GLOBAL VALUE ADVISORS
A Division of Moody Aldrich Partners

International Small Cap

Second Quarter 2023

COMMENTARY*

GVA Expects Higher Interest Rates and Inflation and Bets on Value and Small Cap

**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.*

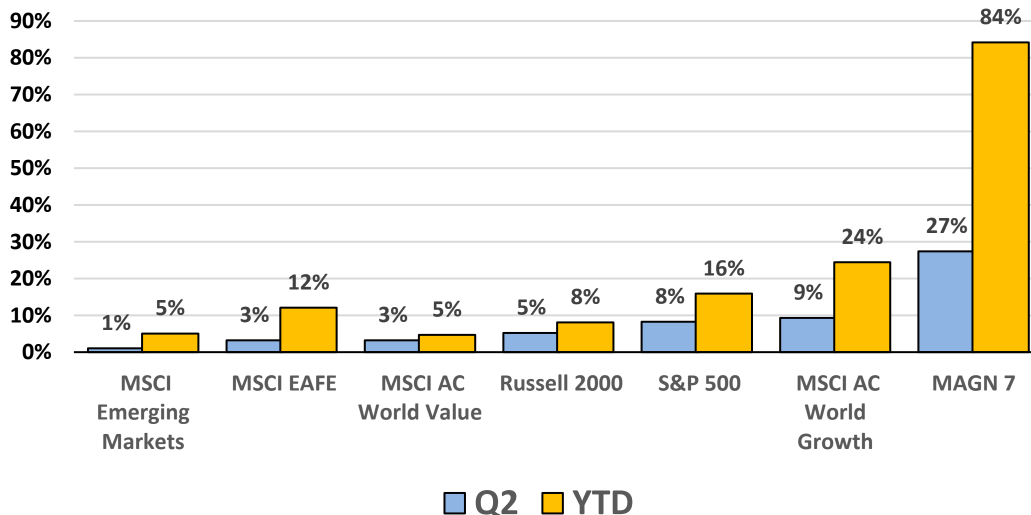
Total Returns (Net of Fees) +	Q2
GVA International Small Cap	**-0.6%**
MSCI All Country World ex-USA Small Cap Index*	2.1%
MSCI All Country World ex-USA Small Cap Value Index	2.3%
MSCI All Country World ex-USA Small Cap Growth Index	1.8%

Regional Indices	Q2
MSCI Japan Small Cap	1.2%
MSCI United Kingdom Small Cap	1.3%
MSCI Emerging Markets Small Cap	6.4%
MSCI Europe ex UK Small Cap	-0.2%
MSCI Pacific ex Japan Small Cap	0.0%

	GVA International Small Cap Net Return	MSCI ACWI ex-USA Small Cap Net Return*
1 Year	12.6%	10.9%
3 Years**	9.1%	8.2%
5 Years**	1.5%	2.6%
Since Inception**	0.7%	2.0%

*Benchmark | **Annualized +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 market dynamics observed in Q1 of 2023 gathered pace in the second quarter of this year. Driven by the seemingly unstoppable rebound of the Magnificent 7*, Growth stocks trounced all the other compartments of the market. On a year-to-date basis, M7 have now returned a stellar +84% on average, recouping the majority of 2022's losses. The S&P soared by 15.9% in the first half, with the M7 accounting for 73% of those gains. Conversely, value, non-US and small struggled over the quarter. In the face of this, GVA's strategies underperformed their respective benchmarks:



*Source: Factset *Magnificent 7 (MAGN 7): Apple, Mircosoft, Alphabet, Amazon, Nvidia, Tesla, and Meta.*

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The Artificial Intelligence craze has been the primary trigger to this tech revival, as the market is trying to identify the next leaders in the field. The market is also gauging the nature of its impact on corporates' business models. In looking at past industrial or technological revolutions, these are not easy tasks. As Warren Buffett famously said as he was speaking to University of Georgia students in 2001: "what you really should have done in 1905 or so, when you saw what was going to happen with the auto is you should have gone short horses. There were 20 million horses in 1900 and there's about 4 million now. So, it's easy to figure out the losers, the loser is the horse. But the winner is the auto overall. Despite knowing this, 2000 carmakers just about failed."

Trying to avoid the businesses at risk of being disrupted away by AI, and striving to methodically deploy capital in the most compelling investment opportunities, GVA differentiates itself by concentrating its efforts on exploiting a market inefficiency called the Advantaged Subset. The Advantaged Subset of the investment universe, consists of superior companies with structural tailwinds: companies with high free cash flow and high shareholder returns. Independent of valuation, this select group of companies has outperformed the index by 3% annually over the past 20 years at a lower level of risk. The structural edge of these superior companies can be observed across geographies sectors, company sizes and most importantly, the edge is robust through time.

GVA then focuses on the value subsegment of the Advantaged Subset, defined as the cheapest 20% of the stocks in the universe. By focusing on this clearly delineated segment of value, GVA accesses the value premium while typically getting downside protection in case of extreme market outcomes. Because they are predominantly internally financed and because they adhere to a disciplined capital allocation process, the value companies we own tend to exhibit higher profitability and lower financial leverage than the rest of the universe, which we believe brings resilience to our portfolios.

GVA believes these attributes will be a competitive advantage going forward. Over the past 2 quarters, markets have been pricing in a painless outcome of the hiking cycle initiated by central banks 18 months ago. There are signs the central banks' efforts are paying off, with CPI coming down and economic growth holding up relatively well. GVA's take on the macro-economic outlook remains cautious, as lag effects in interest rate policies are long and rather variable.

Why is GVA optimistic?

GVA's performance since inception has been in-line with expectations. Our strategies should outperform when market dynamics are not driven by extreme growth. Conversely, we expected to underperform during such market as we have experienced in the first half of 2023 and in 2020. The Advantaged Subset outperformed the market in the first half (and since inception), but this has been more than offset by the dramatic rebound in growth stocks, specifically the Magnificent Seven stocks. During the first half of 2023, MSCI ACWI Value increased by 13.9% vs MSCI ACWI Growth at 24.3%, representing an enormous 10% performance gap. It should be noted that Small Cap International and Emerging Market indexes were not impacted to the same extent, as most mega cap tech stocks are domiciled in the US.

These drastic moves have essentially been driven by multiple expansion as the EPS expectations have barely moved over the same period. The table below from Minack Advisors shows the equity returns in the first half. The green bars show the proportion of equity returns driven by PE multiple expansion, while the blue bars show the proportion coming from EPS expansion.

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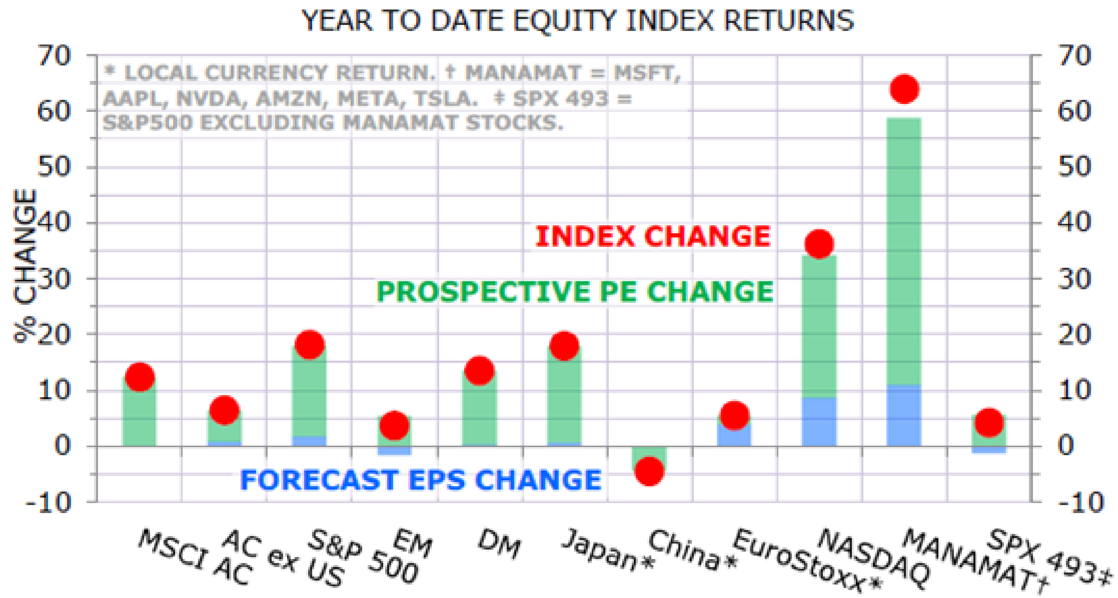

These recent market dynamics have created a very compelling investment opportunity set for GVA's strategies. As highlighted in this recent publication by GMO (https://www.gmo.com/americas/research-library/memo-to-the-investment-committee-a-hidden-gem_insights/), cheap stocks are currently trading at historic bargain basement valuation levels versus the general index but also versus the value universe. GMO's paper focuses on US large caps. GVA observes similar opportunities across geographies and market cap categories. GVA's in-depth analysis of the MSCI ACWI ex USA Small Cap universe is a great illustration of that.

The cheapest 20% segment of the International Small Cap universe is currently trading near its steepest discount to the market (8th percentile over the past 20 years), while the next cheapest 30% of the universe is trading at a premium to what it typically trades at versus the broader market (87th percentile over the past 20 years).* The cheapest 20% is often associated with junk companies or value "traps". This is why GVA's process, summarized above, focuses exclusively on the cheap companies that belong in the Advantaged Subset. In doing so, it weeds off cash-draining overleveraged businesses that typically rely on external funding to finance their operations.

GVA's proprietary Advantaged Value model shows even more compelling valuation levels, trading at the widest discount to the market (1st percentile over the past 20 years) while exhibiting above market profitability and quasi debt-free balance sheets. The following table summarizes this:

*Contact GVA for full results of the International Small Cap study. Value stocks are the focus of GVA's strategies and are defined as the cheapest 20% of the universe using an aggregate of six standard valuation multiples: P/E, P/E NTM, P/B, P/Gross Profit, FCF Yield and Dividend Yield.

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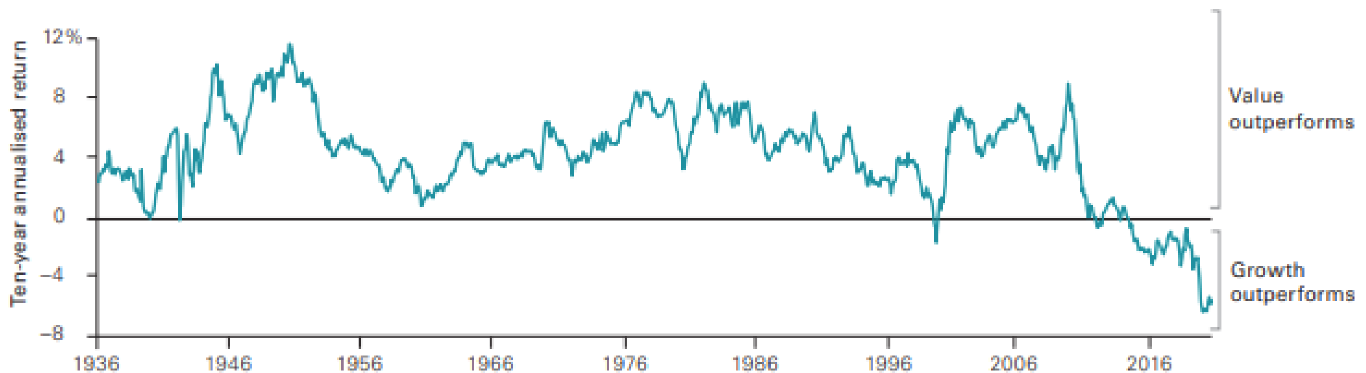
	Compounded Annual Return Last 20 Years	Information Ratio vs. Core Index Last 20 Years	Relative valuation vs market Q2 2023 (percentile)	P/E 2023	Dividend Yield	FCF Yield	Net Debt to Equity	ROE
MSCI ACWI Ex USA SMALL index	6.3%			12.8	3.0	3.5	58.6	11.5
MSCI ACWI Ex USA SMALL Value index	6.5%			9.9	4.2	5.4	80.7	9.2
Shallow Value (next 30% cheap)	6.9%	0.21	87%	11.4	3.7	5.9	76.6	11.3
Deep Value (cheapest 20%)	10.5%	0.68	8%	6.5	6.3	11.9	75.7	14.5
GVA - Advantaged Value	12.4%	0.90	1%	7.3	8.0	18.8	5.8	17.5

Source: GVA research study. FactSet database. GVA Advantaged Value is companies in the cheapest 20%, that also have positive free cash flow and positive shareholder yields. Shallow Value is defined as the next cheapest 30%.

It has been well documented that value outperforms growth in the long run, as depicted in the long term chart sourced from Vanguard below. While there is no guarantee how long this cycle will last, GVA believes we are at the tail end of what is now the longest and deepest period of value underperforming growth in the last 70+ years. Valuation spreads between growth and value have been stretched to unsustainable levels as seen on the chart on the next page. The NASDAQ just finished its best first half performance in the history of the index (+31.7%), on the back of AI-fueled market euphoria. AI is likely to lead to significant positive shifts in business models around the world, but the record growth performance experienced in the 1H is highly unlikely to be repeated.

The unprecedented outperformance of growth over value



Past performance is no guarantee of future returns.
Notes: The chart displays annualised ten-year trailing returns of a long-short value versus growth portfolio over the period of June 1936 to January 2021 constructed using Fama-French methodology, available at https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/Data_Library/f-f_5_factors_2x3.html.
Source: Fama-French research returns, outlined at http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html#Research.

Eventually, animal spirits will wane, and investors will once again focus on companies with strong fundamentals: high FCF, high shareholder returns, strong balance sheets, & cheap valuation. We believe GVA is well positioned among peers in these four cornerstone investment criteria.

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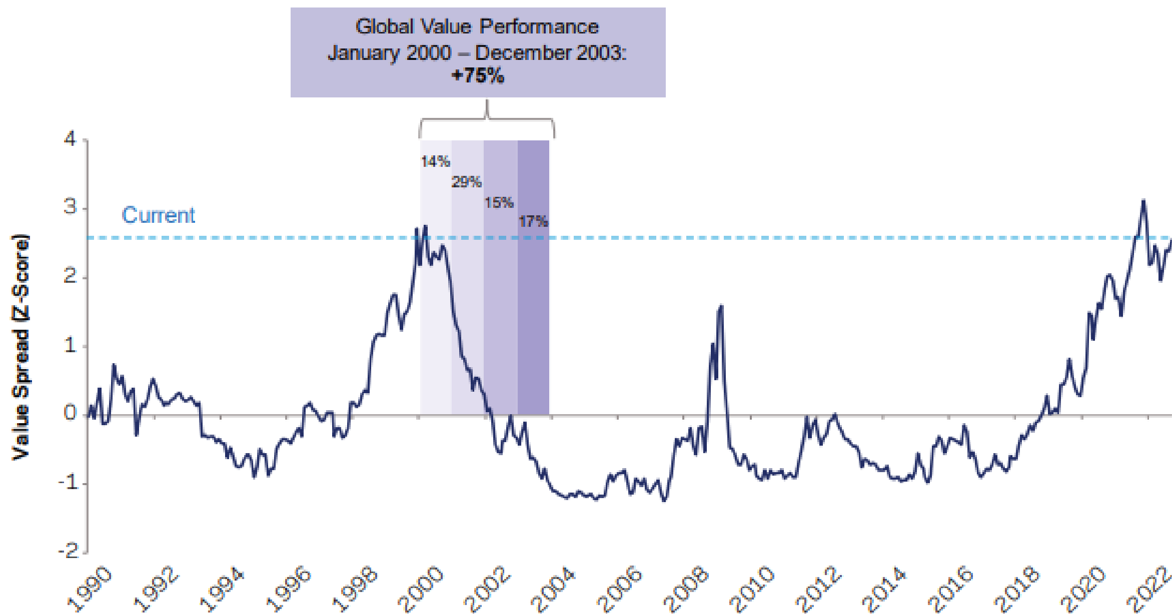
The PE NTM on the S&P 500 ended the quarter at 19.1x vs a 50-year average of 14.7x. Valuations of Growth, Mega Cap, and Tech+ are all extremely stretched, while areas like Financials and Small Caps trade at a large discount to the broad market.

Valuation spreads of US markets vs non-US markets are also near historic highs.* GVA's strategies are honing in on these disparities and taking contrarian bets. In broad terms, GVA's strategies are underweight the US, overweight Emerging Markets, overweight Cyclicals, overweight Small Caps, and heavily focused on Value. We believe that many, or possibly all, of these bets will pay off in the medium term and provide positive tailwinds to performance.

"History never repeats itself, but it does often rhyme." Mark Twain probably had no idea how much professional investors would embrace that quote, decades later. GVA does not have a crystal ball on how the economy will play out, but our best comparison for the current market dynamics is the early 2000s following the bursting of the TMT bubble. The year 1999 was eerily similar to today, with overall market valuations near all-time highs (Cyclically Adjusted PE ratios, Price to Sales, and GDP/Mkt Cap) and valuation spreads of growth vs value at their widest. Tech stocks were taking over the world, as AI appears to be now. A handful of large cap Tech stocks were driving most of the broad market performance. What followed was a recession driven by the Fed raising and then slashing interest rates, and value stocks outperforming for four consecutive years. The chart published by AQR in Q4 2022 illustrates this:



**Source: AQR. **See further information in disclosure section*

If a similar scenario unfolds in the coming years, GVA strategies are well positioned to outperform. In the interim, we are comfortable getting paid high single digit dividend yields to wait.

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.

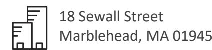
Sincerely,

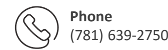
Phillippe Rolland
CIO, Portfolio Manager

Todd Bassion, CFA
Portfolio Manager

Matthew Marotta, CFA
Investment Research Portfolio Implementation

OFFICE CONTACT


18 Sewall Street
Marblehead, MA 01945


Phone
(781) 639-2750

Fax
(781) 639-2751

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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 the Hypothetical Value portfolio as described below, and are adjusted to be dollar-neutral, but not necessarily beta-neutral through time. Hypothetical value composite 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. To construct industry-neutrality, the value spreads are constructed by comparing the aforementioned value measures within each industry, which are then aggregated up to represent an entire portfolio. Please see the Hypothetical Global Developed Value Factor Description in the Appendix. Return data is the Hypothetical AQR Style Premia Global Value Backtest, which targets roughly 7% volatility over time, is net of trading costs, is net of 2% management and 20% performance fees, and is excess of cash returns proxied by 3m T-bills.