Why Are Institutional Investors Missing the International Small Cap Opportunity?

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Introduction

Most U.S.-based investors have built and maintained a sizable position in international equities, heavily focused on large-cap companies in developed economies along with some exposure to larger companies in emerging markets. While international investing programs have matured and allocations to non-US stocks have grown, small companies in international markets have, for the most part, been overlooked and left behind by US investors. This has happened despite strong performance, better diversification potential, and the opportunity available for active management to deliver strong returns with international small cap stocks. We argue that a truly complete global or international equity program needs to include an allocation to small non-U.S. companies.

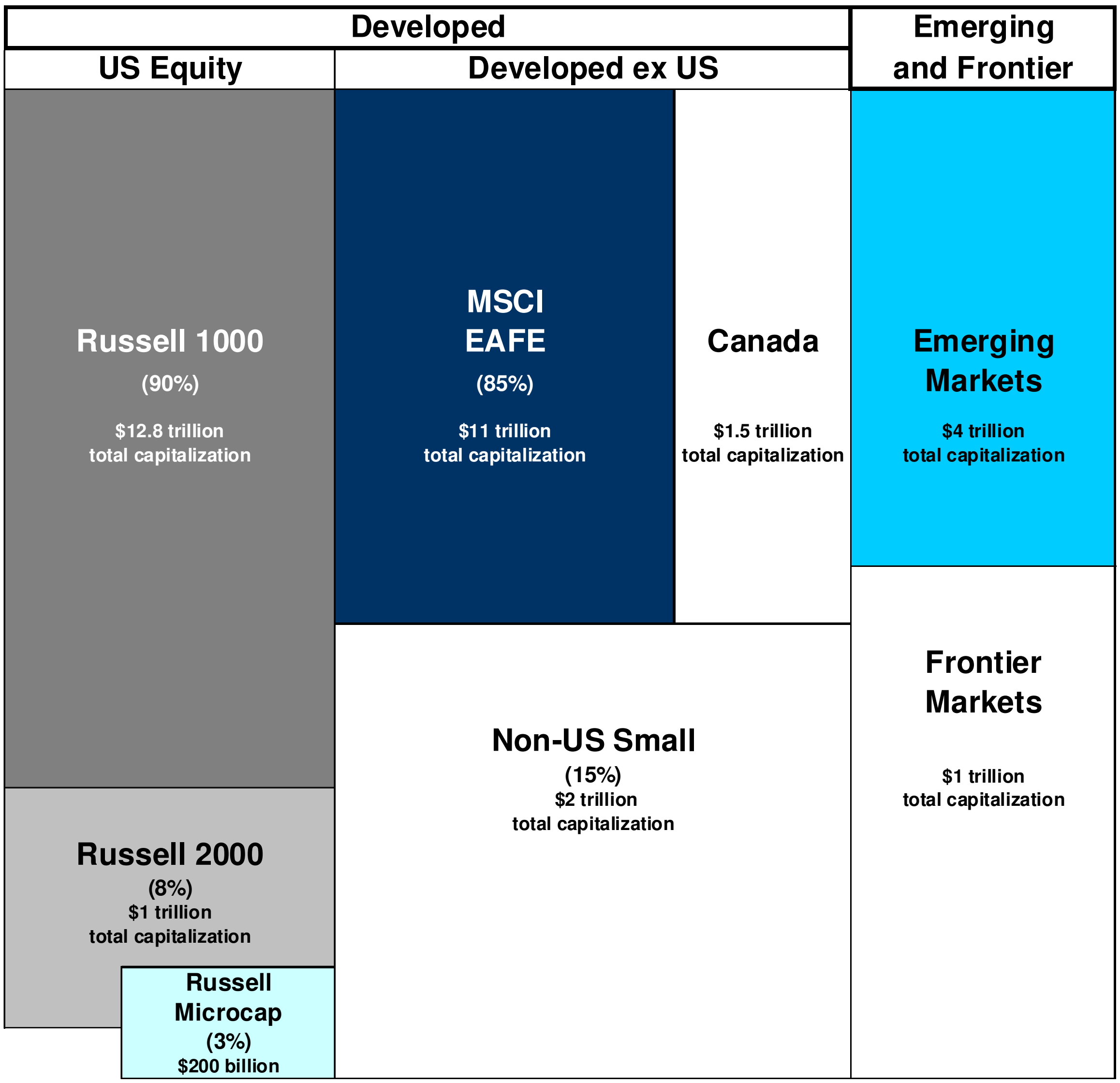
The Benchmark Problem

By far, the most common international equity benchmark for US investors is the MSCI EAFE Index. MSCI EAFE captures approximately 85% of the total capitalization of companies in developed European and Asian countries – around $11 trillion in total capitalization. Over the past 35 years, EAFE has become shorthand for “international equities” and as investors have moved away from an equity portfolio dominated by US companies. This index is made up of securities from twenty two countries in Europe, Australasia and the Far East. The largest country weight is Japan, followed by the U.K. and stocks like Nestle and Toyota maintain the largest weights in the cap-weighted index as opposed to names like Exxon and Apple in the Russell 3000 Index. To best understand if EAFE exposure provides sufficient international exposure and best captures the desired risk and return profile it is important to understand what EAFE is missing.

What Are We Missing?

The chart below shows a rough sketch of the investable equity market, and what tends to be included in the portfolio of a US-based investor.

Exhibit 1: Breakdown of Publicly Traded Global Equity Market



Source: Acuitas, Factset, MSCI, Russell Investments

Most investors have recognized that EAFE is a developed market index and does not completely represent the opportunity set outside the US – which is why they have an allocation to emerging markets.

However, the focus on MSCI EAFE as the primary benchmark for “foreign stocks” ignores some other important points about of the index.

- It excludes Canada – a $1.5 trillion market with the unique feature of being in the developed world, but also having a large amount of natural resources exposure.
- EAFE is a large cap index. The weighted average market cap is $50 billion and companies below $2 billion in market cap represent less than 1% of the index.

We believe that the adoption of MSCI EAFE as the primary “foreign stock” benchmark has left many investors under-invested in Canada and small companies outside the United States.
We will focus on the opportunity that is being missed in international small caps, though similar arguments can be made for the distinctiveness and utility of frontier markets and Canadian equities.

International Small Cap

Many active managers are willing to go outside EAFE’s borders and supplement their portfolios with opportunistic allocations to emerging markets – typically with larger companies from those economies. However, products indexed to MSCI EAFE average just 3 to 4% allocation to small companies, mostly concentrated in only the largest of the small cap stocks.

According to eVestment Alliance, there is over $3 trillion in institutional global and international products, though 96% of this is in large or all-cap products. The number of international products oriented toward large cap stocks outnumbers the number of small cap products by nearly 10 to 1. Put simply, investors have not given the space the attention it deserves. Highly scalable large cap products remain the focus for investment managers despite the performance history of small cap beating large cap. To give some idea of what exactly is being missed: over the last 10 years, even a passive exposure to international small cap stocks has outpaced a large cap exposure by 440 bps per year. Of course the active opportunity for skilled investment managers makes the case even more compelling. The additional returns available to being active in international small cap will be discussed later.

Exhibit 2: Annualized Returns for Periods Ending 9/30/2011

Cap Range	Index	1 Year	3 Years	5 Years	10 Years	15 Years
Large Cap	MSCI EAFE	-12.1%	7.1%	-3.7%	5.2%	3.7%
	Russell Developed ex US Large Cap	-11.8%	8.4%	-2.8%	5.9%	4.8%
Small Cap	MSCI EAFE Small Cap	-8.7%	16.0%	-2.2%	9.6%	5.2%
	Russell Developed ex US Small Cap	-7.5%	16.6%	-1.6%	10.2%	5.7%
	Difference - MSCI EAFE	**3.4%**	**8.9%**	**1.5%**	**4.4%**	**1.4%**
	Difference - Russell Global	**4.3%**	**8.2%**	**1.2%**	**4.4%**	**0.9%**

Returns expressed in US dollars
Source: Acuitas, MSCI, Russell Investments

Potential for Diversification

The potential for diversification from international equities can tend to be overstated. Large cap international companies are, for the most part, companies that operate globally, in the same markets as large cap US companies. By contrast, small international companies tend to have less exposure to markets outside their own local economy. While large cap companies tend to be levered to global economic growth, small cap companies tend to be more levered to their own economy. These characteristics of international small companies help drive the lower correlation with large cap US equities as seen in the table below. With lower correlation comes a greater benefit for investors seeking diversification.

Exhibit 3: Correlation of International and US Equities

		Correlation with Russell 1000
Large Cap	MSCI EAFE	0.82
	Russell Developed ex US Large Cap	0.83
Small Cap	MSCI EAFE Small Cap	0.66
	Russell Developed ex US Small Cap	0.70

Note: Calculated from weekly US dollar returns, January 2001 to October 2011
Source: Acuitas, Factset, MSCI, Russell Investments

Small cap companies are more idiosyncratic than large companies – they tend to behave more uniquely. Being more levered to local economies and a smaller basket of products they sell, a small cap stock's price behavior tends to be harder to explain with a factor model. We can see it in the table below. Stock volatility not explained by a single factor model increases as you go down the cap spectrum. Stocks behave more uniquely as we move down the cap spectrum.

Exhibit 4: Percentage of Stock Volatility Not Explained by a Single-Factor Model

	Percentage of Price Volatility Left Unexplained
Mega Cap	47.9%
Large Cap	49.8%
Mid Cap	55.7%
Small Cap	67.1%
Micro Cap	84.9%

Note: Single-factor model is a CAPM-style beta model.
Source: Acuitas, Factset

The idiosyncrasy of international small cap stocks can also be seen in the table below. By comparing the index return volatility with the average volatility of a stock in the index, we can estimate how similar the behavior is of the stocks within the index.

Despite having higher average stock volatility, the small cap indices have similar index-level return volatility. The reason is because small cap stocks *have lower correlation with each other* – they are more differentiated and behave more uniquely.

Exhibit 5: Estimated Stock-Level Correlation by Cap Size

Index	Index Volatility	Average Stock Volatility	Est. Stock Level Correlation
MSCI EAFE	21.71	29.05	0.747
Russell Developed ex US Large Cap	21.65	29.00	0.747
MSCI EAFE Small Cap	20.92	36.15	0.579
Russell Developed ex US Small Cap	19.23	34.60	0.556

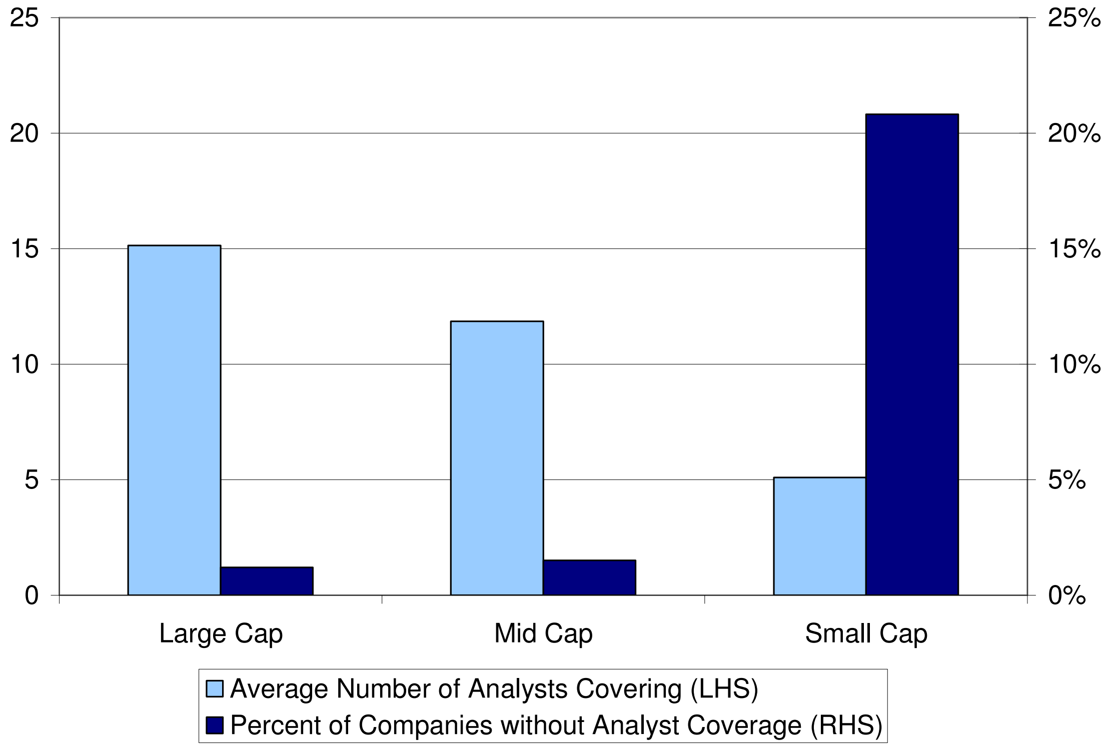
Souce: Acuitas, Factset, MSCI, Russell Investments

The story that each of these three tables is telling us is that international small cap stocks tend to behave on their own terms. If active management and stock selection is be rewarded, we believe the rewards will be greater and more frequent in a place where stocks are behaving more uniquely – namely in international small cap.

Active Management Opportunity

While passive exposure to international small cap can benefit institutional investors, we believe the most compelling argument is driven by the superior returns available through active management due to investors' inattention to the space. One of the reasons to be excited about the potential for active managers to add value in international small cap is that most of the companies have yet to be discovered. The average international small cap company has only 5 sell-side analysts covering it (compared to 15 for large cap) and over 20% of the companies have no sell-side coverage at all.

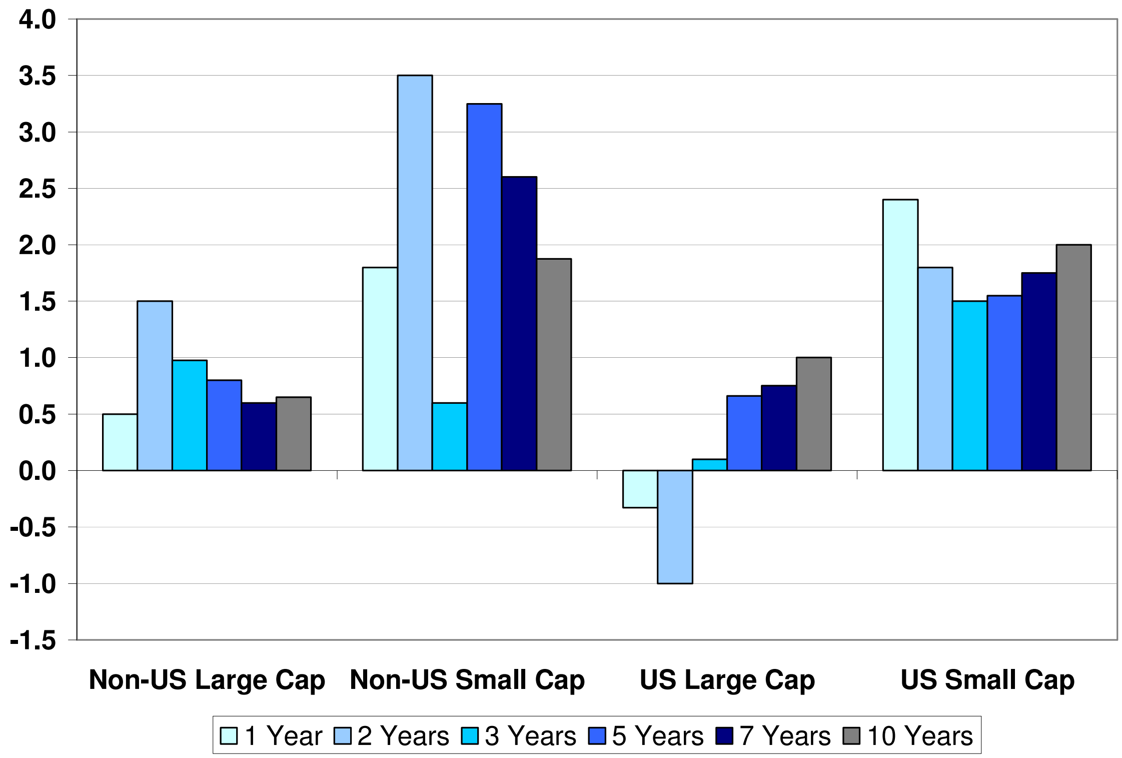
Exhibit 6: Analyst Coverage Internationally



Based on Russell Global Developed ex US indexes
Source: Acuitas, Russell Investments, Factset

This combination of high information inefficiency, high idiosyncratic behavior, and low stock-level correlation enables skilled active managers to generate outsized excess returns for investors. Over the last 10 years, the average international small cap manager has added nearly 200 bps over the benchmark, while international large cap managers have added just over 50 bps of value.

Exhibit 7: Average Active Manager Excess Returns by Cap Size and Geography
Periods ending 6/30/2011



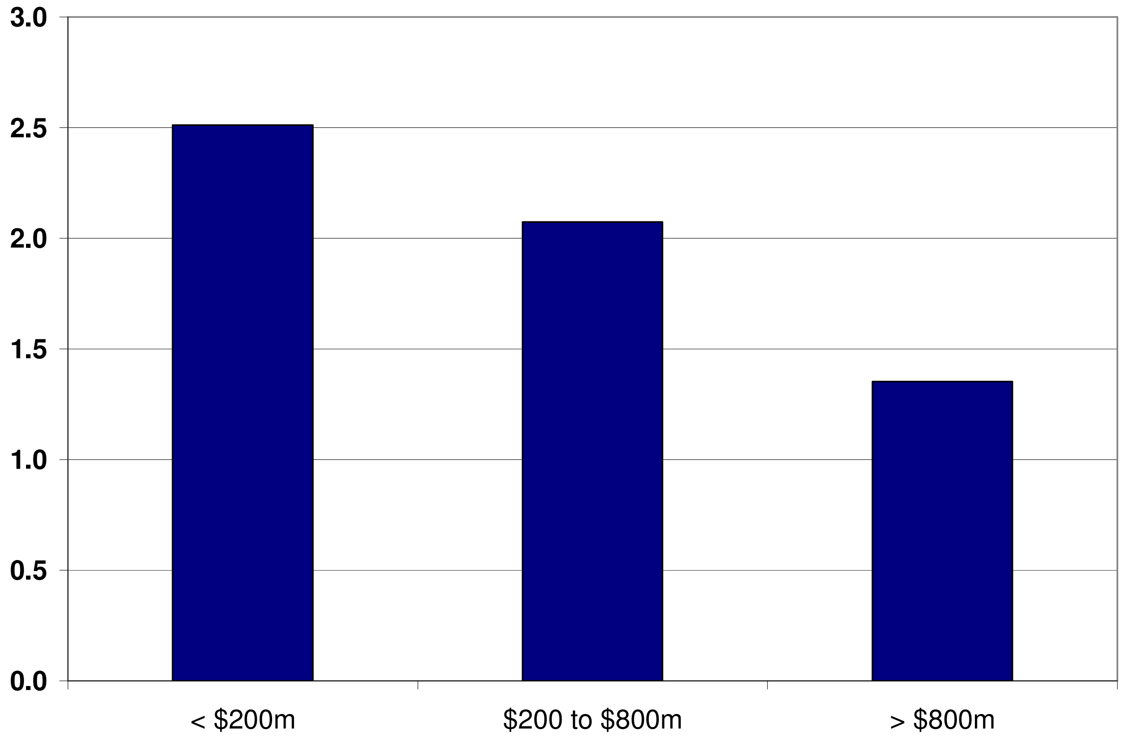
Source: Acuitas, eVestment, MSCI, Russell Investments

Limited Capacity

Of course, along with the limited analyst coverage and inefficiencies in international small cap, there is also lower available liquidity, which drives the limited asset capacity of managers. Many large investment management firms avoid offering products in the space due to limited revenue potential, and great investment management teams can fill up their available capacity quickly - often closing international small cap products somewhere below $1 billion in assets.

However, we also note that investors tend to benefit from managers who do not stretch their capacity. Managers with smaller products are able to operate nimbly and tend to realize the best performance. When we look at the performance of the products segmented by their asset size, we find that smaller products outperform larger ones by a significant margin.

Exhibit 8: Global and International Small Cap, Average Annual Excess Returns by Product Size
10 years ending 6/30/2011



Source: Acuitas, eVestment Alliance

A Compelling Opportunity

We believe that international small cap represents a compelling opportunity. However, there is also a set of challenges to implementing an international small cap program. International small cap stocks can be less liquid, fees tend to be higher, and individual manager performance can appear volatile when looked at in isolation. Lastly, perhaps the greatest challenge is finding the appropriate capacity with strong investment teams who can take full advantage of the extensive opportunities to add value. For investment teams that do focus their efforts on international small cap stocks, the opportunities for skilled active managers to add value are worth plan sponsors' attention.

International small cap is a very compelling investment for plans that have a sufficient asset base. It enjoys the same small cap premium that has existed in US small cap and perhaps even broader opportunities for skilled active managers to add value. The asset class also provides institutional investors a unique opportunity to improve the expected risk/return profile of their overall portfolios.

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