# INTERNATIONAL SMALL CAP EQUITIES

Canadian pension plan sponsors have long recognized the merits of small cap equities to enhance portfolio returns and diversification. However, the allocation has generally been to domestic or US small cap equities.

This note provides background on International small cap equities and the merits it offers to expanding a small cap allocation, as well as reviewing the general case for small cap investing. The highlights include:

**Key insights**

| | |
|---|---|
| **Not that small** | Over 690 International small cap companies have a market capitalization greater than US $1 billion. |
| **Breadth and depth** | Largest stock is only 0.3% of the index and there is broader sector diversification compared to other major market indices. |
| **Active added value** | Active managers have, on average, delivered 1.5% p.a. added value over the MSCI EAFE Small Cap Index over the past five years ended December 31, 2011 (Source: eVestment Associates). |

## BACKGROUND TO EAFE SMALL CAP

Under MSCI Index construction, small cap is defined as stocks in the range of US $100 million to US $5 billion. Many of the stocks in the International small cap universe are household names in their local market, and some even have a global brand such as Flight Centre (Australia) and Vitasoy (Hong Kong).

International small cap is not that small. For the MSCI EAFE Small Cap Index the median company size is US $602 million and there are 695 companies with a market capitalization greater than US $1 billion. There are only 201 such companies in the S&P/TSX Composite Index and 39 companies in the S&P/TSX Small Cap Index.

The largest individual stock in the MSCI EAFE Small Cap Index represents only 0.31% of the index, which is similar to the US Small Cap Index (Russell 2000 Index) where the largest stock represents 0.34% of the index. In contrast, the largest individual stock in the S&P/TSX Composite Index represents 5.3% of its index and the largest 15 stocks account for 44% of the index.

To achieve a similar representation in International and US small cap context, you would need to invest in 353 International small companies and 287 US small cap companies. We are not suggesting a portfolio should hold that many stocks, but it highlights the broad investment opportunity set of the International and US small cap universes.

While the major Canadian indices are heavily skewed to the energy, material and financial sectors (see Table 1), the International small cap market provides representation across a broader range of sectors, including higher exposure to industrials (e.g. transportation, railroads and building and construction companies), consumer discretionary (e.g. companies in the restaurant, luxury goods and travel industries) and information technology.

Table 1 – a different opportunity set (December 31, 2011)

| GIC Sector | MSCI EAFE Small Cap | S&P/TSX Composite Index | TSX Small Cap Index | Russell 2000 Index |
|---|---|---|---|---|
| Energy | 4.8% | 27.1% | 21.6% | 6.7% |
| Materials | 11.1% | 21.1% | 34.5% | 4.5% |
| Industrials | 23.0% | 5.8% | 12.1% | 15.6% |
| Consumer Discretionary | 17.5% | 4.0% | 5.9% | 13.1% |
| Consumer Staples | 6.5% | 2.8% | 3.7% | 3.7% |
| Health Care | 5.5% | 1.4% | 2.3% | 12.7% |
| Financials | 19.7% | 29.3% | 12.2% | 22.3% |
| Information Technology | 8.6% | 1.3% | 2.2% | 17.1% |
| Telecomm. Services | 1.2% | 5.2% | 0.0% | 0.8% |
| Utilities | 2.0% | 2.0% | 5.5% | 3.7% |
| **Total** | **100.0%** | **100.0%** | **100.0%** | **100.0%** |

Source: MSCI and Thomson Reuters Datastream.

Many larger companies have been burdened with huge pension obligations which has been a drain on cash flows. Based on our research into the US and International small cap companies in our portfolios, there are no major pension burdens to deal with.

# INTERNATIONAL SMALL CAP EQUITIES

## SMALL CAP BENEFITS

While International small cap represents a "different" opportunity set, does "different" imply a good opportunity? Consider these potential benefits:

| | |
|---|---|
| **Growth opportunity** | The most basic premise supporting an allocation to small cap equities is that large companies start small. If you can find the next generation of small companies that will grow fast and graduate into the large cap segment, the reward may be significant. It may be hard to believe, but only in November 2004 did Apple Inc. graduate into the MSCI US Large Cap Index.<br><br>International small cap companies tend to have a more focused line of business and higher insider ownership than is the case for large cap companies, resulting in greater alignment of interests between the owners and shareholders. |
| **Sector opportunity** | Plan sponsors can benefit from the higher industrial, consumer discretionary and information technology sector representation offered by the international small cap index relative to other major indices.<br><br>The spending patterns in developed and emerging markets should see the consumer discretionary sector perform well over the long term. A heightened demand globally for better infrastructure would benefit the industrial sector. |
| **Active opportunity** | Small cap companies also tend to be less externally researched by the analyst community. As a result, active managers have a greater opportunity to outperform their index benchmark by identifying companies whose share price does not fully reflect their intrinsic value or growth prospects.<br><br>For example, active managers over the past five years ended December 31, 2011 have, on average, delivered 1.5% p.a. added value over the MSCI EAFE Small Cap Index (Source: eVestment Alliance). |

## NOT WITHOUT RISKS

Small cap equities are not without their risks. While active managers can mitigate some of these risks through research and careful selection of individual stocks, investors should consider the following risks:

| | |
|---|---|
| **Liquidity risk** | It can take longer to trade a small cap stock compared to large cap stocks. Small cap stocks also tend to be more sensitive to changes in market sentiment such as a change from a bullish to bearish outlook for a particular sector, which can contribute to the more volatile performance. |
| **Information flow** | While higher insider ownership aligns with the interests of investors, it can also lead to lack of transparency and lack of flow-of-information that would be common with large cap investments. |
| **Large competitors** | Small companies do not have the same access to credit markets as larger companies as a result of their size. This can sometimes limit a small company from realizing its potential at the expense of a larger competitor |

## CASE FOR INTERNATIONAL SMALL CAP EQUITIES

The need for growth while being ever mindful of total portfolio risk is still at the forefront of the minds of institutional investors. Where size of pension assets allows for a multiple manager structure, by extending a small cap bias to International equities, investors may benefit from a broader opportunity and enhanced portfolio diversification.


**For further discussion about the ideas discussed in this article contact:**

**Robert Beauregard, MBA, CFA, CMA**
Chief Investment Officer
Global Alpha Capital Management
514 490-2788 | rbeauregard@cclgroup.com

**Peter Muldowney**
Senior Vice President, Institutional Strategy
Connor, Clark & Lunn Financial Group
416 304-6810 | pmuldowney@cclgroup.com


GLOBAL ALPHA