



The Case for International Small Cap Equities

Canadian investors 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 they offer 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 1,167 International small cap companies have a market capitalization greater than US \$1 billion (Source: MSCI)

Breadth and depth

Largest stock is only 0.3% of the index and there is broader sector diversification compared to other major market indices (Source: MSCI)

Active added value

Active managers have, on average, delivered 1.4% p.a. added value over the MSCI EAFE Small Cap Index over the past five years ended December 31, 2017 (Source: eVestment Alliance)

To achieve a similar representation in international small cap context, you would need to invest in 416 companies. We are not suggesting a portfolio should hold that many stocks, but it highlights the broad investment opportunity set of the International small cap universes.

While the major Canadian indices are heavily skewed to energy, material and financial sectors (see Figure 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.

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 \$1,214 million and there are 1,341 companies with a market capitalization greater than US \$1 billion. There are only 217 such companies in the S&P/TSX Composite Index and 25 companies in the S&P/TSX Small Cap Index.

The largest individual stock in the MSCI EAFE Small Cap Index represents only 0.3% of the index. In contrast, the largest individual stock in the S&P/TSX Composite Index represents 6.7% of its index and the largest 15 stocks account for 47% of the index.

Figure 1 - Small Cap Diversification Merits

	MSCI EAFE Small Cap	S&P/TSX Composite Index	TSX Small Cap Index
Energy	2.5%	19.7%	22.2%
Materials	9.5%	11.5%	26.8%
Industrials	21.4%	9.5%	12.2%
Consumer Discretionary	16.1%	5.4%	9.0%
Consumer Staples	7.0%	3.7%	1.7%
Health Care	6.7%	1.0%	5.1%
Financials	11.5%	34.6%	5.4%
Information Technology	11.4%	3.2%	5.6%
Telecommunication Services	1.4%	4.7%	0.2%
Utilities	2.0%	3.8%	2.1%
Real Estate	10.4%	2.9%	9.9%
Total	100%	100%	100%

Source: MSCI and Thomson Reuters Datastream. As at December 31, 2017

Not Without Risks

International 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.

Small Cap Benefits

While international small cap represents a “different” opportunity set, does it imply a good opportunity? Consider these potential benefits:

Growth opportunity	<p>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.</p> <p>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.</p>
Sector opportunity	<p>Investors 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.</p> <p>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.</p>
Active opportunity	<p>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.</p> <p>For example, active managers over the past five years ended December 31, 2017 have, on average, delivered 1.4% p.a. added value over the MSCI EAFE Small Cap Index (Source: eVestment Alliance).</p>

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The need for growth while being ever mindful of total portfolio risk is still at the forefront of the minds of investors. International small cap equities offer investors a broader opportunity and enhanced portfolio diversification.

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