



# International Small Cap

## Fourth Quarter 2022

### 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.

*\*This commentary has been modified as of November 2023. The modifications were limited to a change in referenced GIPS presentations that can be viewed via hyperlink within this commentary.. The remaining content remains as originally written.*

Total Returns (Net of Fees)		Q4
<b>GVA International Small Cap</b>		<b>15.6%</b>
MSCI All Country World ex-USA Small Cap Index*		13.3%
MSCI All Country World ex-USA Small Cap Value Index		14.9%
MSCI All Country World ex-USA Small Cap Growth Index		11.7%

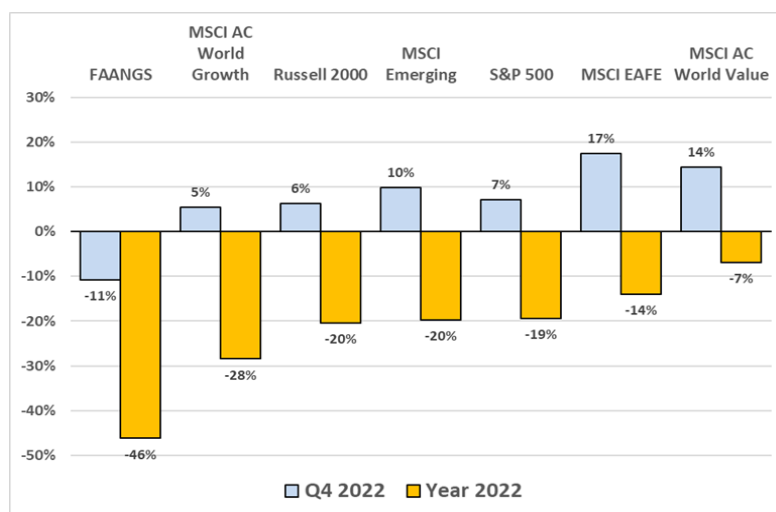
Regional Indices		Q4
MSCI Japan Small Cap		12.0%
MSCI United Kingdom Small Cap		18.9%
MSCI Emerging Markets Small Cap		8.2%
MSCI Europe ex UK Small Cap		21.7%
MSCI Pacific ex Japan Small Cap		13.0%

GVA International Small Cap Net Return		MSCI ACWI ex-USA Small Cap Net Return*	
1 Year	-8.2%		-20.0%
3 Years**	-1.3%		1.1%
Since Inception**	-0.5%		0.8%

\*Benchmark | \*\*Annualized

The fourth-quarter market dynamics were similar to the ones observed since the beginning of the year: growth names were under pressure, particularly the FAANGS, as value stocks registered their second year of outperformance versus growth. Worth noticing, US markets underperformed non-US markets over the quarter, as investors came to realize that the Fed may not pivot any time soon. International Developed markets had the best return, driven by the strong recovery of European markets, as investors reassessed the impact of the region's energy crisis under a milder winter scenario. Also noteworthy, Emerging Markets rebounded by +10%, as investors welcomed the easing of Covid 19 lockdowns in China. The unexpected, fast-tracked grand reopening of China has, of course, multiple implications as far as the country's economic growth and the demand for resources are concerned.



\*Source: Factset

In that context, GVA's International Small Cap strategy outperformed its benchmark in Q4, adding to their positive relative returns for the year.

	Quarter to Date			Year to Date		
	Total Net Return	Bench. Total Return	Variation in Total Return	Total Net Return	Bench. Total Return	Variation in Total Return
<b>GVA International Small Cap</b>	15.6%	13.3%	2.3%	-8.2%	-20.0%	11.8%



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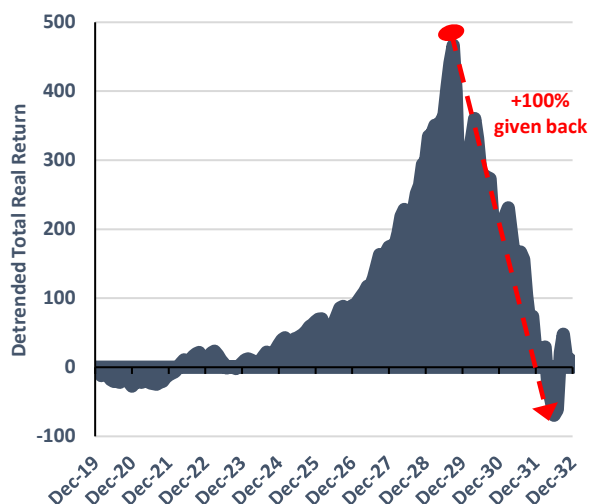
#### What have we learned and what to expect?

In our 2nd quarter 2021 market commentary, we wrote a piece titled “Many elements point to a value recovery.” We presented the key facts that gave us conviction that the growth bubble, that had been driving the markets for the last decade, had popped, and why we believed a new market regime that was going to rejuvenate the value style was under-way.

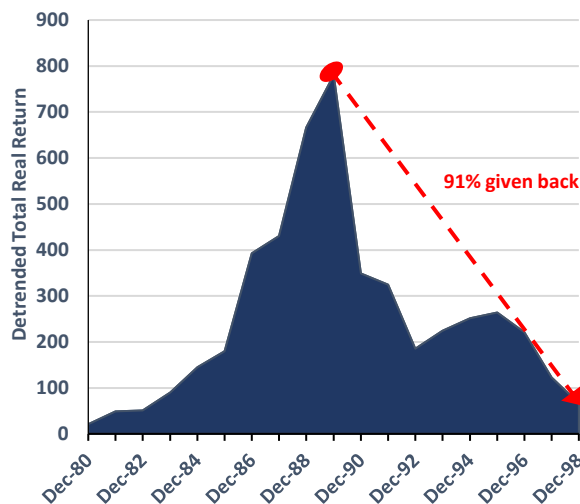
Eighteen months later, we thought it would be timely to revisit our thesis. The market dislocations that have been triggered by the bubble unravelling bring a new set of compelling investment opportunities that we’d like to walk you through.

The “everything” bubble has finally burst. Its build up was a lengthy process, taking its roots in the Great Financial Crisis. More than a decade of ultra-low interest rates enabled it to prosper. The Covid 19 crisis allowed it to reach epic proportions. And the unintended consequences of this healthcare crisis provoked its demise. As was the case with all of the illustrious preceding bubbles, the digital economy mania (i.e. meme stocks, unprofitable growth companies, crypto currencies, SPACs, NFTs, IPOs, etc), was not different this time.

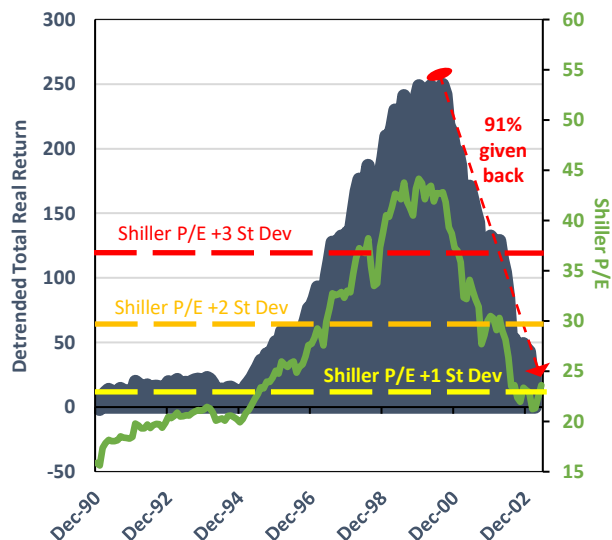
**S&P 500  
1920-1932**



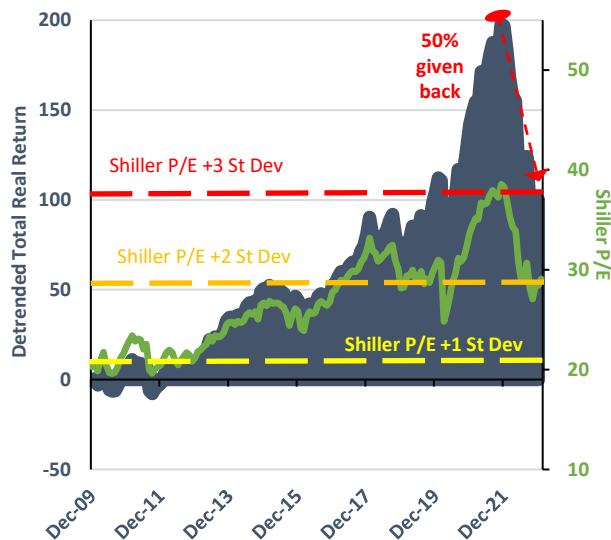
**Japan  
1980-1998**



**S&P 500  
1990-2003**



**S&P 500  
2010-2022**



\*Source for above 4 graphs: Robert Shiller, Yale <http://www.econ.yale.edu/~shiller/data.htm> \*\*\* Additional Footnotes can be found in the Disclosure section



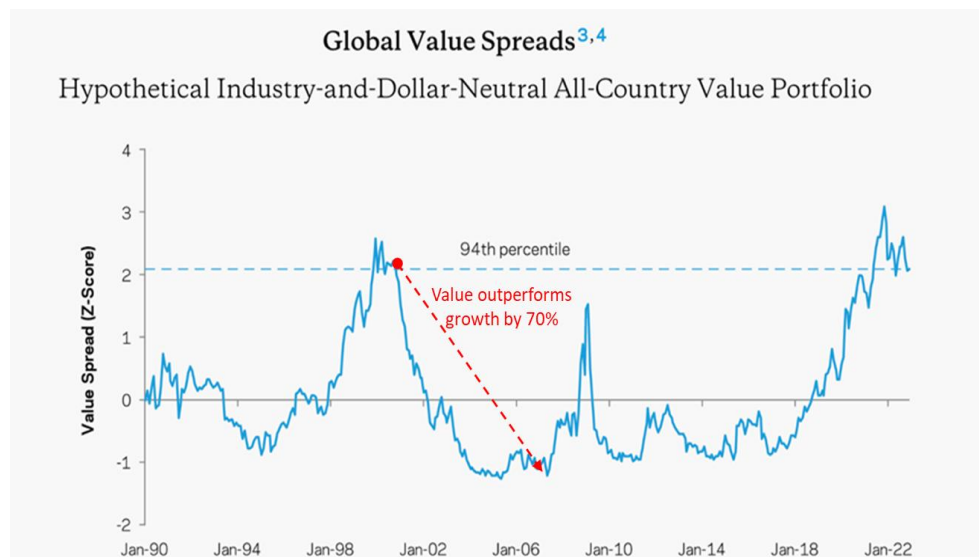
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When comparing the current cycle to the most prominent manias in the financial history (Great Depression 1929, Japanese bubble, and the TMT bubble of 2000), one common denominator is that the extraordinary capital gains that they have generated, have typically been given back nearly 100% and have sometimes overshot to the downside once the deflating process has been complete. If history is our guide, it is reasonable to believe that more downside could be expected going forward, particularly from overpriced growth stocks.

Valuation spreads between cheap and expensive global stocks tell the same story. Despite the underperformance of growth stocks over the past 18 months, the spread is still extremely wide. AQR's recently updated chart estimates that it is currently in the 94th percentile:



\*Source: AQR. January 1, 1990 – December 31, 2022. \*\*Additional Footnotes can be found in the Disclosure section

GVA believes we are entering a favorable multi-year dynamic, where the upside for value and downside for growth are similar to what they were mid-2000. From June 2000 to December 2006, the MSCI ACWI value returned +66% when the MSCI ACWI growth returned -4.5%. The Nasdaq lost a stunning 80% peak to trough from March 2000 to October 2002, as the TMT bubble deflated. From its most recent peak in November 2021, the Nasdaq has “only” retreated by 33% and the FAANGS by 45%. These names have become engrained in our lives and their market titan status so deeply imbedded in investors’ minds that it is hard for many to imagine that they could drop from their pedestal. Although not focusing on market bubbles specifically, Research Affiliates wrote a great paper on “The Fall of the Titans” that tracked the top 10 global market caps at the beginning of each decade over the past 50 years. Here is the summary:

#### Ten Largest Market-Capitalization Stocks in the World at the Beginning of Each Year

2021	2010	2000*	1990	1980
Apple	PetroChina	Microsoft	Nippon T&T	IBM
Microsoft	Exxon Mobil	General Electric	Bank of Tokyo-Mitsubishi	AT&T
Amazon	Microsoft	NTT DoCoMo	Industrial Bank of Japan	Exxon
Alphabet	ICBC	Cisco	Sumitomo Mitsui Banking	Standard Oil
Facebook	Wal-Mart	Wal-Mart	Toyota	Schlumberger
Tencent	China Construction Bank	Intel	Fuji Bank	Shell
Tesla	BHP Billiton	Nippon T&T	Dai-ichi Kangyo Bank	Mobil
Alibaba Group	HSBC	Exxon Mobil	IBM	Atlantic Richfield
Taiwan Semiconductor	Petrobras	Lucent Technologies	UFJ Bank	General Electric
Berkshire Hathaway	Apple	Deutsche Telekom	Exxon	Eastman Kodak

New Addition to List

Drops Off List Next Period

Flip-Flop; New, Then Drops

Company is:

US

European

Emerging Markets

Japanese or Australian

\*Year 2000 represents holdings as of March, three months late. Source: Research Affiliates, LLC, using data from Financial Times, Wikipedia, and Gavekal Research. Rankings shown represent beginning-of-year rankings



The reality is that titans stumble and GVA believes that markets have already begun the process that will give birth to a new leadership in the years to come.

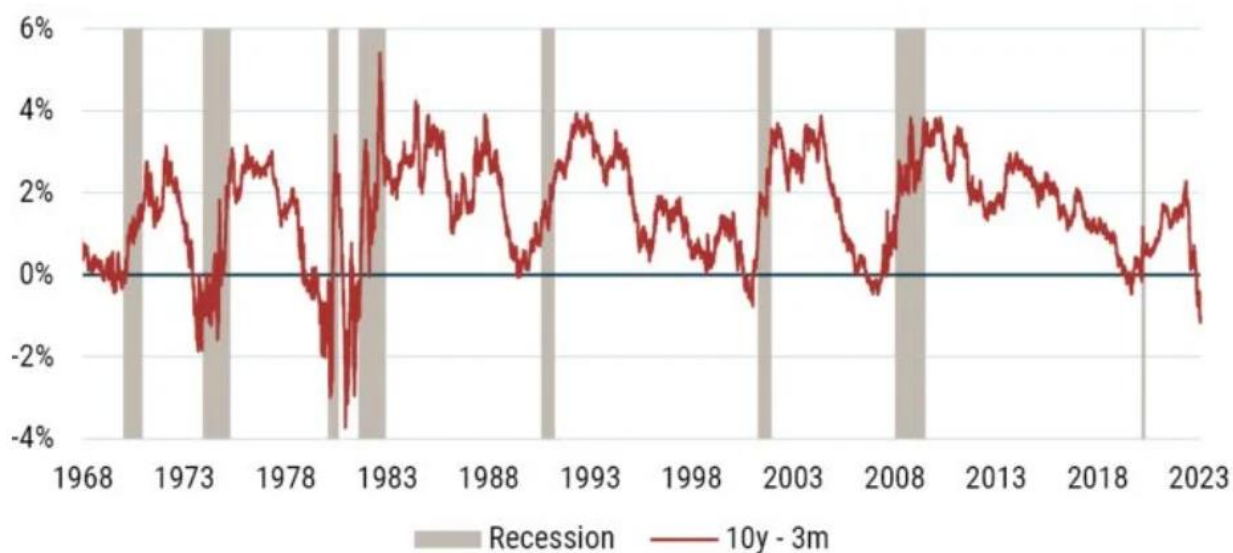
The case for value is extremely compelling, but the timeline for this process to play out remains unknown. We wrote extensively in our [Q3 2022 letter](#) about our belief that the tightening cycle currently unfolding would ultimately trigger fundamental deterioration. In our opinion, this could potentially be the catalyst we've been anticipating. Economic indicators and interest rates are certainly pointing towards further vulnerability.

### Odds of Recession

Over time, the three most common factors that tend to lead recessions are an inverted yield curve, a rate hiking cycle, and some type of commodity shock. Currently all three of these appear to be occurring at the same time. This has dramatically increased the odds of a recession in 2023.

1. **Yield Curve Inversion:** The yield curve inversion is often cited as the single best indicator of recessions. Over the last 50 years, there have been 8 recessions in the US and the inverted yield curve has correctly predicted all of them. In fact, every time the yield curve inverted, a recession followed. For the current cycle, the yield curve first inverted in late October 2022 with the 10 year yield dropping below the 3 month yield, signaling recession within the next year. The chart below shows each yield curve inversion (below 0%), followed by the predicted recession (gray bars).

### 10 Year – 3 Month Yield Curve and NBER Recessions

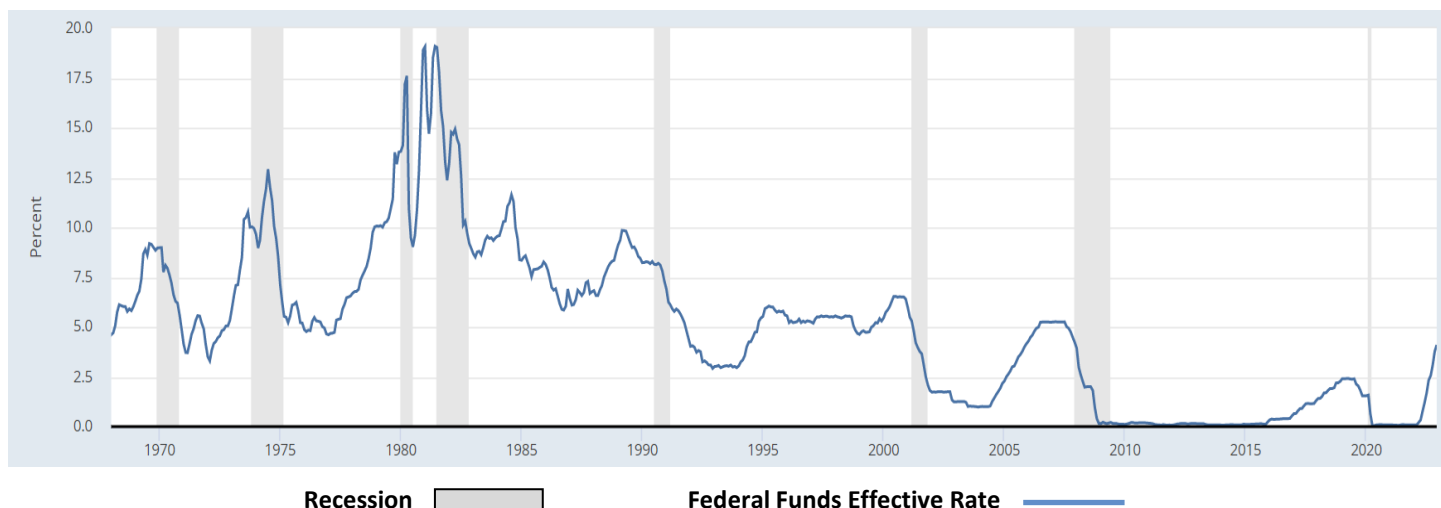


\*Source: FRED data. GMO Letter 1/24/23.



2. **Rate Hiking Cycles:** Over the last 50 years, all 8 recessions have been preceded by rate hiking cycles. The Fed has only succeeded twice in raising rates without forcing the economy into recession (1983 and 1994). In 2022, the Fed hiked rates by 4.25% and the ECB hiked by 2.25%. The Central Bank's aim is to raise rates to slow the economy and get wage growth under control to ease inflation. Ideally, Central Banks would like to accomplish this without a major impact on the economy, but history suggests this type of "soft landing" is a complex balancing act.

#### US Federal Funds Interest Rate with NBER Recessions



\*Source: St Louis Fed

3. **Oil Shock:** In the past 50 years, every time oil prices, adjusted for inflation, rose 50% above trend, a recession followed. The COVID recession ended with Brent crude prices at \$30 per barrel in 2020, which then rose to \$83 per barrel at the end of 2022. Note that this is still well off the June 2022 peak of \$122 per barrel, at the height of the Ukraine/Russian conflict uncertainty.

#### Real Oil Prices % Change and NBER Recessions



Source: Pictet Asset Management



Although the probability of a recession in 2023 is high, there is still ample debate surrounding the depth of the recession. Several indicators are providing optimism that a soft landing could be possible. Inflation indicators have started to roll over globally, which has resulted in rising investor confidence that central bank efforts are starting to pay off. On top of this, China's easing of pandemic restrictions and supportive policy measures for the property market have created a reopening tailwind to the global economy. Lastly, the rollover in energy prices has resulted in lower odds of recession occurring in Europe.

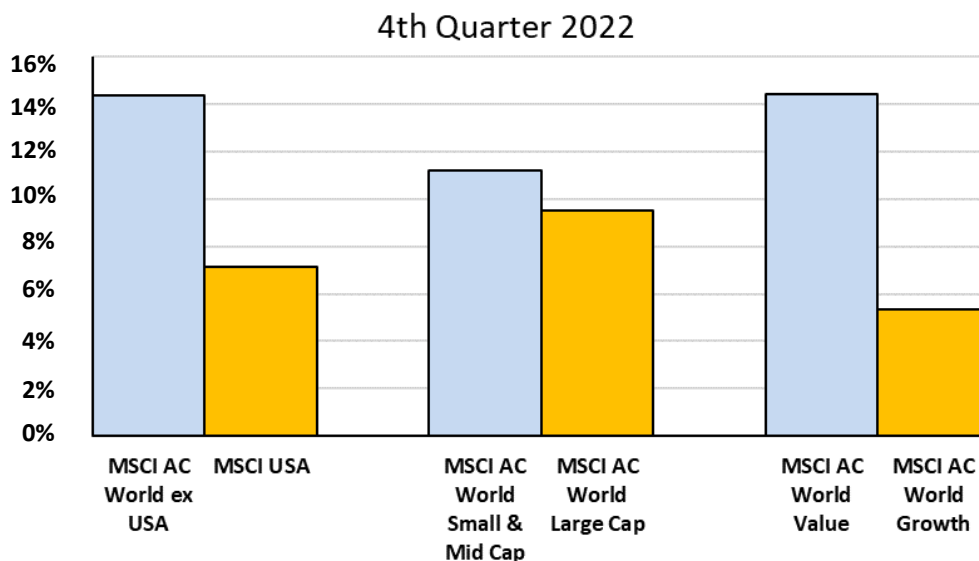
### GVA's Positioning

We believe GVA's strategies are well positioned to outperform in the current operating environment. Our research shows that companies with high and consistent free cash flow that return cash to shareholders, outperform the market in a variety of market dynamics, including recessions. Our strategies also focus solely on companies that have strong balance sheets and valuations in the cheapest 20% on a global basis. Both characteristics should provide downside protection, possible positive returns and allow GVA's strategies to outperform through the global slowdown.

In addition to this, macroeconomic uncertainties around the globe have created large valuation disparities across regions, styles, and market caps. GVA's strategies are managed to take advantage of these divergences. Over the last decade, there have been three major trends which GVA believes could reverse going forward (see our [Q2 2022 letter](#) for an in-depth analysis of this topic):

1. Growth outperforming value.
2. Large cap outperforming small.
3. US outperforming International/Emerging Markets.

The reversal of these trends in the mid-term have the potential to create a structural tailwind to GVA's strategies. GVA's strict investment selection process for highly profitable value companies ensures that its portfolios will never style drift. GVA has a sizable exposure to small and mid-cap companies across all of its strategies. It is also significantly underweight the US, due to more attractive valuation in International and Emerging Markets. For the first time in a while, GVA's strategies benefited from the positive contribution of each of these 3 themes over the past quarter:



\*Source: Factset



**GLOBAL VALUE ADVISORS**  
A Division of Moody Aldrich Partners

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GVA's best years of outperformance likely lay ahead of us. The end of zero interest rate policy has refocused investor's attention on companies that have strong fundamentals (strong FCF and returning capital to shareholders). Despite the recent outperformance of value, we are likely still in the early innings. The valuation gap between growth and value remains extremely elevated and cannot be justified by the differential of growth outlooks of the 2 segments of the market. If the current cycle plays out similar to the collapse of the TMT bubble, as we expect, we are just now entering a multi-year cycle of value outperformance.

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,



**Phillippe Rolland**  
CIO, Portfolio Manager



**Todd Bassion, CFA**  
Portfolio Manager



**Matthew Marotta, CFA**  
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This information is presented as supplemental to the GIPS Report, which is available [here](#).

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.

\*\*Spreads are constructed using a hypothetical value composite that includes five value measures: book-to-price, earnings-to-price, forecast earnings-to-price, sales-to-enterprise value, and cash flow-to-enterprise value. Spreads are measured based on ratios and are adjusted to be dollar-neutral, but not necessarily beta-neutral through time. To construct industry-neutrality, the value spreads are constructed by comparing the value measures within each industry. The all-country universe is based on roughly 87% developed / 13% emerging weights. The developed data starts January 1990, while the emerging universe is included starting December 1994. Hypothetical data has inherent limitations, some of which are listed in the Disclosures. For illustrative purposes only and not representative of an actual portfolio AQR currently manages. Please read the Disclosures for important information.

Over the last few years, we've calculated the value spread various ways in these blogs. Sometimes just in the USA. Sometimes using only one measure like P/B when we want to go really far back in time. Other variants may differ somewhat.

\*\*\*We use the detrended total real return to measure the deviations from trend. It is the real market return (dividend included) corrected for the trend of the market total real return (+6.6% annual from 1900 to 2022).

\*\*\*Shiller P/E: The Cyclically-Adjusted Price-to-Earnings Ratio or Shiller P/E is calculated by dividing a company's stock price by the average of the company's earnings for the last ten years, adjusted for inflation.

\*\*\*Standard deviation is a statistical measure of the amount of dispersion around the average. One standard deviation, plotted above or below the average value on a normal distribution curve, defines a region that includes 68% of all the data points. Two SD above or below include about 95% of the data, and 3 SD include 99.7% of the data. When the Shiller P/E reached 38.6 in November 2021, it became a 3 Standard Deviation event, as only 0.3% of the monthly observations from 1900 to 2022 were equal or superior to that number.