QUARTERLY INSIGHTS

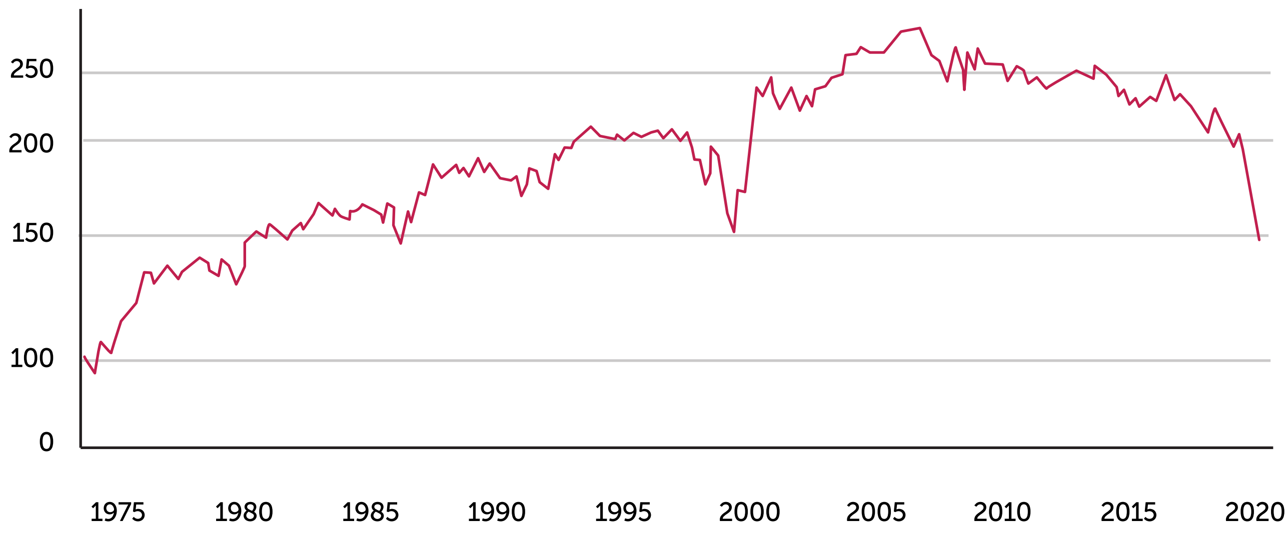
HOLD ASSET MANAGEMENT — THE CENTRAL-EUROPEAN VALUE-BASED EQUITY SPECIALIST

CEE EQUITY STRATEGY IN THE CONTEXT OF VALUE VS. GROWTH PROSPECTS

VALUE VS. GROWTH UNDERPERFORMANCE AND PROSPECTS

One of the most spectacular trends in capital markets recently is the underperformance of value stocks relative to growth stocks. *(Figure 1.)* This trend started in late 2007 and has been accelerating since 2017 and particularly this year during the COVID-19 crisis. The underperformance of value stocks hurt ex-US equity markets in general and CEEMEA region in particular due to its sector composition tilted to value. Moreover, value investors like HOLD AM have been fighting a headwind more recently.

1 MSCI WORLD VALUE VS. GROWTH TOTAL RETURN



SOURCE: BCA RESEARCH, HOLD ASSET MANAGEMENT

There are various explanations for this phenomenon. Some of the most credible ones are as follows:

A. Fundamental. Growth stocks typically come from sectors with structural earnings growth (e.g. tech and health care) meanwhile the profitability of value stocks is in a structural decline (banks, energy). Additionally, the COVID-19 crisis accelerated this trend providing further boost to the relative growth outperformance as many growth stocks became also defensive plays, whilst cyclical stocks that are overrepresented in the value category came under pressure.

B. Structural. The close to 40 year-long global disinflationary process and declining trend of nominal and real interest rates was much more beneficial for growth stocks since their value derives mostly from their distant cashflows. As the discount rate decreases companies with modest current but growing distant cashflows appreciate disproportionately more.

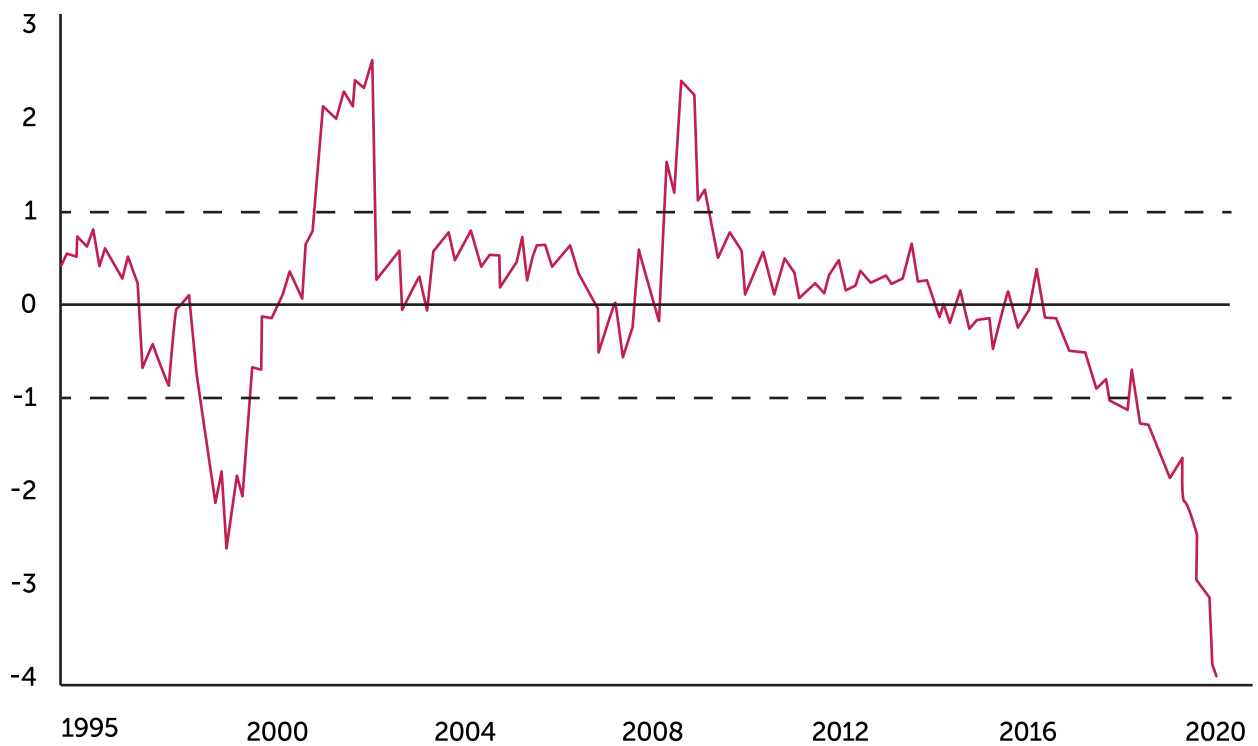
C. Methodological. Traditional ways like price/book ratio to classify stocks as value or growth do not work properly more recently because of inadequate measurement of intangible assets in book value[1].

D. Investor behavioral. The rapidly spreading of passive investments and indexing magnifies the structural effects as the weight of active value investors gradually shrinks meanwhile trend-following, passive and index ETF investors become dominant market players.

E. Valuation. Investor expectations reflect the continuation or even the acceleration of the above mentioned trends and thus the valuation gap between value and growth stocks became extreme. *(Figure 2.)*

We acknowledge these arguments but as contrarian investors we think that the last one became unjustifiable more recently. Usually as a trend matures the causes underpinning the trend become more and more obvious[2] and investors start to extrapolate and exaggerate. However, historically the value/growth ratio has held a mean reverting relationship, one which has recently excessively deviated from its long term average.

❷ GLOBAL VALUE VS. GROWTH RELATIVE VALUATION



SOURCE: BCA RESEARCH, HOLD ASSET MANAGEMENT

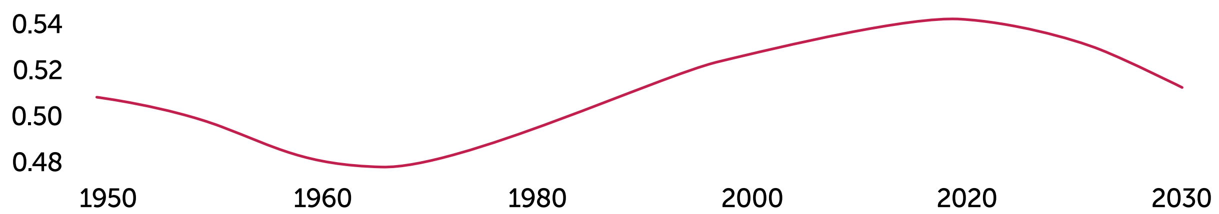
[1] Arnott Rob, Campbell Harvey, Vitali Kalesnik, and Juhani Linnainmaa: "Reports of Value's Death May Be Greatly Exaggerated." Research Affiliates Publications, August 2020.
[2] As the old traders' phrase says: 'The more you know the latter it is'.

Additionally, we think that some other factors above also went to extreme and there is a chance for a reversal in the next couple of years. We would not be surprised if regulation gradually turned more hostile against powerful monopolistic tech giants (i.e. high-flying growth mega caps). We also expect the perceptible easing of the COVID-19 pandemic from the middle of 2021, benefiting value stocks. However, we think fiscal policies will remain very loose in the next decade (the Genie is out of the bottle) helping the revival of global growth and thus value stocks in an environment where growth is less scarce. (Core CEE countries are well placed on this fiscal trend as they are significantly less levered than developed markets, moreover European Union grants provide "free" fiscal boost in the magnitude of 20-40% of GDP for the 2021-27 period propelling their economic convergence to Western Europe.) Regarding inflation and nominal rates, we are of the view that the tide is gradually turning and – unlike in the past decade – for the 2020s inflation plays like real assets and value stocks will outperform deflation plays like fixed income and growth stocks.

Rates can hardly go lower from this point so the 35+ year-long yield decline is probably over. Besides there is a gradual structural change in some forces helping disinflation:

A. Demographics. The world is aging and the global workers to consumers ratio *(Figure 3.)* started to decline causing the gradual decrease of the current global savings glut as older people tend to become net consumers especially if we take into account social and health related outlays by the state.
B. Deglobalization. With the ascent of China, global geopolitics is gradually moving to a multipolar state. The productivity gains emanating from globalization will tend to shrink due to more geopolitical conflicts and protectionism. Recent experience with COVID-19 reinforces onshoring and changes past practices in inventory management.
C. Leftism. Voters are revolting and want more wealth and income redistribution. Politicians have recognized this need and will serve it. We expect a shift to the left with more regulation and looser fiscal policies. The COVID-19 crisis created the precedent and the policy reactions created the template. Loose monetary policies inflate asset prices meanwhile loose fiscal policies inflate consumers prices as the money is directly sent out to consumers and the real economy resulting in exploding M2 growth rates worldwide. Capitalism is deflationary, socialism is inflationary.

③ WORLD SUPPORT RATIO (RATIO OF WORKERS-TO-CONSUMERS)



SOURCE: BCA RESEARCH, HOLD ASSET MANAGEMENT

To conclude, in the next decade we expect an environment more beneficial to value stocks because **1.** their relative valuation is extremely depressed and **2.** fundamentals are gradually turning in their favor. With more redistribution, looser fiscal policies and better growth prospects (and as a result stronger pricing power) inflation is due to rise and eventually interest rates will follow suit. Absolute and relative long-term prospects of value stocks are better than what their current valuation reflects.

[3] According to Vitali Kalesnik ("Value in Recessions and Recoveries." Research Affiliates Publications, June 2020) value usually outperforms growth stocks after bear markets in the recovery phase, especially when that was preceded by the bursting of a bubble, characterized by a wide value–growth valuation dispersion.
[4] This thought is explained in more detail in several reports written by Peter Berezin, chief global strategist of BCA Research.

WHY IS THIS IMPORTANT FOR US AND THE INVESTORS OF HOLD CEE EQUITY?

Among regions, typical growth sectors and thus the weight of growth stocks are overrepresented in the US and in Emerging Asia. Consequently, equity markets in other regions with heavier weighting in value stocks like Western-Europe or CEEMEA were lagging. *(Figure 4.)* Since the inception of the COVID-19 crisis CEEMEA's underperformance further grew by close to 20 percent compared to the wider Emerging World and based on cyclically adjusted P/E ratios Emerging European countries currently stand among the lowest valued stock markets globally.
Moreover, HOLD AM has a contrarian value investment style so we and our investors have been facing strong headwinds since the Great Financial Crisis in general and for the last 3 years in particular. Despite the 6.5% p.a. (net of fees) alpha HOLD CEE equity strategy achieved since its inception in 2001 and despite the 3.54% p.a. (net of fees) alpha HOLD CEE Convergence Fund generated in the last 3 challenging years we could not compete with the performance of the S&P 500. *(Figure 5.)*

4 SECTORAL BREAKDOWN OF DIFFERENT EQUITY REGIONS (MSCI USA; MSCI EUROPE, MSCI EM EMEA + MSCI EFM CEEC EX RUSSIA, HOLD CEE CONVERGENCE FUND) AS OF END OF SEPTEMBER 2020

	MSCI USA	MSCI EUROPE	MSCI EM EMEA	MSCI EFM CEEC EX RUSSIA	HOLD CEE CONVERGENCE FUND*
INFORMATION TECHNOLOGY	28.76%	7.73%	0.14%	0.00%	0.00%
HEALTH CARE	14.08%	16.30%	1.57%	7.27%	3.62%
CONSUMER DISCRETIONARY	12.20%	10.62%	11.70%	3.10%	7.83%
COMMUNICATION SERVICES	10.67%	3.95%	10.20%	16.45%	10.34%
CONSUMER STAPLES	6.68%	14.84%	5.93%	4.07%	3.86%
INDUSTRIALS	8.14%	14.34%	2.83%	0.99%	8.30%
UTILITIES	2.90%	4.97%	2.08%	6.78%	6.17%
REAL ESTATE	2.78%	1.37%	2.63%	0.00%	5.09%
FINANCIALS	9.36%	14.03%	31.01%	38.91%	26.57%
MATERIALS	2.54%	8.05%	17.89%	6.02%	0.43%
ENERGY	1.89%	3.81%	14.02%	16.42%	7.95%

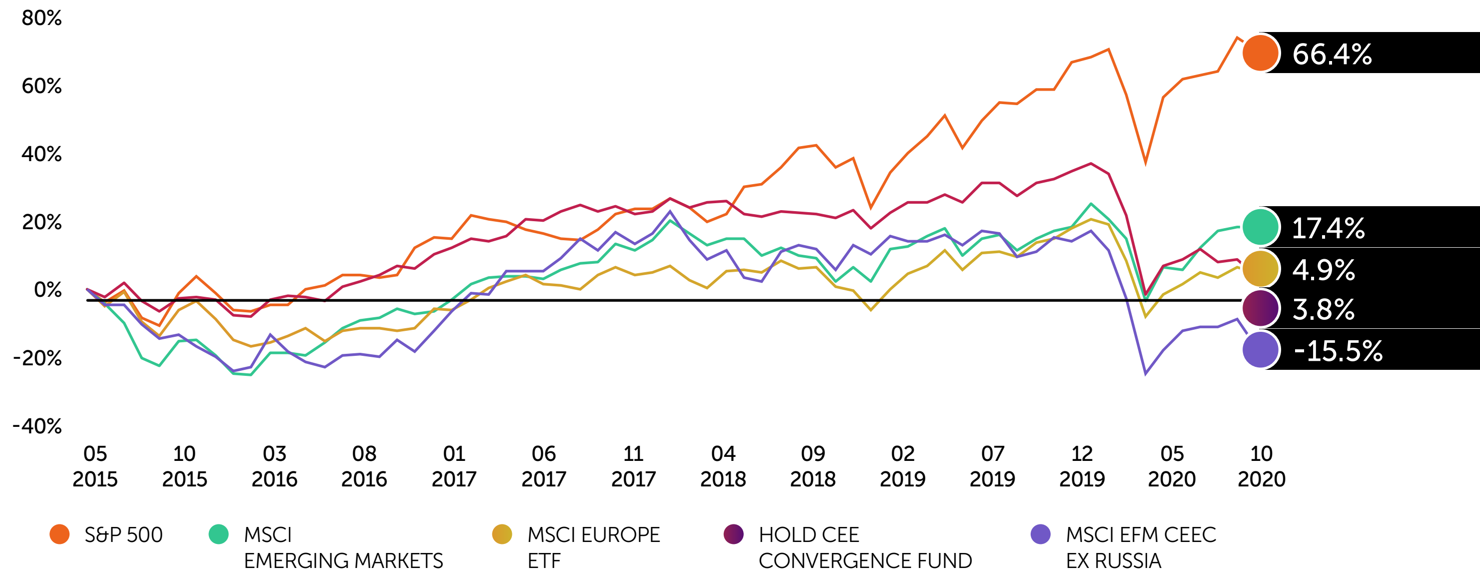
** Total net equity exposure is only 82% and includes 1.8% single country or market exposure*

typical growth sector

typical value sector

SOURCE: MSCI, HOLD ASSET MANAGEMENT

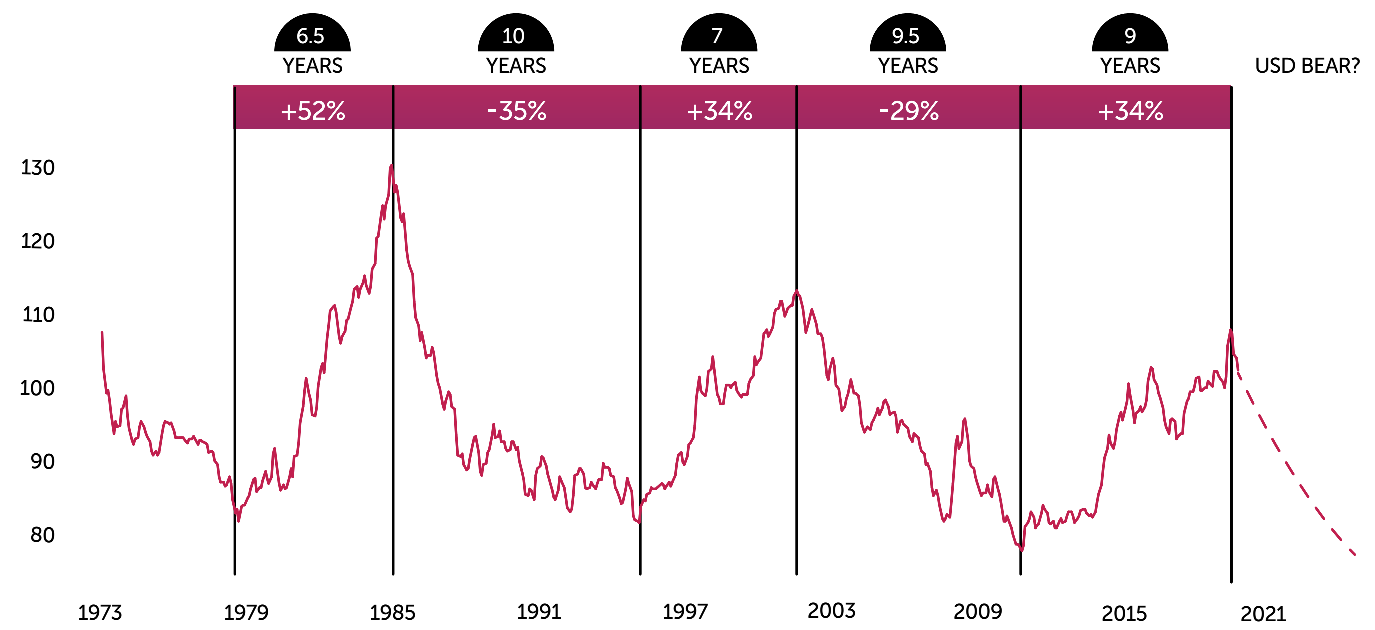
❺ TOTAL RETURN PERFORMANCE OF S&P 500; MSCI EMERGING MARKETS, MSCI EUROPE ETF + MSCI EFM CEEC EX RUSSIA AND HOLD CEE CONVERGENCE FUND SINCE ITS INCEPTION (EUR)



SOURCE: BLOOMBERG, HOLD ASSET MANAGEMENT

The future of the US dollar is a crucial factor that can influence the absolute and relative performance of European and Emerging equity markets. Until March this year the strength of the greenback was a major headwind for ex-US markets. With reflationary policies and as the world gradually tackles the coronavirus problem odds are the USD entered a bear market. Among developed and emerging markets the scale of the fiscal stimulus is by far the largest in the U.S. Parallel with that the U.S. also lost its interest rate advantage and the Fed will probably hold short term rates at close to zero for several years, thus it is unlikely that the USD will regain its real interest rate advantage soon. The USD bull market is probably over and a new long cycle (i.e. a bear market) has just begun. This will likely benefit ex-US equities. *(Figure 6.)*

❻ LONG CYCLES IN THE US TRADE WEIGHTED REAL BROAD DOLLAR



SOURCE: BLOOMBERG, HOLD ASSET MANAGEMENT

HOW TO DEFINE VALUE?

Defining whether a stock is considered a 'value' or 'growth' investment is not straightforward. Apart from chartists or momentum investors, the majority of the investment society looks for cheap, undervalued investment opportunities regardless whether one is value or growth biased. A value investor usually does not mind buying growth stocks if the present value of future growth is not expensive, i.e. she/he is typically more skeptical regarding the present value of growth opportunities. Thus, value investing and being contrarian are usually interrelated.

In practice there are widely applied methods in order to determine whether a stock belongs to value or growth category. Those usually use the variables such as price to book (P/B) and less often also price to forward earnings (P/E) and dividend yield (DY) for defining the value characteristic of a stock. Longer term historical sales and earnings growth (per share) and consensus forward EPS (earnings per share) growth expectations are used for determining the growth characteristic of a stock. Some stocks are classified as value, some as growth but many as both. The methodology defining value and growth equity subindices at both Russell and MSCI aims to classify all the index components so that the market cap of value and growth subindices equals. So for example Russell 2000 Value Index contains 1431 stocks meanwhile Russell 2000 Growth Index has 1072 members.

We tried to classify our positions in HOLD CEE Convergence Fund based on some principles above but also included qualitative considerations in the classification process.[5] Moreover, we split the value category into two subcategories.

A. A stock can be cheap and thus a value investment because its current earnings power or cashflow generation is decent and we are more optimistic than the consensus regarding its sustainability. So we are satisfied with the current earnings or cashflow generation of the company and expect it to either remain or decline slower compared to consensus expectations. In this case we can say that 'no news is good news'.

B. A stock can be cheap and thus considered a value investment because we expect the normalization of its earnings power or cash generation capacity and we are more optimistic than the consensus. In this case we do not bet on a structural growth story but we believe in mean reversion to at least to a normal mid-cycle point. This is a bet on cyclical improvement. In this case 'no news is bad news' since eventually an improvement is required in order to validate the cheapness of the stock.

The common factor in the rationale of the two categories is that value investors are contrarian. Less pessimistic when the market consensus is negative towards a stock shrinking earnings capacity (e.g. for a structural decline) and more optimistic than the market when expecting a cyclical improvement. (One of the best opportunities arise from situations when the market mistakenly underestimates the effect of the cyclical deterioration in fundamentals and considers a structural decline as the major cause. Certainly, the opposite can result in value traps.) This is exactly the reason why value investors tend to underweight growth stocks: being contrarian a value investor is less optimistic when a company is booming and the market reflects fantastic prospects. However, that does not mean a value investor is pessimistic, simply more cautious and strongly believes in mean-reversion. For this reason, during the bottom of a business cycle a value investor overweights cyclical stocks as a bet on the improvement in the business cycle.

[5] It was particularly necessary due to the devastating effect the COVID-19 pandemic had on the majority of companies' earnings.

Thus he/she is more optimistic regarding cyclical risks. However, this is rarely the case regarding long term growth risks in a value investor's portfolio. Analysts tend to overestimate earnings growth on longer-term horizons[6] and probably that is an important factor explaining why investors tend to overpay for growth stocks. It is unanticipated growth (or the lack of thereof) that matters and moves share prices.

HOLD CEE EQUITY STRATEGY: A CONTRARIAN STYLE VALUE APPROACH

After this investment philosophy by-pass, let us see the breakdown of HOLD CEE Convergence Fund's portfolio (also showing other factors) *(Figure 7.)*.

7 STYLE COMPOSITION OF HOLD CEE CONVERGENCE FUND (AS OF END OF SEPTEMBER 2020)

			OUT OF WHICH			
			DEFENSIVE/CYCLICAL		SMALL-MID/LARGE CAP	
	TOTAL NUMBER OF POSITIONS	TOTAL WEIGHT OF POSITIONS	NUMBER OF POSITIONS	WEIGHT OF POSITIONS	NUMBER OF POSITIONS	WEIGHT OF POSITIONS
RATHER (MOSTLY) VALUE DUE TO CURRENT CF	12	28.0%	11/1	27.6%/0.4%	7/5	13.8%/14.2%
RATHER (MOSTLY) VALUE DUE TO EXPECTED CF NORMALIZATION	24	40.0%	4/20	4.9%/35.1%	7/17	12.6%/27.4%
RATHER (MOSTLY) GROWTH	12	15.5%	6/6	9.7%/5.8%	6/6	6.6%/8.9%
SHORT GROWTH	2	-3.4%	1/1	-2.9%/-0.5%	0/2	0/-3.4%
SINGLE MARKET EXPOSURE	1	1.8%				
OTHER (MOSTLY CASH)		18.1%				
TOTAL NET (SINGLE STOCK ONLY)	**50**	**80.1%**	**22/28**	**39.3%/40.8%**	**20/30**	**33.0%/47.1%**
MSCI EFM CEEC EX RUSSIA	39	100.0%	15/24	42.3%/57.7%	9/30	3.0%/97.0%

As mentioned above, when deciding whether a stock is value or growth we took into account not only the P/B of it but also the price to average of the last 5 years' earnings and included some qualitative factors (e.g. profit reinvestment ratio, growth capex). The average P/B of HOLD CEE Convergence Fund was around 0.65 at the end of September 2020. Thus, HOLD CEE Convergence Fund is tilted towards value: 68% of the Fund's NAV is invested into value names meanwhile the Fund has only 12% net exposure to growth stocks. (The value-growth split is 66-34% in case of the benchmark based on our proprietary methodology.)

[6] Loius K. Chan, Jason Karceski, and Josef Lakonishok: "The Level and Persistence of Growth Rates", The Journal of Finance, Vol. 58. No. 2 (2003): 643-684

However, cyclical and defensive exposure is very balanced. The reason is that part of our value exposure (28% of the NAV) is cheap in our opinion because we think the fundamentals will not deteriorate as the market expects it to or not worsen at all. We are satisfied with their current cashflow. These tend to be defensive names. The Fund has the largest, 40% exposure towards value stocks where we expect cashflow normalization mainly due to cyclical improvement or in certain cases an expected company specific turnaround. Obviously, these are mostly cyclical names. We think that currently the business cycle is very depressed and that is reflected in the valuations so we overweight cheap cyclical value stocks betting on gradual improvement.

The table above also shows that small and mid-cap stocks that are below EUR 1bn market cap represent a significant portion of our strategy, currently at 33% out of the total net 80% single name stock exposure. Needless to say that the benchmark is almost 100% large cap.

We are of the view that the smaller a market or a stock is, the less attention it catches from investors hence chances are higher that those investments are mispriced. There is a greater opportunity set to generate alpha in less liquid, more inefficient markets. That is the reason we are continuously searching attractive investment opportunities among small/mid-caps and illiquid names.

IN CONCLUSION

We think investors should do better with non-US stocks in the next decade in general and with CEE (MEA) equities in particular because the latter has **1.** significantly lower starting valuation (Shiller P/E in the US was 30.5 against 12.5 of HOLD Central-Eastern-European equity strategy at the end of August), **2.** more heavy exposure towards value stocks meanwhile we expect the outperformance of value and **3.** the US dollar bull market is probably over. As contrarian style value investors, we manage the portfolio of HOLD CEE Convergence Fund based on this view overweighting cheap and often smaller size value names in our region.