GLOBAL VALUE ADVISORS
A Division of Moody Aldrich Partners

International Small Cap

Fourth Quarter 2023

COMMENTARY

Convergence of Small Caps, International & Value: A Once-in-a-Generation Opportunity

Total Returns (Net of Fees) +	Q4
GVA International Small Cap	**9.8%**
MSCI All Country World ex-USA Small Cap Index*	10.1%
MSCI All Country World ex-USA Small Cap Value Index	10.0%
MSCI All Country World ex-USA Small Cap Growth Index	10.2%

Regional Indices	Q4
MSCI Japan Small Cap	7.5%
MSCI United Kingdom Small Cap	13.3%
MSCI Emerging Markets Small Cap	9.0%
MSCI Europe ex UK Small Cap	15.0%
MSCI Pacific ex Japan Small Cap	9.6%

	GVA International Small Cap Net Return	MSCI ACWI ex-USA Small Cap Net Return*
1 Year	21.3%	15.7%
3 Years**	6.1%	1.5%
5 Years**	7.5%	7.9%
Since Inception**	3.1%	3.3%

*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%).

Market performance in 2023 saw a complete reversal of key trends witnessed the preceding year. Following a dismal 2022, global equity markets staged a robust rally throughout the year, particularly in the fourth quarter. The previous year's losers became this year's winners. The end-of-year rally was driven by the Fed's pivot in December, with a statement that interest rate cuts are "beginning to come into view" on the back of lower CPI readouts. This dovish stance surprised market participants, given the continued strength in economic growth and the Fed's concerns over a tight labor market, both of which are typically inflationary. Overall, the MSCI All Country World Index (MSCI ACWI) rose by 11.0% in the quarter and 22.2% for the year 2023.

In 2023, major long-term market trends resumed their course. US markets outperformed international in both the full year and fourth quarter. Similarly, global growth significantly outperformed value in both the full year and the fourth quarter. Large cap stocks outperformed small caps for the year but saw a reversal in the fourth quarter. GVA anticipates that some or all of these trends to reverse in the medium-term and its strategies are positioned to benefit accordingly.

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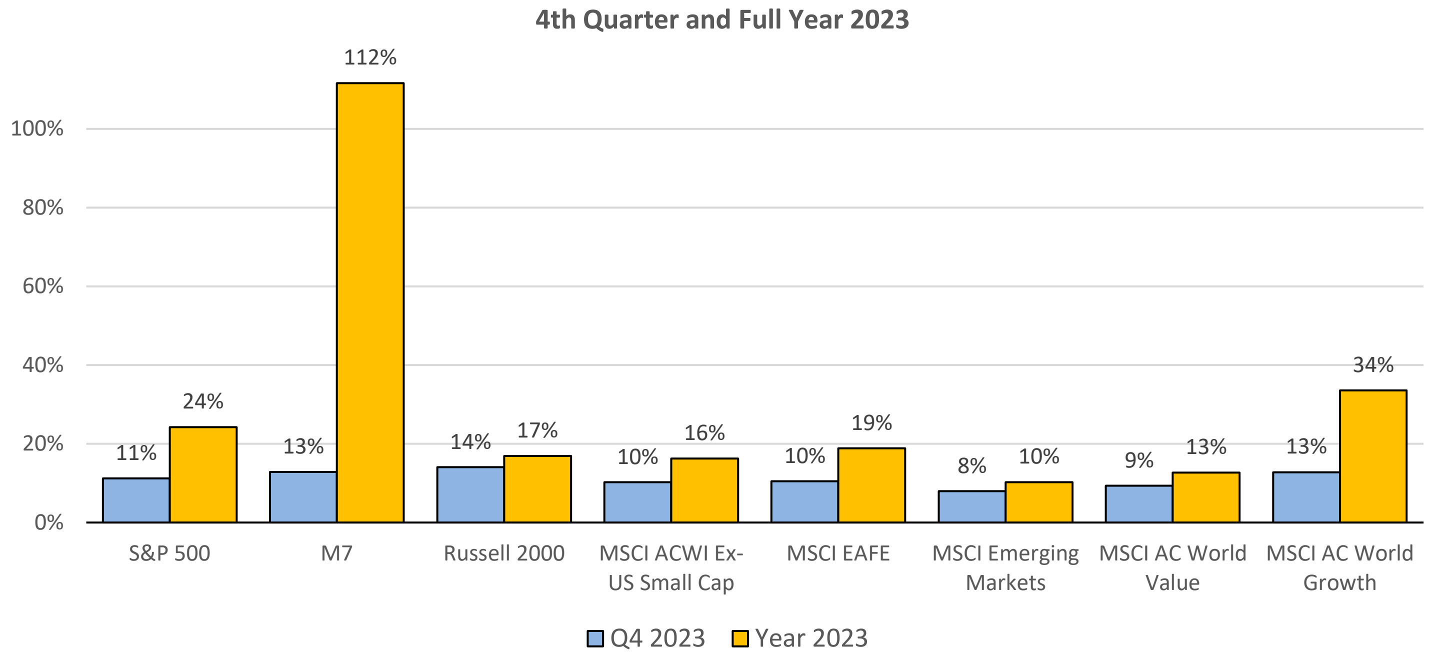

Source: Factset. M7 = "Magnificent Seven" stocks – Apple (AAPL), Microsoft (MSFT), Alphabet (GOOGL), Amazon (AMZN), Nvidia (NVDA), Tesla (TSLA) and Meta Platforms (META)

The "Magnificent Seven (M7)" were the standout contributors to market performance, rising 13% in the quarter and a whopping 112% for the full year. The M7 currently account for almost 30% of the S&P 500's market cap, despite representing a much smaller percent of earnings. The trailing PE multiples of these seven megacaps traded at over 50x at year end, more than twice the S&P 500 at 23x and three times the MSCI ACWI at 18x. The forward PE of the M7 also looks stretched at over 35x vs the S&P 500 at 20x and MSCI ACWI at 17x. Over time, GVA expects this divergence to normalize through lower prices. Companies of this size and valuation usually end up crumbling under their own weight.

Data as of 11/30/2023 Source: LSEG Datastream, Schroders

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Market sentiment swung wildly throughout the year. 2023 started with Bloomberg economic model projections looking for a 100% chance of recession occurring in the next twelve months and ended without one occurring. Animal spirits returned as the year progressed with a renewed belief in the likelihood of achieving a “soft landing” scenario.

The Federal Reserve is now signaling three rate cuts in 2024, which would mark the end of the high interest rate cycle. Consequently, the 10-year treasury yield closed the year at 3.9% following a peak at 5.0% in the previous quarter. In the last 18 months, the Fed’s rate hiking campaign has successfully brought headline CPI down from 9.1% to 3.4%. The Fed’s preferred inflation measure, core Personal Consumption Expenditures Price Index (PCE), also fell back to a reasonable 3.2% at year-end (still above the 2% target). These achievements were made amidst an unemployment rate below 4%, robust consumer spending, and 3.3% GDP growth in the fourth quarter.

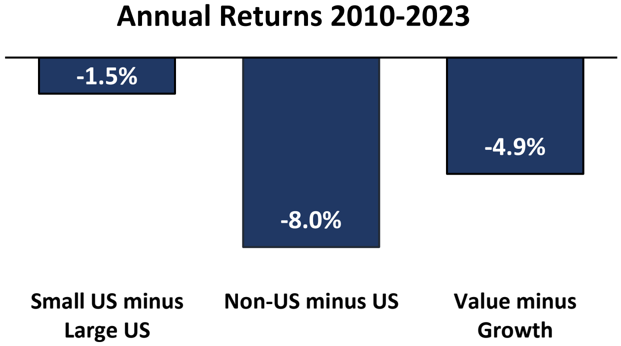
Across the pond, the Eurozone avoided a widely expected recession as GDP growth stabilized in the 4th quarter. The ECB is expected to follow the Fed’s lead with multiple rate cuts in 2024, pending data. Japan remains a unique holdout on monetary policy, with negative overnight lending rates still in place. China underwhelmed the markets again in 2023, despite rolling out multiple stimulative initiatives that failed to impress the market.

As a reminder, GVA focuses exclusively on companies that generate strong free cash flows and return unused capital to shareholders. Companies in this “Advantaged Subset” of the market outperform across various market scenarios and do no rely on any specific economic outcomes. Moreover, GVA’s emphasis on investing in companies with strong balance sheets should provide downside protection, in the event of a deeper than expected recession. Lastly, GVA only invests in the cheapest 20% of stocks globally, a segment that has been overlooked by the market and industry peers, but one poised for performance as investors broaden their equity exposure.

GVA is highly confident that the era of growth’s prolonged outperformance over value is nearing its end. The current stretched relative valuation metrics between the two categories present significant buying opportunities for value. As history suggests, when valuation multiples reach similar extremes observed today, subsequent decades often witness robust relative performance, a scenario for which GVA’s strategies are uniquely positioned.

Small + International + Value
A Once in a Generation Investment Opportunity

Small caps, International and Value have been some of the most unloved segments of the equity markets since the Great Financial Crisis. The following chart summarizes their annual relative returns since December 2009:



Returns above are index returns. Indexes represented are the MSCI AC World, ex US, USA Small Cap, USA Value, USA Growth, USA, & USA Large Cap

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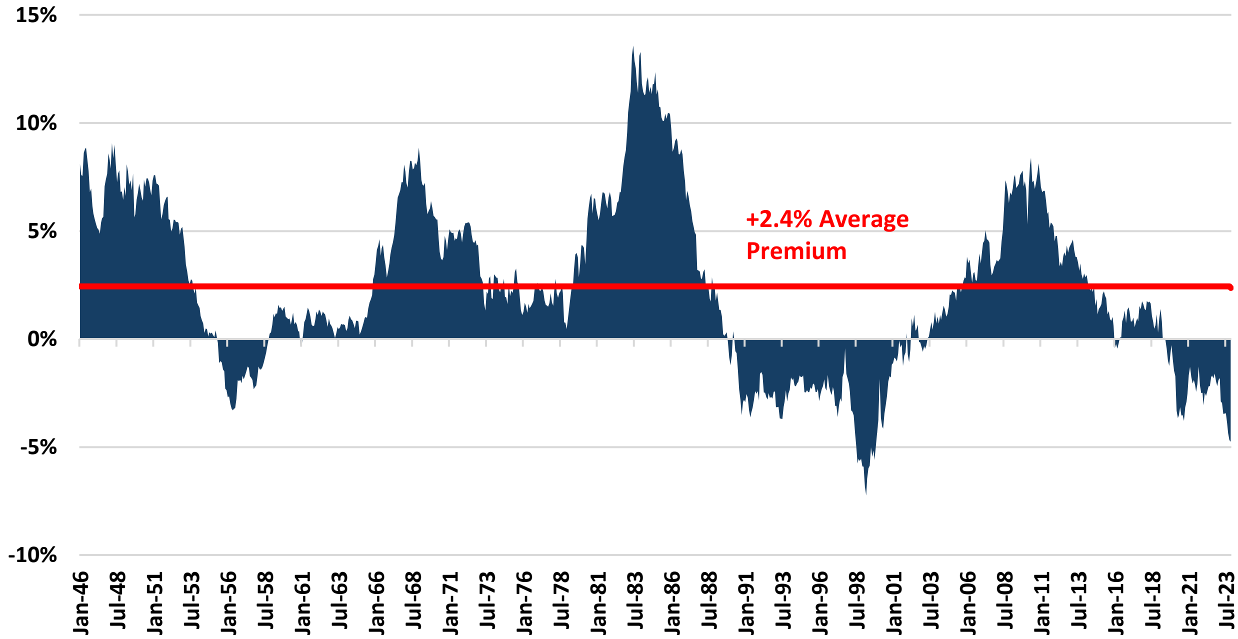
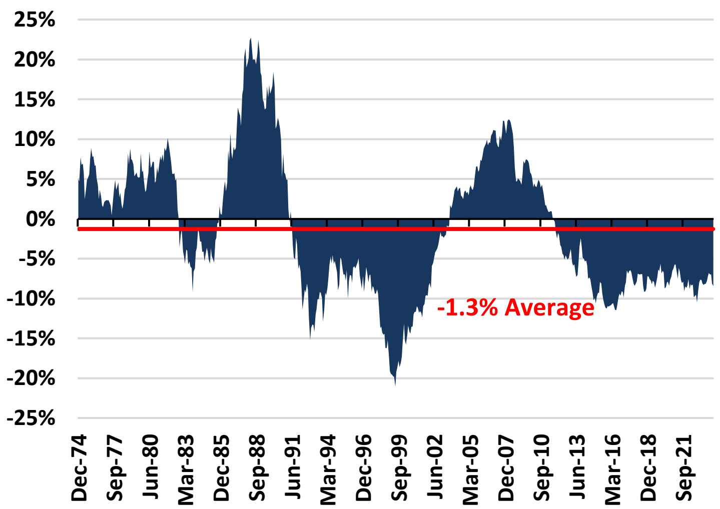
Similar periods of underperformance can be observed throughout history, but they are rare. Typically, these three categories have shown strong performance over the long term. This is particularly true for Value and Small which highlights what academics refer to as the Value and Small premia. Although the International category underperforms the US slightly over the long term, swings in relative performance tends to occur in extended waves of outperformance and underperformance. It is likely we are now at the tail end of what is the longest and deepest period of International underperforming US in over 50 years.

Small US minus Large US
Trailing 10-Year Annual Return



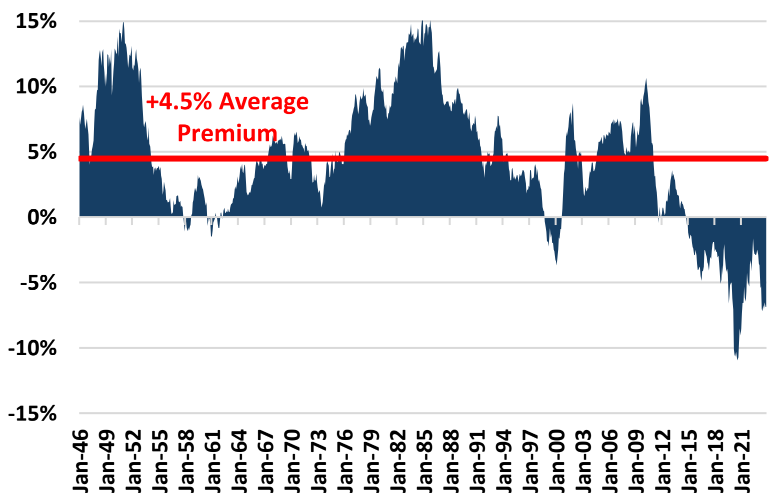
Source: Fama and French – GVA Study

Non-US minus US
Trailing 5-Year Annual Return



Source: MSCI, Factset – GVA Study

US Value minus US Growth
Trailing 10-Year Annual Return



Source: Fama and French – GVA Study

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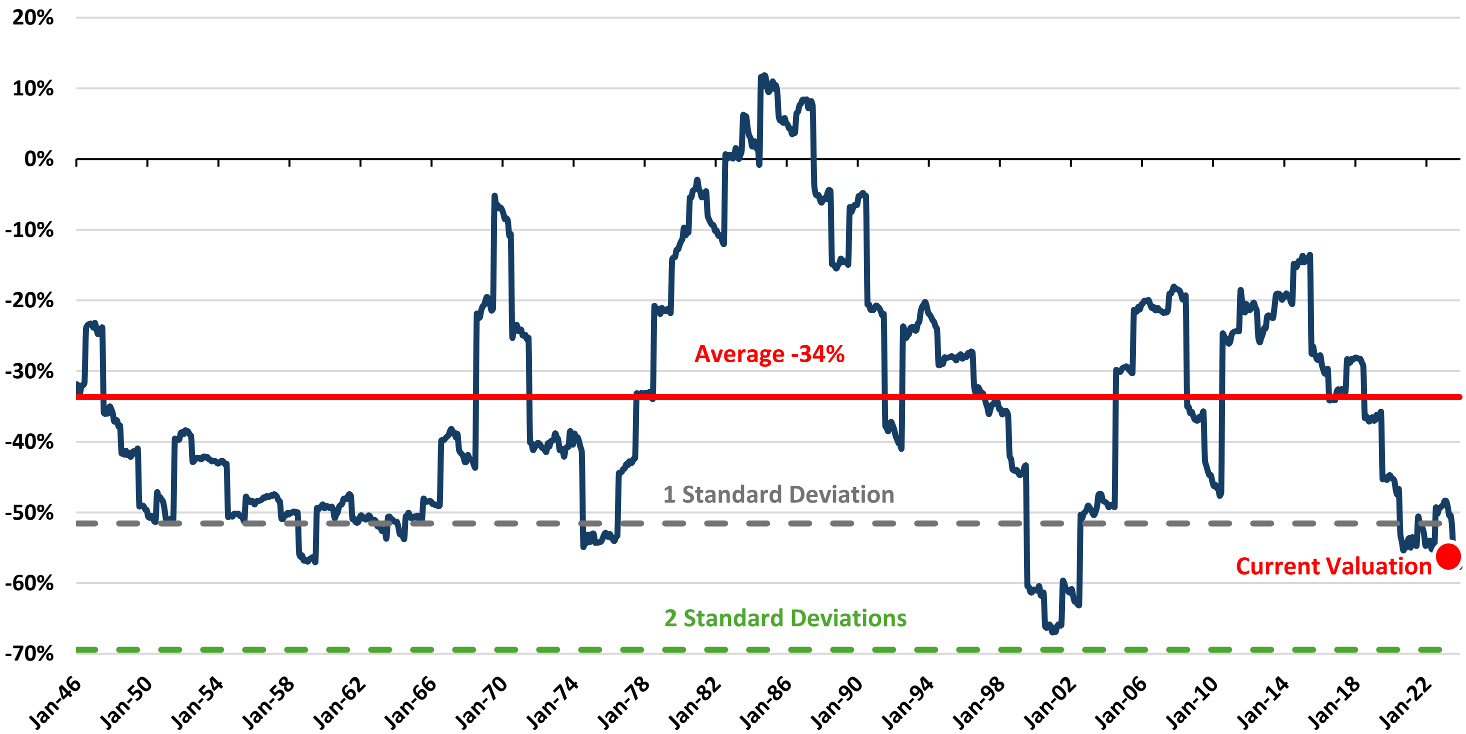
These graphs show that the underperformance following the GFC is both the most severe and prolonged among all observed periods. It's noteworthy that the cycle lows of these categories align for the first time in the studies period. Importantly, each drawdown has been followed by a sustained recovery phase.

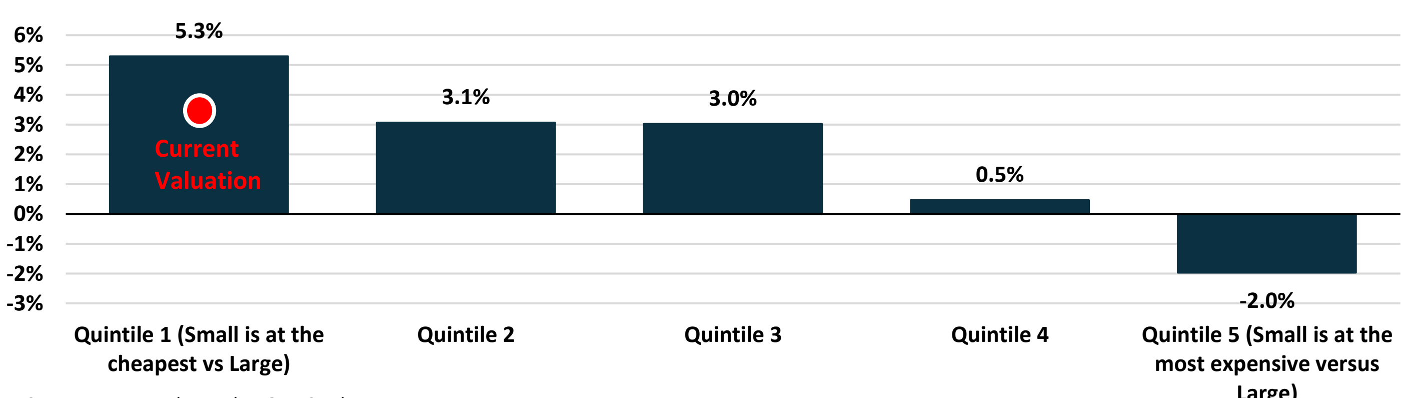
Valuation

These three asset classes trade on extremely compelling valuation multiples when looking at historical series:

US Small vs US Large
Relative Valuation 1946-2023



US Small vs US Large Valuation
Next 10-Year Annual Relative Return



Source: Fama and French – GVA Study

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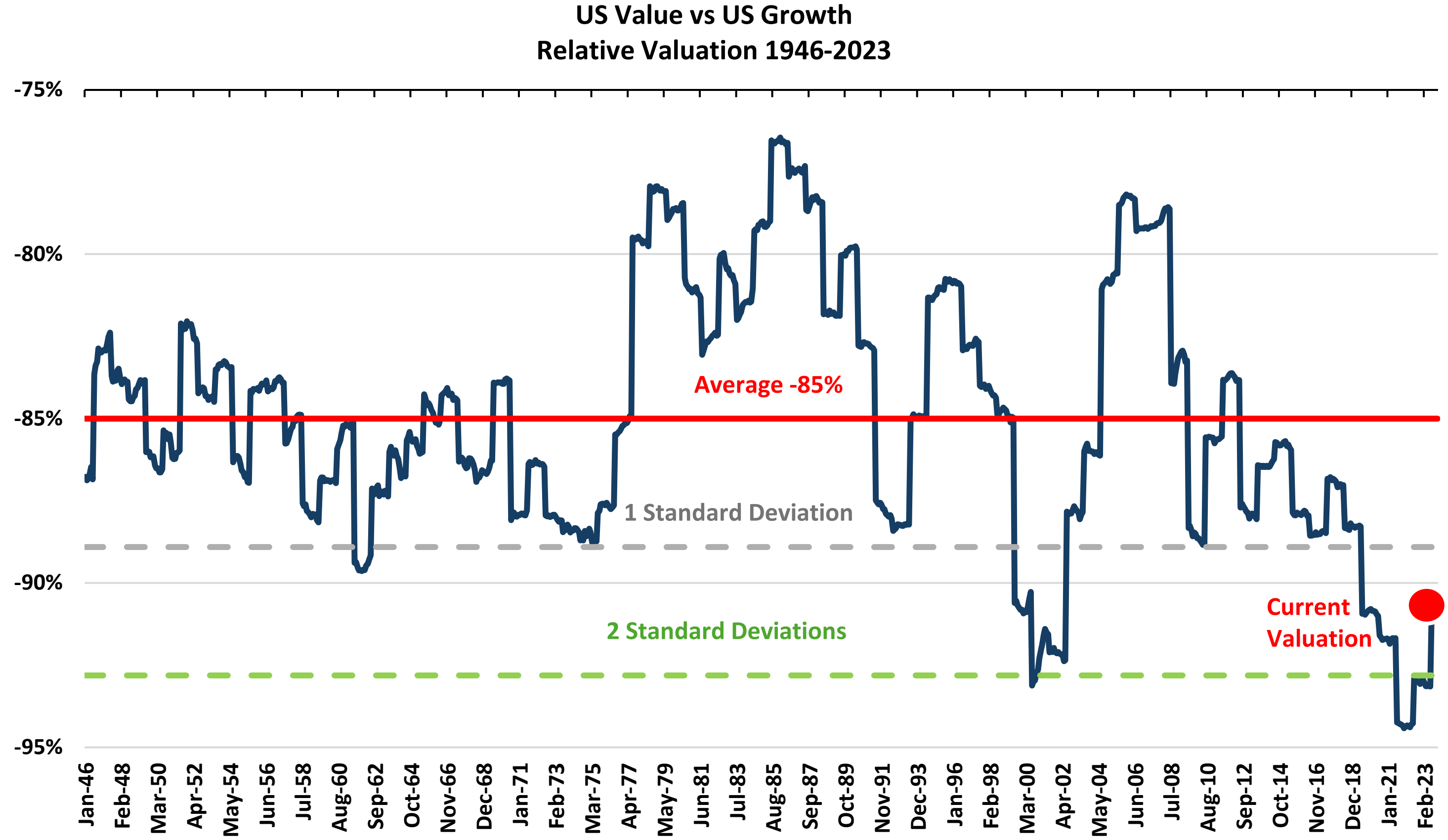
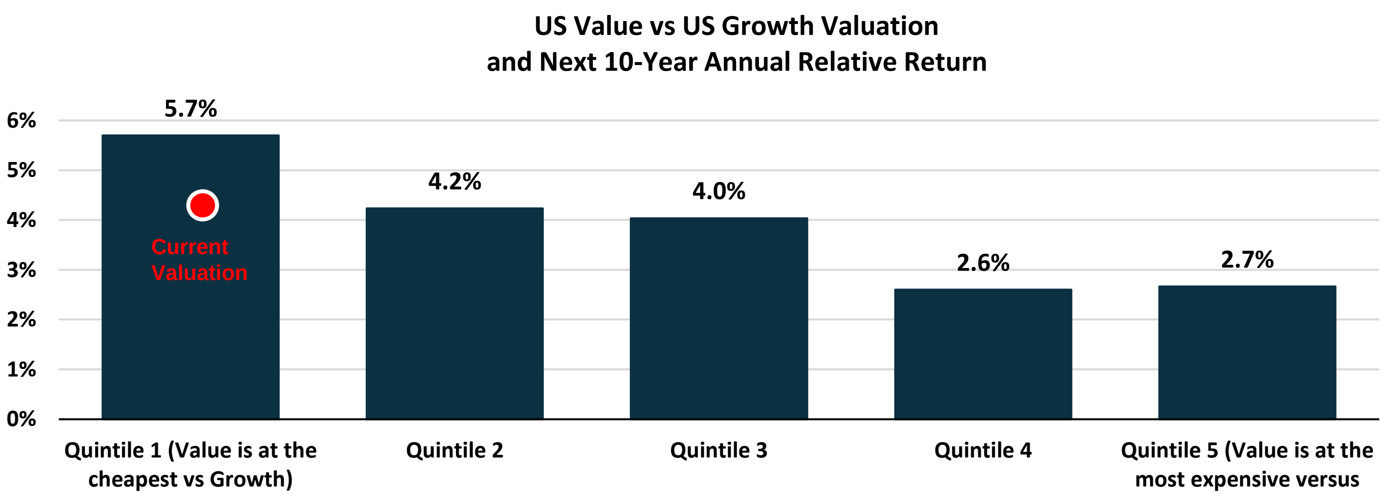
US Small currently trades on 1.7 times its book value, when US Large trades on 4.0 times book. This represents a 58% discount which ranks as the 4th percentile over the past 77 years of study. Historically when Small has been that cheap, they have outperformed Large stocks by 5.3% annually in the following 10 years.

Value





Source: Fama and French – GVA Study

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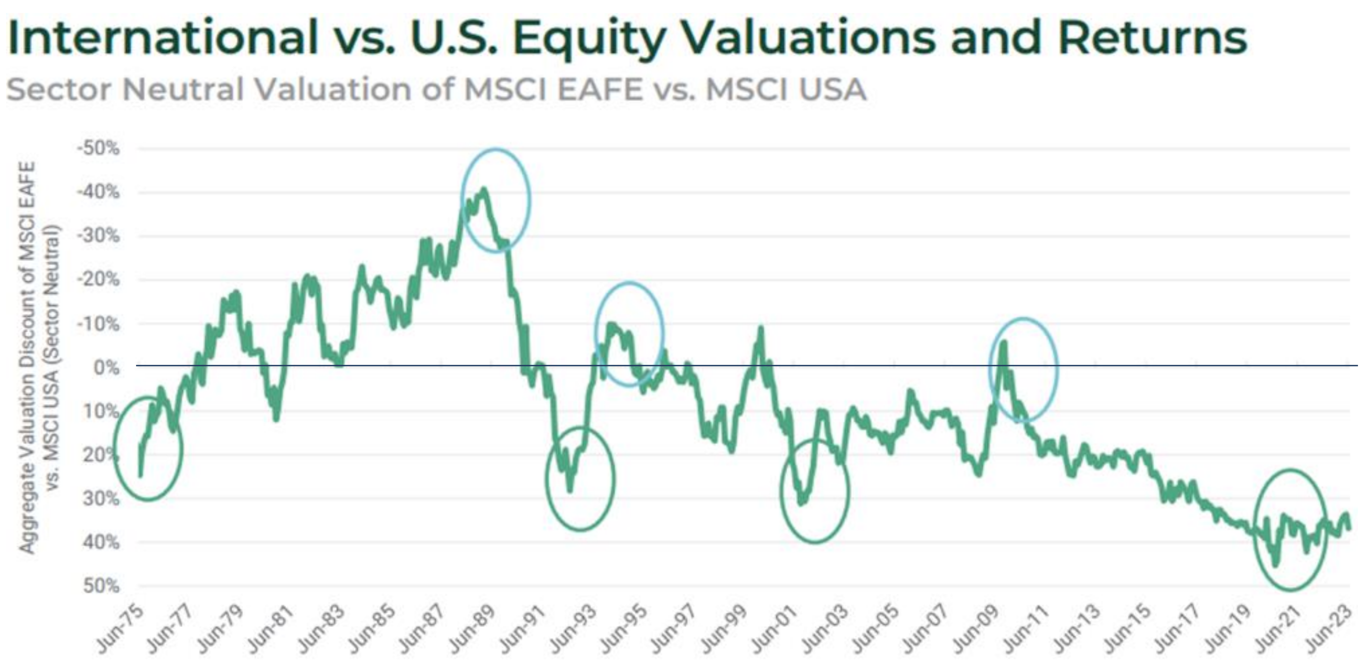
US value trades currently on 0.86 times its book value, when US growth trades on 9.5 times book. This represents a 91% discount which ranks as the 7th percentile over the past 77 years of study. Historically, whenever Value stocks have been that cheap, they have outperformed Growth stocks by 5.7% annually in the following 10 years.

International



Source: Brandes (https://www.brandes.com/docs/default-source/links/chart-of-the-week/international-vs-us-equity-valuations-and-returns-06302023.pdf?sfvrsn=19473593_29)

International has underperformed the US massively since 2008, as shown above. It currently stands at a 40% valuation discount versus the US market. It’s noteworthy that 35 years ago, the MSCI EAFE index traded at a 40% premium to the US, coinciding with the peak of the Japanese speculative bubble.

Small cap, International, and Value have registered their worst drawdowns, and the severity of the correction is such that their relative valuations have reached extraordinary levels. History shows that these events constitute major investment opportunities. Here is how GVA is taking advantage of them.

Confluence of Three Cyclical Lows

At the intersection of these three asset classes, International Small Value presents all the attributes covered above: one of the highest return categories over the long term, it has delivered one of the lowest performance since 2010; it now trades at the steepest discount to the MSCI USA Index, corresponding to a 2 standard deviation event, when analyzing the past 20 years of monthly data:

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Annual Returns

	MSCI ACWI ex-US Small Value	MSCI USA
Since Dec 2000	9.3%	7.8%
Since Dec 2010	5.4%	12.9%

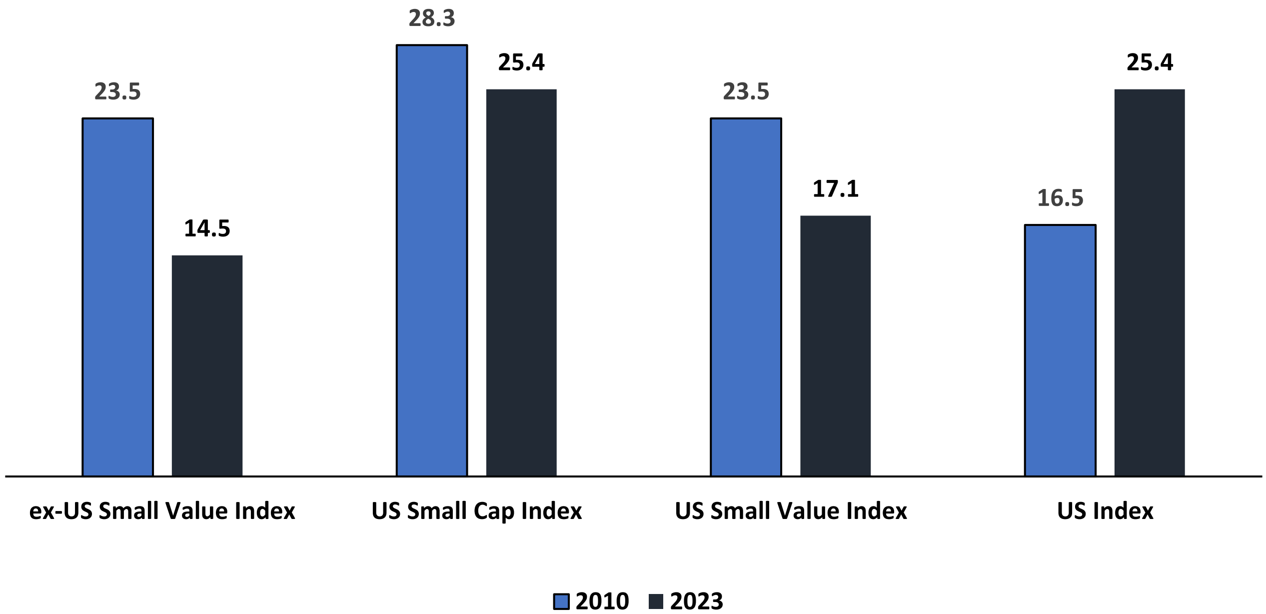
FCF Yield

	MSCI ACWI ex-US Small Value	MSCI USA
Avg. Since 2001	4.1%	5.1%
Current	5.8%	3.9%

Source: MSCI, Factset – GVA Study

Since the GFC, the MSCI USA Index has delivered +12.9% annual while International Small Value has returned +5.4%. +4.6% of the MSCI USA Index return is explained by multiple expansion while International Small Value experienced an annual multiple compression of -3.5%.

Price to Earnings



Source: MSCI, Factset – GVA Study

While International Small Value has maintained growth and profitability consistent with its historical trends in the past 14 years, it has lagged behind the US equity market in these 2 aspects: this topic has been well covered and relies predominantly on the extraordinary performance of a handful of companies known as the Magnificent 7. US Small Value has maintained its profitability thanks to a staggering increase of its leverage.

Leverage is one area where International Small Value distinguishes itself positively from the US equity market in general, and from the US Small category in particular.

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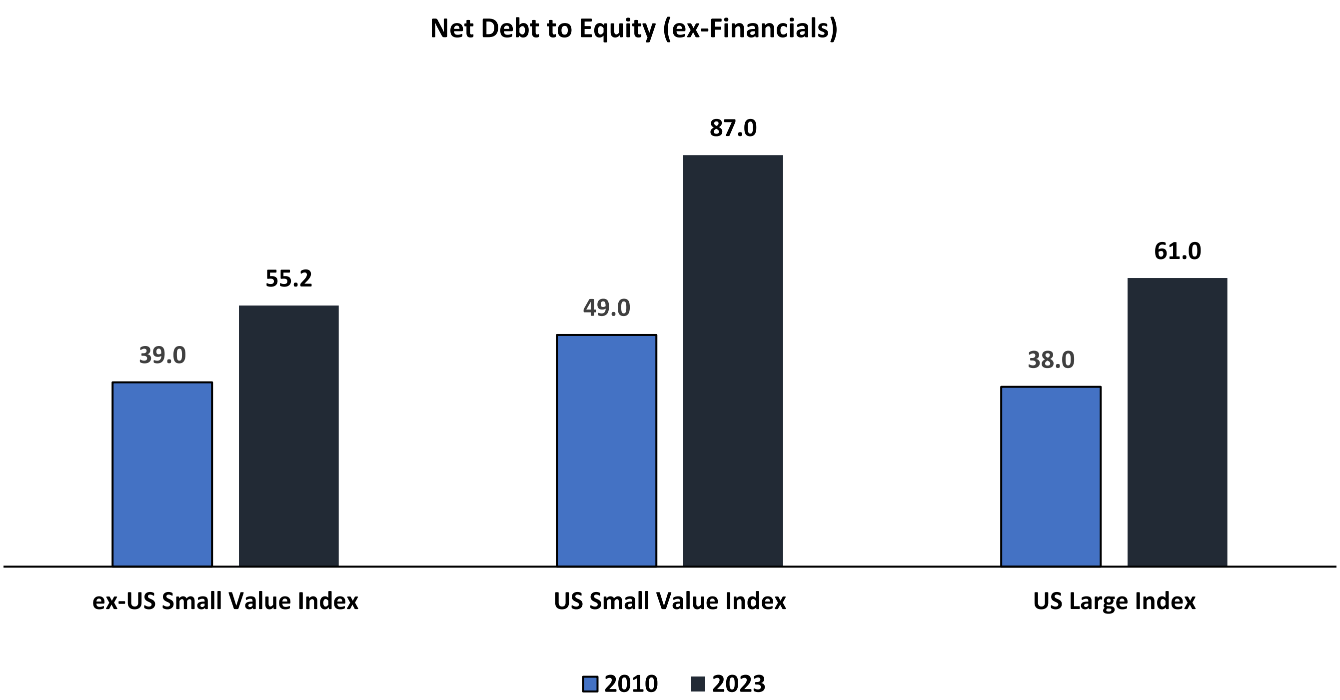
The graph below demonstrates the apparent lack of financial discipline among US Small companies:



Source: MSCI, Factset – GVA Study

This phenomenon is closely tied to the prolonged period of ultra-low interest rates symptomatic of the post GFC era as discussed in our Q3 2023 letter. In addition to a significant valuation differential, that element of risk underscores International Small Value as the category of choice for investors seeking diversification away from US large caps.

International Small remains a complex universe to navigate due to its higher volatility, lower profitability, lower liquidity and lack of coverage. However, GVA's differentiated approach identifies superior businesses with sustainable free cash flow generation and strong return to the shareholder and attractive valuations while maintaining strong profitability and a pristine balance sheets.

GVA's process focuses exclusively on companies that meet our four cornerstone investment criteria:

1) High and sustainable Free Cash Flows
2) High and sustainable Shareholder Yields (dividends + buybacks + debt repayments)
3) Strong balance sheets
4) Cheapest 20% valuation

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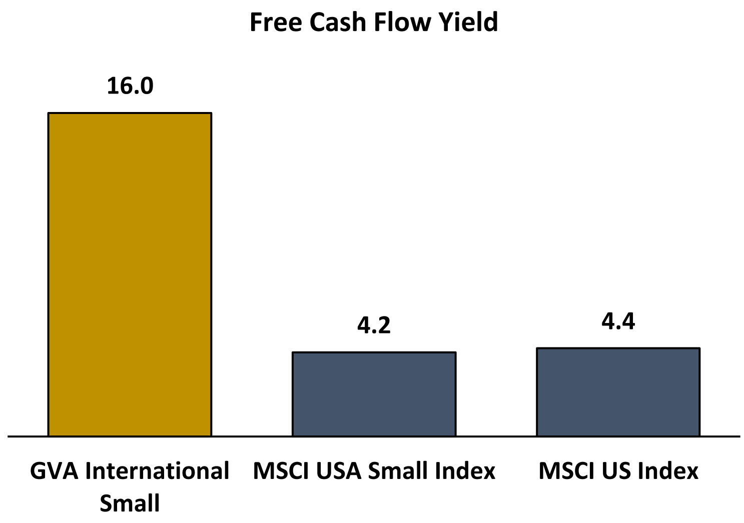
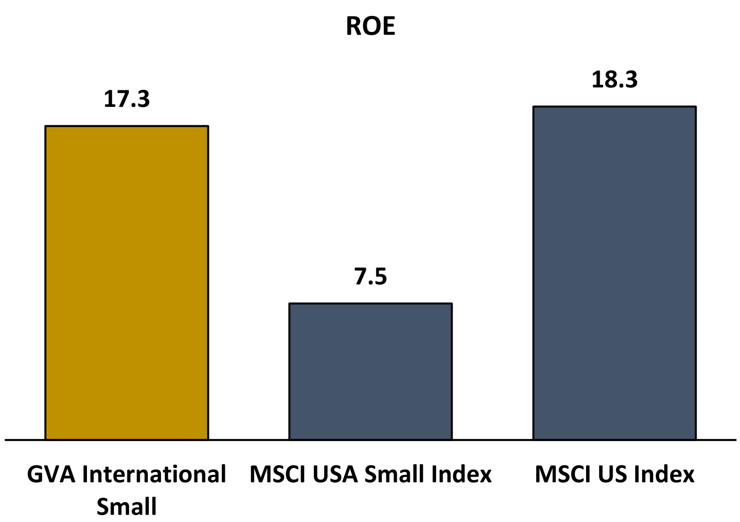
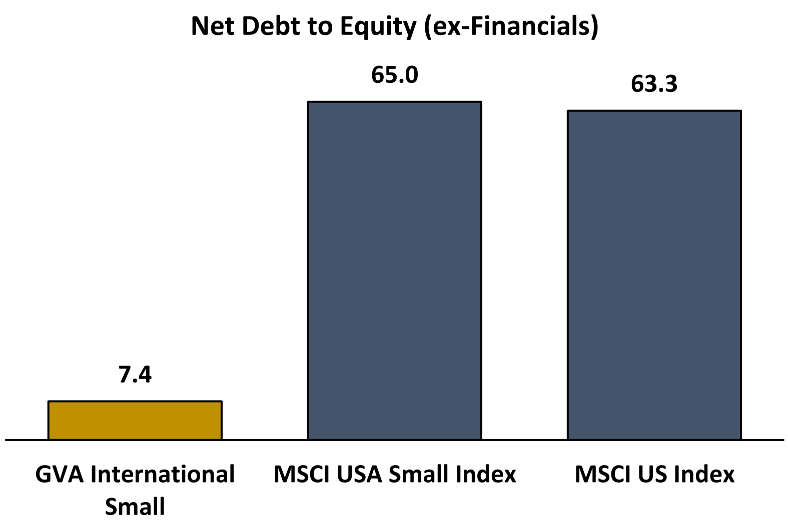
GVA's International Small strategy presents the following attributes, as of Dec 31, 2023:







Source: Factset – GVA Study

It is remarkable that GVA's portfolio trades at the cheapest relative valuation multiple and at the highest relative quality when measured against the US equity market over the past 20 years: GVA's strategies own deep value names without paying up for quality attributes. For more information on how GVA's strategies have never been cheaper please see our Q3 2023 letter.

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Conclusion

Over the past 14 years, markets have produced three unusually long trends: Small Cap stocks have underperformed Large Cap stocks, Value had underperformed Growth, and International had underperformed the US. Typically, these three categories deliver strong returns over the long-term and historical evidence suggests that periods of stretched relative valuation ratios offer the best buying opportunities.

Examining the convergence of these three “mega-trends,” GVA can hone in on international small value stocks to get exposure to a high octane bet on the reversal of some or all of these asset classes. Broadly speaking, GVA’s “go anywhere” approach allows for flexibility to pick stocks around the globe and across the market cap spectrum. By scrutinizing the valuation and performance anomalies within small cap, value, and international stocks, GVA has identified a select group of companies with compelling attributes that has been largely ignored by the market: they generate strong free cash flows, return the unused cash to their shareholders, deliver above average profitability and have limited debt on their balance sheets. Most importantly, they trade on a 50% discount or more to the market.

GVA strategically engages in contrarian investments across all three major trends observed over the past decade, a stance that permeates all its strategies. History suggests that these trends are likely to reverse over the medium to long-term, creating a strong tailwind to GVA's performance.

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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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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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.