Quarter 2, 2022

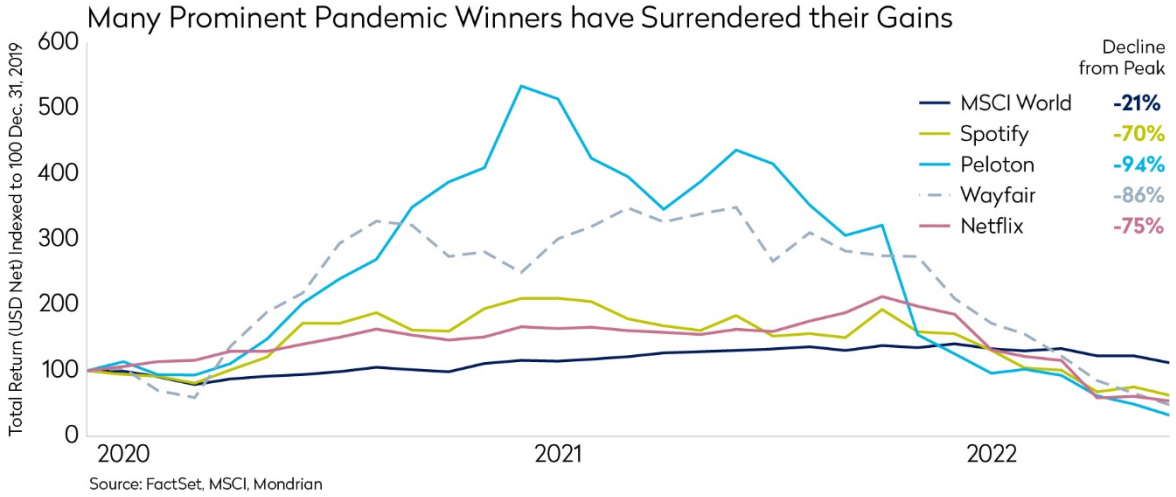
Mondrian INVESTMENT PARTNERS

International Equity Investment Outlook

Value Investing Rebounds

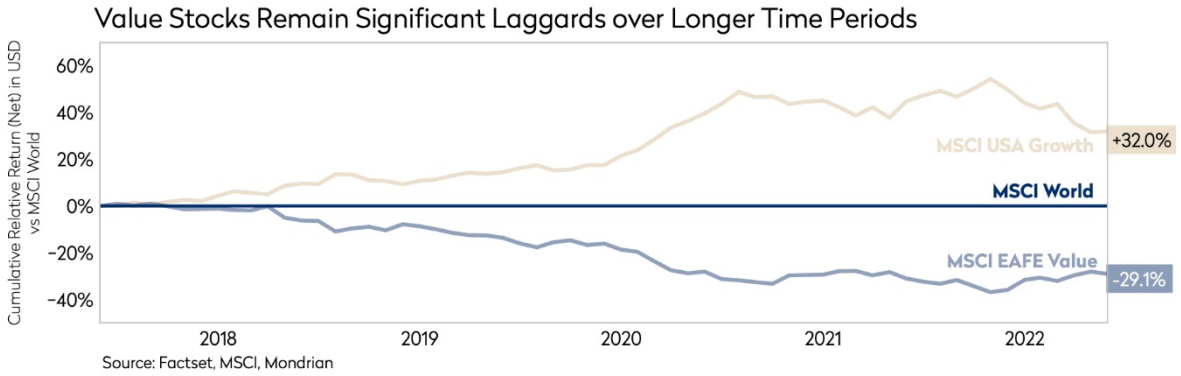
The past six months have seen some spectacular collapses in once high-profile stocks. While the year's weakness had initially been concentrated among the most speculative assets – including meme stocks, cryptocurrencies and special purpose acquisition companies – this sell-off became more broad-based in the second quarter, driven by rising bond yields, a gloomy market outlook and an increasingly aggressive Fed. Shares that had rallied strongly at the height of the pandemic have been knocked from their peaks by war, inflation and the threat of recession.

Earlier this year, we discussed how several pandemic narratives had resulted in significant multiple expansion in "growth" segments of the market. Over the pandemic, investors had built on the "low-interest-rate-growth market" that developed post the financial crisis, focusing even more narrowly on those areas of the economy that they perceived to be pandemic winners. Multiples and share prices expanded for these companies. Markets seemed complacent, we wrote, as investors attached a high probability to the best-case scenario in some segments of the market. Investor exuberance had led to mispricing. In 2022, as the Fed started to tighten, the powerful rally in equities came to an end, and investor confidence in growth stocks has been eroded away. Many of these pandemic "winners" rapidly became losers, as discount rates rose and (in certain cases) COVID-related earnings were shown to be unsustainable. Several companies have entirely ceded earlier gains.

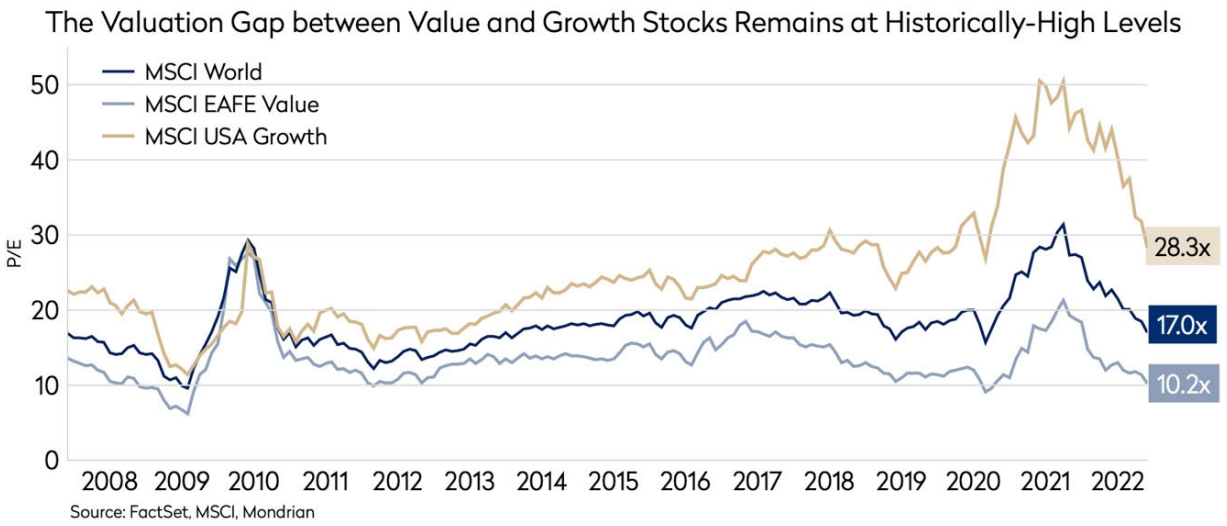


Despite the recovery in Value, the extreme Value/Growth bifurcation has only returned to pre-pandemic levels

The chart below illustrates the bifurcation in returns which has characterized equity markets in recent years. Although the Value style has staged a mini-comeback this calendar year, thus far, markets have only reversed the outperformance of the Growth style since the beginning of the pandemic. Over 5- or 10-years, the Value style remains a very significant laggard.



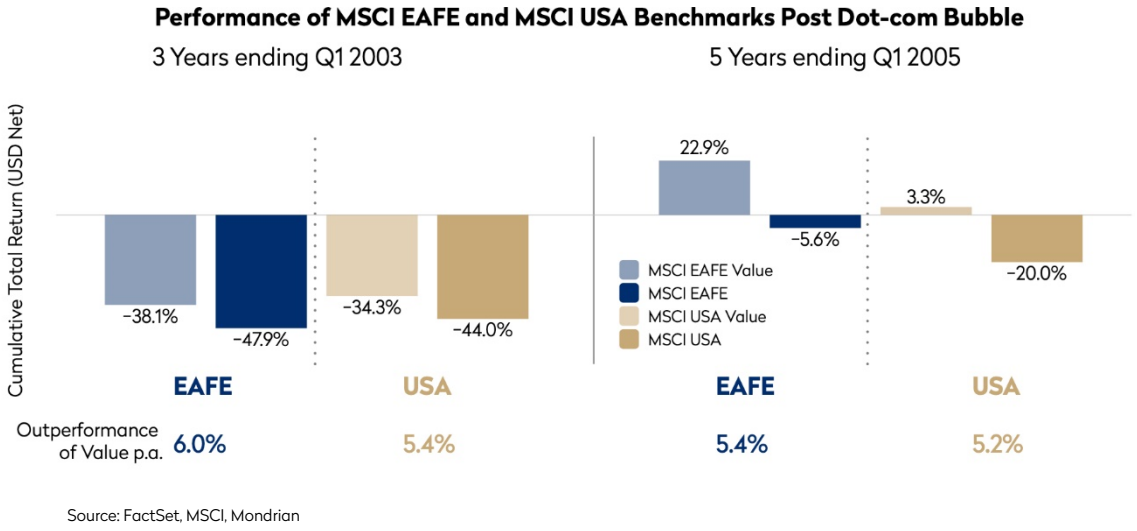
This dispersion in the returns is reflected in a valuation gap which remains at historically extreme levels. Notwithstanding the myriad of risks that currently hang over markets and economies, and which inevitably widen the range of outcomes for many companies, international value stocks trade at very compressed earnings multiples in absolute terms. The following chart shows a 15-year history of price-to-earnings ratios.



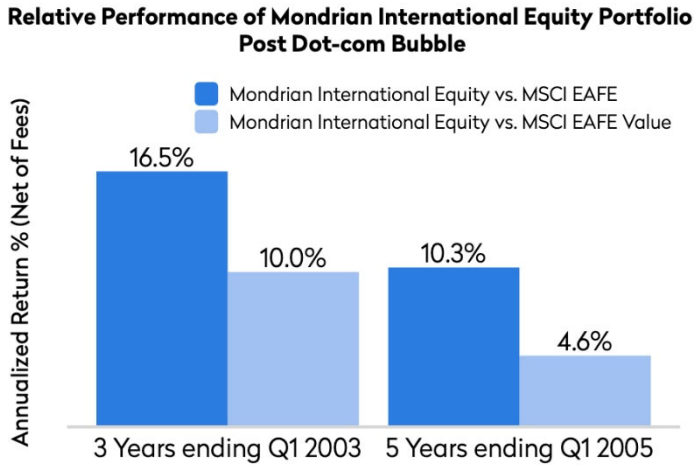
Historically, the deflation of extreme valuations has taken several years

It can take time for markets to resolve issues of overvaluation. The unwinding of the TMT boom in the late 1990s and early 2000s is a case in point: as the technology, media and telecom bubble deflated, Value enjoyed an extended period of outperformance, with the EAFE Value benchmark outperforming the broader benchmark by 5.4-6.0% p.a. in the subsequent 3 and 5 year periods as investors recovered from the excesses of an overheated market.

While the EAFE Value index provided a strong absolute return of +4.2% p.a. over the 5-year period from March 2000, the broader EAFE and US indices suffered losses: EAFE was down 1.1% p.a. while the US Growth index declined by 9.7% p.a. (!) over the same five year period.



Over these periods, the Mondrian IEQ portfolios achieved significant outperformance against both the broad and value benchmarks.

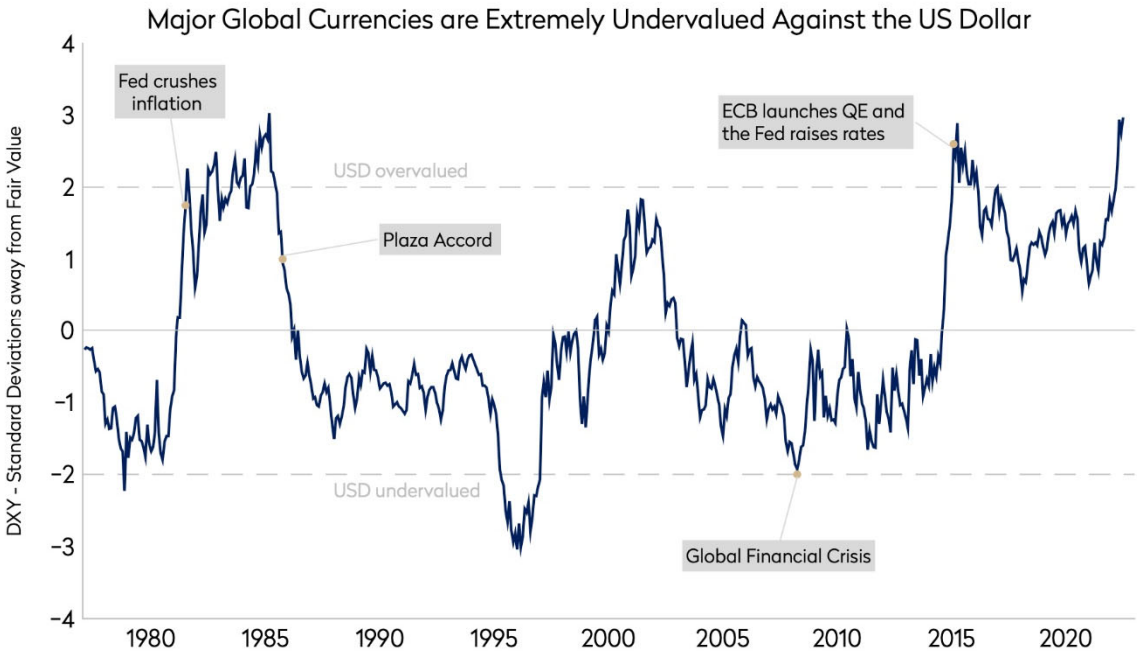


Source: FactSet, MSCI, Mondrian

In a similar vein, in the late 1980s, many investors argued that the stratospheric valuations of the Japanese stock market were justified by fundamentals, citing expectations for the economy's strong future growth and its low discount rate. Alas, the heady growth forecasts embedded in their valuation models never materialized. The Japanese market peaked in the fourth quarter of 1989 and those investors who bought the Japanese market at the end of the 1980s earned nothing for almost thirty years until 2017. Although Mondrian portfolios were underweight Japan during most of this period, we have materially increased our allocation in recent years as we believe the Japanese market now presents many attractive valuation opportunities.

Future real US dollar returns are supported by international currency valuations, which look very undervalued against the USD

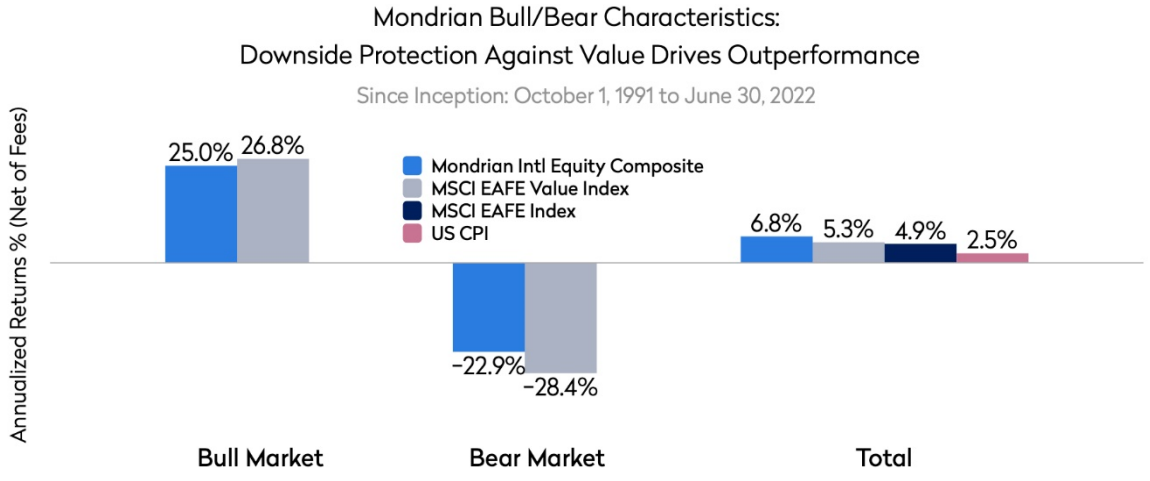
In parallel with recent strength in US equity markets, the US dollar has enjoyed a long period of near-uninterrupted gains. The US dollar has outperformed most major currencies once again this year, as the Fed shifted towards a more hawkish stance. Currency movements are impossible to forecast with confidence over the short-term. At Mondrian, we adopt a Purchasing Power Parity (PPP) approach to focus on the long-term underlying fair value. Our long-run PPP valuations suggest that the major global currencies are currently very undervalued against the US dollar (see below). This holds even relative to other periods when the US Federal Reserve has been raising interest rates.



Source: FactSet, Mondrian

Over the long-term, Mondrian's portfolios have done well against the broad index, the value sub-index, and have achieved strong real (inflation adjusted) returns

Our discipline in adhering to our long-term value philosophy has allowed us to produce attractive long-term real returns, and consistent return characteristics, including downside protection and low absolute risk.



Source: FactSet, MSCI, Mondrian

Historically, it is not unusual for returns from markets or sectors to dominate for a number of years and rotate due to relative valuations, growth and competitive cycles; these cycles may take a long time to unwind. Growth equities provided negative real returns for five years following the bursting of the dot-com bubble while it was possible to achieve positive real returns elsewhere in the market. Mondrian is unusual in the investment industry in that it has stayed true to its philosophy, process and valuation framework across market cycles since its inception as a firm in 1990. We are valuation driven, but we are not wedded to the old economy, or to legacy market leaders. The disruptive integration of the internet, automation, social media and artificial intelligence is transforming business models and reinventing industries. As underlying fundamentals evolve, we incorporate these changes into our long-term valuations, giving us the opportunity to choose the stocks with what we believe are the best risk-adjusted returns within a structured scenario analysis framework. While we are not drawing close parallels between the Japanese or dot-com bubbles and the current equity market environment, we continue to find immense opportunity within the Value segments of the market, despite Value's more recent outperformance.

The past decade has undoubtedly been very challenging for defensive, value-oriented global investors. Today's equity markets, especially those that are highly priced, are facing increased volatility with the repricing of risk and cost of capital. An environment where valuations are becoming increasingly consequential presents opportunities for a manager like Mondrian, which uses a disciplined valuation framework to produce attractive real rates of return with defensive value performance characteristics. We believe that the skew of outcomes is in our favor in the coming decade.

Disclosures

Performance returns marked "Net" reflect deduction of investment advisory fees and are calculated by deducting a quarterly indicative fee from the quarterly composite return.

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