Institutional Insights

Time to downsize?

Big potential in international small-cap

The solid consensus around synchronized global growth has to bring a bit of optimism to even the most cynical investor. With the case for a global upswing grounded in sound economic analysis and earnings data, investors can probably be a bit more comfortable expanding their opportunity set.

While most recognize the value of diversifying across global markets, few have a dedicated allocation to international small-caps. This may be because investors believe international stocks are comparatively risky and therefore small-caps must be riskier still — to the point that the asset class is best avoided altogether. Or perhaps they believe they are getting a measure of small-cap exposure from an allocation to emerging markets; in fact, companies with a market cap under $2 billion represent only about 2% of the MSCI Emerging Markets Index. While the reasons for neglect of international small-caps may be difficult to pin down, we believe these stocks offer a compelling choice for a number of reasons.

A broad and inefficient market

An additional factor that may account for underinvestment in international small-caps is the lack of broad agreement on a definition for the asset class. Rather than a market-cap minimum, index providers such as MSCI and S&P use a percentage of the lowest market-cap stocks in each region or country.

Though the asset class may not yet have the clear parameters U.S. investors prefer, one indisputable fact about this market in general is that it offers a large opportunity set. As of January 31, 2018, the MSCI ACWI Ex U.S. Small-Cap Index included 4,353 stocks and represented just over half of the all-cap MSCI ACWI IMI. While the sheer number of names creates worthwhile consideration, many are too small to warrant analyst coverage. These factors combine to create a less efficient market and an alpha opportunity for active managers.

Key Takeaways

- International small-cap stocks have materially outperformed international large- and mid-cap stocks over multiple time periods.
- Even in the highly correlated global markets of the past decade, international small-caps offered diversification benefits versus wider international indexes.
- With a large opportunity set and greater inefficiency, the international small-cap market is amenable to active management and makes a solid claim for a slice of an investor's active allocation.

Contributors

Jon Adams, CFA
Portfolio Manager
Multi-Asset Solutions Team

Michael Dowdall, CFA
Portfolio Manager
Multi-Asset Solutions Team

Continued

Alpha opportunity

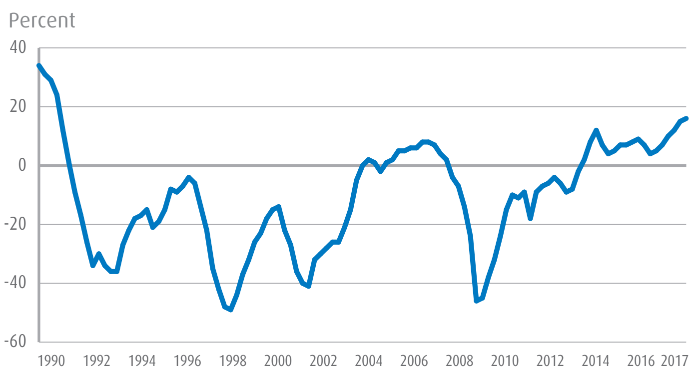
The historical performance of international small-caps helps illustrate the opportunity. International small-cap stocks have materially outperformed developed-market stocks over multiple time periods, as shown in the table below.

As of 12/31/2017	1 YR	3 YR	5 YR	10 YR	15 YR
MSCI ACWI Ex USA Small-Cap NR USD	31.65	11.96	10.03	4.69	12.11
MSCI ACWI Ex USA NR USD	27.19	7.83	6.80	1.84	8.75

Source: Morningstar. Past performance is not a guarantee of future results.

Moreover, we see potential for economic growth that should further support international small-cap equities. All 45 countries tracked by the Organization for Economic Cooperation and Development (OECD) are expected to grow in 2018. Additionally, the OECD expects 33 of these countries to grow at an accelerated pace versus 2017. In Europe and Japan, consumer confidence has improved and spending has finally picked up after many stagnant years. The Japan Tankan Business Conditions Index, which measures the country's overall business sentiment, recently reached its highest level since 1990.

Japan Tankan Business Conditions Index — all enterprises



Source: Bank of Japan

Such conditions are likely to benefit small-cap companies, which are typically more consumer-oriented and directly tied into the economic growth of their country or region. Examples of small-cap companies that could do well in this environment include Earth Chemical Co. (4985.Japan), a manufacturer with a significant household products business, and Metcash Limited (MTS.Australia), a wholesale distribution and marketing company specializing in consumer goods such as groceries, liquor, hardware and home-improvement products.

Correlation benefits

Companies that operate only in a domestic market typically have a lower correlation to U.S. stocks or international large-cap stocks. Recent history suggests that this relationship is changing; after all, global equity returns over the last 10 to 15 years have been highly correlated. However, even within the correlated equity markets of recent vintage, international small-caps did offer an advantage versus wider developed-market indexes, as shown in the matrix below. For comparison purposes, we also include a 60/40 index portfolio (60% MSCI ACWI/40% Bloomberg Barclays U.S. Aggregate Bond Index) to represent a common asset allocation strategy used by many investors.

1/1/2013 – 12/31/2017	1	2	3	4	5
1 MSCI ACWI Ex USA Small-Cap NR USD	1.00				
2 MSCI ACWI Ex USA NR USD	0.95	1.00			
3 MSCI World NR USD	0.88	0.93	1.00		
4 S&P 500 NR USD	0.73	0.78	0.95	1.00	
5 60/40 ACWI/U.S. Agg	0.90	0.96	0.97	0.89	1.00

Source: Morningstar. Past performance is not a guarantee of future results.

As the matrix demonstrates, if a developed-market index is an investor's sole international exposure, an allocation to international small-caps may improve portfolio diversification. Furthermore, with greater dispersion expected due to monetary policy divergence and the business cycle reaching a mid-to-late stage, diversification may become even more important in the coming years.

Risks

Investors may fear that the risks associated with international equities will be amplified with small-cap stocks. To some extent this is true. In terms of currency risk, the domestic focus of most small-cap companies prevents them from gaining the boost that a depreciating currency provides to large-cap companies that do business across borders. Political risk and country-specific economic risk also loom larger, and the flip side of the lack of Wall Street interest in many of these names is an increase in liquidity risk.

What about the most basic measure of risk? Unsurprisingly, international small-cap stocks do exhibit higher volatility than international large-cap stocks over the long term, but perhaps not as much as one might expect given the outperformance noted above. On a five-year basis, standard deviation for international small-caps is in line with broader indexes. Furthermore, rolling three- and five-year standard deviation across international small-cap stocks has dropped steadily over the past five years.

As of 12/31/2017	Five-year standard deviation
MSCI ACWI Ex USA Small-Cap NR USD	11.37
MSCI ACWI Ex USA NR USD	11.50

Source: Morningstar. Past performance is not a guarantee of future results.

In closing

We've seen that international small-caps can add value to a portfolio in terms of returns and diversification. What's more, active managers who are proficient in the space and able to exploit the lack of Wall Street coverage can add alpha, especially in countries that are not well-represented in the most common international equity indexes. Though investors continue to pare down their spending on active management, international small-caps make a strong case for a slice of an investor's active exposure.

The return of volatility in early 2018 is not too surprising following 2017's steady upward climb by equity markets. The underlying economic and earnings data, however, continue to indicate that we are in the midst of a global expansion. Under these conditions, it makes sense to cast a wider alpha net. International small-caps offer an opportunity to do so.

About BMO Global Asset Management

BMO Global Asset Management is a multi-disciplined asset manager providing clients worldwide with access to investment solutions that span the risk-reward spectrum. With more than 20 offices in 14 countries, our goal is to exceed clients' expectations with innovative, relevant investment solutions that achieve their goals with refreshing clarity. We strive to accomplish this mission with a commitment to excellence, integrity, and service quality.

Please visit **bmogamviewpoints.com** to read the latest insights from our investment professionals.

Let's connect

BMO Global Asset Management
115 S. LaSalle, 11th Floor
Chicago, IL 60603

bmo.com/gam

1-312-461-7699

Follow us on LinkedIn

BMO Global Asset Management

The MSCI ACWI Ex USA Small-Cap Index captures small-cap representation across 22 developed-market countries (excluding the U.S.) and 24 emerging-market countries. The index covers approximately 14% of the global equity opportunity set outside the U.S.

The MSCI ACWI ex USA Index captures large- and mid-cap representation across 22 developed-market countries (excluding the U.S.) and 24 emerging-market countries. The index covers approximately 85% of the global equity opportunity set outside the U.S.

The MSCI World Index captures large- and mid-cap representation across 23 developed-market countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

The S&P 500® is an unmanaged index of U.S. large-cap common stocks.

The MSCI ACWI captures large- and mid-cap representation across 23 developed-market countries and 24 emerging-market countries. The index covers approximately 85% of the global investable equity opportunity set.

The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market.