ROUND TABLE
WEALTH MANAGEMENT

DON'T SWEAT THE SMALL STUFF: THE HIDDEN OPPORTUNITIES IN INTERNATIONAL SMALL COMPANIES AND SMALL COUNTRIES

By: Theodore D. Schneider

While having exposure to international equities is a well-documented benefit to an investor's total asset allocation, the underlying composition of an international equity portfolio is often overlooked and under-diversified. As a result, investors may be limiting their opportunity set and potentially missing out on the attractive investment characteristics and beneficial qualities of certain segments of the international equity market. The purpose of this whitepaper is to highlight and examine the investment opportunities in two of the most often overlooked and under-utilized areas of the international equity market: 1) developed market small cap equities and 2) frontier market equities. While we advocate the inclusion of both small cap developed market stocks and frontier markets in a broad international equity portfolio, we believe it is essential to access these markets through active management. Due to the increased inefficiencies and limited transparency in these markets, skilled active managers are best positioned to navigate and capitalize on these market conditions and have consistently shown the ability to provide a significant value-add relative to purely passive strategies.

DEVELOPED MARKET SMALL CAP EQUITIES

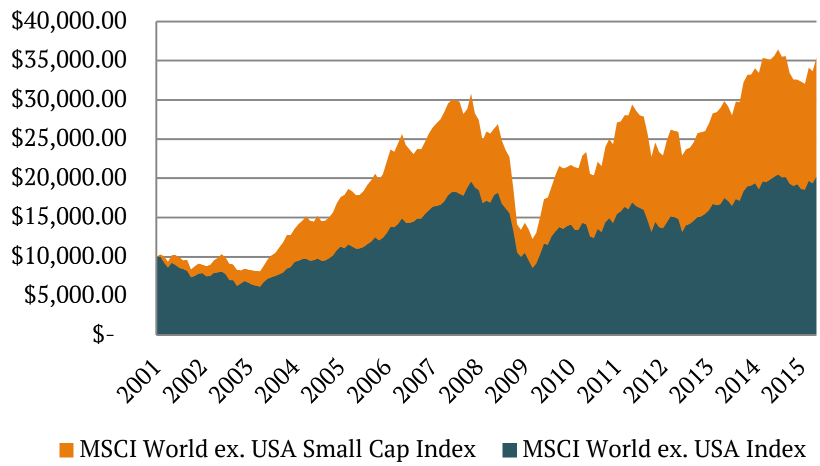
WHY DEVELOPED MARKET SMALL CAP?

Just as small cap stocks are an integral aspect of an investor's U.S. equity portfolio, small cap stocks should garner the same consideration when constructing an international equity allocation. While largely ignored in international equity portfolios, the developed small cap universe is actually quite large, composed of 15,323 stocks.[1] This constitutes roughly 82% of the total number of stocks in the developed market equity universe and approximately doubles the size of the U.S. small cap universe, which contains only 7,080 stocks.[2] The size of the developed market small cap equity universe alone makes it a viable asset class worthy of investment consideration. Developed market small cap stocks have also generated superior absolute performance over the long-term, relative to the broad market. As shown in Figure 1, the MSCI World ex. USA Small Cap Index[3] has consistently outperformed the

[1] Bloomberg Equity Screener. The developed small cap universe was created with the following filters: Active Stock, Common Stock, Primary Ticker Only, Domiciled in an MSCI Developed Market Country, Market Cap <$5 billion USD.
[2] Bloomberg Equity Screener. The developed small cap universe was created with the following filters: Active Stock, Common Stock, Primary Ticker Only, Domiciled in United States, Market Cap <$5 billion USD.
[3] The MSCI World ex. USA Small Cap Index captures small cap representation across 22 of 23 Developed Markets (DM) countries (excluding the United States).

broad developed market benchmark, MSCI World ex. USA Index,[4] over the long term (i.e., greater than 3 years).

Figure 1: Developed Market Equity Performance
(January 2001 – April 2015)



	YTD	1 Yr.	3 Yrs.	5 Yrs.	7 Yrs.	10 Yrs.	Analysis Period
MSCI World ex. USA Small Cap	9.46%	0.70%	10.93%	8.67%	4.30%	7.08%	9.22%
MSCI World ex. USA	8.54%	1.75%	10.93%	7.46%	1.78%	6.25%	5.02%

(Source: Style Advisor. Returns annualized if greater than 1 year)

Developed market small cap stocks have also been efficient performers, consistently exhibiting favorable risk-adjusted measures relative to the broad developed market over the long term. For example, the small cap segment of developed markets has displayed a higher average Sharpe Ratio[5] relative to the broad market when measured over a rolling three year period in addition to generating a superior Sharpe Ratio approximately 65% of the time. These observations are detailed in Figure 2.

Figure 2: Sharpe Ratio
(January 2001 – April 2015)

	Average Sharpe Ratio	# of Rolling Periods with Higher SR	# of Rolling Periods in Analysis	% of Periods with Higher SR
MSCI World ex. USA Small Cap	0.76	88	137	64.2%
MSCI World ex. USA	0.61	49	137	35.8%

(Source: Style Advisor. Rolling 3-Year Periods, Computed Monthly)

[4] The MSCI World ex. USA Index captures large and mid-cap representation across 22 of 23 Developed Markets (DM) countries--excluding the United States.
[5] Sharpe Ratio is a risk-adjusted performance metric that measures the unit of return earned for one unit of risk taken.

WHY ACTIVE MANAGEMENT?

While the size of the developed market small cap universe is substantial, the breadth of analyst and institutional coverage of the underlying stocks is not. The majority of stocks in the developed market small cap universe, roughly 73% according to Bloomberg, have less than two analysts covering the company.[6] This lack of coverage creates information inefficiencies and market dislocations as stock prices may not represent all the available information. These inefficiencies have surfaced through the high dispersion of returns among developed market small cap stocks. While these inefficiencies create transparency issues and potential investment traps, the wide dispersion in the small cap market also offers skilled active managers an opportunity to generate substantial alpha through diligent investment research and analysis. As a result, the performance discrepancy between active and passive strategies in developed market small cap has been historically large as depicted in Figures 3 & 4.

Figure 3: Active Management vs. Passive Indexing[7]
(10 Years: May 2005 – April 2015)

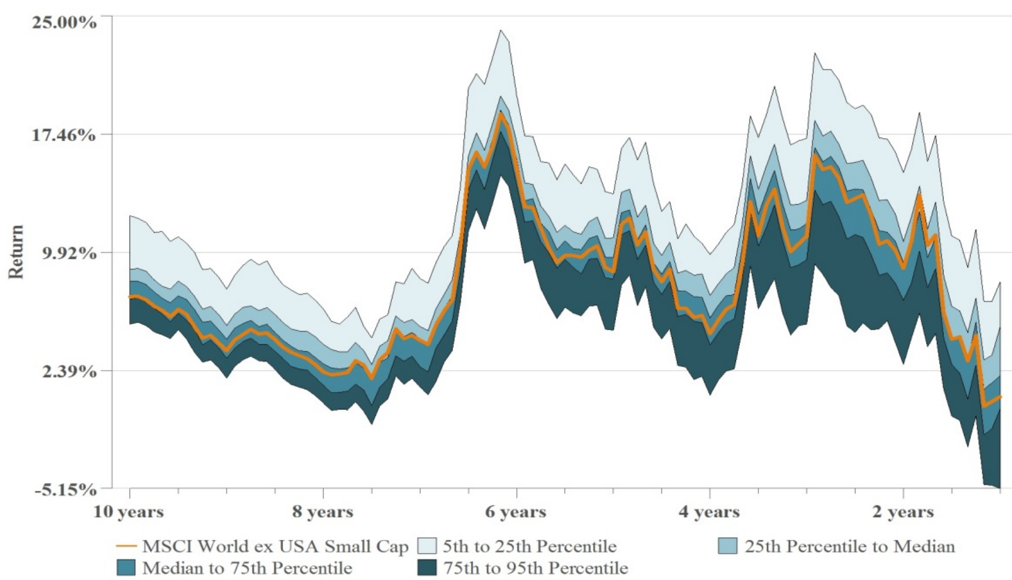


Figure 4: Median Percentile Rank and Trailing Time Period Returns

	10 yrs. Median Rank	YTD (265 mng)	1 Yr. (247 mng)	3 Yrs. (203 mng)	5 Yrs. (167 mng)	7 Yrs. (136 mng)	10 Yrs. (95 mng)
25th Percentile	25.00%	11.36%	5.14%	13.23%	10.84%	5.18%	8.85%
Median Manager	50.00%	10.03%	2.04%	11.76%	9.58%	4.40%	8.09%
MSCI World ex. USA Small Cap	59.04%	9.46%	0.70%	10.93%	8.67%	4.30%	7.08%

(Source: Style Advisor. Number of managers in universe at each time period is listed in the table. Returns annualized if greater than 1 year)

[6] Bloomberg Equity Screener. Analyst coverage is defined as the total number of analyst recommendations for a given stock, as reported by Bloomberg.
[7] Active Management Universe: Constructed using the following Lipper Mutual Fund Universe categories: International Small/Mid – Core, Growth, and Value.

As seen in Figures 3 & 4, the passive index consistently produced returns below 50% of active managers in the universe, generating a median performance rank in the 59th percentile. Additionally, the top 25th percentile of active managers in the universe outperformed the passive benchmark by 1.77% annually over the last 10 years. The results are the same when the passive index and active manager universe is viewed by Sharpe Ratio, where the passive index exhibited a median rank in the 64th percentile over the last 10 years. Thus, an actively managed strategy is essential to capturing the inherent market inefficiencies in the international small cap equity market, which helps provide incremental risk/return benefits to an international equity portfolio.

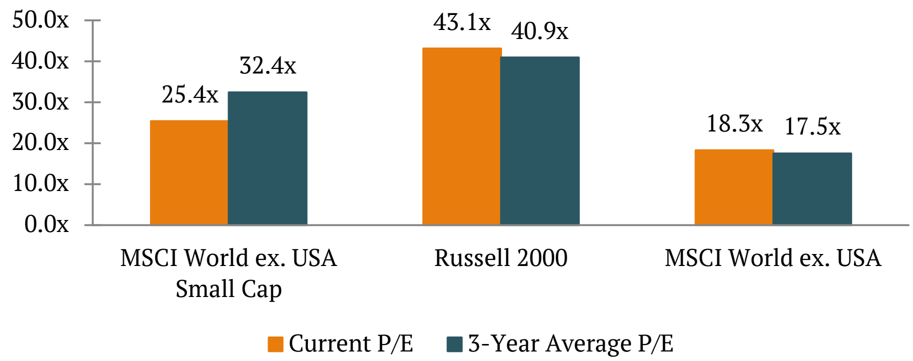
WHY NOW?

The current timing of entry into the international small cap space could also prove favorable. Historically, the international developed small cap index has outperformed the broad developed index during periods of recovery or times following a recession and/or pronounced drawdown. This was evident after the drawdowns in both 2008 and 2011 as the small cap market provided excess returns of 32.50% and 5.33%, respectively, over the broad benchmark during the next two years following these downturns. This is particularly interesting to note now, due the drawdown in international developed markets during the second half of 2014. This presents another opportunity whereas international equity markets rebound, small cap companies drive the performance. This has begun to take hold in the last three months, from 02/01/2015 to 04/30/2015, as the MSCI World ex. USA Small Cap Index has gained 10.43% relative to the broad benchmark return of 9.05%, generating outperformance of 1.38%.

Furthermore, current valuations in the developed market small cap equity space have looked quite attractive relative to both domestic small cap equities and developed market large cap equities, as well as to its own historical average. As of April 30, 2015, the MSCI World ex. USA Small Cap Index exhibited a price-to-earnings ratio (P/E) of 25.4x. When compared to the average P/E of the index during the last 3 years (32.4x), international small caps are currently trading at a 32% discount. In comparison, the Russell 2000 Index[8] is currently trading at 43.1x, a slight premium (~5%) to its 3-year average of 40.9x. Meanwhile, the MSCI World ex. USA Index is also trading at roughly a 5% premium relative to its 3-year average P/E (18.3x vs. 17.5x). The large valuation discount in the international developed small cap equity market is an indication of the strong relative value in the space and possibility for a considerable reversion to the mean. See Figure 5.

[8] The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

Figure 5: Equity Market Valuations - Current vs. 3-year P/E Ratios



(Source: Bloomberg)

FRONTIER MARKET EQUITIES

WHY FRONTIER MARKETS?

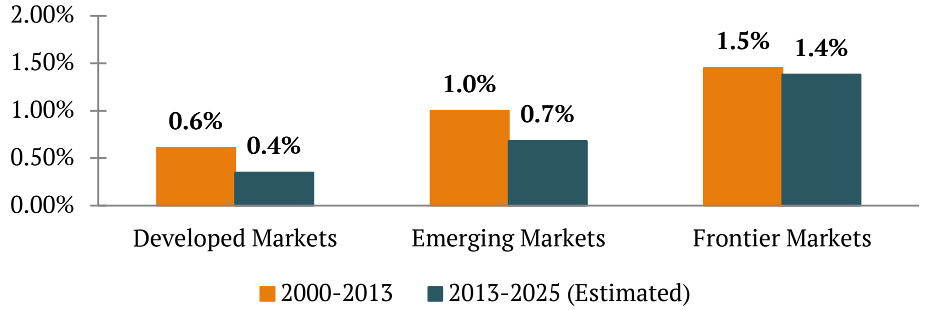
Meanwhile, frontier market equities are another asset class that demand consideration in an international equity portfolio. What are frontier markets? The frontier market classification is composed of countries with early-stage and developing economies. Frontier market economies also tend to be smaller or slightly less institutionalized than their emerging market counterparts. MSCI, the leading index provider for international markets, has classified 24 countries as frontier market countries.[9] The main attraction to frontier markets is the exciting investment opportunity to capture burgeoning economic growth. According to data produced by the World Bank, frontier market countries generated annual GDP growth of 4.7% between 2000-2013, while developed market economies grew at an average rate of roughly 1.9%.[10] Additionally, these high growth rates are expected to continue and potentially accelerate due to the overwhelmingly favorable demographics in frontier market countries. On the other hand, frontier markets also provide exceptional diversification benefits for an international equity portfolio.

DEMOGRAPHICS

Frontier market countries exhibit some of the youngest and fastest growing populations in the world, outpacing the demographics of both developed and emerging market countries as seen in Figures 6 & 7.

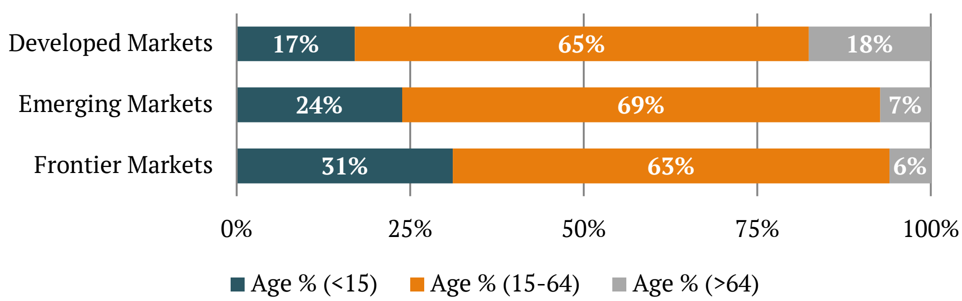
[9] MSCI Frontier Market Countries: Argentina, Bahrain, Bangladesh, Bulgaria, Croatia, Estonia, Jordan, Kenya, Kuwait, Lebanon, Lithuania, Kazakhstan, Mauritius, Morocco, Nigeria, Oman, Pakistan, Romania, Serbia, Slovenia, Sri Lanka, Tunisia, Ukraine and Vietnam.
[10] "World Development Indicators 2015." World Bank. 04/14/15.

Figure 6: Average Annual Population Growth



(Source: "World Development Indicators 2015." World Bank. 04/14/15.)

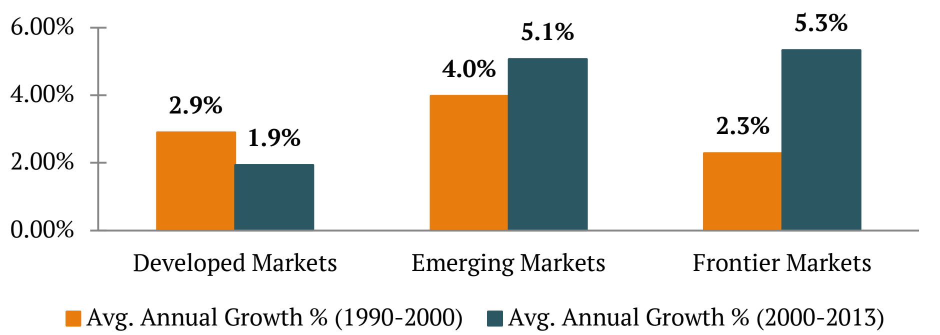
Figure 7: Population Age Composition



(Source: "World Development Indicators 2015." World Bank. 04/14/15.)

These demographics are immensely advantageous for frontier market economies and are strong positive indicators of future economic growth. As these young populations transition into the labor force, frontier markets should experience accelerating rates of economic output and consumption growth. As such, we have begun to see the initial signs of this transition as evidenced in the accelerating domestic consumption growth over the past decade. See Figure 8.

Figure 8: Average Annual Household Consumption Growth



(Source: "World Development Indicators 2015." World Bank. 04/14/15.)

DIVERSIFICATION

Beyond the appeal of the potential for these economies, frontier markets also offer strong diversification and risk-mitigation factors for an international equity portfolio due to the asset class's low correlation with other international equity markets. In a time where emerging markets continue to globalize and become increasingly more correlated with developed markets, frontier markets have operated domestically driven economies, which have been less susceptible to global macro events and global capital market movements. Thus, while the MSCI Emerging Markets Index[11] has displayed an average three year rolling correlation of 0.89 with the MSCI World Index[12] over the last ten years, the MSCI Frontier Markets Index[13] displayed an average rolling three correlation of 0.71.[14] The stark reduction in correlation to the global equity markets is indicative of the diversification benefits that frontier markets can offer above and beyond that of emerging markets.

WHY ACTIVE MANAGEMENT?

Frontier market equities display many similar characteristics exhibited in international small cap equities, including information inefficiencies, a lack of widespread analyst coverage, and reduced transparency and liquidity. In turn, this has created inherent market dislocations and mispricings as well as a high dispersion in frontier market equity returns. These investment characteristics are elevated in frontier markets and present increased risk concerns to a prospective investor. Capital markets in frontier countries, therefore, require an increased level of scrutiny by investors as these markets are often smaller, less regulated, and sometimes difficult to access or easily conduct investment transactions (both into and out of the market). Thus, active management is critical to understanding the nuances of these markets and navigating the inherent investment opportunities and risks posed by these markets.

Additionally, passive strategies in frontier markets pose unnecessary concentration risk on both a geographical and sector basis. For instance, the iShares MSCI Frontier 100 ETF (Ticker: FM), the most widely used passive strategy that is focused solely in frontier market equities, concentrates roughly 70% of its underlying constituents in five countries (Kuwait, Nigeria, Argentina, Pakistan and Kenya) and concentrates over 50% in one sector (financials). This concentration leads to increased performance volatility, which was evidenced over the last three years as the benchmark was in the top 25th percentile of the frontier market manager universe in standard deviation.[15] Utilizing an active manager can help to mitigate the concentration risk in the passive strategy in addition to expanding the opportunity set to capture all of the diversification benefits that frontier markets provide.

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[11] The MSCI Emerging Markets Index captures large and mid-cap representation across 23 Emerging Markets (EM) countries.
[12] The MSCI World Index captures large and mid-cap representation across 23 Developed Markets (DM) countries.
[13] The MSCI Frontier Markets Index captures large and mid-cap representation across 24 Frontier Markets (FM) countries.
[14] Style Advisor.
[15] Style Advisor.

WHY NOW?

The outlook for the asset class looks even more promising due to the increasing political stability and economic developments in these underlying countries as well as the current attractive valuations in frontier equity markets.

PROGRESSION OF POLITICAL CONDITIONS & CAPITAL MARKETS

While frontier market countries have exhibited attractive growth for a number of years, sentiment toward the asset class has been muted due to political instability and a limited institutional economic framework, resulting in a lack of foreign investment and multi-national businesses in the region. However, over the past few years, investors have witnessed widespread political improvements. Countries such as Nigeria and Tunisia have recently conducted successful democratic political elections and peaceful government transitions, which in turn provides a positive example for other frontier market countries to emulate. Additionally, other frontier market countries have made been making great strides to develop their capital markets into more institutionalized systems as well as provide increased access for foreign investors. Saudi Arabia and Myanmar are the most recent frontier market countries that have begun the process of opening up their markets. As a result, these developments will greatly increase the overall transparency and efficiency of the capital markets in the asset class, allowing foreign investment to more freely flow throughout the region benefitting all frontier market economies. These developments have already translated into more positive economic outlooks as there have been several upgrades to frontier market countries from credit rating agencies, including the most recent upgrade in April of Egypt's economy from Negative to Stable by all three major credit agencies (Moody's, Standard & Poor's, and Fitch Ratings).

According to a recent survey conducted by A.T. Kearney, a global management consulting firm, corporations are taking an increased interest in frontier market investment.[16] The survey found that roughly two-thirds of the companies were seeking to maintain or increase their investment in frontier markets. This increased business confidence in frontier markets may also correspond to the dramatic change occurring in global labor dynamics, as rising labor costs in countries like China have initiated a shift of manufacturing and other labor intensive industries to younger, cheaper, labor forces in frontier countries such as Sri Lanka, Vietnam, Bangladesh and others. Consequently, there have been recent record inflows into frontier markets through both foreign direct and indirect investment. For example, China just unveiled a $46 billion infrastructure spending plan in Pakistan, referred to as the China Pakistan Economic Corridor, to develop a more efficient trading corridor between the two countries that will include the construction of new roads, rail links and pipelines.[17] As a result, the persistent inflow of foreign capital, both through the increasing ease of access to capital markets and direct investment, has boosted capital market liquidity and should only improve as more capital continues to

[16] Keeler, Dan. "Firms Focus on Frontier Opportunities, Study Shows." Wall Street Journal. 04/30/15. A.T. Kearney surveyed 500 corporations with revenues larger than $500 million.
[17] Shah, Saeed, and Jeremy Page. "China Readies $46 Billion for Pakistan Trade Route." Wall Street Journal. 04/16/2015.

be allocated to the region. Ultimately, these historic and on-going commitments to the asset class should be the spur that turns the long-predicted potential of frontier markets into reality.

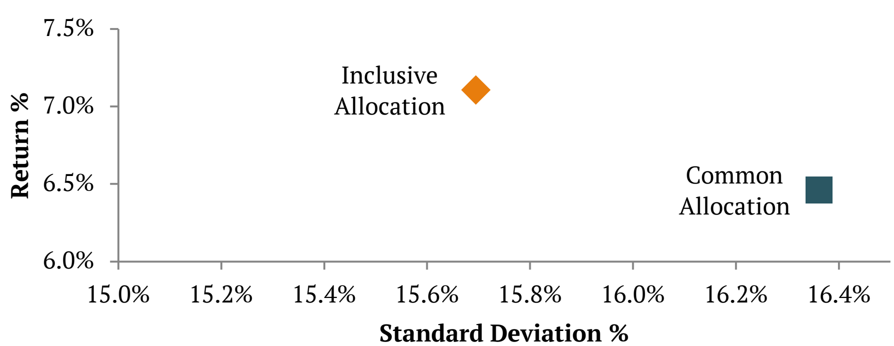
ATTRACTIVE VALUATIONS

Due to price depression in frontier equity markets in recent quarters, the price-to-earnings multiples in the frontier market asset class have fallen to substantially lower levels. As of April 30, 2015, the MSCI Frontier Markets Index displayed a P/E of 11.5x.[18] As a result, the current market value is trading at a discount relative to its 3, 5, and 10 year average P/E levels of 11.7x, 12.5x, and 13.5x.[19] This presents the opportunity to invest at an attractive entry point relative to historical valuations.

CONCLUSION

The incorporation of developed market small cap equities as well as frontier market equities can provide a great benefit to an international equity portfolio. The advantages of having these asset classes in an international equity portfolio become more evident when comparing the common approach to international investing, which focuses on developed large cap and emerging market companies, relative to a more inclusive approach which incorporates both developed small cap stocks and frontier markets. As seen in the following charts, the international equity portfolio inclusive of both developed small cap stocks and frontier markets provided both a risk and return advantage over the most recent trailing 5 year period.

Figure 9: Risk/Return Profile of International Equity Allocations[20]
(5 Years: May 2010 – April 2015)



	Return (%)	Standard Deviation (%)	Sharpe Ratio
Inclusive Allocation	7.11%	15.70%	0.45
Common Allocation	6.46%	16.36%	0.39

(Source: Style Advisor. See footnote for allocation breakouts. Performance metrics are annualized.)

[18] Bloomberg.
[19] Bloomberg.
[20] Common Portfolio: 75% MSCI World ex. USA Index/25% MSCI Emerging Markets Index. Inclusive Portfolio: 55% MSCI World ex. USA Index/20% MSCI World ex. USA Small Cap Index/15% MSCI Emerging Markets Index, 10% Frontier Markets Index.

It is important to reiterate, however, that both of these asset classes contain significant inherent risk characteristics that differ from other segments of the international equity market. Both display increased illiquidity, limited transparency and information inefficiencies, while frontier markets specifically can exhibit restricted access to capital markets, index level concentration risk, and increased geopolitical instability. These risks must be thoroughly considered prior to investing in these portions of the international equity market. Therefore, we advocate the use of active management in these asset classes to provide an extra layer of due diligence and expertise to help navigate these markets and mitigate risk. Despite the risks, both developed market small cap equities and frontier markets can be important components of an international equity portfolio.

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