International Small Cap
First Quarter 2020
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.

Total Returns (Net of Fees)	Q1
GVA International Small Cap	**-31.8%**
MSCI All Country World ex-USA Small Cap Index	-29.0%
Value Added	**-2.8%**
MSCI All Country World ex-USA Small Cap Value Index	-32.1%
MSCI All Country World ex-USA Small Cap Growth Index	-26.0%

Regional Indices	Q1
MSCI Japan Small Cap	-20.2%
MSCI United Kingdom Small Cap	-36.5%
MSCI Emerging Markets Small Cap	-31.4%
MSCI Europe ex UK Small Cap	-27.5%
MSCI Pacific ex Japan Small Cap	-32.7%

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. YTD global Value underperformed global Growth by a massive 11.4% (MSCI All Country World Value Index -27.1% vs MSCI All Country World 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 the 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 (6.4% for MSCI All Country World Index, 5.5% for MSCI All Country World ex-USA Small Cap Index, and 4.0% for MSCI Emerging Markets Index).

During the quarter, size mattered as larger caps outperformed smaller caps by 8.4% in March and 9.9% YTD, measured by the MSCI All Country World Large Cap and Small Cap Indexes.

GVA Small Cap International Review

The GVA International Small Cap strategy returned -31.8% (net) in the first quarter of 2020 versus -29.0% for its benchmark, the MSCI All Country World ex-US Small Cap Index.

Underperformance in March came entirely from negative allocation effect. Stock selection was slightly positive overall, but GVA's sector exposures more than offset selectivity. The largest sector detractors came from GVA's overweight Financials and Consumer Discretionary and GVA's underweight Health Care. The UK was the largest regional drag, where we were equal-weighted, but had poor stock selection. One reason for that was the weakness

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of the British Pound which penalized the returns of GVA's mainly domestic holdings there. This more than offset strength in Japan, which acted, as it often does, as a safe haven in the crisis. As is typical 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 large cap dominance in the quarter was a headwind for the portfolio which is currently finding better value in smaller cap names with a weighted average market cap of $877 million versus $1,429 million for its benchmark. More detrimental to the strategy's relative return, was the 6.1% year-to-date underperformance of Value versus Growth: MSCI All Country World ex-US Small Cap Value Index was -32.1% vs MSCI All Country World ex-US Small Cap Growth Index at -26.0%.

Overall, GVA's -2.8% relative performance was in-line with expectations for the quarter. 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 5.5% within the MSCI All Country World ex-US Small Cap 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 companies typically do not rely on debt or equity to finance their businesses. The average dividend 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 of the names in the industry down 50% during 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 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. We pay close attention to sector and country positioning, but recognize that over time 88% of GVA's added value has been derived from stock selection.

An overweight Emerging Markets (EM) is another area that stands out in GVA's market positioning. GVA currently has a 33% weighting in EM versus the index at 20%. Valuation metrics of emerging vs developed markets have widened to a level not seen since 1998. GVA's model is recognizing this valuation discrepancy and favoring companies with high and consistent free cash flow generation. We've been adding to positions that have staying power to weather the downturn and that are significantly undervalued. An example is Hana Microelectronics, which is based in Thailand and manufactures electronic components. The stock has sold off 30%, due to supply disruptions and weak customer demand from COVID-19. Supply disruptions appear to be largely behind us, with Chinese factory's now back to 100% of pre-Chinese New Year levels. Hana has ample flexibility to wait out the eventual return of demand, as the company has zero debt and 8.5 billion THB in cash on the balance sheet (40% of the market cap). FCF yield is 4%, shareholder yield is 4%, and P/B is 1.4x.

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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 downturns, 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 16% is more than 2x the benchmark at 6% and well ahead of GVA's peer group average at 9%.

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 12%, which is well below the index at 53% and GVA's peer group average of 44%.

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 7x, compared to the benchmark at 12x.

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 GVA'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 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. The strategy has been actively adding to holdings that have been oversold. History suggests that GVA's positioning will be rewarded over time.

Top 3 Performers in Q1 2020

All 3 of GVA's top performers were Japanese companies with strong balance sheets. Japan has done a relatively good job at containing COVID-19, with less than 9,000 cases and less than 200 deaths reported to date. This has been accomplished without formal lockdown orders or official social distancing measures. Mass gatherings and schools were cancelled, but much of the public self-quarantined. As a result, Japan's small caps ended up being the best performing region during the quarter down 20.2%. Note that macroeconomic outlook is still poor, as Japan is an export-driven economy and was already on the cusp of entering a recession, following weak Q4 2019 GDP growth at -7.1%.

Arata Corporation (2733-JP)
Arata is a Japanese wholesaler of cosmetics, daily essentials, household goods, and pet supplies. Its customers are drugstores, home centers, supermarkets and convenience stores. The company's business model stands to benefit from emergency measures in place. The balance sheet is strong with net debt/equity at 25% and interest coverage at 41x. FCF yield is 11%, shareholder yield is 12%, and PE FY1 is 11x.

GEO Holdings (2681-JP)
GEO Holdings is a Japanese retailer of media products (game sales/rentals, mobile phones, consumer electronics, etc). The balance sheet is well positioned to weather the downturn with 12bn yen in net cash, or 22% of the market cap. FCF yield is 13%, shareholder yield is 13%, and PE LTM is 9x.

MEGMILK Snow Brand (2270-JP)
MEGMILK is the leading dairy and cheese producer in Japan. The company stands to benefit from a short term boost in sales, as supermarkets are one of the only retail industries posting solid growth. MEGMILK is expected to grow EPS by 9% in 2020. The balance sheet is solid, with net debt/equity at 45% and interest coverage at 68x. FCF yield is 1%, shareholder yield is 4%, and PE NTM is 12x.

Bottom 3 Performers in Q1 2020

Smiles Fidelidade (SMLS3-BR)
Smiles Fidelidade operates a leading travel rewards program in Brazil. Roughly 90% of Smiles points are redeemed on GOL Airlines. Anything associated with airlines took a significant hit in the quarter. GOL suspended all international flights through May 3rd and domestic capacity was slashed by 92% over the same timeframe. That being said, Smiles is well placed to weather the downturn. The company has an asset light business model and is sitting on R$1.2bn in net cash on the balance sheet, or 66% of the market cap. FCF yield is 81%, shareholder yield is 35%, and PE FY1 is 4x.

Crest Nicholson Holdings (CRST-GB)
Crest Nicholson 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 Crest Nicholson is positioned to survive the downturn. The company cancelled its dividend in the short term to preserve cash and drew on its credit facility. The balance sheet gearing is in decent shape with net debt/equity at 20%. FCF yield is 28%, shareholder yield is 20%, and PE NTM is 8x.

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Vistry Group Plc (VTY-GB)
Bovis Homes, now known as Vistry Group PLC, is a residential homebuilder in the UK. Homebuilding has been halted in the UK, but Vistry is well positioned to weather the downturn. The balance sheet had £339m in net cash at year end, or 23% of the market cap. The dividend has been temporarily suspended to preserve cash. FCF yield is 21%, shareholder yield is 14%, and PE NTM is 6x.

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.

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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 International Small Cap strategy performance is measured against the MSCI All Country World ex-US Small Cap.

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