International Small-Cap

AN UNTAPPED UNIVERSE

As asset allocators increasingly look to diversify their equity exposure, many are discovering the compelling case for international small-caps. A vast and relatively untapped universe, the asset class provides ripe opportunity for generating alpha with lower downside capture and volatility.

In Brief

This white paper provides the facts on investing in small and mid-cap companies in developed markets outside North America — the benefits and opportunities, myths and misperceptions, along with the critical success factors for active management within a globally diversified portfolio.

Key Takeaways

- International small-caps have regularly out-performed their large-cap siblings
- Their higher return profile has also meant less incremental volatility, as evidenced by a higher Sharpe Ratio than both international large-cap and US small-cap
- Performance has low correlation to US small-cap and large-cap indices — providing effective diversification away from US markets which dominate global market capitalization
- The international small-cap investment universe is vast — providing the opportunity for specialist active managers using a concentrated portfolio approach to generate significant alpha with lower volatility than the index
- This whitepaper will show why an allocation to international small-cap is complementary — and possibly an alternative — to an international large-cap strategy

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DEFINING THE INTERNATIONAL SMALL-CAP UNIVERSE

The international small-cap investment universe — also known as the non-US developed market — is best measured by the **MSCI EAFE Small Cap Index**, which captures small-cap representation across developed market countries around the world, excluding the U.S. and Canada. As Figure 2 shows, in terms of the number of securities, it is 22% larger than the US small-cap universe.

For the purposes of this white paper — and our investment approach as global small-cap specialists – we are primarily focused on those companies having **a market capitalization of between $1 billion and $10 billion.**

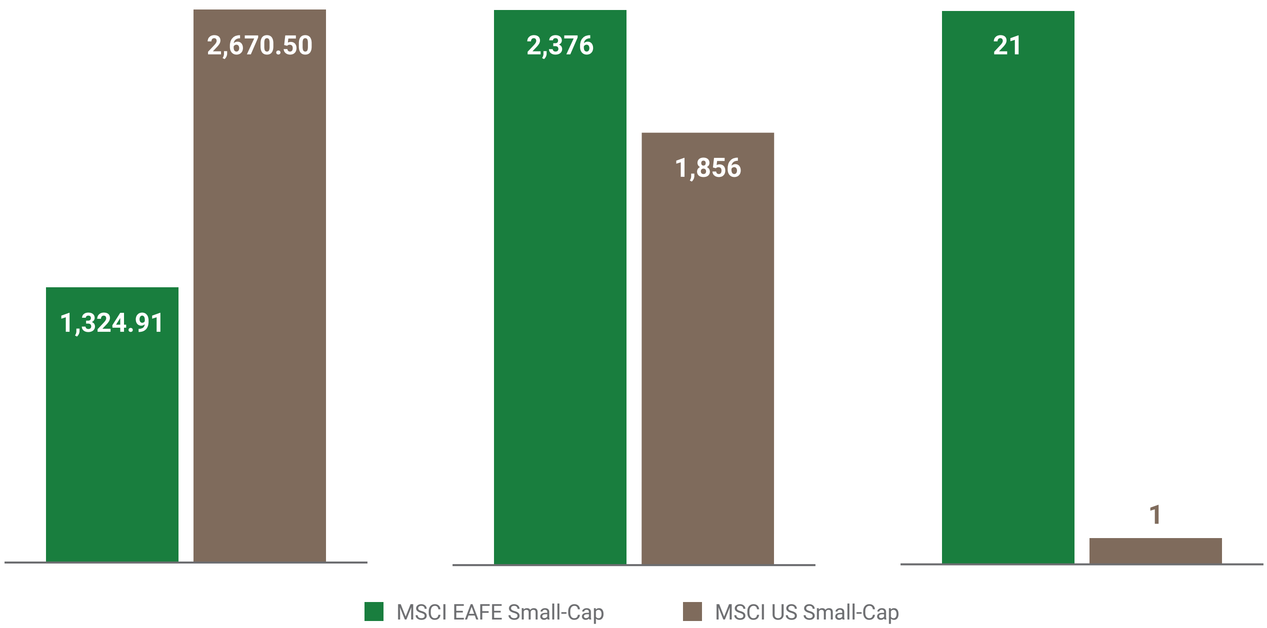
High-quality small-cap companies are the emerging blue-chip stocks of tomorrow. They tend to be young, disruptive in their industry, global in their outlook, nimble and have significant long-term growth potential.

While their higher return profile is expected, what is surprising to many is that small-cap outperformance comes with less volatility than is commonly believed.

FIGURE 1
AVERAGE MARKET CAP ($M USD)

FIGURE 2
NUMBER OF SECURITIES

FIGURE 3
NUMBER OF COUNTRIES

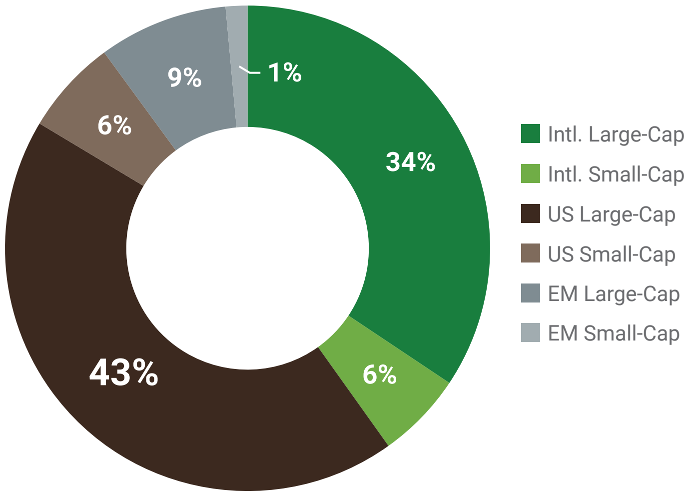


INTERNATIONAL SMALL-CAP — AN UNTAPPED UNIVERSE

The global investable universe (Figure 4), as defined by Morgan Stanley Capital International (MSCI), is dominated by large-cap stocks, with the United States representing almost half of global market capitalization. Using our most recent data, small-cap companies — including those in the emerging economies — currently represent approximately 13% of global market capitalization.

While the international small-cap asset class has recently seen heightened interest from institutional investors, historically, there are several real or perceived challenges that have prevented some investors from allocating to the segment.

FIGURE 4 | **MCSI GLOBAL INVESTABLE UNIVERSE** [1]



Perception of Higher Risk & Volatility

It is true that international small-cap companies are smaller and, predictably, more volatile than their large cap brethren. However, the perception of this risk is often exaggerated and not borne out in fact. As we illustrate herein, volatility patterns are much lower than most investors realize.

Liquidity Risk

Lack of liquidity is most often a concern with the micro-cap segment of the asset class. For high-quality small caps, there is generally more than ample liquidity. Using our own portfolio data as an example, assuming a $50 million portfolio, if we were to hold trading to 25% of daily volume, 96% of the portfolio could be liquidated within two days.

Lack of Familiarity

Many of the best international small-cap investments are not household names and, more importantly, are not widely followed by the broker community. Recent data reveals that approximately 15% of inter- national small-cap companies have one or no sell-side analyst coverage, versus 6% of US small caps.[2]

It is easier for investors to relate to the merits of holding well-recognized names in a portfolio over one that is unfamiliar. Similarly, it is easier to conceive of a smaller and less familiar company having greater risk of business failure than a household name. As a result, this can create a home country bias in favour of portfolios with larger, better-known (and followed) names. Much like the old workplace psychology that said, “Nobody got fired for buying IBM.” These factors all add up to inefficiencies in pricing and opportunities for active management.

1. Source: FactSet, MSCI, 30/06/2021
2. Source: MSCI EAFE vs Russell 2000, 30/09/2020

Not Well Suited to Passive Strategies

Many companies within the broad small-cap universe – and even entire sectors on average -- are either barely profitable or not profitable at all. The range of quality is wide. To produce strong absolute and relative returns, investors must be able to separate the wheat from the chaff. This represents a significant opportunity for active managers with a defined, repeatable process. As discussed herein, the median performance for international small-cap managers exceeds the index.

Specialized Expertise Needed

Compared to their large-cap peers, the average small-cap company is much more recognizably "a business", as opposed to just an equity instrument. Their unique characteristics require the discerning analyst to spend a significant amount of time understanding the underlying risks associated with the business and its management biases, in addition to the traditional fundamental evaluation process.

As an example, evaluating ESG risks is a simpler process with larger businesses that have the capital and resources to meet the requirements of the analytic services. For small-cap companies, it is incumbent on the investor to dig deep to assess ESG risks, often building their own systems for such analysis. Investing in small-cap is much like private equity investing; it requires a special discipline, developed over time, to be successful in the space.

US Small Cap Bias

To the extent that investors allocate to small-cap, they tend toward the US market – and for good reason. US small-caps have provided strong performance. This historical bias has been in part because Russell 2000 names resonate more with the North American investor. After all, today's mega-cap stocks, such as Facebook and Netflix, were the small-cap names of yesteryear.

This may also explain why recent demand for international small-cap strategies is rising — as US investors opportunistically seek to replicate their outsized returns from US small-caps in more diversified global markets.

Harder to Access

The universe of international small-cap managers is a fraction of what it is compared to the availability of US small-cap specialists. Based on Evestment data as of September 30, 2021, there were just 77 international small-cap specialist firms versus 400 US small-cap managers.

The relative rarity of international small-cap offerings represents a differentiation opportunity for asset allocators who seek to add value through a unique and highly curated manager platform that their clients can't easily access on their own.

The opportunity exists for investors to properly understand what the asset class offers and how to invest in it with lower downside capture.

PERFORMANCE, DIVERSIFICATION, ACTIVE MANAGEMENT: THE CASE FOR INTERNATIONAL SMALL-CAP

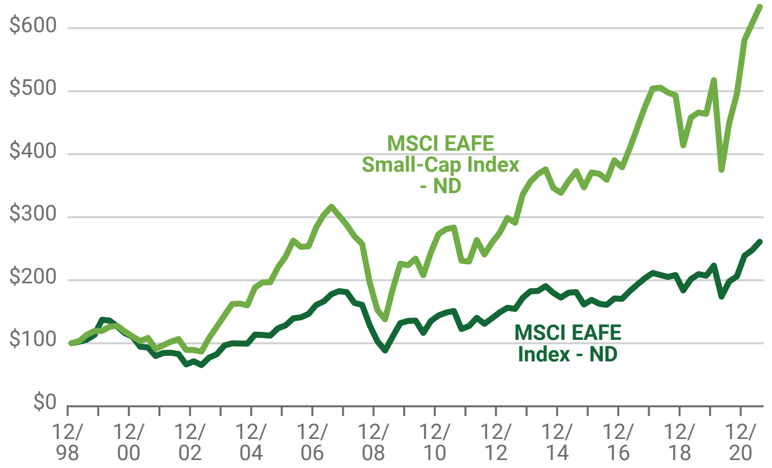
Strong Absolute & Relative Performance

International small-caps have delivered strong performance on an absolute and relative basis. Because asset allocators often compare international small-cap with international large-cap, we thought it was important to examine the relative performance of these two asset classes over multiple time periods.

LONG-TERM OUTPERFORMANCE RELATIVE TO INTERNATIONAL LARGE-CAP

Over the past twenty-five years, the MSCI EAFE Small-Cap Index has significantly outperformed the larger-cap MSCI EAFE Index (Figure 5), though the performance is even more pronounced in the period since the Great Recession concluded in 2009.

FIGURE 5 | COMPARATIVE GROWTH OF $100 FROM INCEPTION OF SMALL-CAP INDEX (12/98)[3]

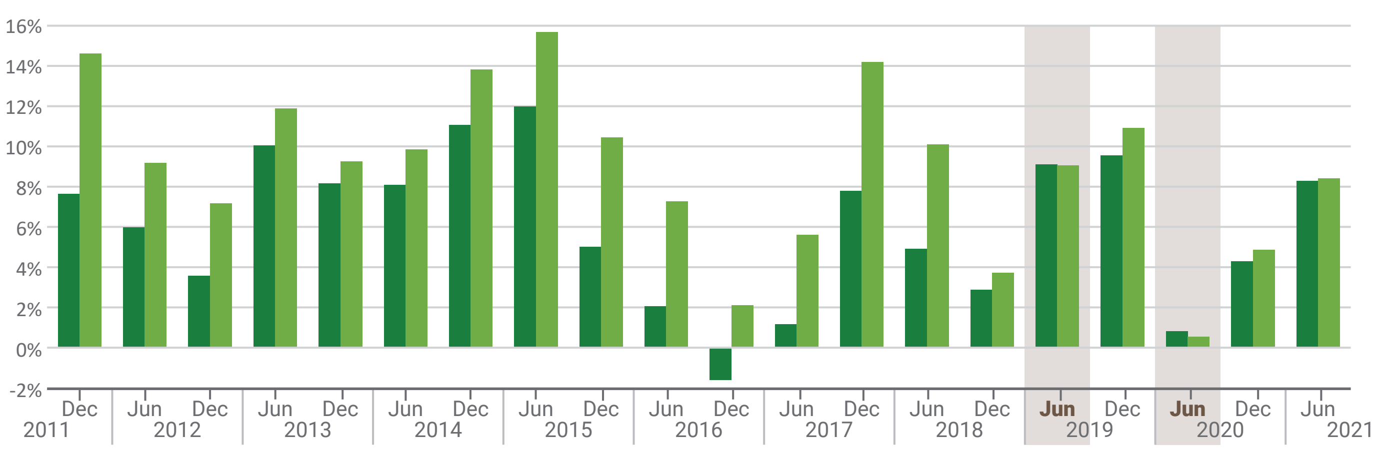


Over 20 of the last quarterly periods, international small-cap outperformed large-cap in all but two periods.

ROLLING THREE-YEAR OUTPERFORMANCE RELATIVE TO INTERNATIONAL LARGE-CAP

Looking back over the past 10 years, we illustrate (Figure 6) comparative performance on a three-year rolling basis beginning the end of 2011. Over 20 of the last quarterly periods, international small-cap outperformed large-cap in all but two periods. While the higher return profile is expected, what is surprising to many is that the outperformance comes with less volatility than is commonly believed.

FIGURE 6 | COMPARATIVE THREE-YEAR ROLLING NET RETURN[4]



3. Created using eVestment.
4. Measured to each quarter end. Results displayed in USD using Spot Rate (SR).

Far Less Incremental Volatility than International Large-Cap

In Table 1, we compare the relative volatility of international small-cap and large-cap stocks over the past ten years. As one would expect, it shows that small caps are somewhat more volatile, with the standard deviation ratio of 117.8% over large caps.

However, the volatility is more than offset by the return generated above large cap — 142.3% for the same 10-year period. As a result, the Sharpe Ratio (the return adjusted for volatility) is significantly higher for international small-cap — .34, versus .24 for international large-caps.

TABLE 1 | **COMPARATIVE VOLATILITY**

STANDARD DEVIATION	5 YRS	7 YRS	10 YRS
MSCI EAFE Sm-Cap Index - ND	21.37	19.13	18.91
MSCI EAFE Index - ND	17.30	16.00	16.05
RATIO	123.5%	119.6%	117.8%
Russell 2000 Index	26.50	23.72	22.37
RETURNS			
MSCI EAFE Sm-Cap Index - ND	12.03	7.75	8.38
MSCI EAFE Index - ND	10.28	4.96	5.89
RATIO	117.0%	156.3%	142.3%
Russell 2000 Index	16.47	11.39	8.38
SHARPE RATIO (assuming 2% risk-free rate)			
MSCI EAFE Sm-Cap Index - ND	0.47	0.30	0.34
MSCI EAFE Index - ND	0.48	0.19	0.24
Russell 2000 Index	0.55	0.40	0.29

Diversification & Low Correlation to Other Indices

TABLE 2 | **COMPARATIVE CORRELATION COEFFICIENTS** [5]

	MSCI EAFE Small-Cap Index-ND	MSCI EAFE Large-Cap Index-ND	Russell 2000 Index	S&P500 Index
MSCI EAFE Small-Cap Index-ND	1.000	0.964	0.857	0.861
MSCI EAFE Large-Cap Index-ND	0.964	1.000	0.885	0.883
Russell 2000 Index	0.857	0.885	1.000	0.919
S&P500 Index	0.861	0.883	0.919	1.000

Ten years based on quarterly returns: 30/06/2011 to 30/06/2021

An attractive way to soften the US imbalance in globally diversified portfolios.

International small caps offer access to local, regional and global businesses hailing from a diverse group of countries that are often at different points in their respective economic cycles.

The addition of an international small-cap portfolio to an international large-cap portfolio would add further diversification and would better represent the international economy, much like the approach taken by US investors who allocate capital to both the S&P500 and Russell 2000.

Alternatively, for asset allocators seeking to generate strong performance outside of US equity markets, the international small-cap asset class offers genuine diversification. As shown by the correlation coefficients in Table 2, the EAFE Small-Cap Index shows a modest 86% correlation to the S&P500 Index and the Russell 2000 Index, respectively — making it an attractive way to soften the US imbalance in globally diversified portfolios.

5. Source: eVestment. Based on quarterly returns June 2011 – June 2021. Correlation is a statistical measure of how two variables move in relation to each other. A perfect positive correlation is represented by the value of +1.000, while 0.00 indicates no correlation and -1.000 indicates a perfect negative correlation. Past performance does not guarantee and is not a reliable indicator of future results.

Active Management Proven to Generate Alpha

TABLE 3 | **COMPARATIVE VALUE ADDED (Measured to 30/06/21)**

The results (USD) of median manager performance relative to the respective index through several allocation sets.

	5 YRS	10 YRS
U.S. Large-Cap Equity Median	16.74	14.07
S&P500 Index	17.65	14.84
VALUE ADDED	-0.91	-0.77
U.S. Small-Cap Equity Median	16.05	13.00
Russell 2000 Index	16.47	12.34
VALUE ADDED	-0.42	0.66
MSCI EAFE Large-Cap Equity Median	11.02	6.97
MSCI EAFE Large-Cap Index - ND	10.14	5.61
VALUE ADDED	0.88	1.36
MSCI EAFE Small-Cap Median	12.91	9.73
MSCI EAFE Small-Cap Index - ND	12.03	8.38
VALUE ADDED	0.88	1.35

There are inherent characteristics of this asset class that offer seasoned investment teams ample opportunity to enhance alpha through active fundamental stock selection. This is owing largely to the huge opportunity set of small-sized companies around the world and the fact that the sheer number of companies makes it very difficult for sell-side analysts to cover every company.

As Table 3 illustrates, over the past five and ten-year periods, the median international small cap manager outperformed the index by .88% and 1.35%, respectively.

By contrast, the data also shows that US markets are difficult to beat. The same table shows that the median manager underperformed both the large cap and small cap indices over the past five years.

CONCLUSION

As this analysis reveals, the strong absolute and relative performance, low correlation with other equity markets and pleasing results in different market environments are among the factors that make a compelling case for including international small-caps in a globally diversified portfolio.

The best way to participate in the asset class is through active management, based on both the historical strength of certain fundamentals and the overall inefficiency of this vast and diverse universe of companies.

THE LAURUS APPROACH: DIG DEEP, OWN LONG

Focus on Quality

We invest in small-cap companies that have high-quality income statements and balance sheets and have the capacity to grow disproportionately.

We define quality in three ways:

ABILITY TO SUSTAIN HIGH RETURNS ON CAPITAL	REPEATABLE CASH FLOW GENERATION	LIMITED EXPOSURE TO FINANCING RISK

Original Viewpoint

Based on our proprietary research process, we inherently believe we know our companies better than other investors. We seek to develop our own original viewpoint for every company we invest in. We may consult conventional research sources for idea generation, but the rest of our process is independent, painstaking, and iterative based on analysis by our diverse team including in-depth discussions with company management and external experts. Our research and due diligence process rivals that of a private equity investor.

Concentrated Portfolios

From the vast universe of international small-cap companies, we focus on finding the best 1%. Our portfolios consist of approximately 30 names that we will know well and own for a long-time. Our average annual turnover across our small-cap portfolios is less than 25%.

Steadier Returns

Our process has proven that a concentrated portfolio of higher-quality companies within the asset class will result in lower volatility and less downside capture than a traditional portfolio of small-cap stocks.

ABOUT LAURUS INVESTMENT COUNSEL

Founded in 2014 and based in Toronto, Canada, Laurus is an employee-owned fundamental investor, searching globally to invest in strong, entrepreneurial small and mid-cap businesses with sustainable competitive advantages. Using an approach similar to private equity, Laurus conducts deep fundamental research, constructively engages with management and adopts an uncommonly long-term investment horizon to each investment. This process has proven to deliver quality returns with lower volatility over multiple market cycles for our institutional clients.

DISCLOSURE

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