





Our fundamental input was twofold. First, at the top down level, we know that, typically after a credit boom, there is a credit bust, regardless of short-term patches that are typically engineered by financial authorities. We also observe that coincidentally with the monetary tightening cycle and the rise in interest rates, hot property markets have started to show some weakness: in Stockholm prices are down 10% over the past year, Sydney -6%, and London -3%. These top down elements add a level of cautiousness when evaluating our exposure to the sector.

Second, at the bottom up level, we identified the stocks whose investment cases depend mostly on overheated property markets that we believe could be at risk of a prolonged downturn. Over the summer we revisited each of these positions, stress tested what a bad scenario would mean in terms of the impairment of their earnings power and consequently on the sustainability of their free cash flow generation and return to shareholders.

Our fundamental research led us to exclude five companies from our portfolio that the model had identified as buy candidates. The portfolio is still exposed to the property sector, but the businesses we own are either located in markets whose fundamentals are not too worrisome, or the companies' valuations and/or business models provide a margin of safety big enough to absorb the impact of unexpected negative outcomes. This fundamental process is of course ongoing and each position is carefully reviewed using this top-down/bottom-up approach.

Other examples of our fundamental research process at work include the decision to avoid Turkey in March of 2018 and our ongoing decision to avoid some traditional retailers given the structural change to the industry from online retailing. We're happy to discuss our thinking on these topics in a future meeting or call.

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<u>October Preview</u>

As of the writing of this letter (Oct 16th), our International Small Cap strategy has outperformed its benchmark by 2.5% (gross of fees) month-to-date. At the beginning of October, the US Treasury bond market broke through a 37-year trend line, as the 10-year Treasury bond yield rose past 3.2%. It is too early to tell whether this is a regime change or a short term bump. The market reaction was immediate and brutal as volatility spiked and equity markets collapsed with value companies holding up better than growth companies. We are encouraged to see the strategy deliver good results in line with our expectations when the inevitable switch to value occurs.

We welcome your feedback or questions and appreciate your interest in Global Value Advisors.

Sincerely,

Phillippe Rolland
CIO, Portfolio Manager

Todd Bassion, CFA
Portfolio Manager

Matthew Marotta
Investment Research Portfolio Implementation

OFFICE CONTACT

18 Sewall Street
Marblehead, MA 01945

Phone
(781) 639-2750

Fax
(781) 639-2751

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For comparison purposes, the GVA International Small Cap Equity strategy performance is measured against the MSCI All Country World ex-US Small Cap.

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