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Making the Case for International Small Caps

INTRODUCTION

The benefits of investing in domestic small-cap companies are firmly established within the U.S. investment community. This popular asset category is widely viewed as providing opportunities for strong total returns on an absolute and risk-adjusted basis relative to large caps, as well as enhancing diversification within a total portfolio context. Despite the presence of these same attractive investment characteristics globally, small-cap investing is often ignored or dismissed as inordinately risky when market participants allocate overseas.

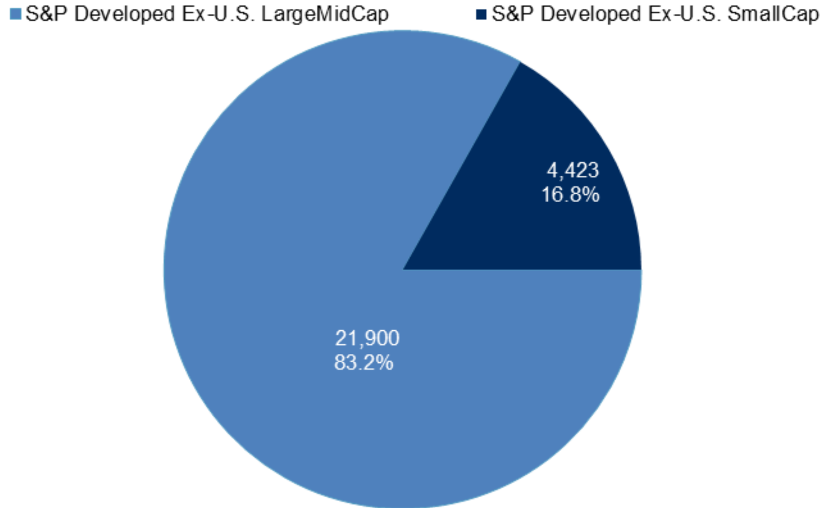
In this paper, we will demonstrate that international small caps represent a meaningful portion of the global equity opportunity set, have historically generated strong absolute and risk-adjusted returns, have been less volatile than U.S. small caps, and have relatively low correlations to U.S. equities and other asset classes. Moreover, mutual fund companies and other investment analysts often argue that the extensive universe of small-cap international stocks and the corresponding lack of analyst coverage make this category ripe for active management. However, our empirical findings suggest that active managers have not demonstrated a particularly high level of success in international small caps.

INTERNATIONAL SMALL CAPS REPRESENT A MEANINGFUL PORTION OF THE EQUITY OPPORTUNITY SET

International small caps represent a meaningful portion of the overall global investable equity opportunity set. Constructed as the lowest 15% of float-adjusted market cap in each country, the S&P Developed Ex-U.S. SmallCap represented nearly 17% of overall non-U.S. equities as of Sept. 30, 2017 (see Exhibit 1). Meanwhile, only 8.1% of international equity ETF holdings were allocated to small caps.[1]

[1] Data from etfb.com; compiled by S&P DJI on Oct. 9, 2017.

Exhibit 1: Comparative Market Cap (USD Billions) and Constituent Count of Developed Ex-U.S. Indices



INDEX	MARKET CAP (USD BILLIONS)	INDEX CONSTITUENTS
S&P Developed Ex-U.S. LargeMidCap	21,900	1,355
S&P Developed Ex-U.S. SmallCap	4,423	3,828

Source: S&P Dow Jones Indices LLC. Data as of Sept. 29, 2017. Chart and table are provided for illustrative purposes.

Some market participants may define small caps within a specific market-cap range, despite their country of domicile and direct peer group. Exhibit 2 displays the size makeup of the S&P Developed Ex-U.S. SmallCap. More than 85% of constituents have market caps below USD 2 billion and over 97% have market caps below USD 5 billion.

Unwittingly, market participants who depend on the MSCI EAFE Index and MSCI World ex USA Index alone for global equity exposure are limited to large- and mid-cap exposure only; these indices don't include small caps—the lower 15% of companies in terms of market cap.

Exhibit 2: Size Buckets of the S&P Developed Ex-U.S. SmallCap

SIZE	MARKET CAP	CONSTITUENTS
< USD 2 Billion (%)	50.7	85.1
< USD 5 Billion (%)	81.9	97.2

Source: S&P Dow Jones Indices LLC. Data as of Sept. 29, 2017. Table is provided for illustrative purposes.

Globally minded market participants who include some portion of international equities in their investments are likely familiar with two widely used indices: the MSCI EAFE Index and MSCI World ex USA Index. Unwittingly, market participants who depend on these indices alone for global equity exposure are limited to large- and mid-cap exposure only; these indices don't include small caps—the lower 15% of companies in terms of market cap. This approach limits potential diversification benefits offered by the asset class.

SMALL CAPS HAVE OFFERED HIGHER TOTAL RETURNS OVER LONG PERIODS

International small-cap stocks have generally generated greater gains than their corresponding large- and mid-cap counterparts over short-, medium-, and long-term periods. Although higher historical returns in this size segment (see Exhibit 3) have not been associated with higher risk over the three- and five-year periods, standard deviations are understandably somewhat greater over longer periods (see Exhibit 4).

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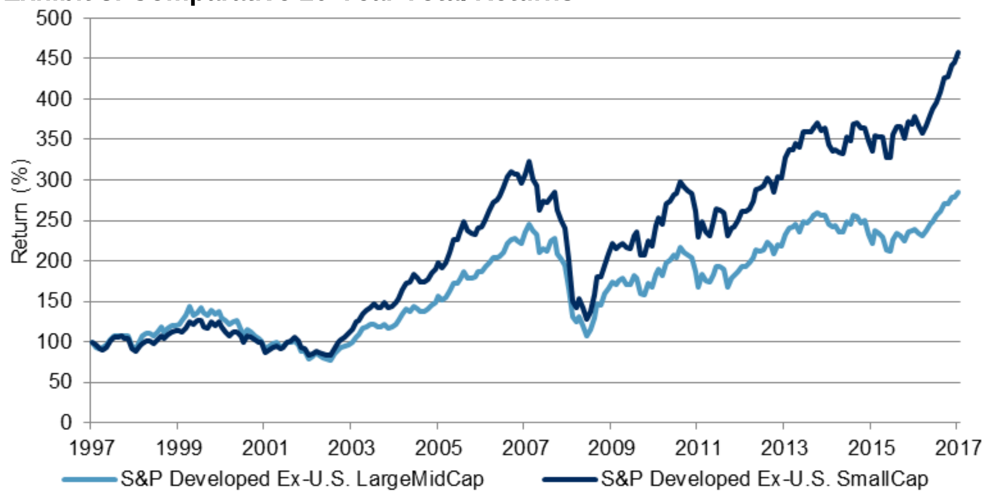
Exhibit 3: Comparative 20-Year Total Returns



Source: S&P Dow Jones Indices LLC. Data from Sept. 30, 1997, to Sept. 29, 2017. Past performance is no guarantee of future results. Chart is provided for illustrative purposes.

The small-cap outperformance phenomenon is particularly telling on a risk-adjusted return basis, which continues to support small caps as an opportunity for improved return compared with large caps over short-, mid-, and long-term horizons.

Combining various asset classes that exhibit relatively low correlations to one another is important in maximizing total risk-adjusted return.

Exhibit 4: Comparative Total Returns & Risk – International LargeMidCap Versus SmallCaps

PERIOD	S&P DEVELOPED EX-U.S. LARGEMIDCAP	S&P DEVELOPED EX-U.S. SMALLCAP
TOTAL RETURN (ANNUALIZED, %)		
1-Year	19.2	20.7
3-Year	5.1	10.1
5-Year	8.2	11.9
10-Year	2.0	4.1
15-Year	9.0	12.0
20-Year	5.4	7.9
From Sept. 29, 1989	5.6	6.2
RISK (STANDARD DEVIATION, %)		
3-Year	12.0	11.7
5-Year	11.4	11.4
10-Year	18.6	20.0
15-Year	16.6	17.8
20-Year	16.7	17.5
From Sept. 29, 1989	16.7	17.6
RETURN/RISK		
3-Year	0.43	0.86
5-Year	0.72	1.04
10-Year	0.11	0.20
15-Year	0.54	0.67
20-Year	0.32	0.45
From Sept. 29, 1989	0.34	0.35

Source: S&P Dow Jones Indices LLC. Data from Aug. 31, 1989, to Sept. 29, 2017. Past performance is no guarantee of future results. Table is provided for illustrative purposes and reflects hypothetical historical performance. Please see the Performance Disclosure at the end of this document for more information regarding the inherent limitations associated with back-tested performance.

DIVERSIFICATION POTENTIAL

Combining various asset classes that exhibit relatively low correlations to one another is important in maximizing total risk-adjusted return. As shown in Exhibit 5, international small caps have relatively low correlation to U.S. large- and small-cap equities as well as other major asset classes, such as U.S. bonds and commodities.

Exhibit 5: 15-Year Correlations to the S&P Developed Ex-U.S. SmallCap

CORRELATION	S&P DEVELOPED EX-U.S. SMALLCAP	S&P 500	S&P SMALLCAP 600	S&P GSCI	S&P U.S. AGGREGATE BOND INDEX	S&P DEVELOPED EX-U.S. LARGEMIDCAP
S&P DEVELOPED EX-U.S. SMALLCAP	1.00	-	-	-	-	-
S&P 500	0.83	1.00	-	-	-	-
S&P SMALLCAP 600	0.76	0.88	1.00	-	-	-
S&P GSCI	0.49	0.35	0.34	1.00	-	-
S&P U.S. AGGREGATE BOND INDEX	0.09	-0.06	-0.15	-0.04	1.00	-
S&P DEVELOPED EX-U.S. LARGEMIDCAP	0.97	0.88	0.77	0.48	0.05	1.00

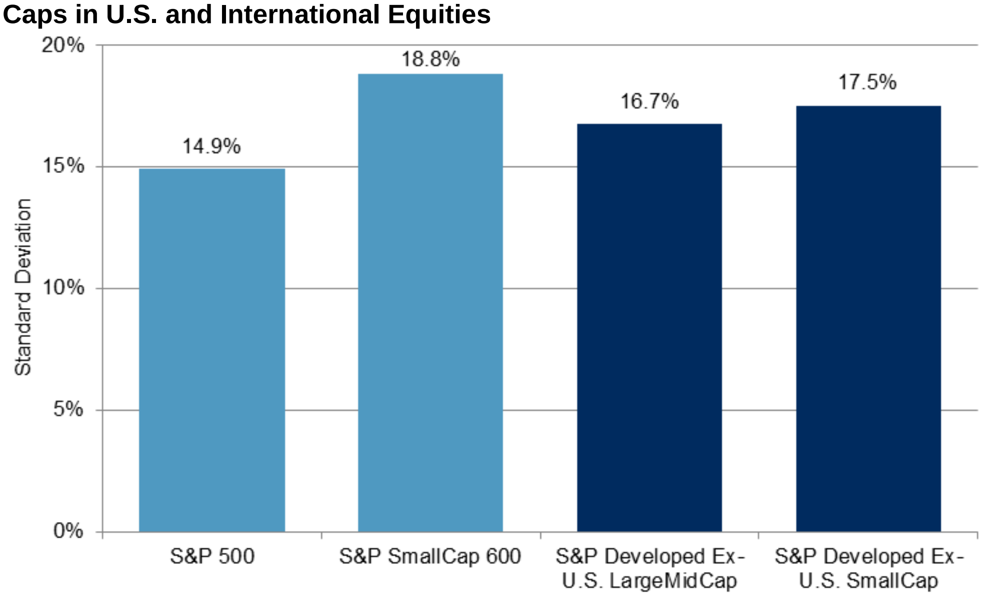
Source: S&P Dow Jones Indices LLC. Data as of Sept. 29, 2017. Past performance is no guarantee of future results. Table is provided for illustrative purposes and reflects hypothetical historical performance. Please see the Performance Disclosure at the end of this document for more information regarding the inherent limitations associated with back-tested performance.

While international equities on the whole experienced greater volatility than U.S. equities over the past 20 years, international small caps have only been modestly more volatile than their large- and mid-cap counterparts.

EVALUATING RISK OF INTERNATIONAL SMALL CAPS

International small caps are typically viewed as an extremely risky asset category. However, an analysis of historical data shows this belief to be largely unfounded. While international equities on the whole experienced greater volatility than U.S. equities over the past 20 years, international small caps have only been modestly more volatile than their large- and mid-cap counterparts. Additionally, the volatility of the S&P Developed Ex-U.S. SmallCap was actually lower than the S&P SmallCap 600.

Exhibit 6: 20-Year Risk (Standard Deviation) Comparison – Small and Large Caps in U.S. and International Equities



Source: S&P Dow Jones Indices LLC. Data as of Sept. 29, 2017. Past performance is no guarantee of future results. Chart is provided for illustrative purposes.

DEBUNKING THE MYTH THAT INTERNATIONAL SMALL CAPS ARE RIPE FOR ACTIVE MANAGEMENT

Increased allocation to international small caps may offer added alpha, increased diversification, and favorable levels of risk for those who seek a truly broad and diversified global portfolio.

Proponents of active management often cite the large universe of small companies and limited analyst coverage as evidence that international small caps are ripe for exploitation by skilled managers. However, empirical evidence of manager performance has found this to be a misconception. In the SPIVA® U.S. Mid-Year 2017 Scorecard, we found that over 83% of funds underperformed their respective benchmark over a 15-year period (see Exhibit 7). Though managers may outperform their benchmark over the short term, the success rate drops dramatically over horizons longer than one year.

Exhibit 7: International Small-Cap Funds Outperformed by Benchmarks

PERIOD	FUNDS OUTPERFORMED BY BENCHMARK (%)
1-Year	46.2
3-Year	67.8
5-Year	70.9
10-Year	64.3
15-Year	83.3

Source: S&P Dow Jones Indices LLC, SPIVA U.S. Mid-Year 2017 Scorecard. Data as of June 30, 2017. Past performance is no guarantee of future results. Table is provided for illustrative purposes.

CONCLUSION

Globally minded market participants may benefit from re-examining their current allocations in order to enhance exposure to international small caps. While many market participants may broadly include international equities in their current allocations, they often omit this important size segment. Increased allocation to international small caps may offer added alpha, increased diversification, and favorable levels of risk for those who seek a truly broad and diversified global portfolio. Furthermore, passive investment strategies work similarly well in this segment—on average, passive indexing has outperformed active management over mid- and long-term periods.

PERFORMANCE DISCLOSURE

The S&P U.S. Aggregate Bond Index was launched on July 15, 2014. The S&P Developed Ex-U.S. SmallCap and S&P Developed Ex-U.S. LargeMidCap was launched on December 31, 1992. All information presented prior to an index's Launch Date is hypothetical (back-tested), not actual performance. The back-test calculations are based on the same methodology that was in effect on the index Launch Date. Complete index methodology details are available at www.spdji.com.

S&P Dow Jones Indices defines various dates to assist our clients in providing transparency. The First Value Date is the first day for which there is a calculated value (either live or back-tested) for a given index. The Base Date is the date at which the Index is set at a fixed value for calculation purposes. The Launch Date designates the date upon which the values of an index are first considered live: index values provided for any date or time period prior to the index's Launch Date are considered back-tested. S&P Dow Jones Indices defines the Launch Date as the date by which the values of an index are known to have been released to the public, for example via the company's public website or its datafeed to external parties. For Dow Jones-branded indices introduced prior to May 31, 2013, the Launch Date (which prior to May 31, 2013, was termed "Date of introduction") is set at a date upon which no further changes were permitted to be made to the index methodology, but that may have been prior to the Index's public release date.

Past performance of the Index is not an indication of future results. Prospective application of the methodology used to construct the Index may not result in performance commensurate with the back-test returns shown. The back-test period does not necessarily correspond to the entire available history of the Index. Please refer to the methodology paper for the Index, available at www.spdji.com for more details about the index, including the manner in which it is rebalanced, the timing of such rebalancing, criteria for additions and deletions, as well as all index calculations.

Another limitation of using back-tested information is that the back-tested calculation is generally prepared with the benefit of hindsight. Back-tested information reflects the application of the index methodology and selection of index constituents in hindsight. No hypothetical record can completely account for the impact of financial risk in actual trading. For example, there are numerous factors related to the equities, fixed income, or commodities markets in general which cannot be, and have not been accounted for in the preparation of the index information set forth, all of which can affect actual performance.

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