International Small Cap

Third Quarter 2023

COMMENTARY

GLOBAL VALUE ADVISORS
A Division of Moody Aldrich Partners

Reversion Could Be Mean:
The Case For Pure Value Has Never Been Stronger

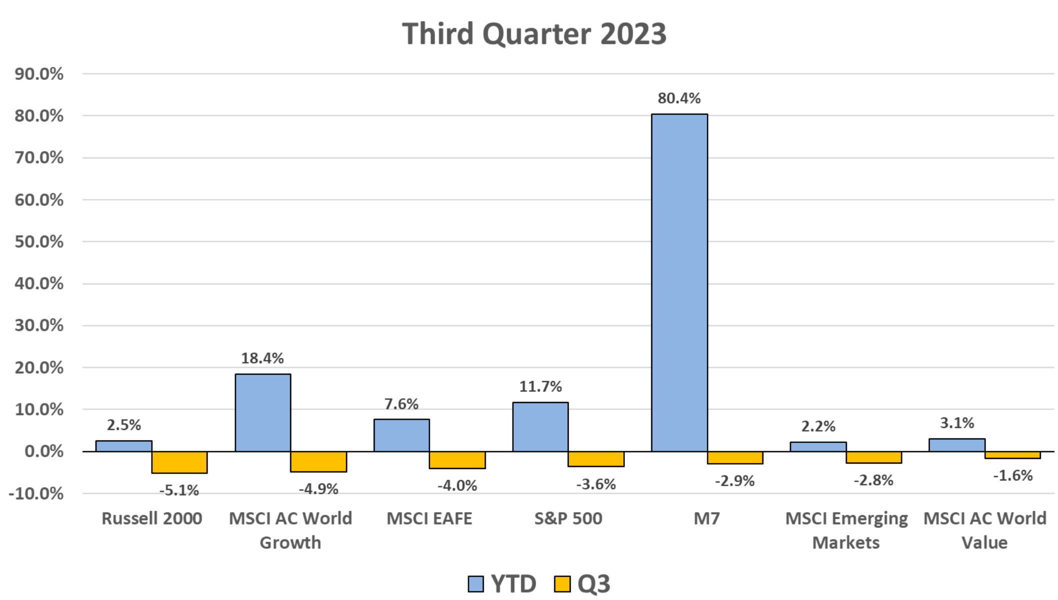
Total Returns (Net of Fees) +	Q3
GVA International Small Cap	**4.0%**
MSCI All Country World ex-USA Small Cap Index*	-1.7%
MSCI All Country World ex-USA Small Cap Value Index	0.3%
MSCI All Country World ex-USA Small Cap Growth Index	-3.7%

Regional Indices	Q3
MSCI Japan Small Cap	0.2%
MSCI United Kingdom Small Cap	-3.1%
MSCI Emerging Markets Small Cap	2.9%
MSCI Europe ex UK Small Cap	-6.8%
MSCI Pacific ex Japan Small Cap	-4.6%

	GVA International Small Cap Net Return	MSCI ACWI ex-USA Small Cap Net Return*
1 Year	27.7%	19.0%
3 Years**	9.6%	4.0%
5 Years**	2.6%	2.6%
Since Inception**	1.4%	1.6%

*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%).

After a torrid first half of the year, markets took a breather this past quarter. As the Fed keeps tightening, investors reassessed what peak rates could be for this cycle as well as the long run neutral rate. The repricing of 'higher for longer' interest rates created headwinds across the different equity categories. In that context, shorter duration value stocks beat growth, and emerging markets beat developed.



Source: Factset. M7 = "Magnificent Seven" stocks – Apple (AAPL.O), Microsoft (MSFT.O), Alphabet (GOOGL.O), Amazon (AMZN.O), Nvidia (NVDA.O), Tesla (TSLA.O) and Meta Platforms (META.O)

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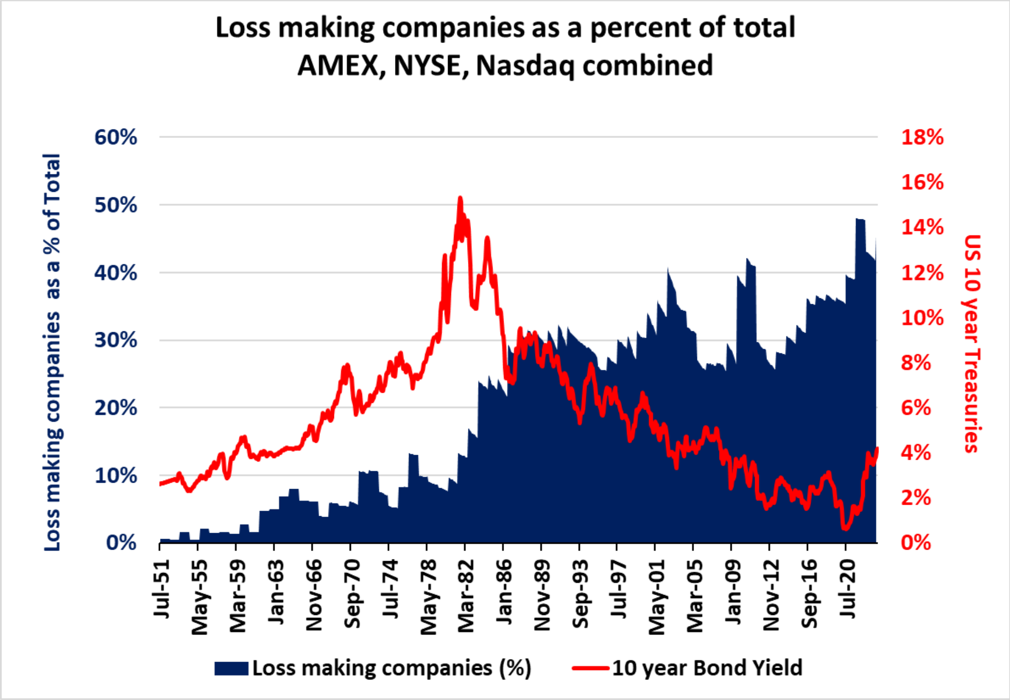
Investors remain cautiously optimistic but have started to doubt the soft-landing scenario. The 10-year treasury yield ended the quarter at 4.8%, the highest level since 2007. Although markets seem to be incorporating the higher-for-longer thesis into their thinking, there is still a widespread belief that we are at the tail end of the central bank hiking cycles. In September 2023, we saw a flurry of central bank meetings from the RBA (Sept 5th), Bank of Canada (6th), ECB (14th), Fed (20th), BOE (21st), SNB (21st), and BOJ (22nd). Out of all of these meetings, the ECB was the only central bank that hiked rates. Everyone else left rates unchanged.

Rates may have peaked, but they still remain elevated and quantitative tightening continues. Higher rates are starting to have the desired result of slowing economic growth. This can be seen through cuts to global GDP estimates and rising debt delinquency rates across the board. The additional list of investor worries include oil prices approaching $100/barrel, the UAW strike, a looming government shutdown, student loan payments restarting, and mortgage rates approaching 8%. Looking globally, we also have a recession in Germany, housing sector rolling over in Europe, and weak growth in China. Despite all this, equity markets have remained remarkably resilient.

The rise in interest rates penalized particularly leveraged, cash draining businesses over the quarter. Four decades of a steady decline in interest rates (and artificially ultra-low rates from the GFC to Q4 2020) have obviously not incentivized corporates to financial discipline. The following chart shows the proportion of US listed companies that are loss making over time. We find similar dynamics in non-US markets.



Source: Factset

Higher for longer interest rates have major implications that have started to impact businesses. Low leverage firms have been relatively undisturbed by the rise in rates over the recent past. Highly leveraged businesses, however, have had to deal with costly debt refinancing. This could of course become more painful, knowing that 8% to 10% of that debt must be refinanced every year in the coming 3 years. We quantify in the following table the impact of the recent rise in the cost of financing for the top 3,000 non-financial firms of our Ex-US small cap universe. The leverage ratios of companies are divided up into quintiles, with Quintile 1 representing companies with low amounts of debt and Quintile 5 representing companies with high debt levels.

Quintiles formed on net debt to equity (1 is low leverage & 5 is high)		Interest expense as a % of EBITDA		Average US$ return 06/2022 09/2023
		Q2 2022	Q2 2023	
	1	3.6%	3.0%	31%
	2	4.1%	4.9%	23%
	3	8.6%	11.3%	30%
	4	13.3%	16.6%	20%
	5	22.0%	27.6%	12%

Source: Factset

GVA's exclusive focus on companies that generate strong free cash flows and return the unused capital to their shareholders do not belong in this high-risk segment of the universe. Our emphasis on investing in only companies with strong balance sheets should also provide downside protection. September 2023 was the worst performance month of the year for the S&P 500 (and MSCI ACWI), but it was also the best month of the year for GVA in terms of relative performance across all three strategies.

Why GVA Now?
Many Elements Point To A Value Recovery

Having studied past cycles, GVA believes the current market conditions constitute a favorable backdrop to value's continued outperformance. There have been 5 major value recoveries experienced since the 2nd World War, which usually followed the last phase of an equity bubble: The Nifty Fifty in the 1970s, the Oil Shock in the 1980s, the Biotech Bubble in the 1980s, the TMT bubble in the 1990s, and the GFC in the 2000s. We first completed the GVA study below in 2021 (see GVA Q2 2021 commentary[1]) and revisit our thesis here and update our data through September 2023. The key conclusions remain the same: A regime change back to value likely started in October 2020 and has the potential to be the starting point for the 6th major value recovery. GVA believes we are still in the early stages of that recovery for the follow reasons:

[1]*Available at https://moodyaldrich.com/gva/strategies/*

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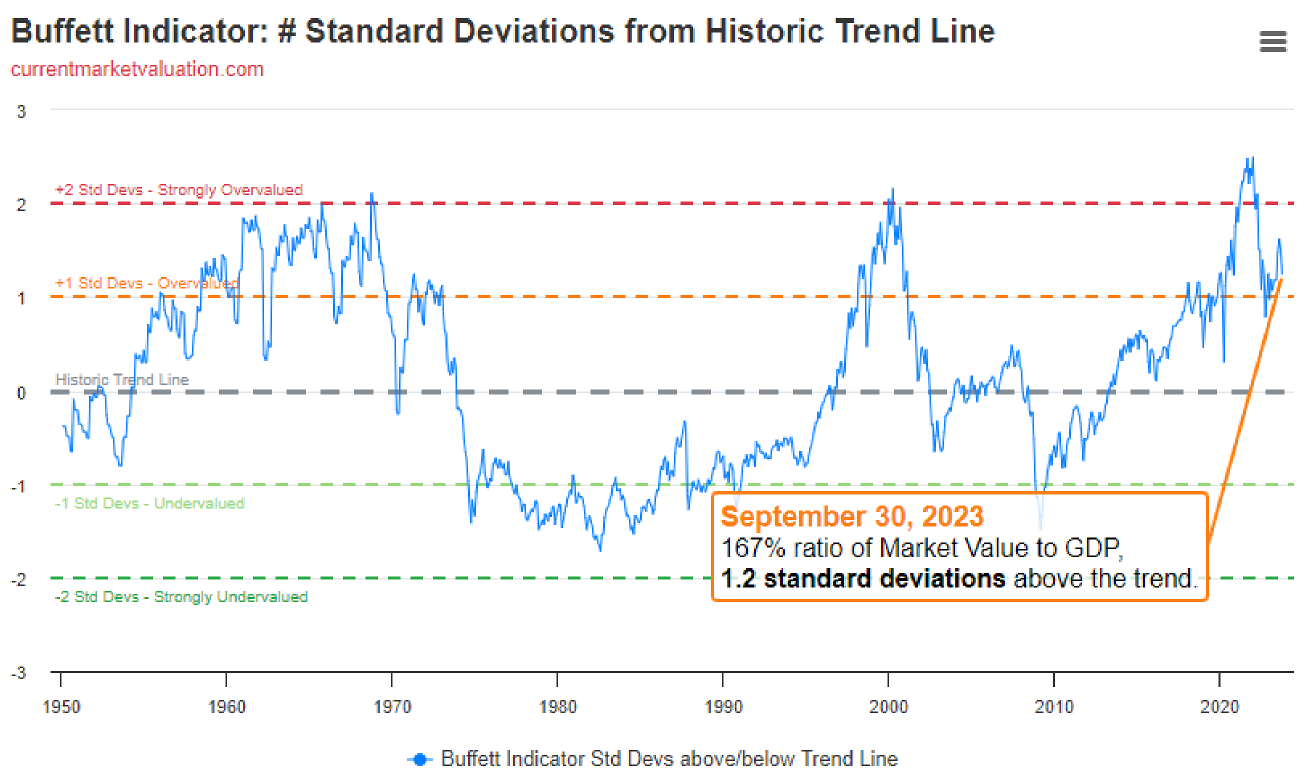
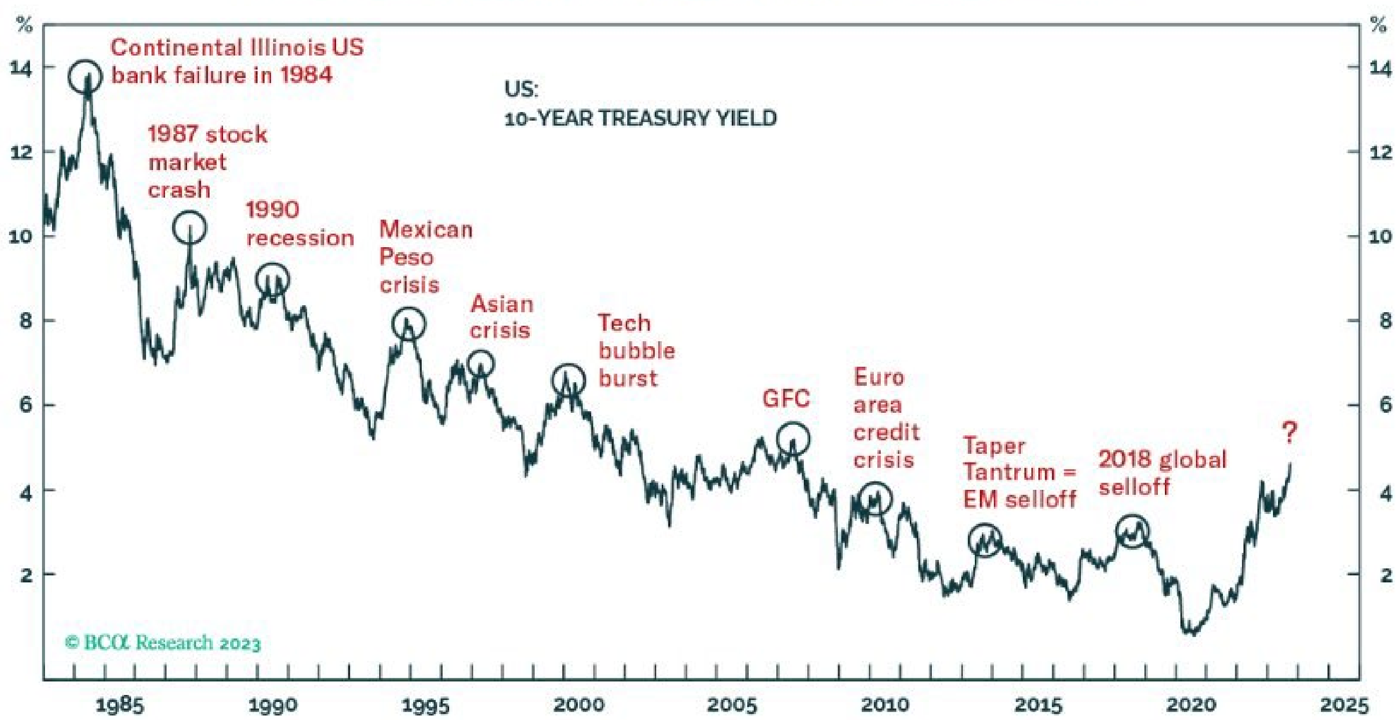
1. Markets Prime for Value Recovery: Since the 2nd World War, most of the 5 major value recoveries have taken root in the last phase of an equity bubble. The following graph shows the Buffett Ratio (Total US stock market valuation divided by GDP) which GVA believes does a pretty good job at identifying equity bubbles. The current 167% reading puts the current market valuation at 1.2 standard deviations above trend, implying that the stock market is significantly overvalued. The current readings are not far off from the levels reached at the height of the TMT bubble in 1999. It is worth noting that the Buffett Indicator hit a 70+ year high in December 2021, preceding the market collapse in 2022. When looking at the other common valuation metrics (Shiller PE, Price to Sales) a similar conclusion can be drawn.



Source: Factset

Not only do market valuations appear stretched; prior increases in interest rates have all resulted in significant market corrections. The 40-year history of the 10-year treasury yield shows this.

A Rise In Bond Yields Typically Ends With A Financial Accident



Source: [*https://x.com/bcaresearch/status/1708855522772844986?s=20*](https://x.com/bcaresearch/status/1708855522772844986?s=20)

2. Valuation Spreads at Extremes: The same 5 major value recoveries since the 2nd World War have, without exception, materialized once the valuation spread between cheap stocks and expensive stocks was significant, or "wide." The wider the spread, the bigger the value recovery. The following chart illustrates that and puts into perspective both the relative return of value versus growth (dark blue line) and its corresponding relative valuation (gold line).

The dark blue line shows the relative performance of value vs growth since 1949. If you invested $1 in value stocks in 1949, your end value would be 6 times as high as if you had invested in growth stocks. Although this is impressive, value has underperformed since 2006 and has given back more than half of its total outperformance (peak 13 times). Over the course of the entire study, value has outperformed growth by an average 3.2% per annum.

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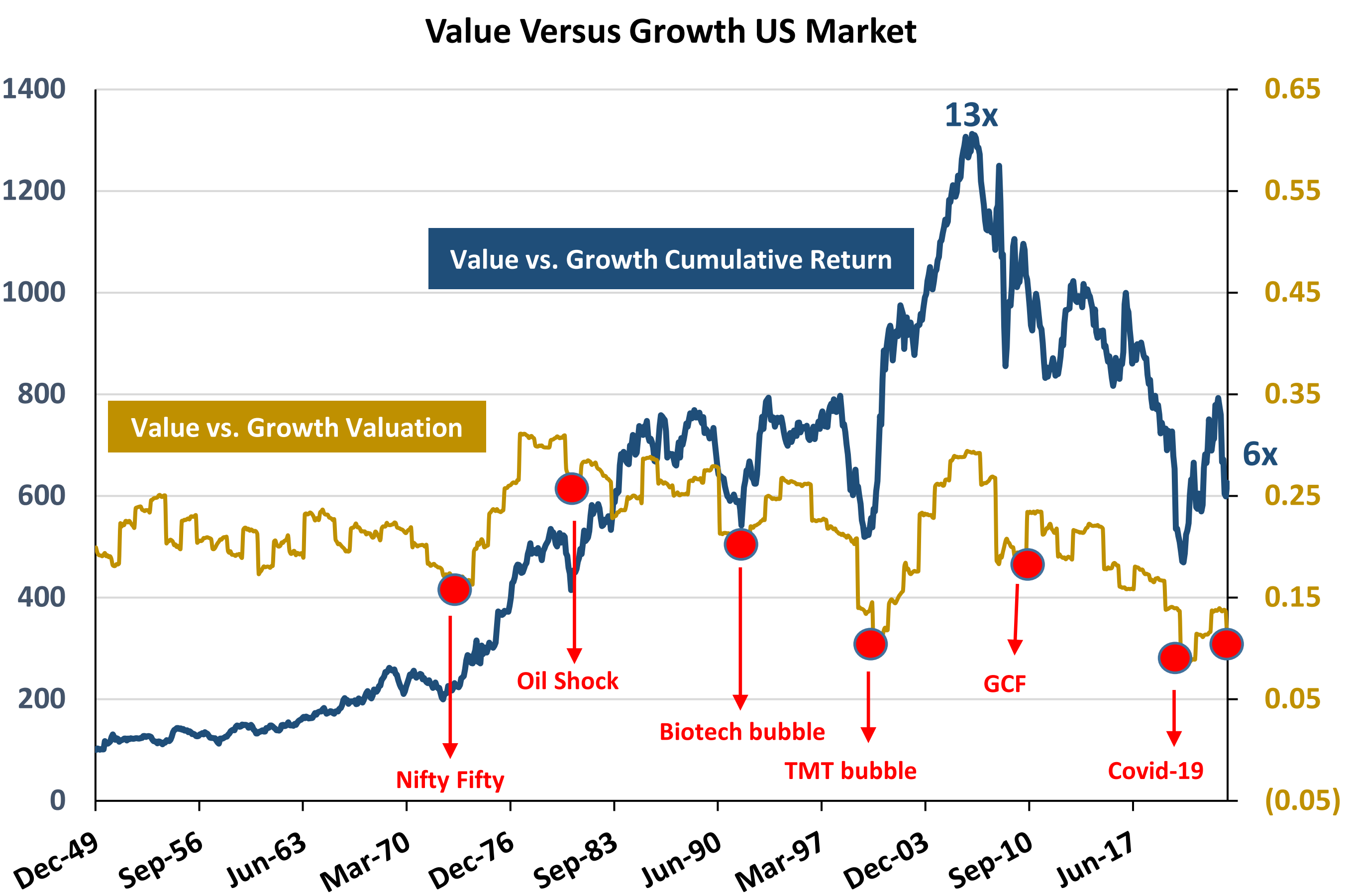

Source: GVA Research, utilizing the US Fama & French database. Relative valuation is based on P/B of growth (top 30%) and value stocks (bottom 30%), market cap weighted. This study was recreated from a Research Affiliate white paper entitled Reports of Value's Death May Be Greatly Exaggerated https://www.researchaffiliates.com/en_us/publications/journal-papers/reports-of-values-death-may-be-greatly-exaggerated.html

The gold line shows the relative valuation spread of value vs growth. When the gold line goes down, value becomes cheaper vs growth. The median ratio between "cheap" P/B and "expensive" P/B is 0.22 since 1949, which means that growth stocks were, on average, 5 times as expensive as value stocks. The previous peak in spreads was during the TMT bubble, when growth was 10 times as expensive. After 15 years of multiple expansion for growth and multiple compression for value, the valuation spread is now close to an all-time high, with growth once again trading at 10 times more expensive than value. Also note that the valuation spread has barely narrowed since bottoming during Covid 19 in 2020, which is highlighted by the red circle on the bottom right.

3. <u>Value Recovery in Early Innings</u>: Despite the AI driven growth reversal seen in 2023, GVA believes we are still in the early innings of a multi-year regime change back to value. Looking at complete cycles, the average length of a value rebound lasts 6.6 years, and the average annual relative return (versus index) delivered by the cheapest 30% of the universe is 7.6%. GVA believes that the relative upside for value is significant, given that we are less than three years into the current value recovery, and we are coming off the deepest period of value underperformance in history. The following table summarizes that:

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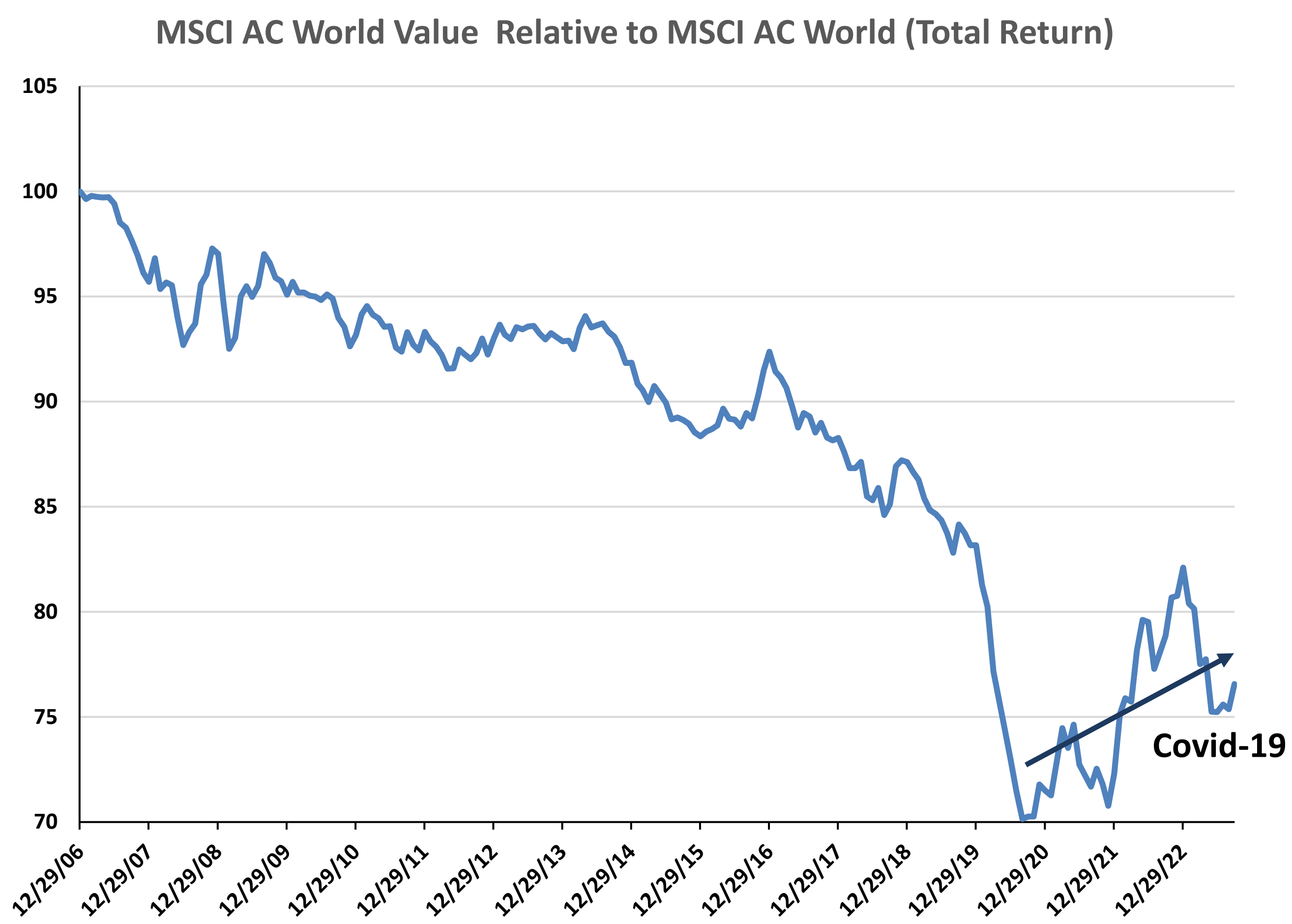
Theme	Value Trough	Next Value Peak	Length of Value Rebound (Years)	Value Annual Relative Return During the Rebound
Nifty Fifty	Jul-72	Jul-79	7.0	9.1%
2nd Oil Shock	Mar-81	Sep-86	5.5	6.6%
Biotech Bubble	Oct-90	May-98	7.6	5.0%
TMT Bubble	Feb-00	May-07	7.2	13.6%
GFC	Feb-09	Jul-14	5.4	3.8%
Average			*6.6*	*7.6%*
Covid 19	Oct-20	?	?	?

Source: GVA Research utilizing the Fama French database, based on PE metric. Dec 1951- Sept 2023. Note that similar results can be seen using the P/B database.

The chart below shows the global underperformance of MSCI ACWI Value vs. ACWI since 2006, as well as the potential turning point for the style in 2020.



Source: Factset. Total returns.

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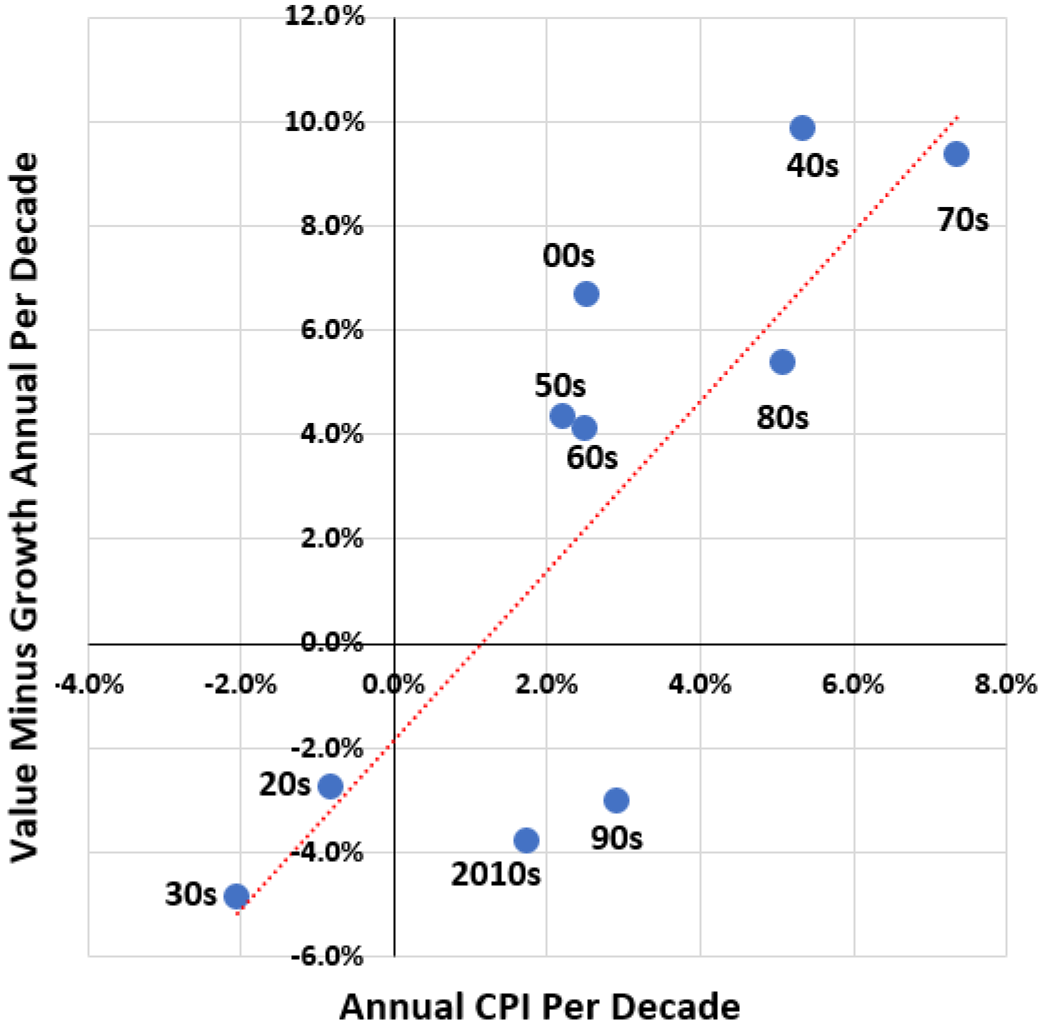
4. The Interest Rate Context Might Provide Tailwinds: Although pinpointing the exact catalyst is always difficult, it appears we have finally ended the unprecedented zero interest rate policy (ZIRP) experienced for the last 15 years. Growth stocks in particular have benefited from ZIRP, as investors' risk appetite rose, and their valuation multiples expanded. It currently appears that we are entering a sustained higher-for-longer period, represented by both interest rates and inflation. A higher-for-longer scenario should prove favorable to value (see GVA Q1 23 commentary[2]). Value investing is often viewed as a hedge against inflation, as value investors focus on current earnings while growth investors value companies based on *future* earnings. During periods of high inflation, money in the *future* becomes less valuable than in the present. Therefore, *future* earnings (growth stocks) become less valuable than present earnings (value stocks). Similarly, in higher interest rate environments, the present value of *future* earnings discounted back at the higher rate become less valuable compared to current earnings.

Historical data shows that value investing strategies perform well, on average, during periods of high inflation. The positive correlation between value and inflation can be seen below, going back 100 years. As inflation rises, value typically outperforms growth by larger amounts.



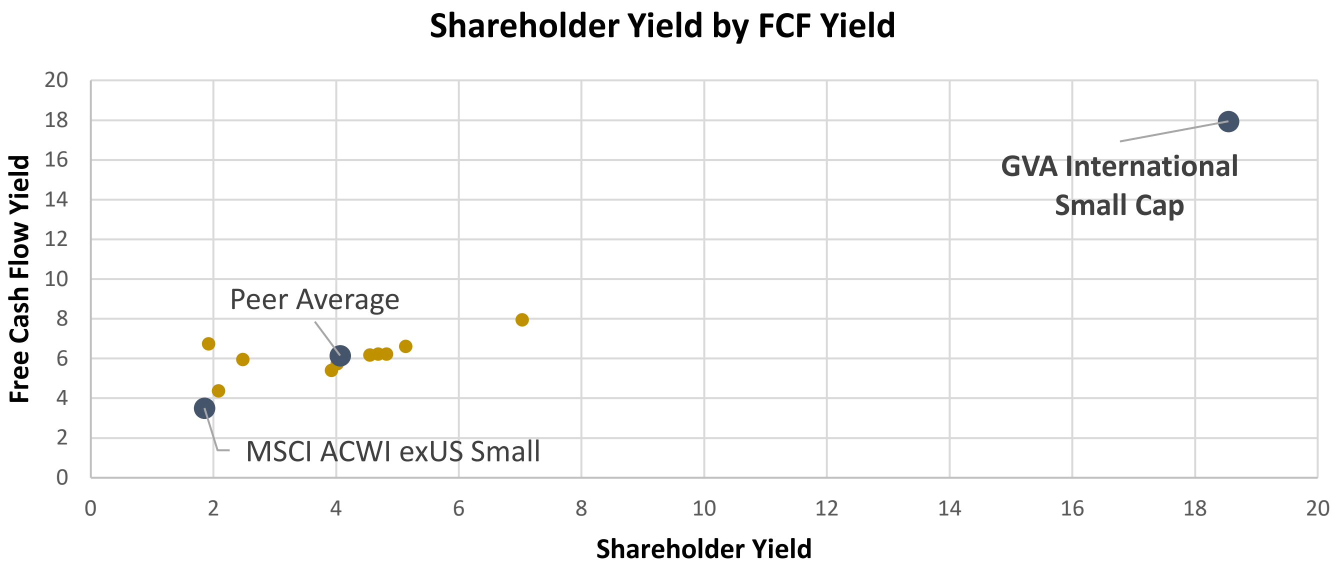
Source: GVA study using CPI and Fama French database.

[2] *Available at https://moodyaldrich.com/gva/strategies/*

GVA is Uniquely Positioned in Its Peer Group

GVA's disciplined process ensures that it remains committed to a clearly defined segment of value and that its strategies will not style drift over time. GVA's research shows that focusing on the Advantaged Subset[3] of value companies, leads to outperforming core and value benchmarks, and traditional value peers historically. GVA's strategies typically outperform during both value and modest growth outperformance markets. GVA expects to underperform during extreme growth led markets, as experienced through much of 2020 and 2023.

GVA stands out among its peers in terms of investing in companies with high free cash flow and Shareholder Yields (dividends + buybacks + debt repayments).



Source: The GVA peer universe ("GVA Universe") displayed is a custom universe created by GVA and reflects data as of September 30, 2023. The GVA Universe is a carve-out of the U.S. mutual fund constituents in the eVestment's International Small Cap Value Equity universe that have holdings information available in Factset. As of September 30, 2023, the GVA Universe captures 83% of the eVestment International Small Cap Value Equity Universe AUM. Aggregate metrics presented are derived from the most recent quarterly reported holdings, ex-financials, for each constituent and analyzed in Factset. Past performance is not indicative of future results

As a reminder, GVA is a pure value manager and only invests in companies in the cheapest 20% valuation. This segment of the universe has been largely ignored by the market, as investors have chased performance in more expensive areas. GVA's study over the last twenty years shows the relative valuation of the cheapest 20% of international small cap stocks vs the market is now in the 8th percentile of its history (yellow line below). Similarly, GVA's International Small Cap model currently ranks in the 1st percentile, meaning it has never been cheaper vs. the market (blue line). GVA's peers are positioned in the "shallow" value segment which we define as the next cheapest 30% of the value universe. Shallow value currently ranks in the 87th percentile of relative valuation vs the market, as this has become a crowded trade.

[3]Advantaged Subset = companies with positive free cash flow and positive shareholder yields. Contact GVA for studies.

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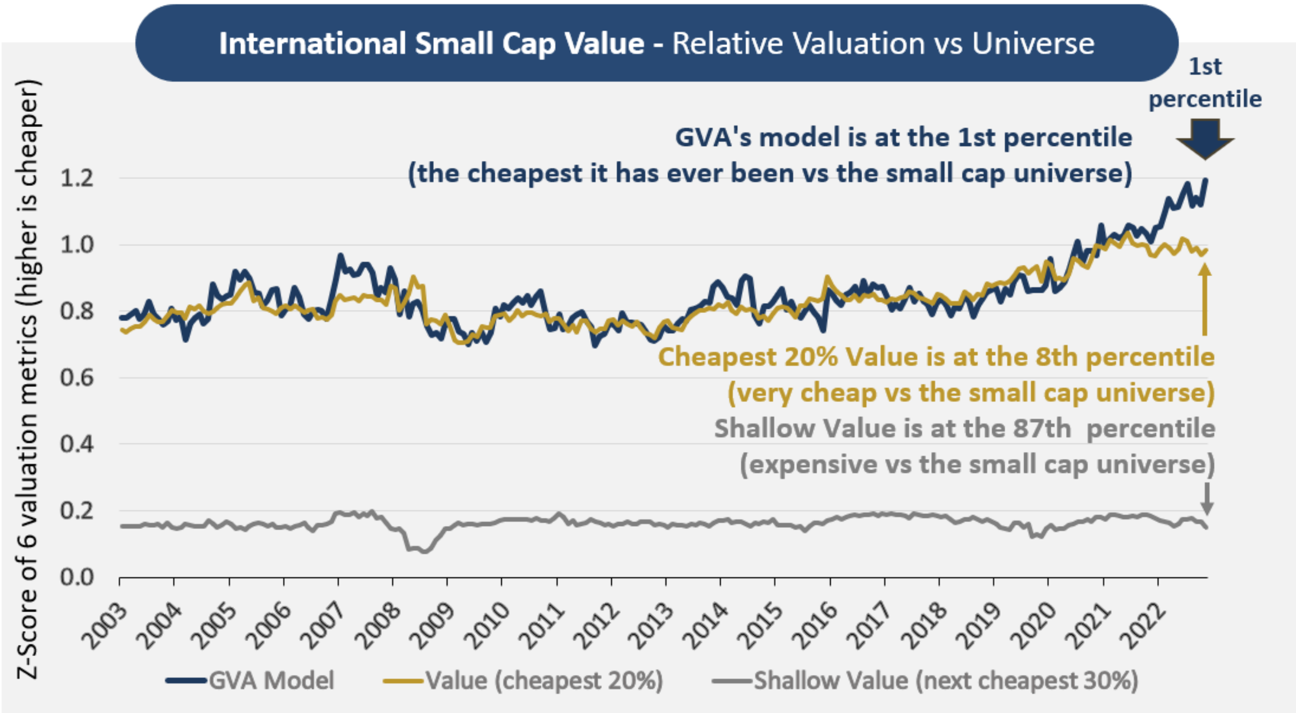

Source : FactSet – Index is MSCI All Country World ex-United States Small Cap Index. Value factor is calculated as the average z-score of six individual valuation metrices (Book to Price, Dividend Yield, Earnings Yield, Free Cash Flow Yield, Forward Earnings Yield, Gross Profit to Market Cap. An Index cannot be invested in directly.

GVA's universe has never been cheaper, but it is important to note that the value names we own have rarely seen these levels of profitability and balance sheet strength; the following table summarizes this:

	Relative Valuation vs. Market Q2 2023	P/E 2023	Dividend Yield	Net Debt to Equity	ROE	FCF Yield	Compounded Annual Return	Information Ratio vs. Standard Index
	Percentile	Jun-23	Jun-23	Jun-23	Jun-23	Jun-23	Last 20 Years	Last 20 Years
MSCI ACWI Ex USA SMALL Index		12.8	3.0	58.6	11.5	3.5	6.3%	
MSCI ACWI Ex USA SMALL Value Index		9.9	4.2	80.7	9.2	5.4	6.5%	
Shallow Value (next 30% cheap)	87%	11.4	3.7	76.6	11.3	5.9	6.9%	0.21
Cheapest 20%	8%	6.5	6.3	75.7	14.5	11.9	10.5%	0.68
GVA - Advantaged Value (quality stocks w/in cheapest 20%)	**1%**	**7.3**	**8.0**	**5.8**	**17.5**	**18.8**	**11.3%**	**0.99**

**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%.*

Outlook

GVA's Advantaged Subset[3] has outperformed over time and GVA's process has delivered alpha in both value and modest growth markets. Extreme growth markets have been a headwind to performance in both 2020 and 2023. GVA remains optimistic, as our strategies are uniquely positioned vs its value peers and do not allow for style drift. GVA believes the markets are at an attractive point in the cycle for value investors.

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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

Disclosures

*The GVA Study utilizes the FactSet database to analyze its investable universe and break it down into key investment statistics and associated hypothetical results.

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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.