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The Case for International Small Caps

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International small caps make up an attractive asset class that often is overlooked by investors. The benefits of international investing are well-known and include diversification, expanding the investment universe, and enhancing the risk-return profile of a portfolio. However, investors and advisors tend to gravitate toward large-cap international exposure when considering foreign investing. In some cases, international small caps are completely absent from portfolios. By contrast, U.S. small caps almost always are given a separate and specific allocation, especially at the institutional level.

International small caps have several benefits and exhibit compelling statistical evidence supporting their inclusion into a diversified portfolio. Specifically, international small caps:

1. Represent a meaningful investment opportunity set
2. Have demonstrated strong long-term returns
3. Have an attractive risk profile
4. Provide diversification benefits
5. Can be implemented with both active and passive investing

Each of these areas will be reviewed below as evidence is presented for why investment consultants should consider recommending international small-cap equities for their clients' portfolios.

A MEANINGFUL INVESTMENT OPPORTUNITY SET

In general, international small caps can be defined as those non-U.S. stocks from developed countries representing the lowest 15 percent of market capitalization. An examination of popular international indexes shows that this is a reasonable characterization of this asset class.

The MSCI EAFE Index is widely known as a proxy for foreign equity.[1] The index is weighted by market capitalization and ranks each stock in the investable universe from largest to smallest. The MSCI EAFE is composed of the largest 85 percent of those stocks. These stocks traditionally would be considered large-cap or mid-cap. By contrast, the MSCI EAFE Small Cap Index represents the 85th to 99th percentiles.[2]

Similar to the MSCI EAFE Small Cap, the S&P Developed Ex-U.S. SmallCap also is used as a proxy for non-U.S. small-cap equities.[3] This index seeks to measure the stocks representing the lowest 15 percent of float-adjusted market capitalization in each developed country, excluding the United States.

Both indexes, however, consider approximately the lowest 15 percent in non-U.S. market capitalization as small caps (note that the lowest 1 percent often is considered as "micro" caps).

Regardless of which index is used, the international small-cap universe represents nearly three-fourths of all non-U.S. equities. Table 1 shows that the MSCI EAFE Small Cap Index represents

Table 1

INDEX COMPOSITION

Index	# Companies		Total Market Cap Represented	
MSCI EAFE	926	28%	$14.3 Trillion	85%
MSCI EAFE Small Cap	2,360	72%	$2.5 Trillion	15%
S&P Developed Ex-U.S. LargeMidCap	1,357	26%	$22.2 Trillion	83%
S&P Developed Ex-U.S. SmallCap	3,815	74%	$4.6 Trillion	17%

72 percent of non-U.S. equities and the S&P Developed SmallCap Index represents 74 percent of non-U.S. equities.[4]

Despite encompassing the majority of investable equities, international small caps often are ignored by investors. Research conducted by S&P Dow Jones cites that only 8.1 percent of international equity exchange-traded fund (ETF) investors were allocated to international small caps. This indicates a potential gap in investors' portfolios, and investment consultants can provide meaningful value with the introduction of international small caps. Smaller companies can provide investors with exposure to developing products, services, and technologies, with the potential for better long-term returns.

STRONG RELATIVE RETURNS

The long-term performance record for international small caps provides a compelling case for their inclusion in a portfolio. For the 15-year period ending 2017, the MSCI EAFE Small Cap Index provided an average return of 12.2 percent annually. This compares favorably to the MSCI EAFE, which returned 8.1 percent annually (including reinvestment of dividends for both indexes).

Table 2 shows the returns over various time periods. In each period, international small caps provide competitive returns by outperforming their large-cap counterparts.

As an aside, international small-cap returns also compare favorably to U.S. small-cap returns over the same 15-year period (12.2 percent for the MSCI EAFE Small Cap versus 11.2 percent for the Russell 2000).

Although the returns noted provide a strong case for international small caps, we also must consider end-point risk. This is the risk that one strong period (quarter, year, market cycle, etc.) may skew the average despite a lower return experience in most quarters. By looking at rolling period returns, we can eliminate the concern that any one specific period is skewing the average.

If we examine the rolling returns for any 12 consecutive quarters in the past 20 years, we find that the international small-cap index outperformed the MSCI EAFE 83 percent of the time. In other words, if we randomly selected any three-year period over the past 20 years for any given quarter-end, there would be an 83-percent likelihood that international small caps would have outperformed the international large-cap index. By comparison, U.S. small caps outperformed 61 percent of the time versus U.S. large caps over the same 20-year period.

Regardless, both perspectives—performance during static time periods and during rolling time periods—provide strong evidence in favor of the inclusion of international small caps.

Lastly, looking beyond absolute returns to a risk-adjusted comparison also may be helpful. The Sharpe ratio measures the average return above the risk-free rate for each unit of risk. In other words, the Sharpe ratio adjusts for risk and allows for a more apples-to-apples comparison. Table 3 compares the Sharpe ratio for international small caps with international large caps and shows that international small caps also outperform on a risk-adjusted basis.

ATTRACTIVE RISK PROFILE

International small caps have an attractive risk profile compared to the broad international market. This becomes evident by studying the 80 quarters of returns over the 20-year period ended December 31, 2017.

Of those 80 quarters, the MSCI EAFE has been negative 30 times (37 percent of the time) and positive 50 times (63 percent of the time). Likewise, the MSCI EAFE Small Cap also has been negative 30 of those 80 quarters. We would expect this

Table 2

ANNUALIZED ASSET CLASS RETURNS FOR YEAR ENDED 2017

Asset Class	Index	5-Year	10-Year	15-Year
International Small Cap	MSCI EAFE Small Cap	12.9%	5.8%	12.2%
International Large Cap	MSCI EAFE	7.9%	1.9%	8.1%

Table 3

SHARPE RATIO COMPARISON FOR YEAR ENDED 2017

Asset Class	Index	5-Year	10-Year	15-Year
International Small Cap	MSCI EAFE Small Cap	1.08%	0.67%	0.67%
International Large Cap	MSCI EAFE	0.69%	0.17%	0.48%

Table 4

UPSIDE AND DOWNSIDE CAPTURE BASED ON QUARTER WHEN MSCI EAFE IS POSITIVE OR NEGATIVE

Asset Class	Index	# Positive Quarters	# Negative Quarters	Upside Return	Downside Return
International Small Cap	MSCI EAFE Small Cap	50	30	8.0%	-6.4%
International Large Cap	MSCI EAFE	50	30	7.2%	-7.4%

Table 5

STANDARD DEVIATION AND DRAWDOWN, 15-YEAR PERIOD ENDING 2017

Asset Class	Index	Standard Deviation	Max Drawdown
International Small Cap	MSCI EAFE Small Cap	17.8%	60%
International Large Cap	MSCI EAFE	16.5%	57%
U.S. Small Cap	Russell 2000	18.2%	53%

Table 6

CORRELATIONS TO THE RUSSELL 1000 (CALCULATED QUARTERLY FOR YEAR ENDING 2017)

Asset Class	Index	5-Year	10-Year	15-Year
International Small Cap	MSCI EAFE Small Cap	60%	86%	84%
International Large Cap	MSCI EAFE	71%	90%	89%
U.S. Small Cap	Russell 2000	81%	94%	93%

because the international large-, mid-, and small-cap markets generally should move together.

However, international small caps distinguish themselves with upside and downside capture. Over the 50 positive quarters, international large caps returned an average of 7.2 percent on the upside per quarter. International small caps, however, returned 8.0 percent on average during those same positive quarters, or 0.8 percent more per positive quarter.

During the 30 negative quarters, international large caps lost, on average, 7.4 percent each negative quarter. International small caps lost only 6.4 percent on average during those same 30 quarters. This data is summarized in table 4.

In other words, international small caps capture 110 percent of the upside of international large caps but only 86 percent of the downside. The perceived riskiness that may be associated with international small caps appears to be a misconception.

What about other risk metrics, such as standard deviation and maximum drawdown? Table 5 shows standard deviation and maximum drawdown for the 15-year period ending 2017.

International small caps did have the largest maximum drawdown, but it was not by a significant margin, especially given the magnitude of the drops. Moreover, international small caps actually produced a lower standard deviation than U.S. small caps for that period of time. These metrics indicate that international small caps are not materially more or less risky than their large-cap or domestic counterparts.

DIVERSIFICATION BENEFITS

As one might expect, international small caps also have lower correlation to U.S. large caps than both international large caps and U.S. small caps. Over the past 15 years (period ending 2017), international small caps were 84-percent correlated to U.S. large caps. By comparison, international large caps and U.S. small caps have higher correlations of 89 percent and 93 percent, respectively. If we look at shorter windows, a similar pattern exists. Table 6 shows that international small caps have a lower correlation in the five-year, 10-year, and 15-year windows.

ACTIVE AND PASSIVE MANAGEMENT

International small caps also may benefit from inefficiencies that could lead to enhanced returns through active management. International small-cap companies typically receive limited analyst coverage, which could allow for opportunities for active managers to add value.[5] The investment universe of international small caps is wide-ranging, diverse, and esoteric—therefore offering potentially low-hanging fruit for active managers. Research by MSCI revealed that small-cap companies experienced an average of 30 percent more return dispersion compared to large- and mid-cap firms, indicating an increased opportunity for active management.[6]

Although conventional wisdom may suggest that active management is appropriate for international small caps, security selection within this asset class also presents meaningful hurdles. Ironically, the quality that makes international small caps attractive for active management—their diverse opportunity set—also presents challenges because a significant amount of resources is necessary to effectively research such a broad asset class. Any individual small company anywhere around the globe will be affected by myriad idiosyncratic issues including company-specific issues, local economies, local currencies, etc. It can be difficult for any firm to understand and scrutinize these issues across a very divergent opportunity set. The required resources for researching these companies ultimately results in higher management fees. The average expense ratio of the unique actively managed international small-cap mutual fund is 1.19 percent. By comparison, the five largest passive international small-cap ETFs have an average expense ratio of only 0.32 percent.

Although international small caps provide the right environment for active management, industry data indicate that this asset class can be challenging for consistent outperformance by active management. The SPIVA scorecard, developed by S&P Dow Jones research, provides a thorough review of active-manager performance in various asset classes versus an appropriate benchmark for those asset classes. It provides a rich data set and corrects for style drift and survivorship bias. Based on the data provided by Dow Jones in the SPIVA scorecard, the majority of international small-cap managers underperform the S&P Developed Ex-U.S. SmallCap Index. After correcting for survivorship bias, nearly 80 percent of managers underperform the index over the 15-year period (see table 7).[7]

Table 7

PERCENT OF INTERNATIONAL SMALL-CAP FUND MANAGERS UNDERPERFORMING BENCHMARK

3-Year	5-Year	10-Year	15-Year
65.8%	65.5%	72.6%	78.1%

Source: S&P Dow Jones June 2017 SPIVA Scorecard

We can examine the data in another way by comparing existing international small-cap mutual fund returns to the index. This simple examination does not adjust for survivorship bias because only funds that currently are operating in the database are included (i.e., those that have survived). Table 8 outlines the results on a three-, five-, 10-, and 15-year basis. There was no period where more funds outperformed the index than underperformed. Keep in mind this sample is not adjusted for survivorship issues, because only existing funds were included. Of the 32 funds that survived and had 15 years' worth of data, only 44 percent outperformed.

Table 8

EXISTING FUNDS PERFORMANCE RELATIVE TO MSCI EAFE SMALL CAP, YEAR ENDING 2017

	3-Year	5-Year	10-Year	15-Year
MSCI EAFE Small Cap Return	14.2%	12.9%	5.8%	12.2%
Number of Funds with History	78	68	46	32
Number of Funds Underperforming	63	54	29	18
Number of Funds Outperforming	15	14	17	14
% Funds Outperforming	19%	21%	37%	44%

Although active managers as a group may struggle, investors may be able to find skilled managers who can outperform. Of the 14 funds that outperformed the MSCI EAFE Small Cap Index over the past 15 years, the average outperformance (i.e., alpha) was 1.5 percent per year. Moreover, these outperforming funds typically exceeded the index in nine out of the 15 years, indicating a degree of consistency. Active management may be difficult, but it also may be possible with skilled managers and resourceful investment firms.

Review of the data shows there may be validity to both passive and active approaches. Clearly, active managers as a group struggle to outperform the passive index, with most active managers underperforming. However, there is also an indication that the very top-performing managers may be able to add value through their stock selections.

PRACTICAL IMPLEMENTATION ISSUES

Although international small caps provide several benefits, it is important to recognize specific implementation issues associated with the asset class. In general, smaller companies have lower liquidity. As a result, execution costs (trading costs and commissions) tend to be higher with smaller companies and the internal hurdle costs for the management of small-cap stocks likewise will be greater. Moreover, lower liquidity can result in a higher bid-ask premium, particularly in periods of stress. According to a study by Deutsche Bank, the average bid-ask spread for small European stocks was approximately 14 basis points in early 2011 (a relatively calm period) but then rose to as high as 37 basis points later that same year as volatility increased.[8]

In examining exchange-traded index products, investors generally will find relatively higher spread in the monthly premium and discount associated with international small caps. Premiums or discounts in ETFs often arise if the underlying securities are less liquid or if there are higher transaction costs within the market. Evidence of this liquidity risk seems apparent with a simple review of premiums and discounts over the past 10 years (2008–2017). If we examine the past 10 years of performance of the iShares MSCI EAFE Small-Cap ETF, the premium and discount have ranged from a high premium of 4.92 percent (2008) to a low discount of 1.86 percent (2009), for a total range of 6.78 percent. By contrast, the iShares S&P 500, representing the very liquid U.S. large-cap market, had a total range between discount and premium for that same period of only 1.14 percent. Clearly, liquidity and premium-discount spreads should be considered by the international small-cap investor.

Beyond the liquidity issues, an investor needs to determine the appropriate vehicle for investing in the asset class. As noted earlier, both active and passive management can play a part and evidence supports both philosophies. Within the active management space, the consultant should look toward funds with long track records (i.e., 10-plus years) that have shown consistent performance relative to the benchmark. If a more passive approach is desired, a number of high-quality passive ETF and mutual fund options are available. In selecting a passive option, the consultant will be well-served by selecting a recognized product that follows a broad-based small-cap index, such as the MSCI EAFE Small Cap Index, the S&P Developed Ex-U.S. SmallCap Index, or the FTSE Developed Small Cap Ex U.S. Index. Within the passive choices, the largest international small-cap ETFs are the following:

- iShares MSCI EAFE Small-Cap ETF (SCZ)
- Vanguard FTSE All-World ex-US Small-Cap ETF (VSS)
- Schwab International Small-Cap Equity ETF (SCHC)

Each of these choices has specific differences that the consultant will need to further research. However, they all provide broad exposure to the international small-cap market and are well-known within the investment industry. Moreover, the industry is now expanding, and factor-based options are becoming available within the international small-cap space. These choices will give the consultant additional ability to tailor the client's exposure.

CONCLUSION

Consultants and their clients should consider a meaningful allocation to international small caps as part of their portfolios. International small caps can be added to a portfolio with either an active or passive approach, or a combination thereof. Note that implementing international small caps comes with potentially higher costs. Specifically, there can be larger bid-ask premiums on securities within the asset class, due to lower liquidity. Moreover, international small-cap ETFs can experience a higher range of premiums and discounts, depending on given market conditions. Also, this asset class, like other equity investments, can experience significant downside in periods of market distress, so this allocation needs to be appropriate for the investor's risk profile.

Despite the costs and risk, significant positives are associated with international small caps. First, these stocks are a meaningful part of the investment opportunity set, representing nearly three-fourths of the traditional non-U.S. investment universe. Next, they have demonstrated strong long-term returns and have outperformed the MSCI EAFE in more than 80 percent of rolling three-year periods during the past 20 years. International small caps also have shown compelling diversification and risk characteristics, including a lower correlation to U.S. large caps than international large caps and U.S. small caps. Moreover, their downside risk profile is compelling, with international small caps having only 86 percent of the downside of the MSCI EAFE Index.

Finally, if we consider that U.S. small caps are often a separate asset class of any diversified portfolio, it is difficult to justify not also including foreign small caps as an equally important part of a portfolio. The reasons cited for including U.S. small caps (diversification, better long-term returns, larger investment universe) exist in an even more compelling way for international small caps. With the non-U.S. markets representing nearly 50 percent of the entire investable universe, foreign small caps should be an important part of any global portfolio, just as U.S. small caps are a staple in most portfolios. In the competitive landscape prevalent in the advisory profession, an investment consultant can show and add meaningful value to their clients by considering international small caps.

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ENDNOTES

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