The Case for International Small and Microcap: An Underutilized Source of Excess Returns

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Matt Nieman, CFA
mnieman@acuitasinvestments.com

Dennis Jensen, CFA
djensen@acuitasinvestments.com

Introduction

Many decades ago, most U.S. investors' equity portfolios consisted primarily of large cap, blue chip domestic stocks. However, as investors became more sophisticated and markets more globalized, investors increasingly sought the return and diversification benefits that other segments of the equity markets offered. Today, most investors' portfolios include dedicated exposure to both small cap and international stocks. However, many investors continue to have a glaring gap at the intersection of the two segments – dedicated international small cap. As U.S. based investors have built and maintained a sizable position in international equities, they have focused on large cap or all cap strategies and companies. Surprisingly few investors have taken the extra step to allocate money directly to small and microcap outside the U.S., even though it is a natural intersection of the traditional "style boxes" that consultants espouse and most U.S. investors use.

Compounding the issue is the difficulty investors have had with active management in U.S. markets. For many years, as large cap managers struggled to beat their benchmarks, U.S. small cap remained an area where skilled investment managers could generate a return advantage. Unfortunately, over time the correlation between small and large cap stocks has increased due to increased information flow in small cap stocks, institutional investors increased exposure to small cap, and the increased use of exchange traded funds. This has resulted in U.S. small cap becoming increasingly efficient. Internationally, increased global investing has led to crowding and efficiency in the most liquid and large cap stocks. However, small companies in international markets have, for the most part, been overlooked by institutional investors.

Most investors do not have dedicated exposure to international small cap stocks, which has unfortunately caused those investors to miss out on what we believe is one of the most attractive return opportunities in the equity markets. The opportunities are magnified in international microcap where there is even less institutional attention and even fewer investors have dedicated exposure. We believe that the international small and microcap spaces are among the least efficient areas of the equity markets, providing skilled active managers a meaningful opportunity to generate strong absolute and excess returns. Surprisingly, these opportunities remain despite

the strong performance, better diversification potential, and the considerable active management opportunity. We argue that a complete global or international equity portfolio will be able to generate better returns with lower risk when including a dedicated allocation to international small and microcap.

How Do We Define International Small and Microcap?

Loosely defined, we think of international microcap stocks as those with market cap below $1 billion, while international small cap stocks are generally viewed as stocks below $4 billion. As you can see in Exhibit 1 below, the non-U.S. small and microcap markets offer a much more expansive universe of stocks for managers to select from than the mid and large cap markets. This opportunity set is also expanding, unlike in the U.S. (IPOs outside the United States outpace the rate for domestic stocks). The breadth of the universe and expanding opportunity set is a critical source of inefficiency and amplifies the potential return for skilled active managers who stay invested down the cap spectrum.

As the table shows, a market cap weighting to international small and microcap would be roughly 16.9%. This may be a good starting point for investors thinking about how to size an appropriate allocation, but we would argue that given the attractive return opportunity, investors may be rewarded for overweighting this segment of the market relative to their mid and large cap exposures.

Exhibit 1: Russell Global ex-U.S. Index Representation by Market Cap (June 30, 2017)

Market Cap Range	Total # of Stocks	% of Index by # of Stocks	% of Index by Market Cap
$50m - $1b	**2945**	**41.5%**	**4.2%**
$1b - $4b	2390	33.7%	12.7%
$4b - $10b	946	13.3%	15.6%
$10b+	797	11.2%	67.5%

Source: Acuitas, FactSet, FTSE Russell.

MSCI offers the most commonly used non-U.S. equity benchmarks, but at Acuitas we usually use FTSE Russell's benchmarks for analysis due to our emphasis on microcap across our product set and the prevalence of Russell's U.S. and global microcap benchmarks. As you can see in Exhibit 2 below, the weighted average market capitalizations of the global small and microcap benchmarks fit well within our view of what constitutes small and microcap.

Looking at some of the other characteristics of the small and microcap benchmarks relative to their large cap counterparts, international small and microcap stocks have lower valuation characteristics (P/E and P/B) than all other segments, higher quality (lower debt), and stronger growth characteristics. This suggests that these stocks remain undiscovered and inefficiently priced by institutional investors, as their valuations do not reflect the solid growth opportunities they offer relative to more well-known, broadly-owned stocks. The lack of institutional attention in

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small and microcap is also confirmed by the low percentage of institutional ownership and low number of sell side estimates.

Exhibit 2: FTSE Russell Index Characteristics (June 30, 2017)

	Market Cap ($bil)		Valuation		Quality & Growth			Discovery	
	Weighted Average	Largest Company	Price / Book	Price / Earnings	LT Debt to Capital	3Yr Sales Growth	Est 3-5Yr EPS Growth	% Institutional Ownership	Average # Sell Side Estimates
R.1000® (US Large)	151.29	818.27	2.9	21.2	44.7	5.3	12.3	78.2	16.2
R.2000® (US Small)	2.05	10.23	2.1	19.8	34.1	14.3	11.7	84.8	5.6
R.Microcap® (US Micro)	0.50	1.50	1.8	14.0	32.3	15.2	14.4	65.1	2.9
R.Global ex-US Large Cap	58.79	447.95	1.7	15.5	34.2	5.5	12.6	36.5	13.6
R.Global ex-US Small Cap	**1.52**	**13.18**	**1.5**	**15.0**	**24.7**	**19.4**	**13.5**	**31.7**	**4.1**
R.Global ex-US Microcap	**0.69**	**3.47**	**1.3**	**14.3**	**21.2**	**16.9**	**13.4**	**25.3**	**2.8**

Source: Acuitas, FactSet, FTSE Russell.
Note: The Institutional ownership data is based on regulatory filings. Some institutions based outside of the U.S. are not subject to the same regulatory filing requirements, therefore the ownership data for the international indexes may not be directly comparable to the U.S. Indexes. In that case, the comparisons between large cap, small cap and microcap within geographic markets is more relevant than comparing across geographies.

It is important to note that investors often confuse microcap stocks with unusually risky stocks such as penny stocks, pink sheet stocks, or those that are untradeable due to liquidity constraints. In practice, those stocks are not considered part of institutional active managers' investment universes, nor part of the indexes. When constructing global indexes, FTSE Russell's methodology excludes securities that do not meet liquidity thresholds that make them viable for institutional investors. Active small and microcap managers tend to buy stable companies with meaningful revenues that are listed on exchanges and are viable for institutional investment. For more detail on FTSE Russell's index methodology and liquidity requirements, they are outlined on their website at www.ftserussell.com.

International Small Cap Benchmarks and The Small Cap Effect

The return premium associated with global small cap stocks has been documented extensively, dating back to Rolf Banz in the Journal of Financial Economics, 1981. More recently, MSCI's research, "One Size Does Not Fit All" by Oberoi, Rao, Brig and Subramanian, highlighted the historical small cap return premium in global markets. Of course, one of the more prominent papers on the small cap effect was Fama and French's "The Cross-Section of Expected Stock Returns", first published in *The Journal of Finance* in 1992. Importantly, what Fama-French referred to as small cap corresponds most directly with microcap stocks, a relationship we looked at in depth in our whitepaper "A Case for Microcap" (which focuses on U.S. equities). For another perspective, we looked at the Russell Global ex-U.S. Index's historical returns. As Exhibit 3 shows, since December 31, 1999, small cap stocks have outperformed their large cap counterparts across the FTSE Russell Developed, Global, and Emerging Market Indexes.

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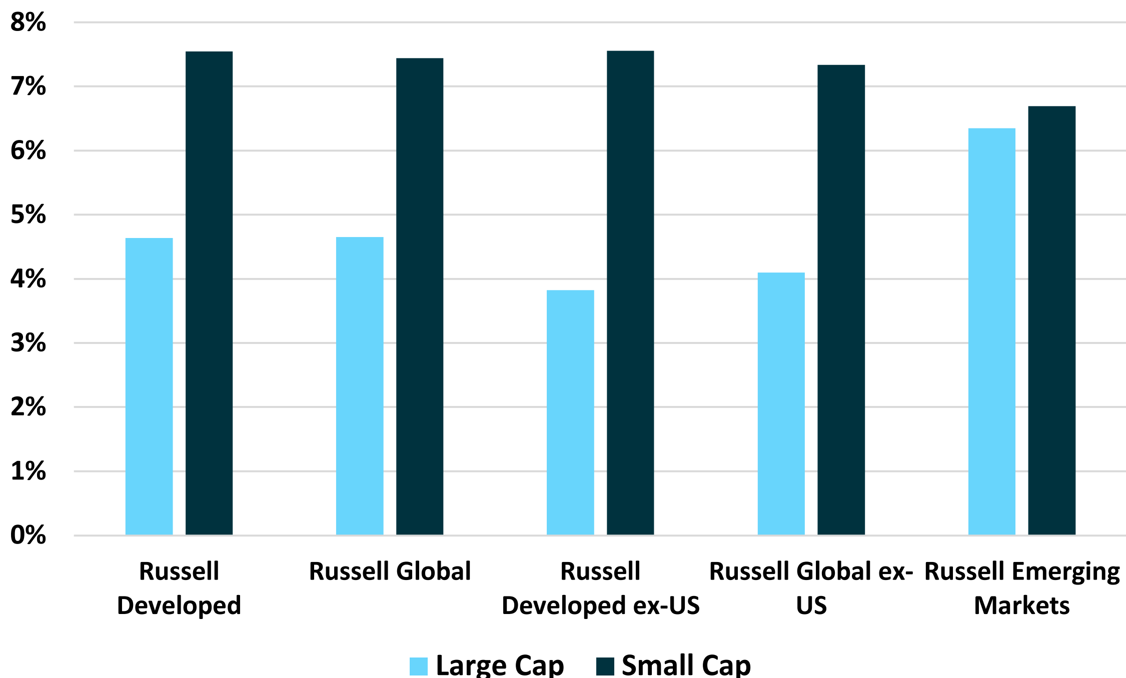
Exhibit 3: Annualized FTSE Russell Index Returns (December 31, 1999 - June 30, 2017)



Source: Acuitas, FTSE Russell.

As we noted earlier, most investors gain international exposure through allocations to large cap or all cap managers, leaving significant gaps in the lower market cap segments that have historically outperformed. For example, a passively managed Russell Global All Cap strategy has a very small allocation to the areas of the market that have historically delivered higher returns. To demonstrate, we split the FTSE Russell Global ex-U.S. Index into deciles based on market capitalization (similar to what Fama and French used in their original work). Exhibit 4 shows the weight of the Russell Global ex-U.S. large, small, and microcap Indexes that fit into each of the Russell Global ex-U.S. Index's market cap deciles. Virtually all of the Russell Global ex-U.S. Microcap Index falls within the 10th decile, and the Russell Global ex-U.S. Small Cap Index is split roughly 80/20 between the 10th and 9th deciles, respectively. This indicates that small and microcap managers that stay invested in true small cap stocks would be the primary beneficiaries of what Fama and French established as the small cap effect, which is supported by the FTSE Russell Index returns since the turn of the millennium (Exhibit 3).

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Exhibit 4: FTSE Russell Index Weights Based on Equal Weighted Deciles of the Russell Global ex-U.S. Index (June 30, 2017)

Decile	Market Cap Range ($mil as of 6/30/17)	Russell Global ex-US Large Cap	Russell Global ex-US Small Cap	Russell Global ex-US Microcap
1	151,794.5 - 356,387.4	11.1%	0.0%	0.0%
2	84,947.5 - 144,414.4	11.0%	0.0%	0.0%
3	51,218.3 - 84,426.7	10.8%	0.0%	0.0%
4	35,494.8 - 51,065.1	11.4%	0.0%	0.0%
5	23,099.5 - 35,339.9	11.2%	0.0%	0.0%
6	14,695.0 - 23,025.9	11.1%	0.0%	0.0%
7	9,007.5 - 14,681.3	11.3%	0.1%	0.0%
8	5,180.1 - 9,000.7	11.2%	0.8%	0.0%
9	**2,222.3 - 5,170.0**	**8.7%**	**19.2%**	**1.4%**
10	**13.9 - 2,221.8**	**0.6%**	**79.7%**	**98.4%**

Source: Acuitas, FactSet, FTSE Russell.

Additionally, as we will elaborate on later, many international small cap managers drift up in market cap, often well into the mid cap space where information efficiencies are more significant and the opportunity for excess returns is more limited. The primary reason for managers to drift into larger stocks is that it allows them to increase their capacity and manage more money (thereby boosting revenues). In our view, small cap managers that invest in larger stocks are sacrificing returns available in the smallest, least efficient areas of the international small cap universe.

Passive Return and Risk Comparison

As discussed above, we believe the size premium in small cap investing exists both domestically and internationally. However, small and microcap stocks are often perceived as having significantly higher risk than larger cap stocks, particularly internationally. This perception is once again magnified with microcap stocks, where there has been less historical familiarity and exposure among investors. It is our view that this perception of meaningfully higher risk often overstates reality. Exhibit 5 below shows the volatility of monthly returns for FTSE Russell's Indexes. It is important to note that this data set is the same as what was used to show the return premium associated with international small cap stocks in Exhibit 3.

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Exhibit 5. Annualized Volatility of FTSE Russell Index Monthly Returns (December 31, 1999 - June 30, 2017)

	Russell Developed	Russell Global	Russell Developed ex-US	Russell Global ex-US	Russell Emerging Markets
Large Cap	15.49	15.83	17.06	17.53	22.81
Small Cap	17.47	17.88	17.48	18.42	22.99

Source: Acuitas, FTSE Russell

The key takeaway here is that when comparing the risk of international small caps versus international large caps, the difference is not as significant as many investors might think. In our view, the return premiums provided by international small caps (Exhibit 3) compensate investors quite well for taking on the small incremental increase in volatility between large and small caps (Exhibit 5). Unfortunately, due to its short history we couldn't include the Russell Global ex-U.S. Microcap Index in the analysis, however it is worth noting the marginal increase in volatility since the global microcap index's inception in 2014 has been almost non-existent relative to the small cap index (an increase of just 0.14). This relationship is similar in the U.S. markets where there is a much longer history. As we discussed above, international microcap stocks are not penny stocks nor excessively risky, and in aggregate they tend to have risk characteristics and return patterns similar to small cap stocks. Additionally, as we discuss later, the return patterns of international small and microcap stocks are more diversifying than other segments of the equity markets, offering meaningful diversification benefits relative to other segments.

Active International Managers and Excess Returns

While we believe that the small cap premium exists globally from an absolute return perspective, it is the *active* management opportunity that drives us to focus our business exclusively on small and microcap stocks. This opportunity exists for several reasons, including the lack of institutional attention and low cross-sectional correlation between small and microcap stocks. Even during shorter-term environments when passive small and microcap indexes lag large cap indexes, we believe active management can overcome this headwind through security selection. We cover the drivers of the attractive active management opportunity in more detail below, but first we examine the active environment historically for both U.S. and non-U.S. managers.

Exhibit 6 highlights the active returns for managers broken out by market cap and international or U.S. We looked at the average excess return of all investment managers in eVestment's respective databases, gross of management fees, for the periods ending 6/30/17. In each trailing period (3, 5, 7, and 10-year), the excess returns that international small and microcap managers have generated outpaced the active returns of large cap managers, both domestically and internationally. In addition, international small cap managers have produced higher excess returns than those of U.S. small cap managers. These results clearly support the case for investors to consider including active international small and microcap managers in their portfolios.

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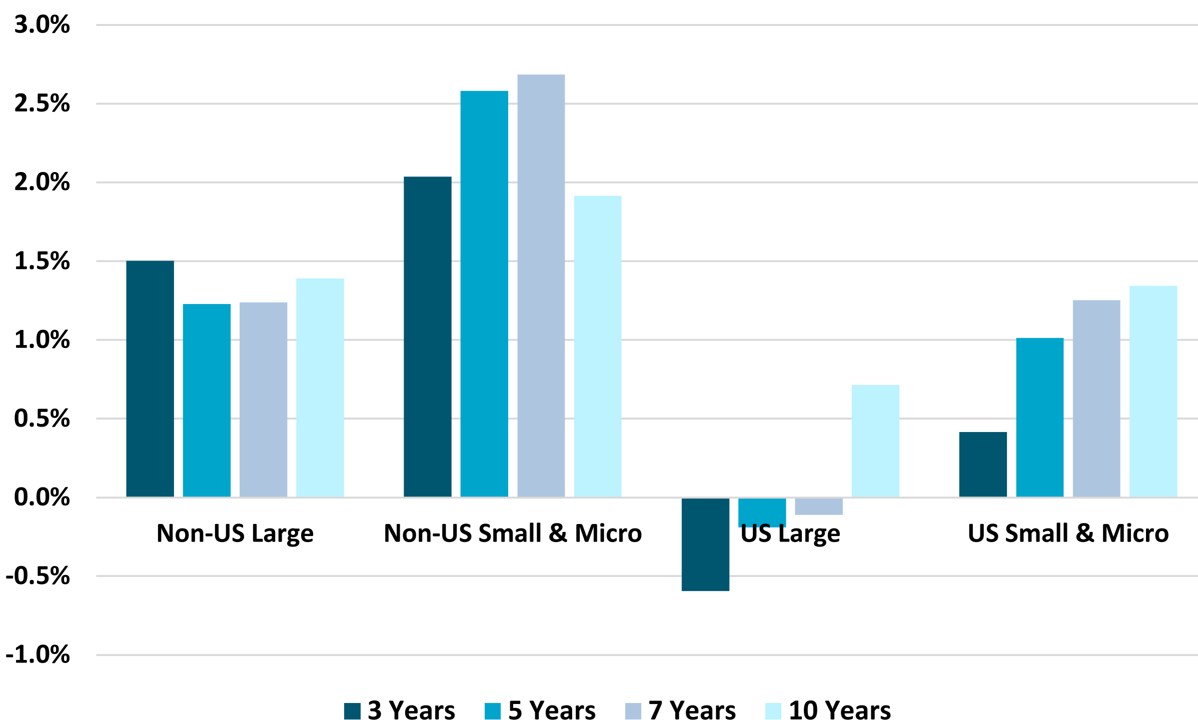
Exhibit 6: Average Active Manager Excess Returns by Cap Size and Geography (Periods ending June 30, 2017)



Source: Acuitas, eVestment.

The Active Return Opportunity – Inefficiency

There are several factors that contribute to active managers' success investing in international small cap stocks. These include limited analyst coverage and an expansive universe of stocks, both of which contribute to the inefficiencies of the space and result in more idiosyncratic returns for the individual securities. In addition, in Exhibit 2, we showed that there are few professional investors looking at these smaller stocks, and a much larger proportion of these stocks are held by relatively less sophisticated retail investors, company management, and/or family members of the companies' founders. Finally, finding company management teams that are experienced and efficient operators is more challenging in international small cap, requiring significant time and resources to visit these teams in person during the fundamental research process. This serves as an additional barrier to investing in international small cap companies. We expand on each of these topics in the sections below.

As a note, eVestment doesn't split out international microcap managers, instead including them within their small cap universe. That said, we think the factors that contribute to international small cap managers' success are magnified for international microcap managers.

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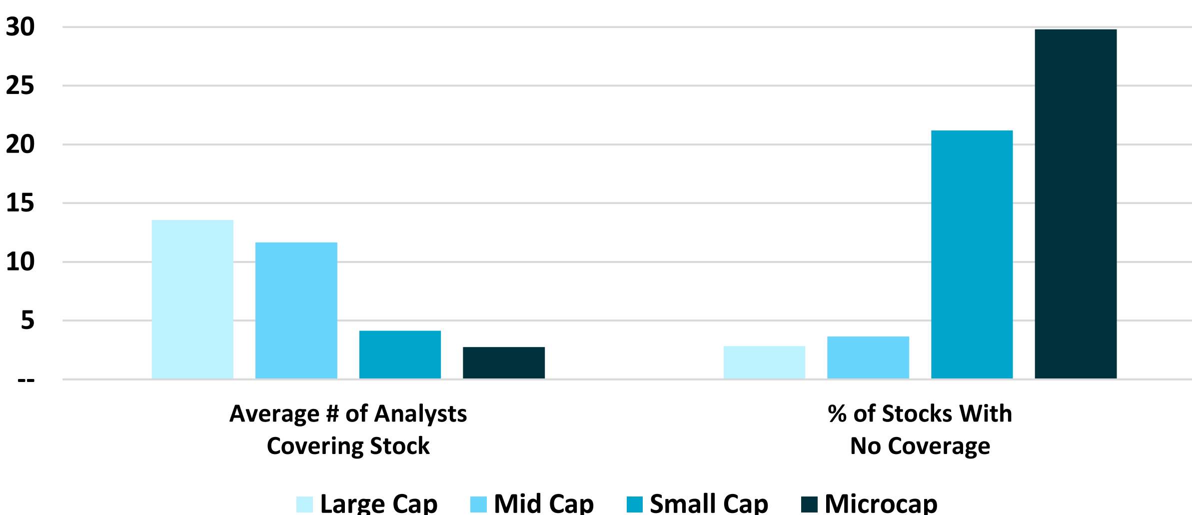
Low Analyst Coverage

Sell-side analysts provide several services to the market. Institutional investors often rely on sell-side analysts for the company and industry data they provide, the financial models they create, and at times even the buy/sell/hold recommendations they offer on individual stocks. Additionally, sell-side analysts take company management on "road shows", visiting potential investors, hosting investors at a factory, or bringing them to conferences. These activities help distribute management's strategic message and provide management access to investors.

Unfortunately, sell-side research is often viewed as a cost center. The work done by analysts can help generate trading and investment banking revenue, but it is challenging to generate sufficient trading volume or generate investment banking revenue on small, locally owned international stocks. This is a key reason why international small and microcap stocks tend to have significantly less coverage than their larger cap and U.S. counterparts, as shown in Exhibit 7. Less coverage, fewer road shows and lower conference attendance by company management causes these companies to be less accessible to institutional investors. This causes the ownership profile of these companies to be tilted more toward local retail investors. Additionally, some of these companies publish information such as quarterly/annual reports less frequently than U.S. companies, and often these reports are only published in their local languages.

This lack of visibility presents challenges for investors to get the information they need to build a proper investment thesis and make informed investment decisions. As a result, news is not reflected in market prices as quickly. There are more good companies with improving fundamentals selling at attractive prices, and those companies are easier to identify for investors willing to dedicate the resources and effort to gain an informational edge.

Exhibit 7: Global Equity Analyst Coverage by Market Capitalization (June 30, 2017)



Source: Acuitas, FactSet, FTSE Russell. Market cap groups are based on the associated Russell Global ex-U.S. Index.

While relatively few institutional investors are watching the international small cap space, we believe the opportunities are further magnified in international microcap. Looking at Exhibit 7 above, the disparity is clear. Mid and large cap stocks average roughly 12 and 14 sell-side analysts, respectively. However, there are only about 4 sell side analysts looking at the average international small cap stock, and less than 3 for microcap. Importantly, 21% of small cap stocks and 30% of microcap stocks have zero sell-side analyst coverage. This is one of the core reasons many sophisticated investors are drawn to international small cap and microcap investing. Investors willing to dedicate themselves to uncovering unique, undiscovered investment ideas in these less efficient markets may be rewarded with strong performance. Additionally, because fewer professional investors are paying attention to these stocks and liquidity is thinner, there is more short-term volatility among individual stocks that investors can exploit through timely buys and sells.

The Discovery Effect

Another source of returns in these less efficient markets is the "discovery effect". As high quality small and microcap companies perform well fundamentally, they gain attention from sell-side research analysts. When analysts initiate coverage, it creates a snowball effect, drawing attention from additional investors. This increases the opportunity for brokers to generate trading revenue in the stock, causing additional analysts to pick up coverage. The result can be a virtuous cycle of stock price increases and increased institutional attention. We refer to this as the "discovery effect" for international small and microcap stocks. Skilled investors can exploit the return premium associated with the discovery effect by identifying these stocks before others and by predicting increasing analyst coverage or institutional awareness. For stocks with low levels of analyst coverage that have not yet experienced this effect, there is more room for institutional investors to add value by doing their own independent analysis on the fundamentals of a company and purchasing the stock before it appears on other institutional investors' radar screens.

The Active Return Opportunity - Capacity Constraints

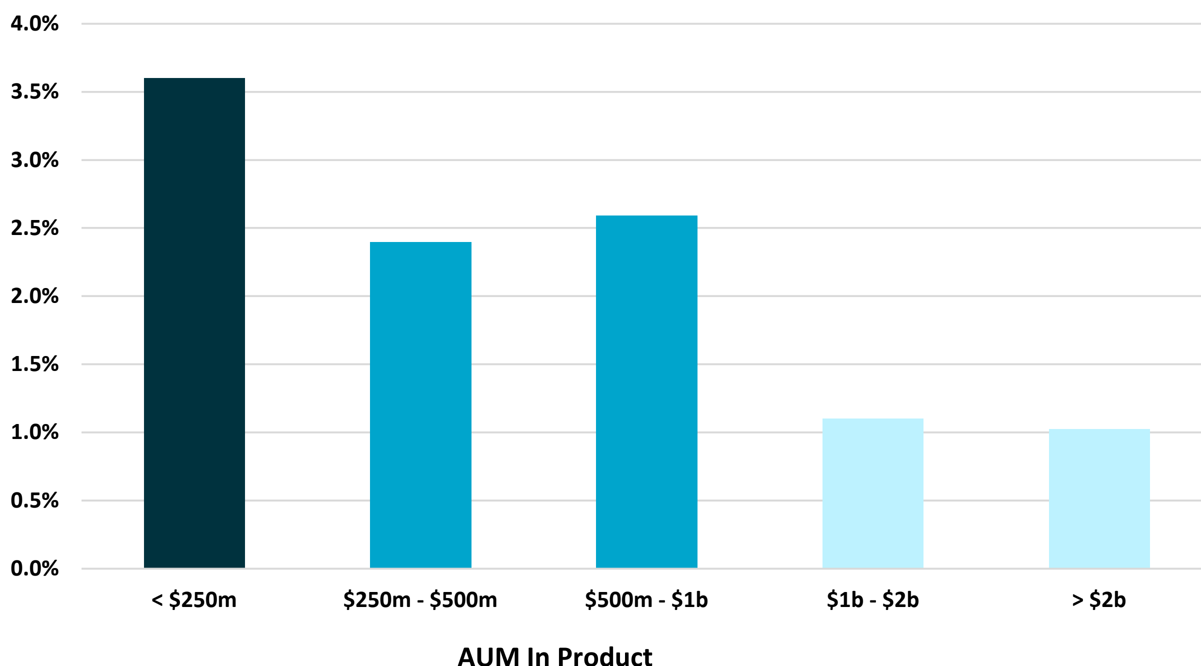
Despite the opportunity to generate attractive active returns in international small and microcap markets, there is relatively little money invested there. Institutional money managers prefer to offer international large cap and all cap strategies for a simple reason: capacity. International small and microcap stocks are less liquid and consequently, products are more capacity constrained than large cap or all cap products. Investors can only allocate small amounts of capital to individual international small and microcap stocks before they own an uncomfortably large percentage of the company. Moving too much money into these smaller stocks can lead to negative price impacts and further challenges due to liquidity constraints.

Conversely, investment managers can manage an asset base in large cap that is many multiples of what they can manage in the small and microcap spaces, making the incentives to run a capacity constrained product such as international small cap quite low. Several investment managers that we research have specifically stated that it would be too expensive and difficult to cover international small cap stocks to warrant launching a product. Thus, despite the stronger performance opportunities available in active small cap, most managers focus on scalable large cap products where they can manage a larger asset base and generate more revenue. With fewer

professional investors looking at international small and microcap stocks, skilled investors willing to invest in these companies can gain a competitive advantage and potentially deliver stronger performance for their clients.

As a compromise, some investment managers choose to manage international small cap products but take on too large of an asset base in search of additional revenues. We firmly believe that assets impair performance. Managers with smaller assets under management have greater flexibility, can more effectively exploit mispricings, and can implement their process more efficiently. 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 below shows the average annual excess return for the last 10 years based on each manager's assets in the product at the start of the year (i.e. 2013 excess returns are based on 12/31/2012 asset levels). There has been a clear relationship between asset size and performance, as those products with less than $250 million in AUM have meaningfully outperformed larger products.

Exhibit 8: Global and International Small Cap, Average Annual Excess Returns by Product AUM. (Ten years ending June 30, 2017)



Source: Acuitas, eVestment Alliance

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Market Cap Drift

As we mentioned above, it is common for international small cap managers to expand their selection universe into the mid cap space. This may be to offer a broader investment universe or because it is easier to research mid cap stocks where company information and sell-side research is more accessible. Additionally, a common reason for this market cap drift is to increase capacity within the product so that the manager can manage a larger asset base, thereby increasing revenues. Regardless, we have noticed that the marketplace is less strict about how it defines small cap within the international universe than it is in U.S. markets. In fact, Morningstar and eVestment lump global ex-U.S. microcap, small cap, and small/mid cap (smid cap) products into a single universe, while in the U.S. there is greater differentiation among those segments.

In our view, many investors are sacrificing return opportunities by using managers that invest a meaningful amount of their portfolios in more efficient, larger stocks. Earlier we noted that we view stocks below $3-$4 billion in market cap as small cap. We looked at the managers in eVestment's international small cap universe to assess the typical market cap exposure of these products. Our expectation for small cap managers is that most of their portfolio should be invested in true small cap stocks (sub $3-4 billion), with the weighted average market cap within "shouting distance" of the global small cap benchmarks (as of 6/30/2017, the Russell Global ex-U.S. Small Cap Index had a weighted average market cap of roughly $1.5 billion). Unfortunately, many managers have market cap exposure that is much higher. Of the 131 products that report market cap statistics in eVestment's respective international small cap universes, only 27% have a weighted average market cap below $2 billion. 60% of the products have a weighted average market cap between $2 billion and $4 billion, which we view as higher than ideal. 12% have a weighted average market cap above $4 billion, which by our definition does not qualify as small cap.

In Exhibit 9 below, we looked at the average annual excess returns of international small and microcap products based on the individual product's weighted average market cap. What we found was a clear excess return advantage for products that remained invested down the market cap spectrum. Products below $1 billion in market cap (which includes microcap) outperformed their benchmarks by more than 5% per year. For those products with a weighted average market cap between $1b - $3b, the average annual outperformance was just north of 2%. Perhaps most notable from this analysis was that as products drift above the small cap range and into what we would consider to be smid cap, the excess returns declined meaningfully, with products above $3b in market cap outperforming by less than 1% on average.

As we have noted, we believe the opportunity for excess returns increases the further down the capitalization spectrum investors go. Managers and investors that stay focused on the lower end of the market have an inherent return advantage, while those who allow their portfolios to drift up are handicapping themselves from a performance perspective. Given this, (and consistent with our findings in the U.S.) we believe microcap managers have the greatest opportunity for excess returns, followed by the managers in the sub $3 billion grouping. Conversely, we suspect that investors allocating to international small cap managers who drift up into mid cap are leaving returns on the table.

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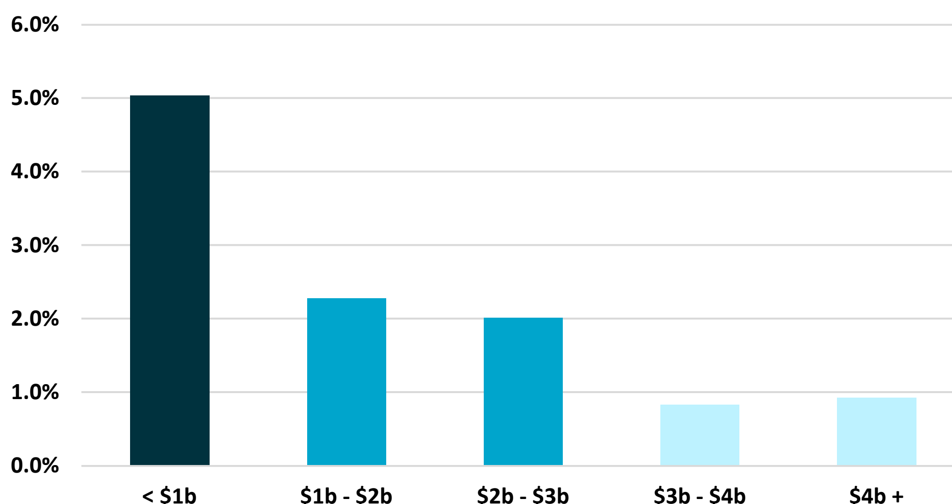
Exhibit 9: Global and International Small Cap, Average Annual Excess Returns by Weighted Average Market Cap. (Ten years ending June 30, 2017)



Source: Acuitas, eVestment Alliance. Market cap data is based on the prior year end weighted average market cap.

On a related note, many investors attempt to access the international small cap space through all cap managers. We don't think all cap managers are well-positioned to exploit the inefficiencies in international small cap stocks. All cap managers' investment teams are accustomed to more accessible information flow on most of the stocks they follow, and are generally less effective at digging into local markets to identify stocks that are off the institutional radar screen (i.e. those that offer the most attractive excess return potential). Instead, they are more likely to gravitate toward easily accessible stocks that have strong investor relations groups, widespread coverage from sell-side analysts, and participate in U.S. road shows that are convenient to attend. While the idea that they can "opportunistically" pick up small cap investments can be intuitive, they are unlikely to be focusing enough on idea generation to uncover the unique investment opportunities that make international small and microcap investing so appealing.

The Active Opportunity – Idiosyncratic Stock Behavior

An additional characteristic that favors international small and microcap managers is that companies tend to be less correlated with each other and display more idiosyncratic return patterns than large companies. Their success is driven more by company specific factors than large cap stocks, including product cycles, management strength, and local industry dynamics. As such, a small cap stock's price behavior tends to be harder to explain with a factor or industry model, which we demonstrate in Exhibit 10 below. The takeaway is that stock volatility not explained by a single factor model increases as you go down the cap spectrum. In other words, smaller stocks behave more uniquely than large stocks, offering active managers greater opportunity to differentiate themselves through generating stock specific research and insights.

Exhibit 10: Percentage of Stock Volatility Not Explained by a Single-Factor Model (12/31/2014 – 6/30/2017)

	% of Stock Level Volatility Unexplained by Model
Large Cap	46.0%
Mid Cap	47.9%
Small Cap	**58.0%**
Microcap	**58.8%**

Source: Acuitas, FactSet
Single-factor model is a CAPM-style beta model. Cap tiers are based on the associated Russell Global ex-U.S. Index

An interesting contrast is to compare international small and microcap stock behavior to U.S. small cap stocks. Many years ago, U.S. small cap was also a lucrative place for active managers to invest, but it has become increasingly difficult for active managers in U.S. small cap. As we have discussed in our previous white paper, "Microcap – Lower Volatility, Greater Opportunity, 2012," and continue to observe, cross-sectional correlations of U.S. small cap stocks have risen with the popularity of passive instruments, particularly the iShares Russell 2000 ETF. Lower levels of market volatility and less cross-sectional return dispersion have provided a headwind for active management. As we see plan sponsors increasingly consider these passive investments, we continue to believe that there are corners of the equity markets that remain highly inefficient, including international small and microcap.

The idiosyncratic nature of international small cap stocks can also be seen in Exhibit 11. By comparing the volatility of the overall index's returns with the average volatility of individual stocks in the index, we can estimate how similar the behavior is of the stocks within the index. Despite having meaningfully 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 hence behave more uniquely.

Exhibit 11: Estimated Stock-Level Correlation by Cap Size.
(Ten years ending June 30, 2017)

	Index Volatility	Average Stock Volatility	Avg. Stock Correlation w/ Index
Russell Global ex-US Large Cap	19.41	37.06	0.51
Russell Global ex-US Small Cap	**20.42**	**46.05**	**0.44**

Source: Acuitas, FactSet, FTSE Russell.

The key takeaway from Exhibits 10 and 11 is that stock specific factors are significantly more impactful on international small and microcap stock returns than they are for large cap stocks. This provides active managers a compelling opportunity to generate above-index returns through stock selection.

Potential for Diversification

It is important to understand the impact international small and microcap have on investors' total portfolio risk. For the most part, international large cap companies operate globally, in the same markets as large cap U.S. companies. Their success is increasingly driven by global economic growth factors. By contrast, most non-U.S. small, and especially microcap companies, have less global exposure, and the drivers of their success are company specific or confined to their own local economy. This dynamic results in a lower correlation with U.S. equities, as seen in Exhibit 12. The lower correlation to U.S. markets may reduce portfolio level risk for investors seeking a diversification benefit from their allocation to international markets.

Exhibit 12: Inception to Date International Index Return Correlations with Russell 3000 (June 30, 2017)

	Correlation with Russell 3000
Russell Global ex-US	0.78
Russell Global ex-US Large Cap	0.77
Russell Global ex-US Small Cap	**0.75**
Russell Global ex-US Microcap	**0.69**

Source: Acuitas, FactSet, FTSE Russell. Correlations are based on monthly returns since the inception of the indexes. Inception dates for the all cap, large cap, and small cap indexes is August 1996. Inception for the microcap index is March 2014.

For further perspective, it is interesting to examine how the various segments have evolved over the last 20 years. As Exhibit 13 demonstrates, although international small cap has remained more diversifying than large cap, it is notable that the correlations across the board have increased in the most recent 10-year period. International small cap stocks' correlation versus the Russell 3000 Index jumped from 0.68 during the 1997-2007 period to 0.84 for the most recent 10-year period. The full historical data isn't available on the microcap index, but the 0.68 correlation for small cap during the first period is in line with microcap's 0.69 correlation since its inception (Exhibit 12). The takeaway for us is that although international small cap remains more diversifying than large cap, it has lost some of its uniqueness in recent periods, while international microcap continues to stand out as a uniquely diversifying segment of the equity markets.

Exhibit 13: International Index Return Correlations with Russell 3000 by Time Period (June 30, 2017)

	Correlations with Russell 3000	
	Trailling 10 Years (7/2007 - 6/2017)	Previous 10 Years (7/1997 - 6/2007)
Russell Global ex-US	0.89	0.72
Russell Global ex-US Large Cap	0.89	0.71
Russell Global ex-US Small Cap	**0.84**	**0.68**

Source: Acuitas, FactSet, FTSE Russell. Correlations are based on monthly returns for the time periods shown.

Conclusion: A Compelling Opportunity

At a time where return targets are increasingly hard to meet, investors need to do everything they can to improve their odds of success. In an environment of lower return expectations, scarce alpha, and the shift toward passive management, we believe international small and microcap stocks stand out as an area where skilled investment managers can still generate attractive excess returns, and investors can find strong returns that will help them meet their targets. Additionally, we believe these opportunities are sustainable given the structural inefficiencies present in the space.

Unfortunately, many investors are not taking advantage of the opportunities available to investors in non-U.S. small cap stocks. Some don't allocate to small cap stocks outside the U.S. at all, while others are counting on obtaining exposure to the space through all cap managers or small cap managers with most of their portfolio invested in larger, heavily trafficked mid cap stocks. In our view, these managers are usually leaving money on the table by not focusing enough attention on the least efficient, undiscovered stocks at the lower end of the cap spectrum.

We believe the most effective way for investors to exploit the returns available in non-U.S. small cap stocks is through dedicated, focused international small cap managers that stay true to investing in small cap companies. Additionally, we believe incorporating microcap within a non-U.S. small cap portfolio improves investors' odds of delivering better long-term returns and improve the risk/reward characteristics of their portfolio.

520 Pike St, Suite 1221 | Seattle, WA 98101 | +1 206 299 2070 | www.acuitasinvestments.com

Disclosures

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520 Pike St, Suite 1221 | Seattle, WA 98101 | +1 206 299 2070 | www.acuitasinvestments.com