GLOBAL VALUE ADVISORS
A Division of Moody Aldrich Partners

International Small Cap

First Quarter 2019

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.

Q1 2019 Total Returns (Net of Fees)	
GVA International Small Cap	**8.46%**
MSCI All Country World ex-US Small Cap	10.26%
Value Added	**-1.80%**
MSCI All Country World ex-US Small Cap Value	8.99%
MSCI All Country World ex-US Small Cap Growth	11.56%

Regional Indices	
MSCI Japan Small Cap	7.11%
MSCI United Kingdom Small Cap	14.75%
MSCI EM (Emerging Markets) Small Cap	7.76%
MSCI Europe ex UK Small Cap	10.90%
MSCI Pacific ex JP Small Cap	12.47%

The GVA International Small Cap Equity strategy returned 8.53%/8.46% (gross/net) in the 1st quarter of 2019 versus 10.26% for its benchmark, the MSCI All Country World ex-US Small Cap Index. The quarter saw a significant recovery of global markets after a dismal Q4 2018.

The -1.80% relative performance of the fund was driven by a negative regional allocation impact combined with a weak stock-picking contribution, generally a reflection of the value style being out of favor this quarter. Continental Europe and Japan were the two contributors of underperformance in the portfolio. Our overweight Japan penalized us as the country and its currency's defensive nature were a headwind in the global equity markets recovery. Similarly, our positive bet on the emerging markets was a drag on performance. Thankfully, the stock picking effect in the region remained strong. Overall, our exposure to technology, transportation and autos were the main detractors in the portfolio.

The market dynamics observed in Q1 2019 were pretty much the exact opposite of those seen in the big market scare at the end of 2018. Following the Federal Reserve's interest rate policy U-turn in January 2019, equity markets recouped most of what they had lost late last year as "risk-on" kicked in and value stocks lagged lower quality and more richly valued companies.

Our investment methodology characterizes 'risk' as the inability for a company to internally finance its operations: it has a negative free cash flow and relies on external sources of financing (debt or equity) to survive. Our research shows that over the past 20 years, these companies structurally underperform (by 8% annually) our pool of "better" companies, the ones that generate positive free cash flow and positive shareholder yield[†].

[†]*Shareholder Yield = Dividends + Net Buy Backs + Change in Debt. Free Cash Flow = Cash Flow from Operations minus CapEx.*

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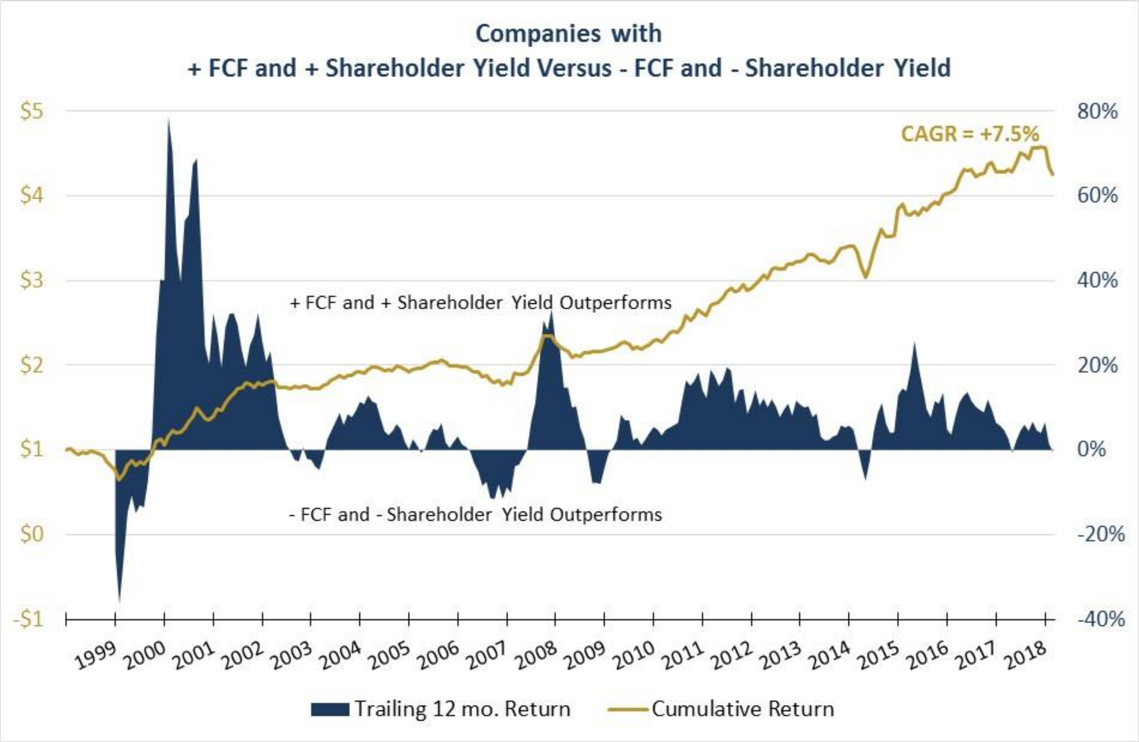

Source: FactSet, Largest 5,000 market cap companies in the world. Equally weighted returns.

Only 5 times have companies with negative FCF and Shareholder Yield outperformed on a trailing twelve months basis. The outperformance of the risky names was typically short lived (less than a year), and usually coincided with bubble episodes (1999 and 2007) or central bank interventions. The first quarter of 2019 saw a similar pattern which was a headwind to our portfolio.

These brutal stock market fluctuations and changes in style leadership have no influence on our investment methodology: we are committed to value and our portfolio will always trade at a significant valuation discount to the market. Similarly, we are not now nor will we ever be exposed to this risky segment of the market.

Our systematic approach ensures adherence to our key investment principles: the companies we invest in 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, and most importantly, we only purchase companies with cheap valuations using a blend of standard valuation metrics. We revisit on a monthly basis the compliance of each stock within the portfolio: any non-compliant name will be sold immediately. This prevents any drift away from our investment philosophy.

Our discipline produces a differentiated strategy compared to our peers, as illustrated by the research paper published earlier this year by Martin Lettau, Sydney Ludvigson and Paulo Manoel titled "Characteristics of Mutual Fund Portfolios: Where are the Value Funds?". It studies the positioning of active mutual funds, Exchange-Traded Funds and hedge funds through the lens of risk factors mainly size, value and momentum. Their observations are summarized here:

> *"We show that that **these funds** **do not systematically tilt their portfolios towards profitable factors, such as low price to book ratios, high momentum, small size, high profitability and low investment growth**. Strikingly, there are virtually no low price to book funds in our sample while there are many high price to book "growth" funds.*

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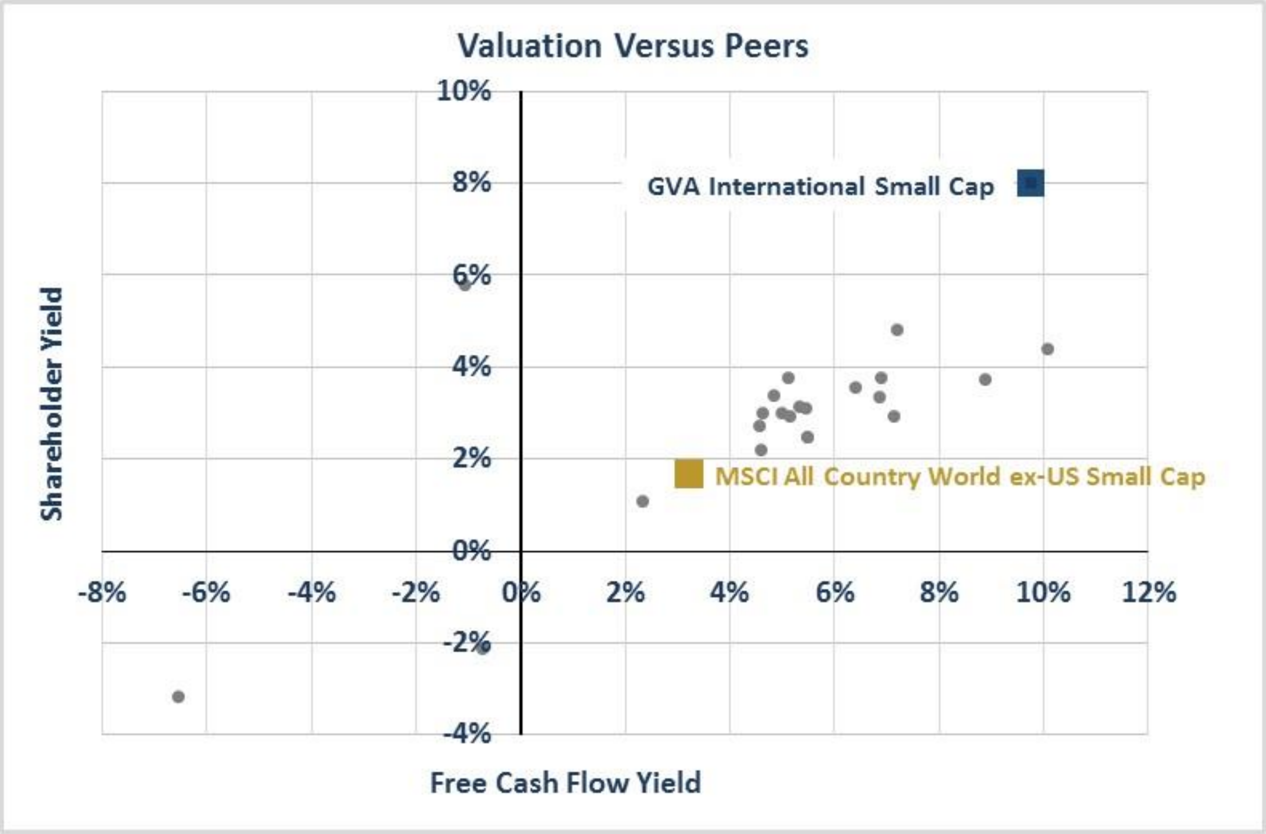
> *Portfolios of "growth" funds are concentrated in high price to book stocks* ***but "value" funds hold stocks across the entire price to book spectrum. In fact, most "value" funds hold a higher proportion of their portfolios in high price to book ("growth") stocks than in low price to book ("value") stocks.*** *While there are some micro/small/mid-cap funds, the vast majority of mutual funds hold very large stocks. But the distributions of mutual fund momentum, profitability and investment growth are concentrated around market average with little variation across funds. The characteristics distributions of ETFs and hedge funds do not differ significantly from those of mutual funds. We conclude that the characteristics of mutual fund portfolios raise a number of questions about why funds do not exploit well-known return premia."*

Our portfolio positioning is significantly different from our peer group, as our investment approach precisely tries to take advantage of the return premia discussed in the above study, such as value, small size, high profitability and low investment growth. For instance, the following graphs demonstrate the magnitude of our value tilt versus peers combined with a best-in-class quasi debt free profitability level.



Source: Morningstar constituents in the Foreign Small Mid category as of March 31, 2019. Holdings, ex-financials, for each fund were analyzed in FactSet.

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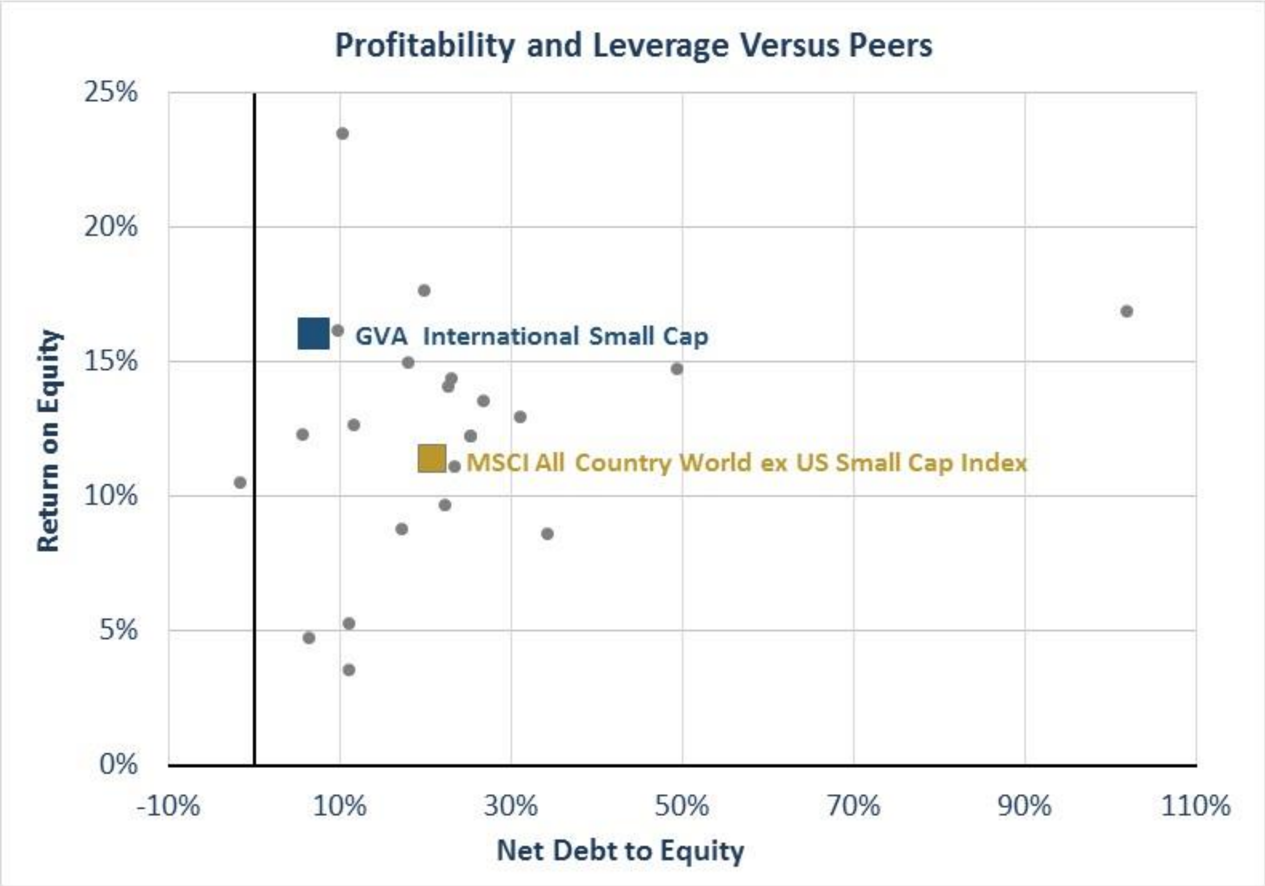

Source: Morningstar constituents in the Foreign Small Mid category as of March 31, 2019. Holdings, ex-financials, for each fund were analyzed in FactSet. Median ROW and Net Debt to Equity.

We remain steadfast in our confidence that GVA's disciplined approach that captures several proven alpha premia will deliver superior returns over time.

Top 3 Performers

Companhia de Saneamento de Minas Gerais (CSMG3-BR)
CSMG is a leading water utility operator in Brazil. The stock has been a strong performer as the company stands to benefit from anticipated liberalization/privatization following the recent presidential election of Bolsonaro (sworn in Jan 1, 2019). There are also several areas to improve the operating efficiency. The company reported decent Q4 results in early March. Group EBITDA came in at $399m BRL (-1% YoY, but in-line with consensus). The company generates consistent FCF with a 5-year average FCF yield of 6%. Management pays a 2% dividend. The balance sheet is decent with net debt to EBITDA below 2x. Valuation is cheap with a PE NTM at 11x, P/B close to 1x, and EV/EBITDA below 7x.

Pets At Home Group (PETS-GB)
Pets At Home is the leading pet care provider in the UK, with around 450 stores (target 500). The company reported a solid Q4 trading statement at the end of January. Like-for-like (LFL) growth in its core retail division grew a healthy 5%, which was ahead of expectations. The Vet business also saw strong growth, with LFL up 9%. Full year profit and FCF guidance was reiterated. Note that FCF has been positive in each of the last 5 years, with an average FCF yield of 5% (recently 9%). Management pays a 6% dividend. The balance sheet is in good shape with net debt to EBTIDA at 1x. Valuation is cheap: PE NTM at 12x, P/B at 1x, and EV/EBITDA at 10x.

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Ashmore Group (ASHM-GB)
Ashmore Group is a UK based asset manager, focused exclusively on Emerging Markets. Ashmore reported 1H results in February that were largely in-line with expectations, but the outlook remained positive. 1H EBITDA came in at 99m GBP (+8% YoY and 1% ahead of consensus). Increased management fees were slightly offset by lower performance fees. AUM sits at $77bn (+4% since June). Management also noted that they are off to a "positive start" in 2019. Ashmore has reported positive FCF in each of the last 10 yrs, with an average FCF yield of 7%. Dividend yield is 4%. The company has no debt and 460m GBP in cash on the balance sheet, or 15% of the market cap. Valuation is reasonable: PE NTM 18x and EV/EBITDA at 15x.

<u>Bottom 3 Performers</u>

GAM Holding AG (GAM-CH)
GAM is an asset manager based in Switzerland. The company has been struggling to maintain assets following the loss of a star fund manager and the liquidation of his funds (largest in the company). On top of this, the company's second largest fixed income fund has underperformed its benchmark recently and has lost 1/3 of its assets. In December, the company announced a profit warning as well as plans to take a write-down on the value of their business. The company also announced the cancellation of its dividend in 2018, which would cause shareholder yield to drop to zero. Zero shareholder yield is an automatic sell trigger for GVA and we sold our position ahead of the model change.

K'S Holdings Corporation (8282-JP)
K's Holdings is a consumer electronic retailer in Japan, with roughly 500 stores. K's Holdings saw its stock price decline in the quarter, following weak Fiscal Q3 results reported in February. Operating profits were down 19% YoY due to sluggish sales of high margin products, but full year guidance was left unchanged. There doesn't appear to be any major evidence of structural headwinds at this point. Sales fell by less than 1% in the quarter and full year guidance is looking for 2% growth. The 10 yr average FCF yield is 5%. Dividend yield is 3% and management regularly buys back shares (positive for Japan). PE NTM at 10x and P/B at 1x.

Kanamoto (9678-JP)
Kanamoto is based in Japan and is a leading company in the construction machinery rental sector. The company reported weak Q1 results in early March. Rental demand for construction was strong, but pricing took a hit due to heightened competition. Sales grew by 4% YoY, but operating profit fell by 27%. Price pressure is likely to level off over time. Kanamoto generates very high and consistent FCF, with a 10-year average FCF yield at 26%. Dividend yield is 2%. The balance sheet is in good shape with interest coverage over 100x. Valuation remains cheap: PE NTM at 9x, P/B at 1x, and EV/EBITDA below 3x.

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

Sincerely,

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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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