International Small Cap: An Overlooked Opportunity

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OVER THE PAST SEVERAL DECADES, THE EQUITY ALLOCATION OF INVESTOR PORTFOLIOS HAS EVOLVED FROM CONTAINING SOLELY U.S. LARGE CAP STOCKS TO THE ADDITION OF DEDICATED INVESTMENTS IN U.S. MEDIUM AND SMALL CAP STOCKS, INTERNATIONAL LARGE AND MEDIUM CAP STOCKS, AND EMERGING MARKETS STOCKS. THE ADVANTAGE OF INVESTING IN THESE SEGMENTS OF THE EQUITY MARKETS IS THE POTENTIAL FOR HIGHER RETURNS WHILE REDUCING VOLATILITY AND ADDING DIVERSIFICATION. THROUGHOUT THE EVOLUTION OF EQUITY PORTFOLIOS, ONE SEGMENT REMAINS LARGELY OVERLOOKED IN MOST INVESTOR PORTFOLIOS: INTERNATIONAL SMALL CAP STOCKS. LIKE THEIR U.S. COUNTERPARTS, INTERNATIONAL SMALL CAP STOCKS OFFER THE SAME BENEFITS: THE POTENTIAL FOR ENHANCED PERFORMANCE, AN EXPANDED OPPORTUNITY SET, AND INCREASED DIVERSIFICATION.

DIVERSIFICATION

An important element of diversification lies in the expanded opportunity set that international small cap stocks offer. As of March 31, 2010, the MSCI EAFE Small Cap Index contained 2,245 stocks compared to only 952 stocks in the MSCI EAFE Index (Exhibit 1). The S&P Developed ex-US Broad Market Index shows an even greater disparity in the number of international small cap stocks versus international medium and large cap stocks (3,326 versus 1,160 as of 12/31/2009).

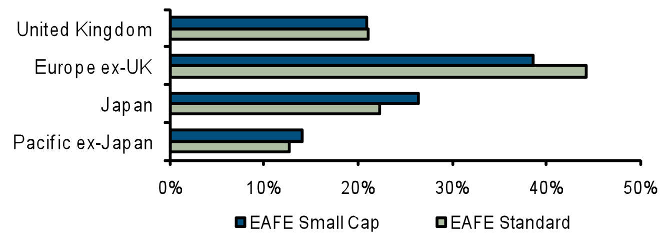
Exhibit 1: Number of Stocks as of 3/31/2010

	EAFE Standard	EAFE Small Cap
United Kingdom	102	280
Europe ex-UK	362	808
Japan	340	818
Pacific ex-Japan	148	339
Total	**952**	**2,245**

Source: MSCI

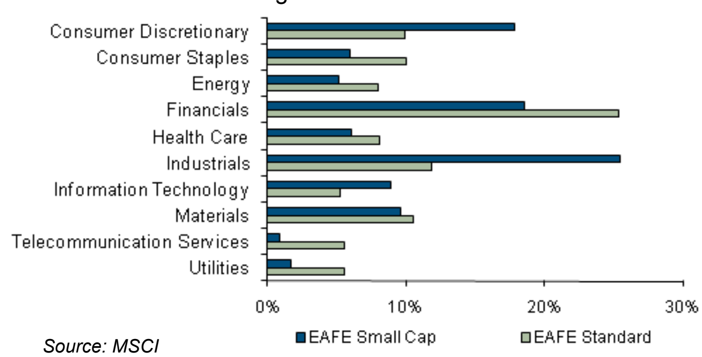
There are also significant differences in the composition of the opportunity set depending on the capitalization range (Exhibits 2 and 3). When comparing the sector weights of the MSCI EAFE Small Cap and MSCI EAFE Indexes as of March 31, 2010, the small cap space has much greater exposure in the Industrials, Consumer Discretionary, and Technology sectors. Conversely, the small cap universe has less exposure to the Telecomm Services, Consumer Staples, and Utilities sectors. Additionally, there are notable differences in the country composition of the indices. The MSCI EAFE Small Cap Index has a greater exposure to Japan and the smaller European countries (e.g., Norway, Sweden, and Austria) and less exposure to the larger European countries (e.g., France, Germany, and Switzerland).

Exhibit 2: Regional Weights as of 3/31/2010



Source: MSCI

Exhibit 3: Sector Weights as of 3/31/2010



Source: MSCI

These differences in the opportunity set within international small cap stocks have resulted in low correlations to the other segments of the global equity universe. Over the past 15 years (1995-2009), performance of the MSCI EAFE Small Cap Index has shown relatively low correlations to the S&P 500 Index (0.65), Russell 2000 Index (0.68), MSCI EAFE Index (0.88), and MSCI Emerging Markets Index (0.79). An allocation to international small cap stocks can help diversify an overall equity portfolio.

INEFFICIENT MARKET SPACE

A key differentiator of international small cap stocks is the inefficient behavior of this segment of the equity markets. In general, broker coverage of small cap stocks is minimal when compared to large cap stocks (Exhibit 4). Public information on smaller companies is often difficult to find and not well analyzed. As a result, stock prices for the most part do not reflect all available information on a company, creating valuation opportunities for investors who perform in-depth fundamental research.

Exhibit 4: Average Analyst Coverage of Global Stocks by Market Capitalization as of March 2009

Market Capitalization	Average # of Analysts
>$10B	18
$5B - 10B	12
$2.5B - 5B	10
$2B - 2.5B	8
$1B - 2B	6
$500M - 1B	5
$250M - 500M	3
$100M - 250M	2
<$100M	1

Source: Factset

Analysis of company-specific information is vital for investing in international small cap stocks. The Barra Integrated Model (risk analysis) shows that stocks in the MSCI EAFE Small Cap Index have more idiosyncratic (stock-specific) risk and less common local (country-specific) risk when compared to stocks in the MSCI EAFE Index. This bodes well for the prospect of higher returns through active management.

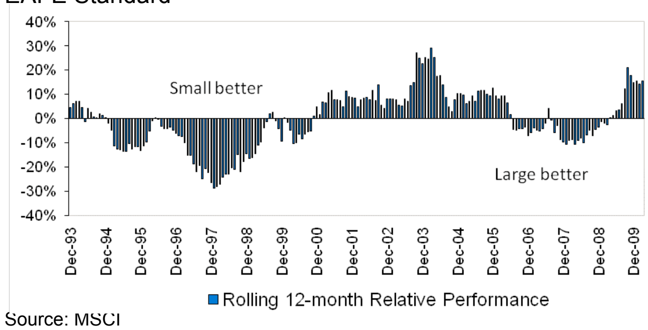
Liquidity also plays a role in the inefficiency of international small cap stocks. Due to their size, normal market flows can often create pricing anomalies for smaller companies. Selling can drive a stock price lower than justified (and vice versa) over short time periods. This illiquidity discount can lead to attractive valuation opportunities for investors.

HISTORICAL PERFORMANCE

As observed in the historical performance of U.S. large and small cap stocks, international small cap stocks have outperformed their large cap counterparts over full market cycles. Over the last 10 years (2000-2009), the rolling 12-month return of the MSCI EAFE Small Cap Index has exceeded that of the MSCI EAFE Index in 80 of 120 months (Exhibit 5). On an annualized basis over that same 10-year time period, the EAFE Small Cap Index outperformed the EAFE Index 6.3% versus 1.2%.

Additionally, international small cap stocks have outperformed international large cap stocks in 84% of rolling 15-year periods and 100% of rolling 20-year and 25-year periods from 1975 to 2009.

Exhibit 5: Relative Performance of EAFE Small Cap vs. EAFE Standard



Source: MSCI

In addition to superior long-term performance versus international large cap stocks, international small cap stocks have produced higher returns after market bottoms. In the 12 months following the past four market bottoms, the MSCI EAFE Small Cap Index has outperformed the MSCI EAFE Index by an average margin of 10.2 percent, including this most recent period (Exhibit 6).

One of the misconceptions of international small cap stocks is that in order to achieve the higher returns associated with that segment of the market one must be tolerant of higher volatility of returns (as measured by standard deviation). Instead, historical performance has shown that international small cap stocks have only slightly higher volatility than U.S. small cap stocks and international large cap stocks, yet have superior absolute and risk-adjusted results.

Exhibit 6: Cumulative Outperformance of Small-Cap Stocks versus Large-Caps after Market Bottoms

Months	EAFE Small Cap vs. EAFE Standard				
Post	Oct 1992*	Feb 1995	Mar 2003	Mar 2009	Average
1	-0.7	-4.2	-0.4	2.5	-0.7
2	0.2	-5.9	2.3	5.6	0.5
3	1.9	-7.0	5.8	8.8	2.4
4	3.3	-7.4	6.8	7.6	2.6
5	5.4	-7.6	12.3	11.9	5.5
6	8.3	-6.3	16.7	14.1	8.2
7	14.4	-8.7	20.3	13.1	9.8
8	8.5	-9.8	16.6	10.1	6.4
9	9.7	-11.6	15.1	9.2	5.6
10	10.6	-12.7	21.5	14.3	8.4
11	10.2	-10.1	22.9	13.1	9.0
12	5.5	-9.5	29.3	15.6	10.2

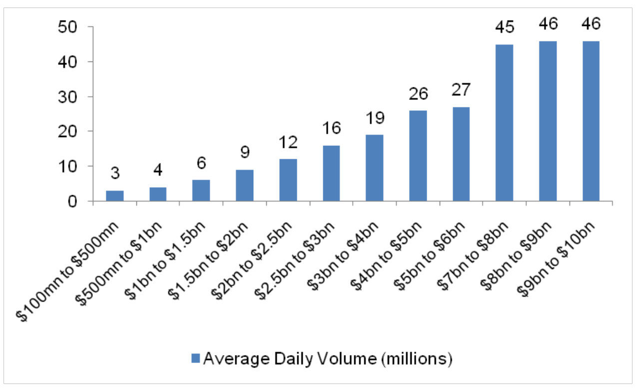
* The first two months after the October 1992 market bottom use the S&P/Citi Small-Cap Index as the EAFE Small Cap Index did not exist. The two indices have a correlation of approximately 95%, thus, the substitution is reasonable.
Source: MSCI

RISKS

Although international small cap stocks provide significant benefits in the form of portfolio diversification and enhanced return potential, investors should be aware of some inherent risks associated with investing in this space.

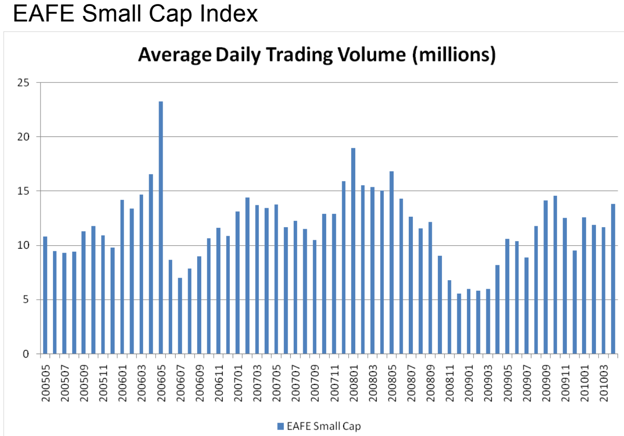
Liquidity is the primary risk associated with international small cap investing. Due to the relatively lower levels of average daily trading volume (Exhibit 7), building or reducing positions in small cap stocks can take several days to avoid adversely impacting stock prices. Furthermore, overall liquidity in the international small cap markets can be impaired during times of crisis (e.g., November 2008 through March 2009), making trading difficult for investors (Exhibit 8).

Exhibit 7: Average Daily Trading Volume by Market Cap Range as of March 2009



Source: Factset

Exhibit 8: Average Daily Trading Volume of the MSCI EAFE Small Cap Index



Source: Factset

Business risk is also elevated for international small cap stocks. In comparison to larger companies, smaller companies often have management teams with less depth and experience, limited financial resources (e.g., access to capital and/or financing), success levered to a single product or service, and undeveloped economies of scale. As a result, the probability of business impairment, or even failure, is greater.

Availability of information (or lack thereof) is another risk related to international small cap investing. Because smaller companies are often managed and/or controlled by the founders and their families, corporate governance in terms of minority shareholder treatment and transparency of company information can be hurdles to overcome. Also, unlike larger companies that have adopted U.S. GAAP or IFRS accounting standards, many smaller companies still use non-standard financial reports that must be obtained, analyzed and adjusted to make appropriate comparisons to other companies.

THE CURRENT OPPORTUNITY

Even with the sharp rally of the international small cap markets in 2009 (43.2% return for the MSCI EAFE Small Cap Index versus 31.8% for the MSCI EAFE Index), valuations are still below their historical averages. While the price-to-earnings ratios are not as appealing due to depressed earnings following the global recession in 2008-2009, current price-to-book ratios for most regions show significant discounts to historical medians (Exhibit 9), representing an attractive opportunity to begin investing in international small cap stocks. Also, cumulative returns since the market peak in October 2007 are still negative (Exhibit 10), suggesting that the non-U.S. small cap markets still have some room to rise before performance returns to pre-crisis levels.

Exhibit 9: Price-to-Book Ratios for MSCI Small Cap Indices

	3/31/2010	Median	Discount to Median
United Kingdom	1.97	1.97	0%
Europe ex-UK	1.39	1.80	23%
Japan	0.93	1.43	35%
Pacific ex-Japan	1.42	1.81	21%
EAFE Small Cap	**1.30**	**1.64**	**21%**

Note: Median calculated over the time period 9/30/2003- 3/31/2010

Source: MSCI

Exhibit 10: Performance from 10/31/2007 through 3/31/2010 for MSCI Small Cap Indices

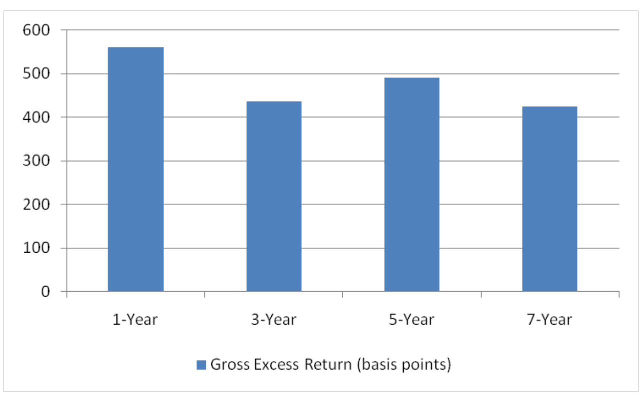
	Cumulative Return
United Kingdom	-34.3%
Europe ex-UK	-29.1%
Japan	-18.8%
Pacific ex-Japan	-28.8%
EAFE Small Cap	**-27.0%**

Source: MSCI

While the universe of international small cap equity mutual funds is limited compared to international large cap equity mutual funds (64 vs. 351 as of 12/31/2009), over 90% are open to new investors, indicating that there is sufficient capacity in the marketplace to access international small cap stocks on a dedicated basis. Additionally, all 58 international small cap equity strategies in PSN (a separate account composite database) are open to new investors in some capacity.

Active management has proven to be a beneficial means of accessing international small cap stocks. Over both short and long-term periods, the median international small cap equity manager has added significant value over the EAFE Small Cap Index on a gross of fees basis (Exhibit 11). Even with an average annual fee of 100 basis points, the median manager would have still achieved significant excess returns.

Exhibit 11: Annualized Performance of the Median International Small Cap Manager versus the MSCI EAFE Small Cap Index as of 3/31/2010



Source: EAI Non-U.S. Small Cap Equity universe, MSCI

SUMMARY

International small cap equities can add meaningful diversification and enhanced return potential in investors' overall portfolios. While this segment of the equity market has been largely ignored in favor of other areas, such as emerging markets equities, it is not too late to begin allocating to international small cap stocks for those investors with medium to long term horizons. With small cap stocks representing approximately 10% of the total non-U.S. equity market capitalization, we recommend that investors devote 10-20% of their non-U.S. equity allocation to small cap stocks.

We are strong advocates of active management for international small cap equities. Manager selection is critical as the aforementioned market inefficiencies lead to a wide range of returns across the universe of international small cap equity strategies. Thorough due diligence is required to identify those managers with the skill and expertise to produce competitive performance on a consistent basis. Evaluation Associates can assist investors in finding and selecting an appropriate international small cap manager to complement their existing portfolios.

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