International Small-Cap

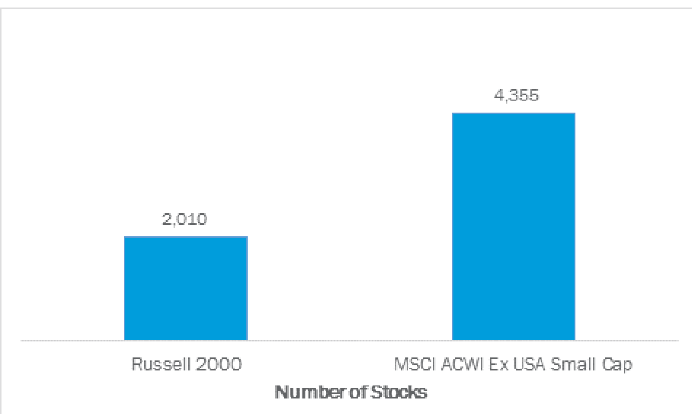
CanterburyConsulting | August 2018

Investors who ignore international small-cap stocks in their global allocation may be doing so at the cost of risk-adjusted performance. Canterbury believes that a current opportunity exists in the asset class due to its attractive return potential and diversification benefits.

An Overlooked Asset Class

U.S. investors may be neglecting an important area of the global stock market. According to Morningstar Direct data on total assets in Morningstar categories as of June 30, 2019, only around 2% of mutual fund assets in the U.S. are invested in international small- and mid-cap stocks, while 7% of assets are invested in U.S. small-cap stocks. However, there are more than twice as many international small-cap stocks, accounting for more than double the overall market value compared to U.S. small-cap stocks (Figure 1). If a goal is to maintain comparable exposure to the global equity market, then international small-cap stocks deserve at least as much capital, if not more, than U.S. small-cap stocks.

Number of Stocks and Total Market Capitalization Comparison



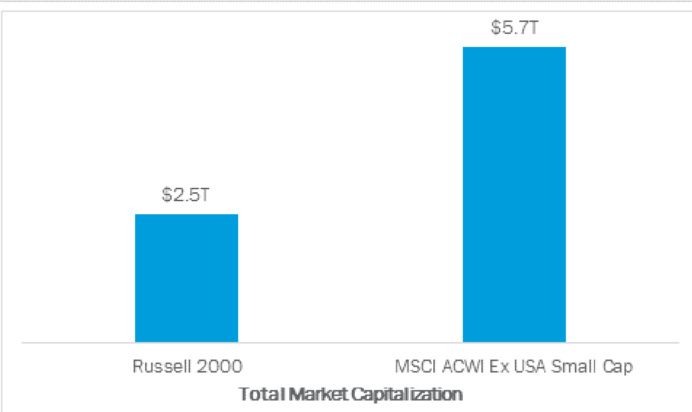


Figure 1. Source: Russell and MSCI, as of 12/31/2017

Avoiding this asset class has not been a harmless oversight. According to "Small Caps — No Small Oversight: Institutional Investors and Global Small Cap Equities" published in March 2012 by MSCI, "Excluding small caps represents an 'active' decision to ignore up to 14% of the universe and amounts to a negative view on the small cap premium. This decision would have forfeited 60 bps of annual performance over the last decade and could have consumed a substantial part of an asset owner's risk budget as well."

Averages of Monthly Rolling Annualized 10-Year Returns
Using Common Inception of MSCI and Russell Indexes, from 2001 to 2017

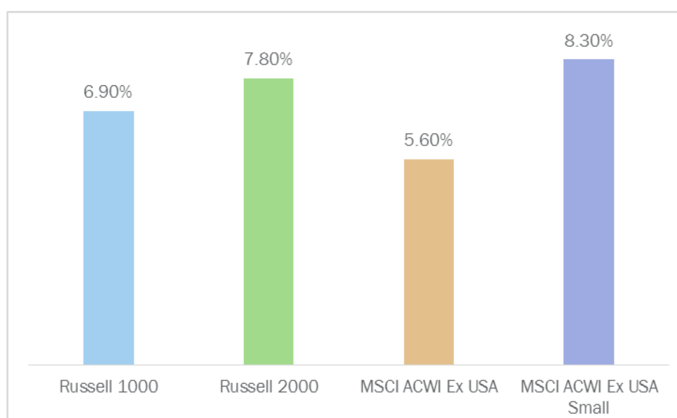


Figure 2. Source: Morningstar, as of 12/31/2017

A key reason why international small-cap stocks appear attractive to us is that they have historically provided higher returns than all other major equity asset classes over 10-year time periods (Figure 2).

While better returns are desirable, they often come with higher risk (i.e. standard deviation, Figure 3). Yet international small-caps have displayed comparable levels of risk to their U.S. counterparts while offering higher returns over the past seven years.

Averages of Monthly Rolling
10-Year Standard Deviation
Using Common Inception of MSCI and Russell Indexes, from 2001 to 2017

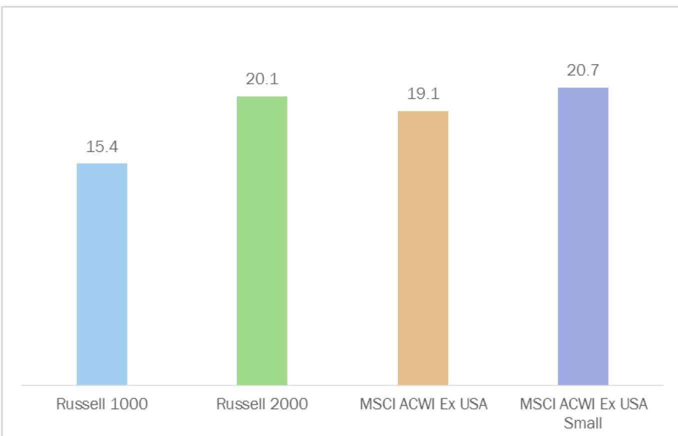


Figure 3. Source: Russell and MSCI, as of 12/31/2017

Despite these advantages, why do investors continue to maintain underweight allocations to international small-caps? Some common explanations include home country bias, a lack of familiarity with foreign small companies, and a perception of greater risk. While we have already debunked the latter concern, there is a significant difference between U.S. and non-U.S. small-cap stocks—just not in the way one might initially think.

A third of the companies in the Russell 2000 Index of U.S. small-cap stocks are not profitable, and more than half of them do not pay a dividend. By contrast, roughly 90 percent of international small-cap companies are profitable and over 80 percent pay a dividend, according to a fund manager at Royce & Associates. Many of these companies are global leaders who own their respective niches. Canterbury Research believes a lack of familiarity or knowledge about these high-quality businesses is not a compelling reason to not own them.

A more practical reason investors may be underweight international small-cap stocks could be the widespread usage of the MSCI EAFE and MSCI ACWI ex-USA benchmarks. These benchmarks each have less than a 1 percent weight to small-cap stocks, because they exclude smaller companies (similar to the Russell 1000 Index for U.S. equities). Using a more comprehensive benchmark, such as the MSCI ACWI ex-USA Investable Market Index (IMI), comprising around 14 percent small-cap stocks, would remedy this.

An Opportune Time

Looking at the strong historical track record of international small-cap stocks, investors may wonder if they have missed the boat. After all, chasing what has worked well in the past has rarely worked well as an investment strategy. However, as of June 30, 2018, the 10-year trailing return for international small-caps is well below its long-term average (Figure 4). This suggests that there is still some potential for mean reversion to become a tailwind for the asset class. In fact, we have

MSCI ACWI Ex USA Small Cap Quarter Rolling 10-Year Returns as of 6/30/2018

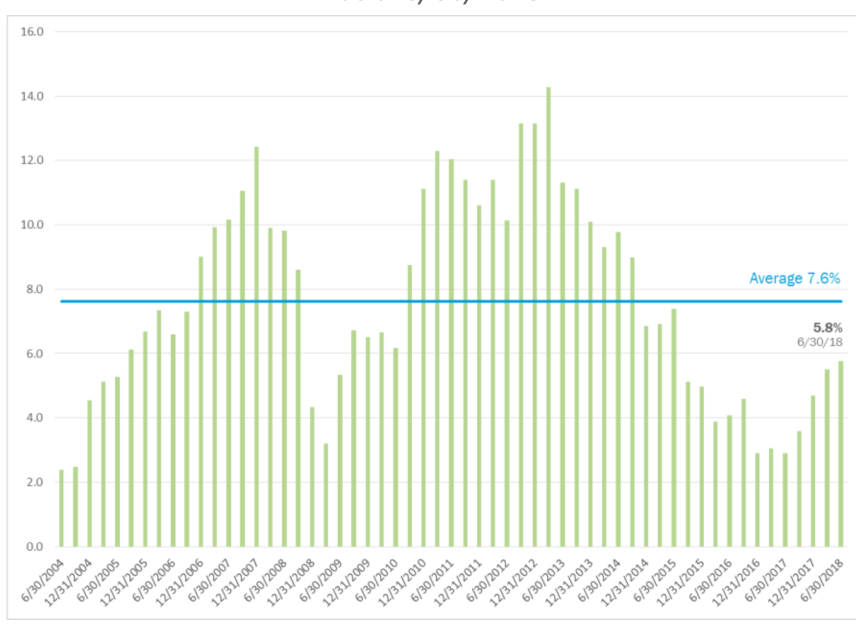


Figure 4. Source: Morningstar

Market Environment		Periods Int'l SC Beat Int'l LC	Batting Average	International Small-Cap	International Large-Cap	Average Spread
10-Year German Bund Yield	Rising	62/91	68.00%	22.90%	19.50%	3.40%
	Falling	101/161	63.00%	2.20%	1.50%	0.70%

Figure 5. Source: Royce & Associates, Russell

seen these long-term results trend back toward their mean over the past few quarters.

Another attractive reason to allocate to international small-cap stocks today is their low correlation to U.S. large-cap stocks (Figure 5), which make up the majority of U.S. investors' equity allocations. With the S&P 500 Index of U.S. large-cap stocks rising for nine straight years since the financial crisis in 2008, investors are right to be concerned about a future bear market. International small-cap stocks provide attractive diversification to U.S. large-cap stocks, as measured by correlation of monthly returns.

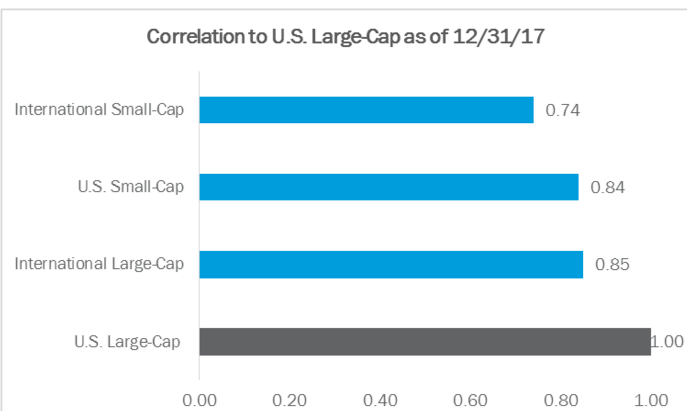


Figure 5. Source: Royce & Associates

Finally, as interest rates begin to rise from record low levels, it is interesting to note that international small-cap stocks tend to do the best in times when interest rates rise. This is because rising rates are typically associated with economic growth, which especially benefits smaller companies. Figure 5 demonstrates this relationship using the performance of international small-cap stocks in different German bund yield regimes, as bund yield is often viewed as a bellwether for the European economy.

Average Intra-Stock Dispersion

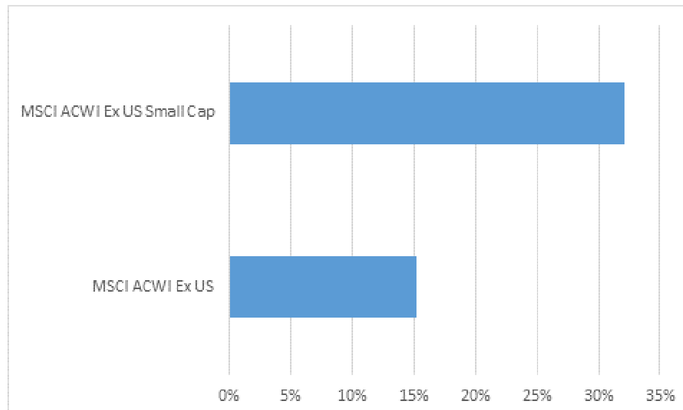


Figure 6. Source: Morningstar

An Inefficient Market

For investors convinced that they need more international small-caps in their portfolio, there is the question of how to access this asset class. Although the index, as we have already seen, is a very high-quality group of companies and would make a fine investment, we suggest an active approach as opposed to a passive or index-based strategy. This is because of the higher dispersion among small-cap stocks arising from the lack of attention paid to them relative to international large-cap stocks (Figure 6). The international small-cap market

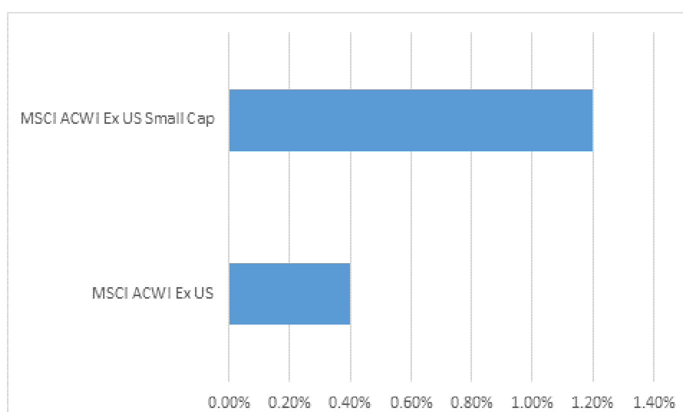


Figure 7. Source: Morningstar, monthly rolling 10-year periods since 1994

is much more inefficient, resulting in a more fertile hunting ground for active managers who seek to identify the higher-quality businesses within the diverse opportunity set. This inefficiency has indeed led to greater outperformance by active managers in the space (Figure 7).

While Canterbury Research believes that it is likely that this inefficiency will decrease over time as more investment capital gravitates towards this space, we are still in the very early innings of what we think to be an alpha opportunity. According to Factset, a financial information and analytic software provider, 36 percent of international small-cap companies had analyst coverage of one or zero, compared to just 16 percent for U.S. small-cap stocks as of June 30, 2018. As we see in the graph to the right, the sheer magnitude of small-cap companies globally makes it difficult for analysts to efficiently cover the entire universe. We believe active managers are able to capitalize on this by being more knowledgeable about the companies they own relative to their peers in more efficient asset classes such as U.S. large-cap equities.

Conclusion

International small-cap stocks have historically provided strong risk-adjusted returns. Canterbury thinks that now may be an especially opportune time to allocate to these relatively high-quality companies using an active approach. We feel this is particularly true for investors who are underweight what we believe is an important area of global equities—one that offers attractive investment prospects.

About Canterbury

Canterbury Consulting is a leading investment advisory firm, overseeing $18.3 billion as of June 30, 2018, for foundations, endowments, individuals, and families. Founded in 1988, the Company designs and manages custom investment programs aligned with each client's goals. Canterbury acts as the investment office for its diverse clients and provides objective investment advice, asset allocation, manager selection, risk management, implementation, and performance measurement. Canterbury Consulting strives to deliver performance and service that exceeds the needs and expectations of its clients.