



## The Case for International Small Cap

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*Diversified Alpha in a Globalized World*

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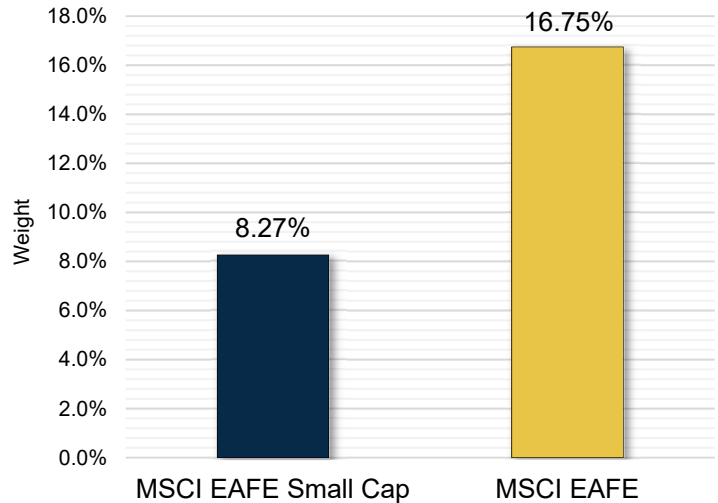


International equity strategies provide investors with access to the world's non-U.S. economies and, importantly, a means to add an impactful diversifier to their investment portfolio.

***But are investors truly unlocking this diversification potential?***

As our world benefits from rising global trade and the blurring of country borders, in our opinion, the diversification sought by international investors may not be to the degree anticipated. Many large cap international companies are multinational with revenue sourced from many countries, including the United States. The MSCI EAFE ("EAFE"), an index of international large cap stocks, has a U.S. revenue exposure of 16.75% - a meaningful weight when seeking to diversify a U.S. equity portfolio. In contrast, the MSCI EAFE Small Cap ("EAFE SC"), an index of international small cap stocks, has a U.S. revenue exposure of 8.27%, less than half of the exposure of the EAFE. International small cap firms tend to have more of their revenue focused in the country in which they are domiciled, providing a differentiated revenue exposure from that of international large cap firms. In reviewing the rolling 5 year return correlations of the EAFE and EAFE SC versus the S&P 500 Index we found that the EAFE has trended closer to the S&P 500 ranging from 0.77 to 0.93 over approximately 18 years ended 3/31/2019. In contrast, the EAFE SC correlation to the S&P 500 has plotted lower than the EAFE and ranged between 0.54 to 0.89 over the same time period.

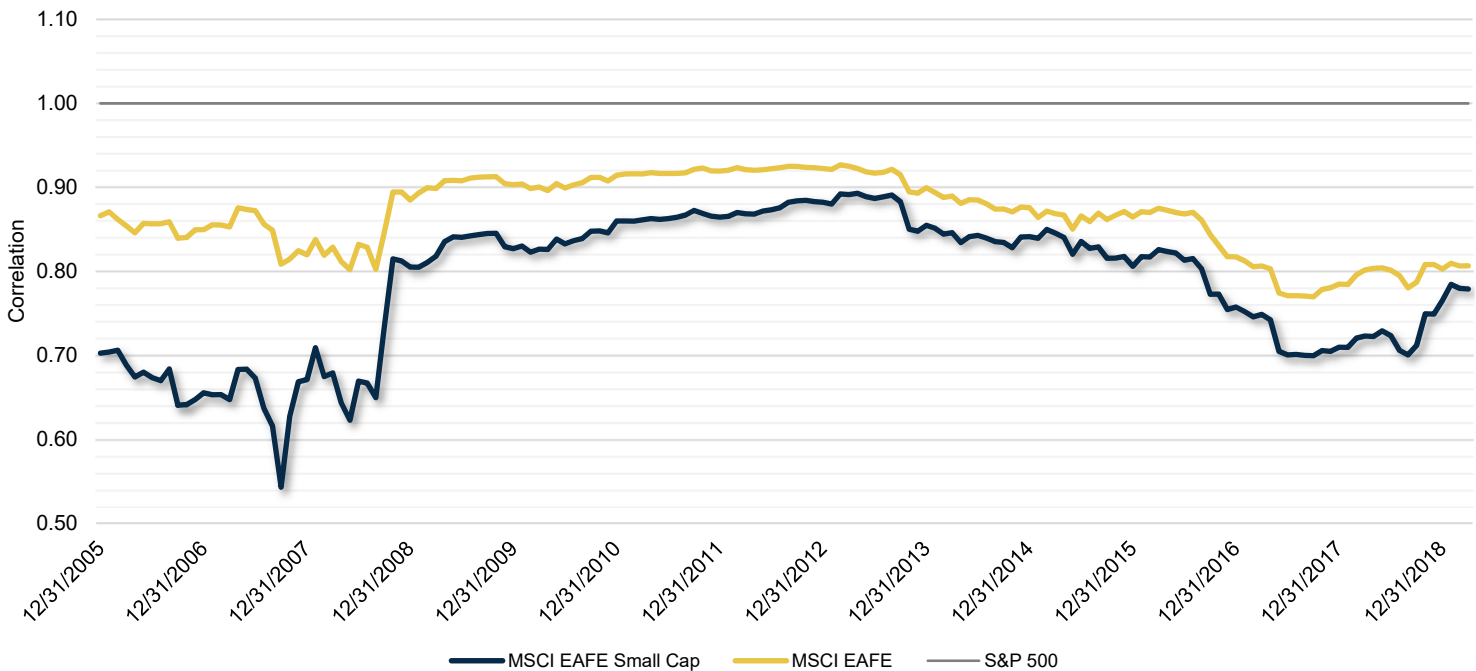
**United States Revenue Exposure**  
as of 3/31/2019



Source: FactSet

**Rolling 5 Year Return Correlation vs. S&P 500**

Time Period: 1/1/2001-3/31/2019



Source: Morningstar Direct



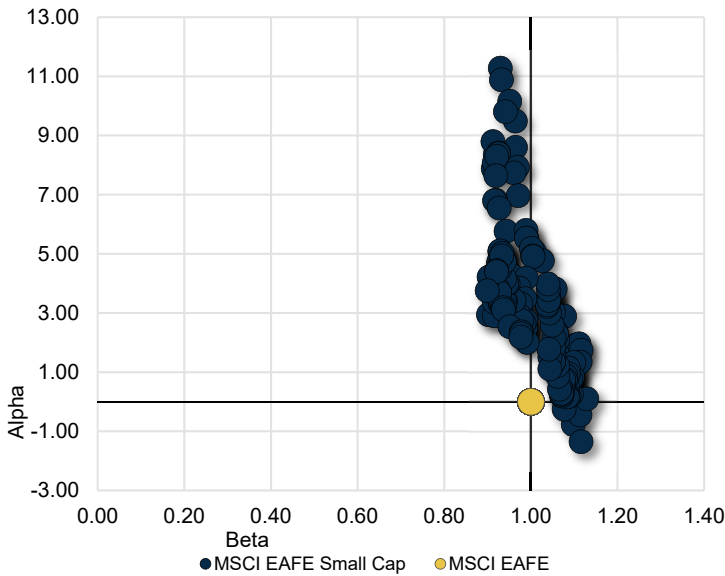
**How has international small cap performed against international large cap?**

In examining 5-year rolling windows since 1/1/2001, we looked at:

1. **Alpha and Beta** – EAFE SC routinely generated positive Alpha while maintaining a steady Beta.
2. **Upside and downside capture** – EAFE SC has generally captured less of the downside of EAFE while maintaining an attractive upside.
3. **Excess returns** – EAFE SC has offered a consistent advantage versus EAFE.

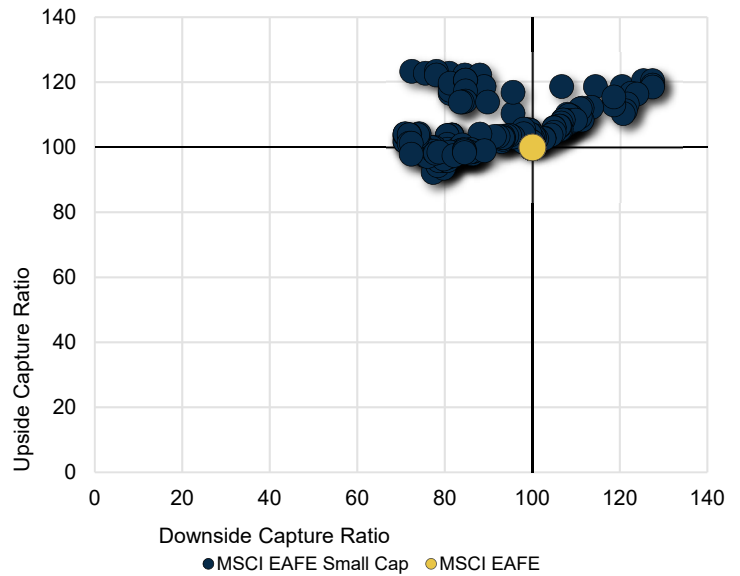
**Rolling 5 Yr Risk/Return vs. MSCI EAFE**

Time Period: 1/1/2001-3/31/2019



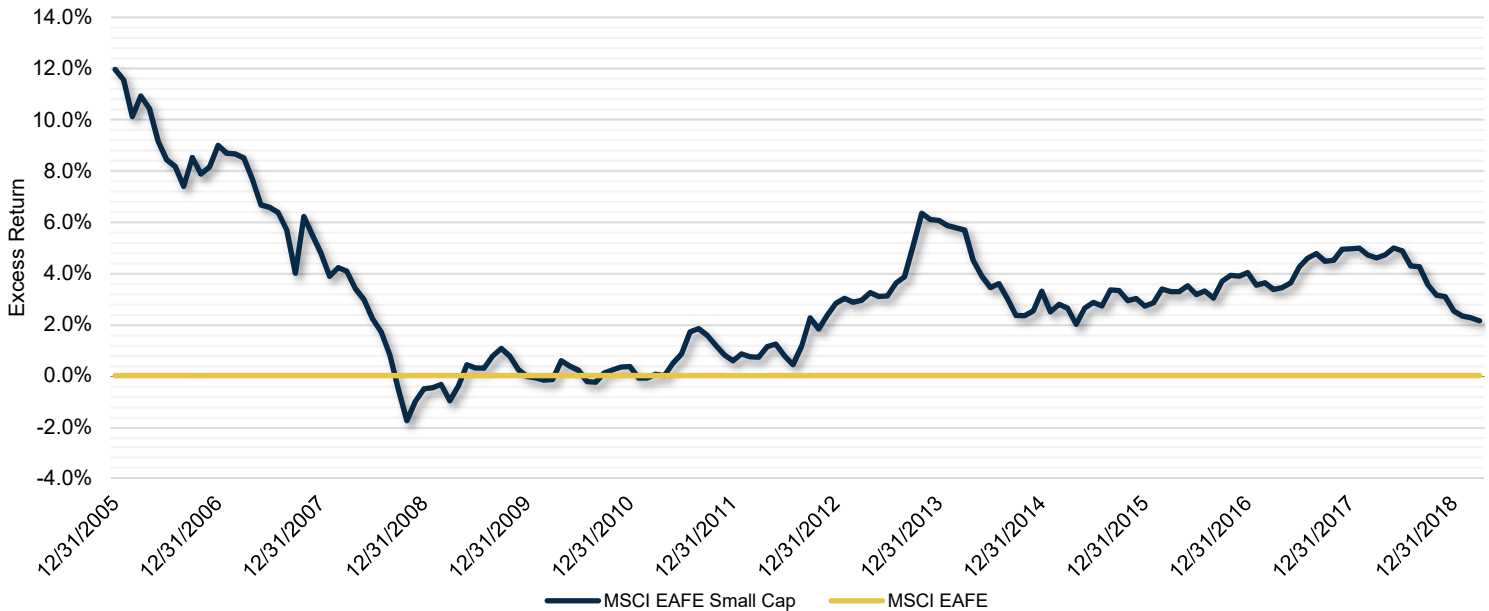
**Rolling 5 Yr Up/Down Capture vs. MSCI EAFE**

Time Period: 1/1/2001-3/31/2019



**Rolling 5 Year Excess Return vs. MSCI EAFE**

Time Period: 1/1/2001-3/31/2019



Source: Morningstar Direct

Investing in international and emerging markets poses special risks, including potentially greater price volatility due to social, political and economic factors, as well as currency exchange rate fluctuations. These risks are more severe for securities of issuers in emerging market regions. Stocks of small cap companies pose special risks, including possible illiquidity and greater price volatility than stocks of larger, more established companies.

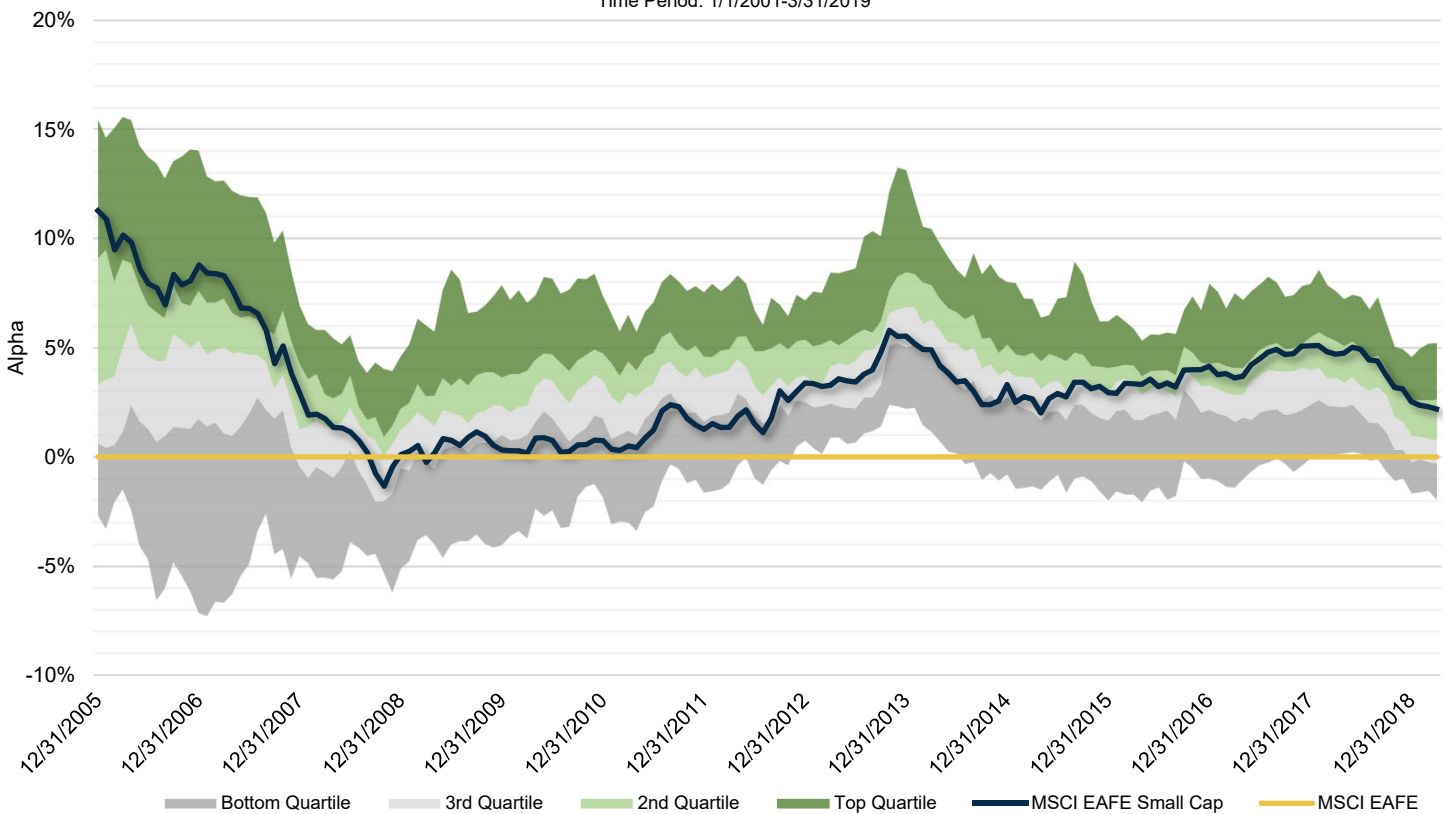


**Active or passive?**

In making the active/passive decision in the international small cap space, we focused on the alpha-generating opportunity within the international small cap universe. Utilizing the EAFE as the benchmark we found that since 1/1/2001, on a rolling 5-year basis, there is a meaningful alpha advantage in favor of the EAFE SC. Active open-end fund managers in the Morningstar Foreign Small/Mid categories (303 funds and share classes as of 3/31/2019) have added meaningful value within this alpha-rich environment as indicated by the alpha quartile ranking of the EAFE Index within the active peer group – even below median active Morningstar Foreign Small/Mid funds have historically, during certain periods, been able to add alpha over the EAFE. The alpha ranking of the EAFE SC indicates that there is actively generated alpha potential above that provided by simply indexing to the EAFE SC.

**Rolling 5 Year Alpha vs. MSCI EAFE**

Peer Group (5-95%): Active Intl. Small Cap Universe  
Time Period: 1/1/2001-3/31/2019

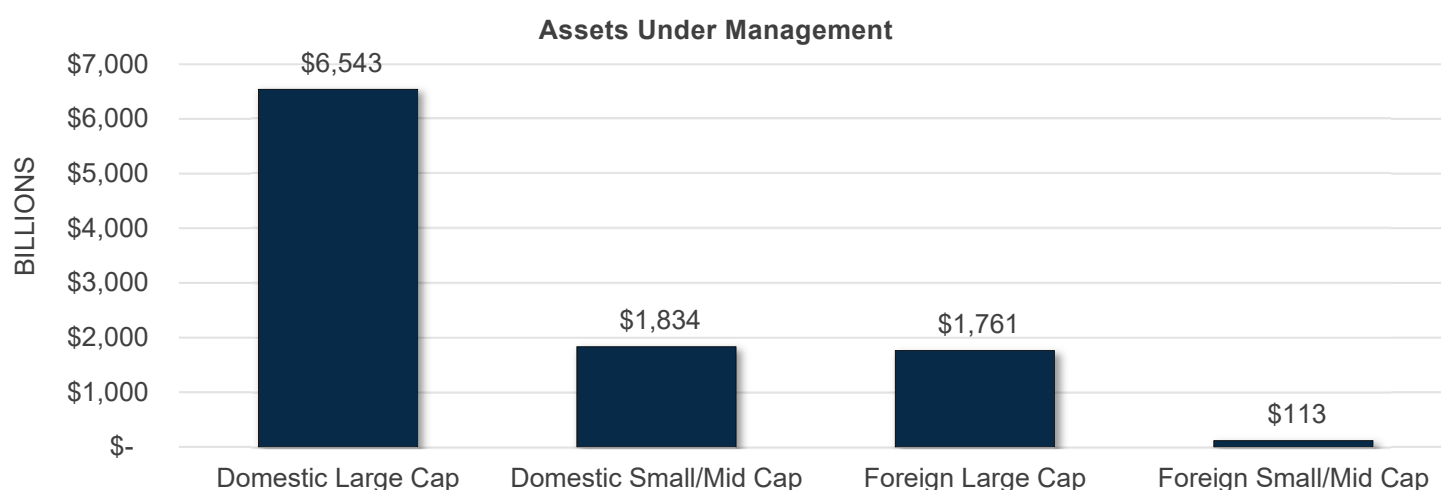


Source: Morningstar Direct



***The diversification and performance advantages of international small cap equities have been consistent historically, but are investors capitalizing?***

When looking at the assets under management in United States mutual funds and ETFs, investor allocations to Morningstar's Foreign Small/Mid Cap asset classes are relatively underrepresented. Overall, there is a home bias in U.S. portfolios as evidenced by the fact that there is \$8.4T in domestically-focused mutual fund and ETF assets versus \$1.87T in foreign-focused assets, or nearly 4.5X the exposure. Focusing specifically on the large cap versus small/mid cap dynamic, domestic large cap represents approximately 3.6X that of small/mid cap assets. In international funds and ETFs we find that large cap represents approximately 15.6X the amount of small/mid cap assets. This relative size inequality highlights the broad underutilization of the international small/mid cap asset class in investor portfolios.



Source: Morningstar Direct

The large differential between the Morningstar Foreign Large Cap and Foreign Small/Mid Cap relative weights is not due to a lack of opportunity. There are more securities in the international small cap universe (as represented by the EAFE SC) than in the international large cap universe (as represented by the EAFE) which may present active managers with the opportunity for increased breadth and potential diversification benefit to investors. It is also worth noting is that this advantage doesn't include the added opportunity of emerging market small/mid caps.

3/31/2019	Russell 1000	Russell 2000	MSCI EAFE	MSCI EAFE Small Cap
# of Holdings	978	1,999	920	2,331
Total Mkt Cap (\$M)	29,412,010	2,411,243	18,483,294	3,382,617
Median Mkt Cap (\$M)	10,548	792	10,196	1,000

Source: FactSet

**Conclusion:**

Given the attractive diversification and performance benefits of investing in Foreign Small/Mid companies and the limited representation in U.S. investor portfolios, we believe this asset class merits a closer look.



**Alpha** is a measure of risk (beta)-adjusted return. **Cash-Adjusted Alpha** subtracts the risk-free rate from the returns of both the manager and the benchmark.

**Beta** is a measure of systematic risk, or the sensitivity of a fund to movements in the benchmark. A beta of 1 implies that the expected movement of a fund's return would match that of the benchmark used to measure beta. **Cash-Adjusted Beta** subtracts the risk-free rate from the returns of both the manager and the benchmark.

**Up and Down Capture** is a measure of how well a manager was able to replicate or improve on phases of positive benchmark returns, and how badly the manager was affected by phases of negative returns.

The **S&P 500 Index** is an unmanaged index generally representative of the U.S. stock market. This unmanaged index does not reflect fees and expenses and is not available for direct investment.

The **MSCI EAFE (ND) Index** is an unmanaged index generally representative of major overseas stock markets. This unmanaged index does not reflect fees and expenses and is not available for direct investment.

The **MSCI EAFE Small Cap (ND) Index** is an equity index which captures small cap representation across developed markets countries around the world, excluding the U.S. and Canada. This unmanaged index does not reflect fees and expenses and is not available for direct investment.

The **Morningstar Domestic Large Cap Universe, Morningstar Domestic Small/Mid Cap Universe, Morningstar Foreign Small/Mid Cap Universe, and Morningstar Foreign Large Cap Universe** represent all funds categorized as such by Morningstar.

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**Diversification does not ensure against loss or guarantee a profit.**

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