INTERNATIONAL SMALL CAPS:
PICKING CHERRIES OR HARVESTING THE FIELD?

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International small caps have attracted attention in recent years due to the appealing characteristics of the asset class. Like US small caps, international small caps tend to outperform the mid and large cap categories,[1] and an allocation provides attractive diversification benefits. The category also represents a fertile opportunity set, with inefficiencies stemming from the breadth of the universe and the associated shallowness of analysts' coverage.

However, while the benefits of the asset class are attractive, how to best achieve exposure to it is not always clear. There is certainly more than one method of reaping these benefits, including both bottom-up and regionally-inspired approaches. However, key traits of the international small cap universe suggest a more structured approach may be warranted. What follows builds the case for how a more growth-agnostic factor-based portfolio can provide attractive exposure to the asset class.

THIS IS NOT THE US

Whether investing in the US or internationally, it is common to look at small caps from a fundamental, bottom-up, growth-oriented perspective. There are merits to this approach given that small caps tend to be less efficient. However, it is a very US-centric way of looking at small caps, and may not be as suitable for international companies.

When comparing the fundamental characteristics of the Russell 2000 with the MSCI ACWI Global ex US ("global small cap index") indices, it becomes apparent why this is the case. As shown in Exhibit 1, the Russell 2000 has a much more outspoken growth profile as evidenced by the higher valuation and lower profitability metrics. This reflects the US's higher entrepreneurial risk culture that allows companies to go to market earlier in their life cycle. Currently, 39% of the companies in the Russell 2000 are unprofitable or trading above 50x earnings, implying very low profitability. In contrast, only 12% of the global small cap index shares the same profile.

FIGURE 1

As of 12/31/17	MSCI AC World ex USA Small Cap	Russell 2000
No. of Securities	4,355	1,983
Market Capitalization	2,452.2	2,389.7
Dividend Yield	2.2	1.2
Price/Earnings	13.9	20.1
P/E using FY1 Estimates	17.3	20.5
P/E using FY2 Estimates	15.4	18.3
Estimated 3-5 Year EPS Growth	14.4	12.5
Price/Cash Flow	8.7	10.4
Price/Book	1.7	2.2
Price/Sales	0.9	1.3
Return on Equity	11.7	6.5

Source: MSCI, Russell, FactSet

Given the differing style profile of the global small cap index, a fundamental, growth-oriented strategy may inadvertently constrain the opportunity set by failing to consider enough companies. Our research has shown that it is more effective to evaluate the universe on valuation, momentum, and liquidity while limiting stock specific volatility, as these factors have persistently positive betas within the asset class. This approach typically provides a broader, more stable set of risk premia to exploit.

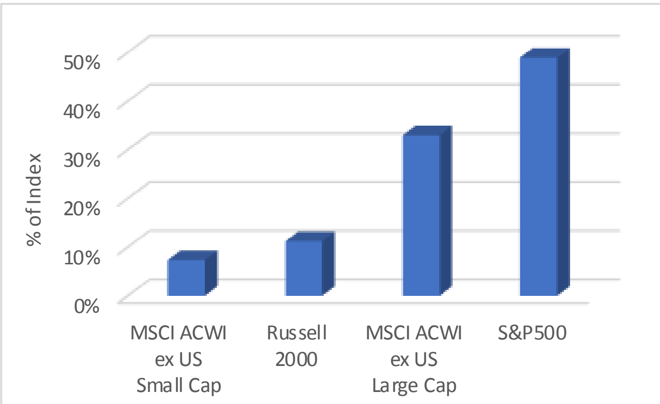
PICKING CHERRIES FROM THE TREE

With over 4,000 stocks, the global small cap index is one of the broadest indexes, and the constituent size distribution is relatively uniform. The size and composition of the index have several implications for active management. Most notably, they lead to higher relative risk for the average manager that looks to cherry pick the "best" stocks from the index. A comparison of the large and small cap indexes illustrates why.

As seen in Exhibit 2 on the following page, the aggregate weight of the top 50 companies in the large cap indexes is much larger relative to the small cap indexes. These companies tend to have an outsized influence on the performance of the overall index. In contrast, the small cap indexes are less top-heavy, reflecting more uniform position sizing. With index performance much less influenced by a top-tier of stocks, the logical inference is that a

[1] As represented by the 15-year annualized return for the MSCI ACWI ex US Small Cap Index (+12.1%), MSCI ACWI ex US Mid Cap Index(+10.5%), and MSCI ACWI ex US Large Cap Index (+8.3%). Index returns computed from the period beginning December 31, 2002 and ending December 31, 2017 (Source: MSCI, FactSet). Past performance does not guarantee future results. Investing involves risk.

Figure 2: Top 50 Holdings as % Index (as of 12/31/17)



Source: MSCI, Russell, S&P, FactSet

small cap portfolio invested in 50-100 holdings will have a naturally higher tracking error.

This logic is reflected in a sample of 53 international small cap portfolios identified from the eVestment database. Of the 53 portfolios, 32 held 75 stocks or fewer while only 8 held more than 200 stocks. The median 3-year tracking error of the sample was 5.42%.[2] The two primary reasons why the relative risk of the average manager is higher are capacity constraints on fundamental research and liquidity. It would be unreasonable to assume that a fundamental bottom-up manager has the bandwidth to cover a meaningful portion of the universe. Further, a sizeable segment of the index is relatively illiquid, and therefore incompatible with, or disproportionately risky for, concentrated portfolios.

The liquidity and coverage constraints both limit access to and, indirectly, help to reinforce the most sustainable inefficiencies within the asset class: the previously identified liquidity and value premiums. This leads to the question: How is it possible to pick the sweetest basket of fruits if you can't see the orchard for the trees? Further, the higher relative risk profile of a high-conviction portfolio will inevitably stray from the risk/reward characteristics of the asset class, leading to the next question: How far are you willing to deviate from and dilute the very characteristics that attracted you to the asset class in the first place?

Harvesting the Field

The practical constraints of the asset class seem to leave few alternatives. Either assume more risk with an active high-conviction portfolio or gain broad exposure using a passive strategy. However, a quantitative, factor-driven strategy can strike a balance between excessive concentration and uncompensated over-diversification. A portfolio with 200 positions may not reflect conviction in the companies, but it can reflect blended conviction in the persistent inefficiencies within the asset class: those amalgamated in illiquidity, valuation, and momentum. A portfolio that is well exposed to these factors provides the opportunity to sustainably harvest a bountiful collection of excess returns.

[2] The sample data represent the ACWI ex US Small Cap Equity universe within eVestment as collected on February 27, 2018. Managers identified as SMID, mid-cap, or micro-cap were removed from the original sample of 65 managers. The median 3-year tracking error is as of December 31, 2017 and is based on monthly returns. The monthly returns reported by each manager may be gross or net of fees (Source: eVestment).

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