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The enduring appeal of international small caps

The Brexit vote and the ensuing ETF flows out of international markets underscore the compelling opportunity for active strategies

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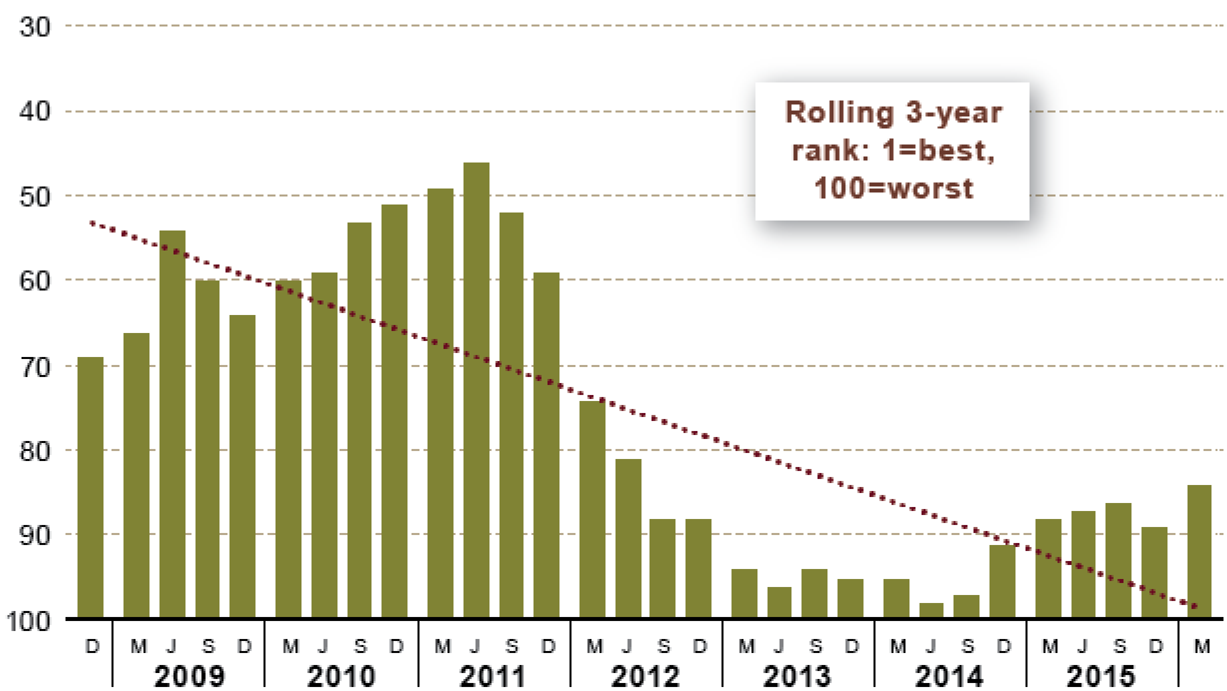
In many ways, the growth of passive investment strategies has been a game changer for institutional investors. What can be overlooked, however, is that exchange-traded funds and index funds are very often the wrong tool for the right job when it comes to portfolio construction.

The commoditization of international investing through passive funds, for instance, provides an easy and cheap way for U.S. investors to access foreign equities. But if the intent of the allocation is premised on diversification, asset owners might be disappointed to discover that there is far more correlation to domestic equities than they realize or desire. This, coupled with the uncertainty following the landmark vote by the U.K. to leave the European Union, is why so many institutional investors are again exploring actively managed strategies for their international exposures and focusing, in particular, on the small-cap segment as a source for alpha in a low-return environment.

Due to the idiosyncratic risk available through international small-cap stocks, the performance of the segment has more than doubled that of international large caps whether looking over a three-, five-, 10- or 15-year timeframe, through June 2016. On a calendar-year basis, international small caps also beat international large caps in seven of the last 10 years. As modern portfolio theory would predict, because international small-cap stocks are less correlated to U.S. stocks than international large caps, they also provide access to the differentiated return streams that improve overall diversification within a total plan portfolio.

While the Brexit vote drove some panic selling that affected the larger indexes, all the moving pieces and the sometimes-indiscriminate price adjustments in global markets present distinct buying opportunities for value-oriented stock pickers, whose conviction is reflected through a buy-and-hold strategy. And if there is any question regarding where the returns of active international small-cap strategies line up against passive alternatives, over a rolling three-year period since December 2008, the performance of the MSCI All Country World Index ex-U.S. Small Cap index has largely resided below the median when ranked against the comparable eVestment LLC active manager universe, showing a distinct downward trend in which the index's performance has fallen into the bottom quartile for the past four years.

Exhibit 1: Rolling 3-year rank of the MSCI ACWI ex-USA Small Cap index within the active manager universe.



Source: eVestment Alliance

The international advantage

While the headlines paint an uncertain macro picture, there remains a deep pool of attractive companies in Europe and Asia — many of which stand to benefit amid the disruption in trade triggered by the U.K.'s pending departure from the EU. And while no country can be expected to replace China as it transitions into a more advanced industrial economy, low-wage manufacturing is migrating to other emerging markets with tremendous growth potential, such as India, Vietnam and Mexico. From a valuation perspective, emerging Europe, Africa and the Middle East also present compelling opportunities to capitalize on growing macro uncertainty through focusing on those assets whose stock prices show the steepest discounts to their intrinsic valuations. But it's essential, even in the smart beta era, to adopt an active approach to take advantage of market inefficiencies. Moreover, since small-cap names tend to be heavily impacted by company-specific characteristics (the source of idiosyncratic risk), these assets favor bottom-up stock picking in which managers focus on assets far removed from analyst coverage. This is where active managers have a distinct edge.

There are some obvious challenges that face international small-cap investors. Just as information can be difficult to obtain in domestic small-caps, this is magnified in international markets. The inefficiency of the segment is a blessing for those that can accommodate the breadth of the universe and a curse for those ill-equipped. This is where a robust quant screen, coupled with fundamental research, allows managers to find the out-of-favor or overlooked names that offer the most upside. This "quantamental" approach can also help portfolio managers make macro calls to manage downside risk or uncover pockets of value amid a flight to safety in the broader markets.

As most realize, not all quant screens are created equal, and international small-cap stocks often behave quite differently from domestic small caps. This makes factor selection and emphasis critically important. For instance, "quality" factors that capture operating momentum — such as sales, earnings, and ROI growth — tend to fare better in the international small-cap space than in the U.S. As an international investor's scope must extend across several regulatory regimes with disparate accounting standards, this favors those utilizing customized metrics to uncover the real top- and bottom-line performance behind the reported numbers. These adjustments create apples-to-apples comparisons and measure the company-specific real costs of capital and cash flows.

Because market prices are more volatile than intrinsic values, it's critical to counterweight market-behavior factors, such as those indicating stock-price momentum or market volatility, with intrinsic-valuation factors. The end result is a target rich opportunity set from which to conduct fundamental research and make qualitative calls, either identifying those assets with appealing catalysts for growth or discarding those facing too much uncertainty. By and large, international investors should become inured to headline noise, as company fundamentals typically trump geopolitics, but recent events in Turkey, for instance, highlight why human intervention is so critical to "quantamental" strategies and risk management.

Other considerations also exist. Mindful of liquidity constraints, positions have to be built without tipping off the rest of the market. In emerging markets, it can take a week or more to trade in and out of securities with small floats. The liquidity challenge is also something that vexes fund managers that become too large, making AUM discipline a crucial, but overlooked differentiator in the space.

Having a concentrated mix of both developed- and emerging-market stocks is also important. Often overlooked are investments in true, hyper-local companies, which closely reflect the desired exposure to the company's respective market. A business might be domiciled in Hong Kong, but how much of its revenue is padded by conducting business in North America? Being able to manage these economic, indirect-country exposures is a key to managing risk.

In the long run, however, the case for international small caps is built around the idiosyncratic alpha opportunity. Passive funds may provide investors with false comfort that they'll benefit from the small-cap premium or that they're diversified across equities; the irony is that the indiscriminate stock selections of indexing adds to the market inefficiencies. This is why active management beats indexing by such a wide margin in the international small-cap space.

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