BALLENTINE PARTNERS

Investment Research

International Small Cap
Hiding in Plain Sight

BALLENTINE PARTNERS | ANDREW HACKER, CFA | MARCH 2019

Executive Summary

Professional investors have long touted the benefits of investing globally in order to expand the opportunity set and diversify the portfolio beyond home country borders. Most investors have expressed this view by investing in large capitalization multinational companies based outside the United States. We believe that investors have largely overlooked a more attractive subset of international equities: small capitalization stocks. Their returns have significantly outpaced large cap international stocks over long time frames with only slightly more risk. They offer significantly higher growth potential than large cap companies, but at similar valuation levels. These companies tend to focus on their local markets, providing significant diversification benefits to a global equity portfolio dominated by global franchises. In addition, they are not widely followed, creating an opportunity for active managers to generate superior returns versus unmanaged indices.

The following presents the case for why small cap international stocks should have a place in every global investment portfolio. For the past 5 years, we have had a significant overweight to international small cap in our recommended international equities portfolio. This paper makes the case for why we will continue to do so.

The Case for International Small Cap Investing

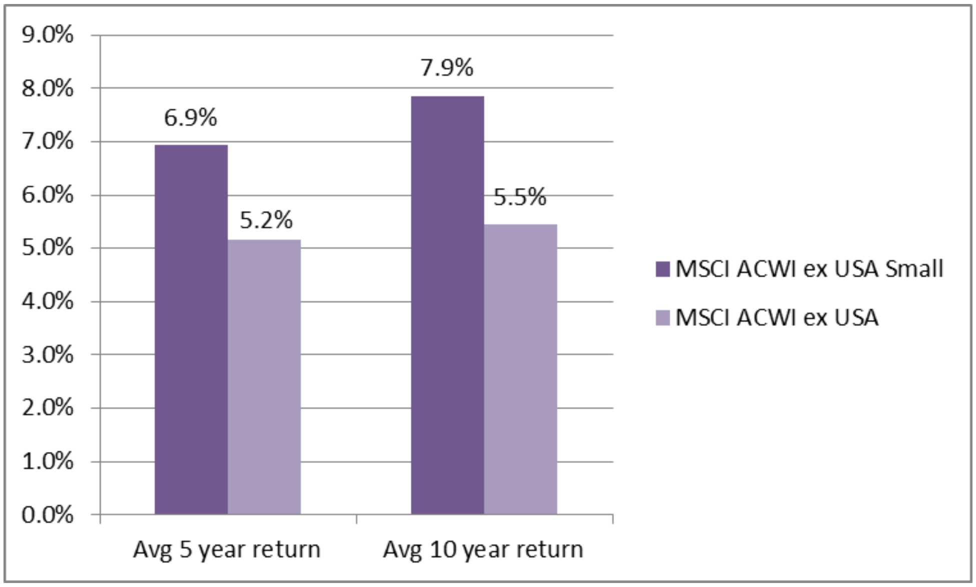
1. Historic outperformance

International small caps have significantly outperformed large caps over trailing 5, 10, and 15 year periods, as indicated in the table below.

Historical performance (annualized)			
	5 yr	10 yr	15 yr
MSCI ACWI ex USA Small	3.9%	11.5%	7.6%
MSCI ACWI ex USA	3.1%	8.4%	5.6%

Source: Morningstar Direct, data as of 1/31/2019

Rolling Returns Since 1995



Source: Bloomberg, data as of 12/31/2018

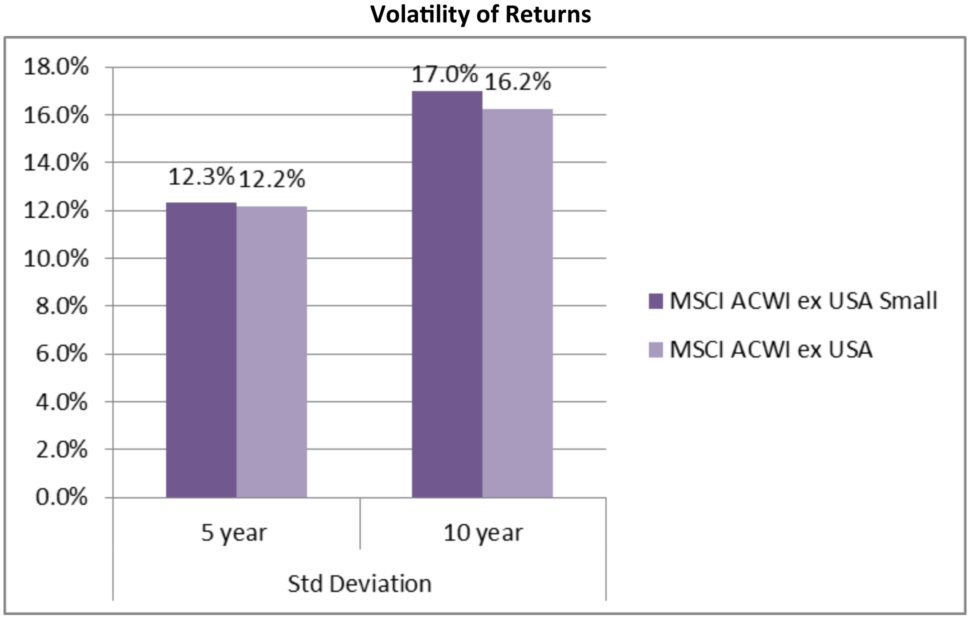
Of course, the past decade has seen one of the longest global bull markets in history. A look at average rolling returns since 1995 demonstrates the consistency of the small cap premium.

Over rolling 5 year periods since 1995, the leading international small cap index (MSCI ACWI ex USA Small Cap) averaged a return of 6.9% versus 5.2% for the large cap index. Over longer-term 10 year rolling periods, small caps outperformed large caps by an average of 2.4% per annum.

Are international small caps riskier than large caps?

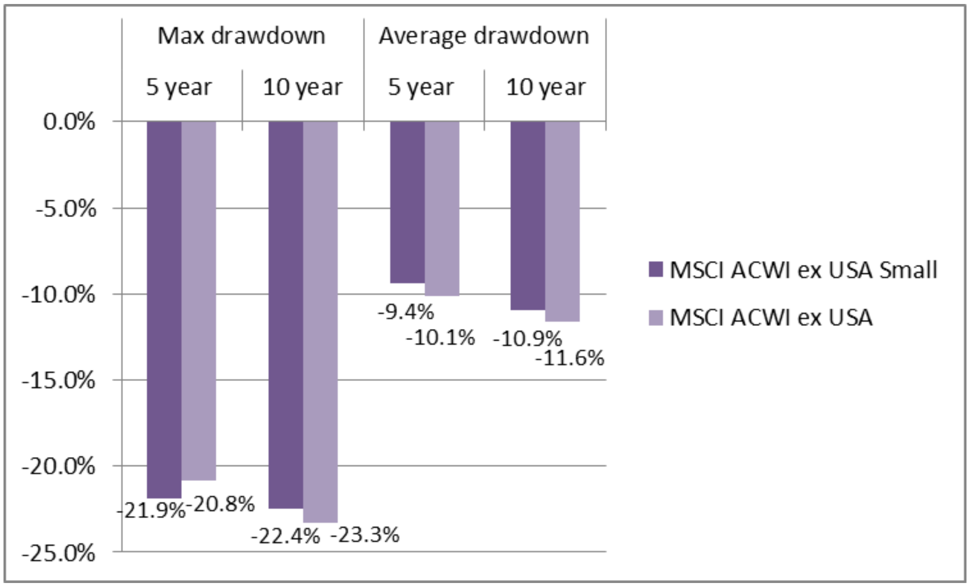
Smaller companies tend to experience large swings in their share prices. Over the past decade, US small cap stocks (as represented by the S&P Small Cap 600 Index) experienced annualized standard deviation of 18%

Volatility of Returns



Source: Morningstar Direct, data as of 1/31/2019

Maximum & Average Drawdown



Source: Morningstar Direct, data as of 1/31/2019. Calculated using monthly total returns since February 2009.

compared to 13.4% for the S&P 500[1]. Outside the US, the volatility gap between small and large caps stocks is less extreme.

Over the past 5 and 10 years, MSCI ACWI ex USA Small Cap exhibited only slightly higher price volatility relative to MSCI ACWI ex USA (large cap). When considered in light of their historical outperformance, the marginally higher volatility of international small caps seems like a worthwhile tradeoff.

For long term investors, price volatility is an incomplete measure of risk. Drawdown-related risk measures are more useful in quantifying the risk of more permanent capital loss.

In terms of average and maximum drawdowns, the data reflect little difference between non-US large and small cap stocks. Only over the past 5 years did MSCI ACWI ex USA Small Cap experience a more severe maximum drawdown than the corresponding large cap index. In fact, small caps experienced more shallow average drawdowns over both 5 and 10 year periods ending 1/31/2019.

The data indicates that international small caps offer a compelling risk-return tradeoff versus large caps. With drawdown risks and price volatility similar to large caps, international small caps have generated a meaningful *risk-adjusted* premium over large cap over multiple time frames.

2. Growth potential

Historically, small caps have exhibited higher earnings growth than large caps. Earnings growth data for MSCI EAFE-based products (developed markets excluding emerging) has a longer history.

Historical earnings growth (per annum)		
	5 yr	10 yr
iShares MSCI EAFE Small Cap ETF (SCZ)	6.9%	7.9%
iShares MSCI EAFE ETF (EFA)	2.2%	4.3%

Source: FactSet, data as of 12/31/2018

[1] Source: Morningstar Direct, data as of 1/31/2019.

Forward-looking growth & valuation		
	2019 Earnings Growth (est.)	Forward P/E
Vanguard FTSE All World ex-US Small Cap ETF (VSS)	14.1%	14.7
Vanguard FTSE All World ex-US ETF (VEU)	6.7%	13.1
Small Cap premium	109.8%	12.5%

Source: FactSet, data as of 1/31/2019

The iShares MSCI EAFE Small Cap ETF (SCZ) grew earnings at nearly double the pace of its large cap equivalent ETF (EFA) over the past decade. Over the past 5 years, the excess growth available in small caps was even more pronounced.

Based upon expected future growth, the international small cap segment currently offers high growth potential at a reasonable price.

Consensus estimates for 2019 earnings growth are 11% and 5.5% for MSCI EAFE Small Cap and MSCI EAFE respectively, according to FactSet. One would expect to pay a higher valuation for the excess growth promised in small cap, and international small caps are no exception. While the small cap index trades at a 13% valuation premium over large caps, earnings are expected to grow at over double the pace of large caps in 2019.

The tradeoff between growth and valuation can be quantified in terms of the PEG ratio, which is calculated as price-to-earnings ratio divided by earnings growth. This measure quantifies the unit of valuation paid for a unit of growth, and a low PEG ratio indicates that a security is relatively attractive based upon its future growth. As expected, the 1.04 PEG ratio of Vanguard's All World ex-US Small Cap ETF (VSS) is significantly lower than the 1.94 PEG of Vanguard's All World ex-US ETF (VEU). In other words, the growth premium available in small cap does not come at a commensurately higher price.

3. Diversification

Over the past decade, international small cap stocks have demonstrated improved diversification potential relative to international large cap stocks.

Over the past 10 years, the MSCI ACWI ex USA Small Cap Index exhibited lower correlation to US and global stocks than the large cap MSCI ACWI ex USA Index.

Small cap stocks tend to generate sales predominantly from their home countries, with less exposure to global systematic risks than larger firms. For example, the iShares Core S&P Small Cap ETF (IJR) generates nearly 80% of its revenues in the US[2]. In contrast, just 62% of S&P 500 revenues originate in the US.

Outside the US, small cap stocks also exhibit a domestic tilt. Companies which generate sales primarily in their home country are exposed to less currency risk. International small caps, therefore, should be less exposed to currency risk than large caps. Comparing US dollar and local currency volatility of both indices gives an idea of their currency exposure.

Correlation		
	Russell 3000	MSCI ACWI
MSCI ACWI ex USA Small Cap	0.83	0.94
MSCI ACWI ex USA	0.86	0.98

Source: Morningstar Direct, data as of 1/31/2019. Calculated using monthly total returns since February 2009.

[2] Source: FactSet, data as of 1/31/2019.

10-year standard deviation: currency effect			
	USD	Local	% from currency
MSCI ACWI ex USA Small Cap	17.0%	12.8%	32%
MSCI ACWI ex USA	16.2%	11.9%	36%

Source: Morningstar Direct, data as of 1/31/2019

The conversion from local currency to US dollars adds more incremental volatility to the large cap index – an indication of its global nature. The tendency for small caps to be more domestic adds to their diversification potential. For instance, the Vanguard FTSE All World ex-US Small Cap ETF (VSS) generates just 9% of sales in the United States compared to 14% for their All World ex-US large cap ETF (VEU)[3]. The improved revenue diversification offered by small caps explains its low correlation to US and global stocks over time.

4. Lack of coverage creates active management opportunities

Institutional investors commonly allocate capital to US small cap stocks on the basis of a historic return premium over large caps and their diversification benefits. As a result, US small cap mutual funds have become widely available in a number of flavors and styles: the Morningstar US Fund Small Cap Growth, Value and Blend categories contain more than 575 funds from which to choose. Outside the US, small cap investing is not as well-followed by Wall Street: the Morningstar Foreign Small/Mid Growth, Value and Blend categories contain only 100 offerings.

A study of the investable universe of non-US stocks by EAM Investors found that just 5.4% of names are large cap, but they make up 62% of the total market capitalization[4]. The broad universe of over 4,000 small and mid-cap stocks outside the US is serviced by relatively few active investment products, creating an abundance of opportunities for alpha generation.

As passive investing has exploded in recent years, active equity fund managers have struggled to keep pace across all styles and geographic regions, as can be seen in the Dow Jones SPIVA U.S. Scorecard.

International small cap managers were not immune to these challenges, but they did fare better than other domestic and international categories. As shown in the table below, a smaller percentage of international small cap managers underperformed their benchmarks than any other category over the past 3, 5, and 10 year periods (although a majority still failed to outperform).

Percentage of funds underperforming benchmark			
	3 year	5 year	10 year
US large cap	78.6%	76.5%	89.2%
US small cap	93.6%	92.9%	93.4%
Int'l	76.8%	74.1%	76.8%
Int'l small cap	67.5%	71.9%	63.3%
Emerging Mkts	73.9%	86.2%	86.3%

Source: SPIVA U.S. Scorecard, data as of 6/30/2018

[3] Source: FactSet, data as of 1/31/2019

[4] Source: EAM Investors, *A Case for NonUS Small Cap*, (2018)

Morningstar takes a slightly different approach to analyzing active manager success rates. They compare performance of actively managed funds against a composite of the passive alternatives available in the category. Morningstar's February 2019 Active/Passive Barometer noted a significantly higher 70.6% 10-year success rate for Foreign Small/Mid Blend Funds.

While the differences in calculation methodologies are beyond the scope of this paper, we note that both approaches conclude that international small cap fund managers perform well relative to other categories. We believe the headwinds faced by active management in the public equity markets may be least powerful in categories such as international small cap, where markets are less efficient and companies have less research coverage.

The international small cap universe is broad and is not well-covered by sell-side analysts. The average stock in the MSCI ACWI ex US Small Cap universe is covered by just 5 sell-side analysts[5]. In contrast, the average US large cap stock in the Russell 1000 index is covered by 16 sell-side analysts. The dearth of Wall Street involvement in small cap markets abroad provides opportunities for active managers to add value through fundamental research. Less readily available information on company earnings and growth prospects create opportunities for an information advantage. In addition, thanks to Europe's MiFID II regulations, Wall Street coverage of the region is set to decline. Asset managers and investment banks plan to reduce sell-side coverage across the Eurozone, which constitutes approximately 25% of the ACWI ex USA Small Cap universe[6].

Active managers in the segment have indeed capitalized on the lack of information and analyst coverage. Since 1995, the Morningstar US Foreign Small/Mid Blend active fund category has added value over the index. The average rolling 10 year return for the active fund category is 9.1%, outperforming the 7.9% average return of the MSCI ACWI ex USA Small Cap Index[7]. Over shorter-term 5 year rolling periods, the active fund category averaged a 9% return, again outperforming the index which averaged 6.9%.

Summary

Opportunities exist in international small cap markets for both active managers and index investors. For similar levels of volatility and downside risk, international small caps have outperformed large caps. International small caps are better diversifiers for global and US equity portfolios. Importantly, we feel that active managers are well positioned to further capitalize on market inefficiencies and lack of Wall Street research coverage in smaller segments of international markets. For these reasons, Ballentine Partners continues to believe that every global equity investor should maintain a meaningful allocation to international small cap stocks.

[5] Source: FactSet, data as of 12/31/2018

[6] Source: Morningstar Direct, data as of 1/31/2019

[7] Source: Morningstar Direct, data as of 12/31/2018

About Andrew Hacker, CFA

Andrew is a Research Analyst at the firm and is responsible for research coverage of global equity markets at the firm. His research helps inform portfolio construction, manager selection, and market outlook.

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