INVESTMENT BULLETIN

Keel Point

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International Small Cap

The historical record shows that smaller companies deliver higher returns over longer timeframes than their larger compatriots. Explanations abound: one might consider the excess return required compensation for taking greater risk, or a gift from overconfident CEOs who are willing to pay a premium to acquire small companies, or even an illusion born of poor data collection and analysis of the asset class. We certainly don't believe this is a secret; data on US small caps is well circulated amongst the investment community and opportunities to invest are plentiful. However, we observe that the US qualifier to that statement is key – non-US small caps have received less attention from investors.

After a September rebalance, Keel Point's strategic portfolios now include an allocation to international small cap companies. Part of the rebalance goal was to expand our footprint within global equities - to increase the breadth, location, and type of enterprises that our clients might profit from. We think that diversifying potential sources of equity returns and risk makes sense. More horses on the track help smooth the inevitable cyclicality of markets. Since international small cap is a horse you may not know, we want to dedicate these two pages to some data that supports its inclusion in portfolios.

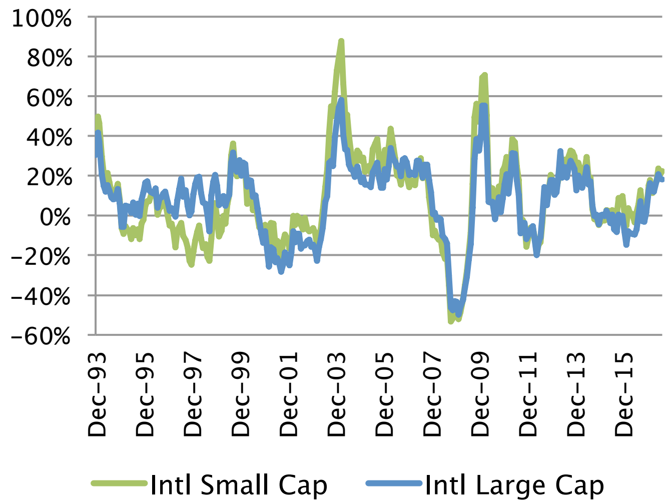
Same Story, Different Protagonist

We begin with some definitions. The MSCI EAFE Small Cap Index (what we own via an iShares ETF, ticker SCZ, and what we analyze here) owns 2,260 stocks domiciled in developed markets excluding the US and Canada. These stocks have a market capitalization below $10 billion and an average capitalization of $1 billion. MSCI reports that as of August 2017, these stocks have an average forward P/E ratio of 15.6, significantly less than the MSCI benchmark that blends US and non-US small caps (a 19.1 forward P/E). Non-US small caps are currently about 20% cheaper than US small caps.

Figure 1 compares the returns of international small cap stocks to international large cap stocks using, respectively, the MSCI EAFE Small Cap Index and the MSCI EAFE Index. We can draw a few conclusions from this comparison of rolling twelve month returns. First, international small caps differentiate themselves. Sometimes this is to the investor's detriment, especially during the late 1990s. More recently, though, the asset class has added value relative to international large cap stocks. The entire period shows a 0.8% annualized improvement in returns. However, since 1999, the return premium is a more impressive 4.8%.

Second, non-US small cap's absolute level of risk, as measured by standard of deviation of returns, is not much higher than large cap's. The former generates about 1.3% more deviation in the data since 1992, thus asking less of an investor's mental fortitude than US small caps, which experienced 4.3% more variation relative to US large caps over the same period per a comparison of the Russell 2000 and Russell 1000 indices. This risk evaluation is evident on the graph – the green small cap line hasn't experienced significantly worse losses than the blue large cap line since the late 1990s.

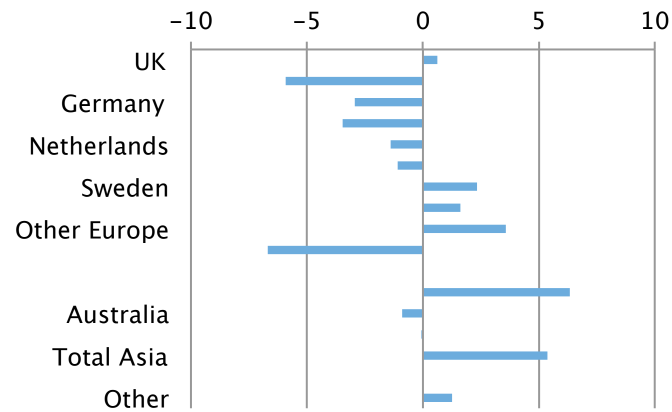
Figure 1: Rolling 12 Month Returns
Intl Small Cap = MSCI EAFE Small Cap
Intl Large Cap = MSCI EAFE
Source: Bloomberg



Other Considerations

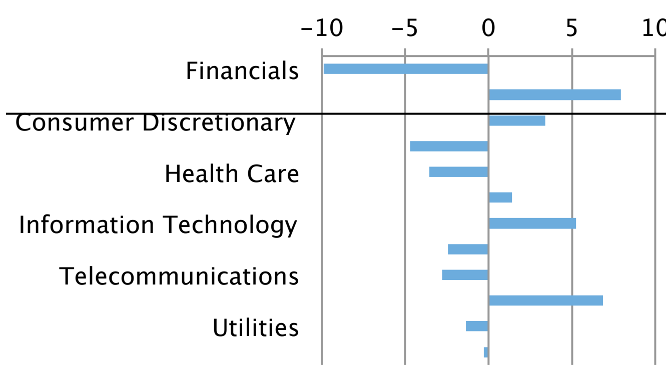
It's important to consider what else changes, other than size, when you allocate to smaller companies. For example, we observe differences in regional and sector concentrations within the asset class. Figure 2 shows a detailed comparison of two ETFs that mimic the two indices considered in Figure 1 - the iShares MSCI EAFE Small Cap ETF (SCZ) and iShares MSCI EAFE ETF (EFA). Relative to international large cap, smaller companies are generally more concentrated in Asia and less in Europe. Japan stands out as prodigious creator of small companies. France, Germany, and Switzerland are all large cap-heavy. This also means the currency risk inherent in non-US small cap equity investment is skewed towards the yen and away from the euro relative to non-US large caps.

Figure 2: International Small Cap Regional Bets
Small Cap Weight minus Large Cap Weight (%)
Source: iShares



Economic sectors differ as well. Financial, consumer staples, and health care companies skew towards large cap, while industrial, tech, and real estate take bigger weights in the small cap universe. Figure 3 shows that some of these differences are quite significant (sourcing data from the same ETFs used in Figure 2). Interestingly, a graph comparing US small caps to US large caps would show similar tilts. One could draw the conclusion that more highly regulated sectors foster larger companies, to spread the costs over a larger asset base, no matter the home country.

Figure 3: International Small Cap Sector Bets
Small Cap Weight minus Large Cap Weight (%)
Source: iShares



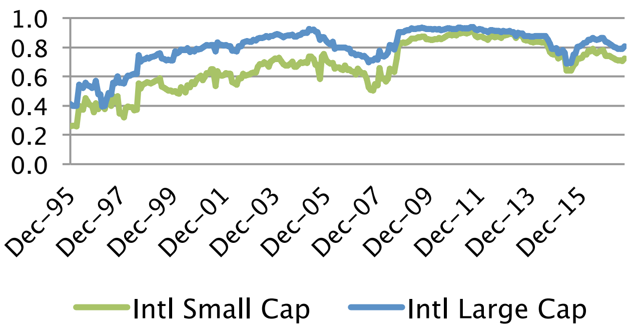
These data give us a partial understanding of why performance might differ between the two non-US equity asset classes. All else being equal, we expect small caps to deliver a return premium to large caps over the long-term. When Japan excels, the yen appreciates, and/or the industrial/tech/real estate sectors outperform, we expect a boost to that premium. However, if Europe leads, the euro strengthens, and/or financials/staples/health care win the day, we expect to see underperformance. Naturally, these are just a few driv-

ers of returns, as many other factors could also impact long-term performance.

Perhaps the Biggest Benefit

International small cap's most beneficial attribute for portfolio construction may be its ability to diversify US stocks. Figure 4 shows how, when compared to international large cap on a rolling three year basis, this asset class provides more differentiation versus the S&P 500. This benefit was wider pre-financial crisis, but still meaningfully today.

Figure 4: Rolling 3 Year Correlation to S&P 500
Intl Small Cap = MSCI EAFE Small Cap
Intl Large Cap = MSCI EAFE
Source: Bloomberg



Conclusion

We believe the data supports an allocation to international small cap equities because the asset class provides a meaningful differentiated source of risk (this alone makes it a strong candidate), while also delivering excess return over the long-term. Further, it should be a logical leap for those comfortable investing in smaller US companies to consider further diversifying equity risk by investing in similar exposure in international markets.