Making the Case for International Small-Cap Stocks

Although the U.S. economy has continued to outpace many of its global peers, investors may want to consider buying international stocks – particularly small-caps – for several compelling reasons, including better diversification, more attractive valuations, more opportunities for stock-picking, currency advantages and stimulative central-bank policies in Europe and Japan.
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Introduction

For much of the past year, the U.S. economy has outpaced its global peers, bucking the slowdowns seen elsewhere in the world and sending American equity-market indexes to record highs. This trend doesn’t appear to be waning just yet. In early 2015, the International Monetary Fund released its near-term global growth outlook, cutting its forecast for much of the world, including Europe, Japan and China – but upgraded its expectations for the U.S., citing the positive impact of low oil prices and accommodative monetary policy.¹

On the surface, investors may be wondering why they should put their money anywhere else besides the U.S. After all, the U.S. is poised to continue growing, at least over the next few years, while international economies are contending with a host of challenges, including a strong dollar, rising volatility, tentative consumers and geopolitical tensions.

We see several reasons why investors should consider buying international stocks – particularly small-caps – as the investing climate shifts in favor of active managers, including better diversification, more attractive valuations, more opportunities for stock picking, currency advantages and stimulative central-bank policies in Europe and Japan.

Better Diversification

Of course, most market participants understand the benefits of portfolio diversification and have implemented it in their retirement plans, 401(k)s and other investments. In the third quarter of 2014, which is the most recent quarterly data available from the Investment Company Institute, equity inflows recorded inflows of $2 billion in the Americas, while European equity funds posted an inflow of $19 billion in the same period.²

But even if investors are putting all of their funds into U.S. names, they are still significantly exposed to international markets. According to our calculations based on FactSet data, approximately 35% of total revenue and more than half of earnings at S&P 500 companies are derived outside the U.S. As such, these investors are in a sense diversified, but they are paying premium valuations compared to people who are directly investing in international stocks and funds.

More Attractive Valuations

Another readily identifiable benefit of international investing right now is the prevalence of attractive valuations across developed markets. The U.S. has been handily outpacing its international peers in terms of recent performance, but that has resulted in some lofty prices for U.S. stocks and some notable bargains elsewhere.

However, some stocks are cheap for a reason, which we believe is the case across many emerging markets. Investing in developed markets offers opportunity to find attractive pricing but poses far less country risk than many emerging markets.

Investors in international markets also stand to benefit from higher dividend yields. As shown in Exhibit 1 below, foreign stocks based on the MSCI EAFE Small Cap Index yielded on average about 1% more in dividends than Russell 2000 components over a seven-year period.

Exhibit 1: Comparing Dividend Yields


Exhibit 2: Downward Trend for Correlations

One common argument for passive investing, regardless of geographical region, is the high correlation among Index components – i.e., a rising tide has been lifting all boats. However, this has been changing over the past two years, and nowhere is that more pronounced than in the international small-cap space, as shown in Exhibit 2.

Median 60-Day Correlation with Index
This means that stocks are less likely to rise and fall in tandem with the broader markets, which will in turn create a better environment for skilled stock-pickers.

Compounding this positive effect for active managers is the wide range of dispersion among international small-cap stocks, as seen in Exhibit 3. This provides even more opportunity for talented investors to earn excess returns, as it demonstrates a sizable gap between the best and worst performers in the asset class. If a manager is able to identify the performance leaders, he/she can potentially generate significant alpha.

**Exhibit 3: A Big Gap Between Winners and Losers**

Currency Advantages for Non-U.S. Companies

Over the past few months, the U.S. dollar has appreciated rather sharply versus most currencies globally, including the euro and the Japanese yen. As noted earlier, with companies in the S&P 500 deriving approximately 35% of revenue and more than half of earnings outside the U.S., a stronger dollar will create a meaningful headwind to revenue and translated earnings in the upcoming period.

The opposite is true for Europe and Japan, which are home to many world-class export businesses. For example, in Exhibit 4, you can see that Continental European small-cap companies generate nearly 30% of their revenue outside the eurozone, which should bolster their earnings over the next 12 months.

According to a similar Credit Suisse analysis for Japanese companies in the middle to upper end of the small-capitalization range (approximately $800 million to $3.5 billion in market cap), the picture is even more compelling, with almost 43% of revenue derived outside Japan.

In fact, both Japanese and European corporate earnings trends benefit from currency weakness versus the U.S. dollar. Exhibits 5 and 6 illustrate this point, as forward earnings expectations maintain a strong, positive correlation with a weakening of their respective currencies on a trade-weighted basis.

**Exhibit 4: Europe’s Revenue Diversity**

<table>
<thead>
<tr>
<th>Region</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Europe</td>
<td>69%</td>
</tr>
<tr>
<td>Other</td>
<td>13%</td>
</tr>
<tr>
<td>North America</td>
<td>12%</td>
</tr>
<tr>
<td>Asia Pac ex Japan</td>
<td>6%</td>
</tr>
</tbody>
</table>

Source: Credit Suisse Research, STOXX Europe Small 200 Index, as of December 2014.

**Exhibit 5: Europe’s Earnings Expectations Rise as Euro Weakens**

**Exhibit 6: Japan’s Earnings Expectations Rise as Yen Weakens**
Finally, international small-caps have historically performed well throughout a full market cycle. While MSCI EAFE small-cap stocks typically perform better in rising markets, their annualized returns stack up well next to their larger-cap international counterparts, as illustrated by Exhibit 7.

Exhibit 7: Small-Caps Hold Their Own

At the end of January, the European Central Bank launched a dramatic bond-buying program in an effort to support the region’s ailing economy, just as the U.S. wraps up its own quantitative-easing program. The central bank’s easing policy has already established negative real interest rates, and the ECB announced that it will purchase €60 billion a month in assets, including government bonds, to combat stagnation and ultralow inflation that threatens to derail the global economic recovery. The euro has weakened, but not as much as oil prices, which has been a boon to eurozone consumers.

Japan’s yen has sagged, and the Bank of Japan recently announced an expansion of the quantitative-easing measures aimed at achieving a 2% inflation rate. Ultimately, these conditions will benefit earnings for Japanese exporters. In addition, the administration delayed its next VAT increase for another year and a half in an effort to bolster consumer consumption trends, which stalled after the April 2014 VAT hike. We see a recovery taking hold in the country.

In addition, as the U.S. dollar strengthens, weakening currencies in developed markets are a tailwind for exports, and we expect the ensuing benefits to filter back into those economies. We also anticipate lower oil prices to boost Japan and Europe as well.

In light of improving economic conditions as well as the aforementioned benefits of diversification, attractive valuations, currency advantages and accommodative policymakers, we believe international small-cap stocks can offer compelling opportunities to generate returns for investors’ portfolios, particularly with guidance from professionals with specialized expertise in the asset class.
End Notes


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