

## International Small Cap: Will it ever lead again?

April 2025

**Doug Porter, CFA**

[dporter@acuitasinvestments.com](mailto:dporter@acuitasinvestments.com)

**Chris Tessin, CFA**

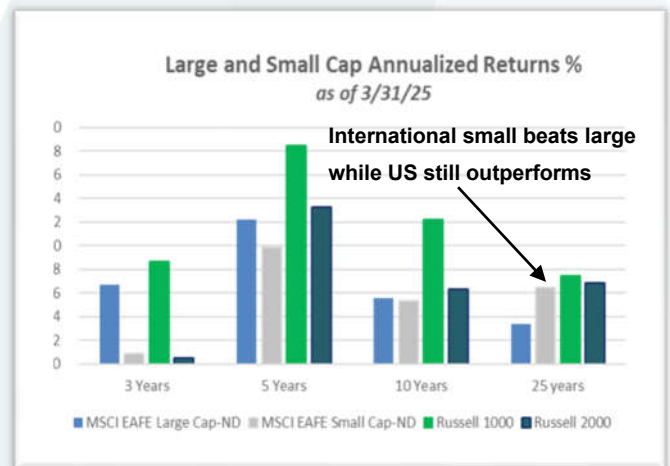
[ctessin@acuitasinvestments.com](mailto:ctessin@acuitasinvestments.com)

*"Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria." -Sir John Templeton*

### Pessimism

#### **It's been a long time since International Small led.**

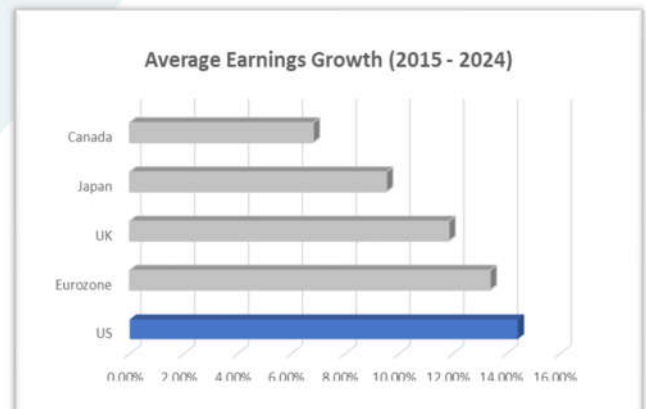
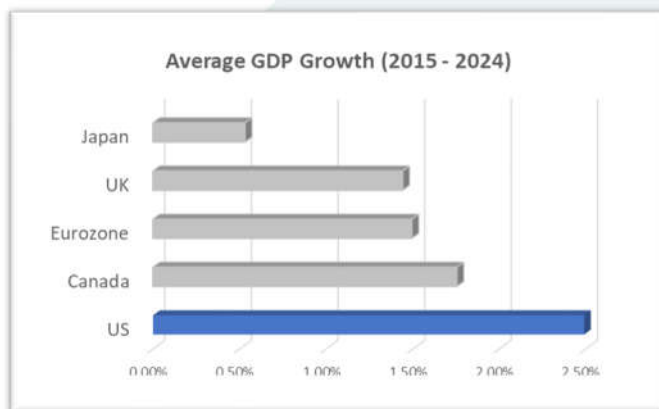
International small companies have underperformed their large cap peers for the past five consecutive calendar years. As a result, allocators now must look beyond 10 years to find a trailing period where international small cap stocks have led large caps. The challenges haven't just been outside the U.S., as investors have grown increasingly skeptical of the 'small cap premium' globally. That said, given international markets have underperformed the U.S. for an extended period, the case is most challenging for international small cap markets.



Source: Acuitas Investments, eVestmentAlliance

#### **The lag has been somewhat warranted.**

Major developed market countries outside the U.S. have experienced lackluster economic and earnings growth over an extended period.



Average of calendar year GDP growth and twelve-month weighted median earnings growth. Source: Acuitas Investments, FactSet

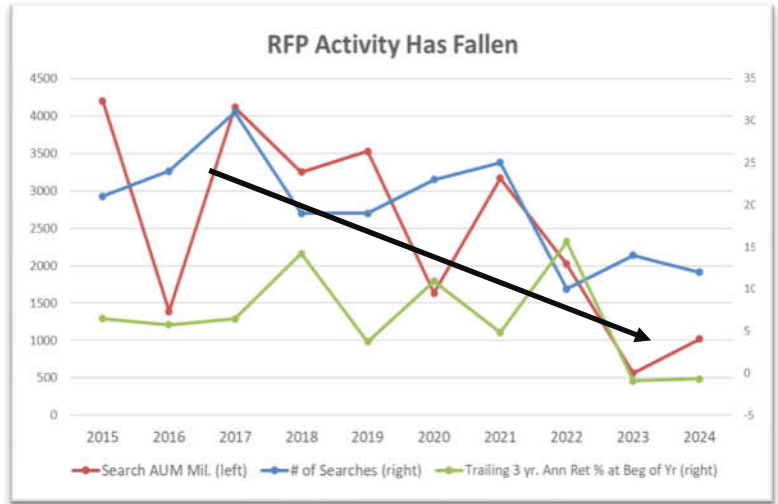


**Strategists now overlook the return opportunity.**

Coming into 2025, strategists seemed, understandably so, hesitant to make the call on a small cap rebound. Some, who acknowledged low valuations, preferred instead to address small cap in a risk context (e.g., reduce your benchmark relative underweight).

**RFP activity is down.**

Concurrent with relatively poor performance, search activity for international small cap has declined.

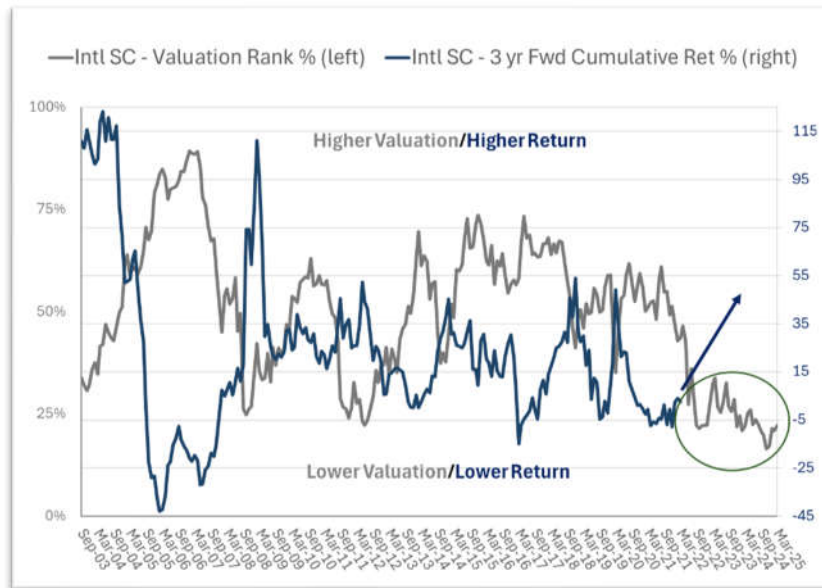


International Small Cap RFP activity and performance. Source: Acuitas Investments, Finsearches

**Opportunity**

**Valuations are at historical lows and expected returns look appealing.**

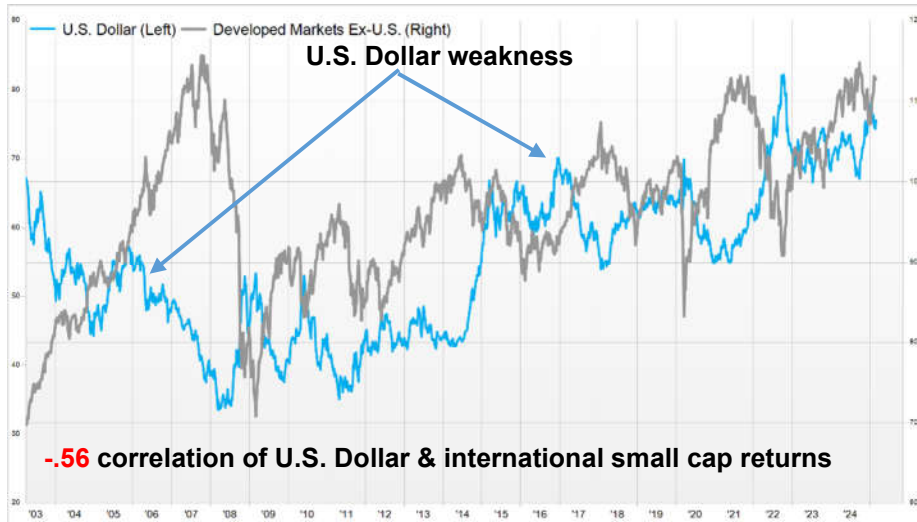
International small caps are cheap, trading at some of their lowest relative valuations in the past 20 years versus other small cap regions, large caps, and their own history. Historically, forward 3-year returns have been strong when investing during periods of low valuation.



Source: Acuitas Investments, eVestmentAlliance. Dates: 09/30/2003 to 2/28/2025. The valuation rank % shown is the equal weighted percentile rank of valuations (price/forward earnings, price/book, price/cash flow, & dividend yield) relative to the historical multiples between 9/30/2003 - 2/28/2025. International small cap returns are represented by the FTSE Small Cap Developed x US Index.

**A weak dollar correlates with strong international small cap returns.**

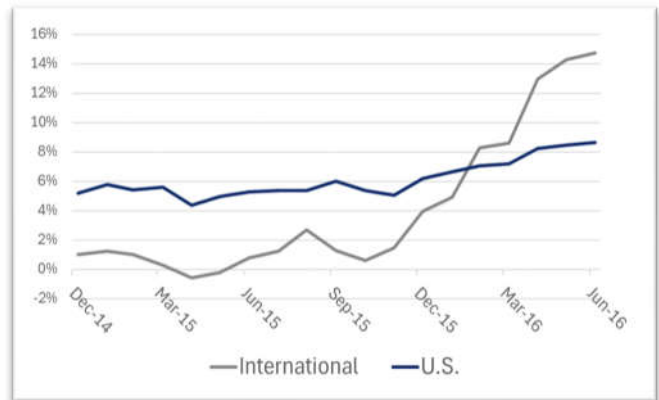
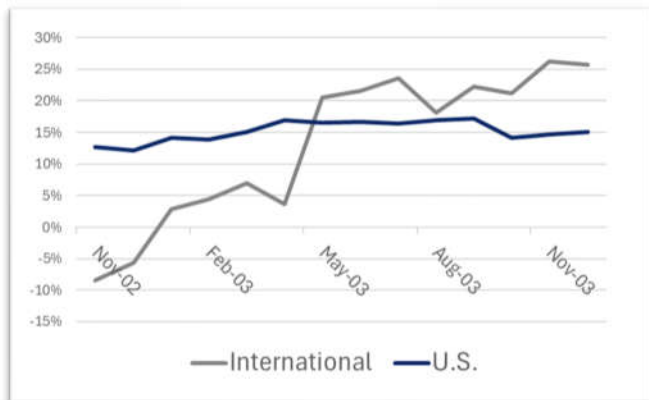
U.S. dollar valuations are negatively correlated to international market returns, and especially international small cap leadership. From 2003 to 2007 and 2015 to 2017, dollar weakness helped drive international small caps to outperform international large caps and U.S. small caps.



Source: Acuitas, FactSet. International price levels are represented by the iShares MSCI EAFE ETF. U.S. Dollar value is represented by the DXY Index. Correlation based on DXY Index and the MSCI EAFE Small Cap Index.

**Relative projected earnings growth has been more resilient abroad.**

Earnings drive returns, especially in small caps. Earnings inflection captures investor attention, driving the discovery effect and positive price momentum. International investors reacted to positive inflections in forecast 12-month earnings growth in 2003 (left) and 2015 (right).



Dates: 11/30/2002 to 1/31/2004 (left). Weighted median forecast twelve-month earnings growth using FTSE Developed Small Cap Ex-US, I-shares MSCI EAFE ETF, and Russell 3000 constituents. Source: Acuitas Investments, FactSet



**International small caps should weather tariffs more favorably.**

International companies outperformed their U.S. counterparts by double digits in the first quarter of 2025, as expected earnings growth held up relatively well, especially in small cap.



Dates: 6/30/24 – 1/31/25, Values represented the weighted median forecast twelve-month earnings growth forecast using the I-Shares MSCI EAFE Small Cap ETF, iShares MSCI EAFE ETF, Russell 2000 Index, and Russell 1000 Index constituents. Source: Acuitas Investments, FactSet

Why? International small caps are more domestically oriented and expected to benefit from deregulation and fiscal spending. For example, Europe intends to increase defense spending while Japan is having success bolstering corporate governance and stimulating demand. Meanwhile, with deficit spending above 6% of GDP, U.S. fiscal policy of the new administration aims to rein in spending. The magnitude and speed of policy changes has increased economic uncertainty, creating headwinds to economic activity and giving the advantage to international small cap markets.

**Closing Thoughts**

International small caps have led the market in periods where they were inexpensive, capital transitioned overseas, and prospective earnings growth improved. As we think about the market environment today, similar dynamics appear to be lining up. Sentiment towards growth prospects overseas coming into 2025 was poor, valuations were near historic lows, and the combination of policy changes and relative expected earnings growth resilience is now driving a change in capital flows. As a result, we believe near term drivers will continue to support international small cap equities and we expect to see further reversion relative to other areas of the equity markets over the next three years.





Past performance is not a guarantee of future returns. Investing in securities involves risk of loss that investors should be prepared to bear. Investments in small and microcap companies may be less liquid and prices may fluctuate more than those of larger, more established companies.

This material contains the current opinions of Acuitas and is presented solely for informational purposes. Nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation or solicitation to buy, sell or hold a security. No recommendation or advice is being given as to whether any investment or strategy is suitable for a particular investor. It should not be assumed that any investments in securities, companies, sectors or markets identified and described were or will be profitable.

Information is obtained from sources deemed reliable, but there is no representation or warranty as to its accuracy, completeness or reliability. Charts and graphs maybe limited by date ranges specified on those charts and graphs; different time periods may produce different results. All information is current as of the date of this material and is subject to change without notice.

Index returns do not reflect any fees or expenses and are not directly available for investment.

Acuitas Investments, LLC is a registered investment adviser headquartered in Seattle, WA serving institutional and individual investors. For more information please visit our website at [www.acuitasinvestments.com](http://www.acuitasinvestments.com) or contact us at 206-299-2070.