



# Smaller stocks, larger opportunity?

THB International Opportunities



## Key Take Aways

- > International small caps are an oft-overlooked area of the market that may offer investors a pathway to strong absolute and risk-adjusted returns.
- > The opportunity set within nearly two dozen diverse developed markets is extraordinarily broad, yet the underlying dynamics within this asset class create a robust environment for active managers to potentially exploit inefficiencies and cultivate alpha.
- > International small cap companies can provide high levels of diversification benefits through country, currency, domestic economic conditions and stock-specific, idiosyncratic opportunities.

## International small cap equities are often overlooked, yet they just might prove invaluable in an era when forward return expectations are falling.

International developed market small capitalization equities are an asset class that can help investors improve portfolio diversification while also creating an opportunity to enhance both absolute and risk-adjusted returns over the longer term. The universe of these “smaller” companies is quite broad with market capitalizations typically ranging from \$100 million to \$9 billion. Yet for some reason much of this universe is neglected by active managers and receives little to no brokerage research coverage. Perhaps that reflects the fact that a large cohort of international small caps sits below the \$1 billion median market capitalization of the MSCI World ex-USA Small Cap Index, the principal benchmark for international small caps. Or, perhaps it's simply too challenging for many active managers to dig into this expansive but difficult to access corner of the market. Whatever the reasons, we believe that the intriguing world of international small caps remains highly inefficient even today and, as a result, offers fertile ground from which to unearth potential alpha (excess return relative to the market).

Although many investors, including institutions, still suffer to some extent from home country bias, we believe global diversification efforts have been improving. Nevertheless, many of these efforts appear to have been focused primarily on large capitalization equities. It's simply easier to allocate more broadly across global developed markets in the large-cap space. As a result, smaller capitalization companies far away from the U.S. often get overlooked, if not downright ignored. Once one moves outside the large cap arena, the sheer breadth of the universe and diversity of manager approaches requires additional effort to analyze the asset class and managers. Passive approaches can also lack adequate breadth. Other factors, such as capacity constraints and geographic exposure, can further complicate the analysis for allocators. Nevertheless, we remain steadfast in our belief that a significant alpha opportunity exists across the international small-cap arena. A comprehensive analysis of the investment universe and the nuances of benchmark construction may be helpful in better understanding this alpha opportunity.

## The Opportunity Set

The opportunity for investors to add potential diversification and other portfolio benefits in the world of small, international equities is significant. The opportunity set not only covers businesses across the full spectrum of industries, but also across a wide swath of geographic markets. Although there is some correlation (or, similar movements) between economies given the effects of globalization, not all local economies move in lockstep or are always at the same point in their economic cycles. This is the basis for an expansive opportunity set.

It's important to understand some of the nuances of index construction and not be limited by such nuances when allocating to small and exciting international equities.

For U.S. small capitalization indices, Russell Indices utilize a methodology that employs overlap between the Russell 2000 (small cap) and Russell Micro Cap indices. The indices "share" or have 1,000 stocks in common. This approach is effective for representing the high number of stocks and rapid migration within the U.S. small capitalization universe. Importantly, MSCI does not use an overlapping system for its smaller cap indices (MSCI World ex USA Small Cap Index and MSCI World ex USA Micro Cap Index). Each index is mutually exclusive, resulting in a broad swath of companies that have overlapping market capitalizations, but are never included in more than one index.

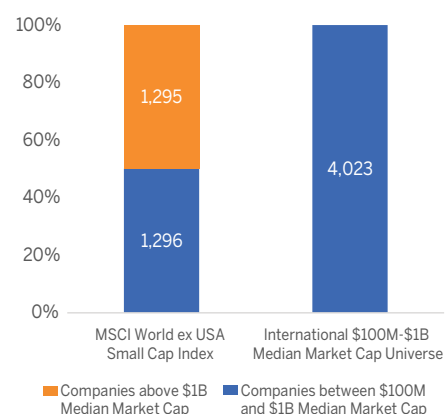
Thus, we believe that expanding the universe to investable (\$100M-\$1B median market cap) companies within the range of the existing small-cap benchmark (the MSCI World ex USA

Small Cap Index) provides increased investment opportunities. As shown in Chart 1, there are approximately 4,000 investable international companies represented in the \$100 million to \$1 billion median market cap universe versus just 1,300 captured in the non-expanded universe (MSCI World ex USA Small Cap Index). This expanded opportunity set offers diversification benefits and multiple ways for active managers to potentially deliver alpha (excess return relative to the market).

It's also important to consider different market capitalization calculation methodologies. For example, MSCI utilizes float market capitalization instead of full market capitalization for weighting in its indices. Float market capitalization methodology penalizes companies with higher insider ownership by excluding the insider shares from market cap calculations, thus lowering float market cap and excluding companies that meet the criteria for inclusion based on total market capitalization. Insider ownership by management is typically regarded as a positive sign of alignment between management and shareholders. Smaller companies generally have higher levels of average insider ownership. Float market capitalization weighting likely creates a situation where smaller capitalization companies with high levels of insider ownership are possibly underrepresented in indices and portfolios. This is illustrated in Chart 2, which shows the number of companies included when float market cap methodology is used versus full market cap methodology.

The large opportunity set in international small caps is further

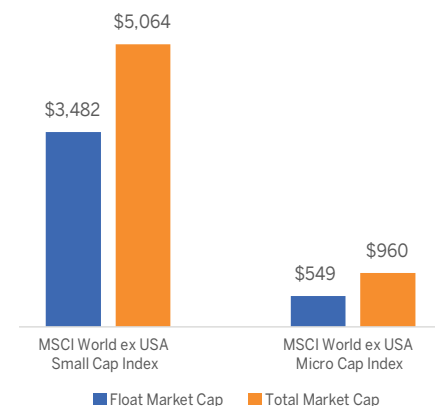
**CHART 1:  
INTERNATIONAL SMALL CAP  
OPPORTUNITIES  
(\$100M-\$1B MEDIAN MARKET CAP)**



Source: THB, MSCI. As of 12/31/2021.

*International \$100M-\$1B Median Market Cap Universe: International Small Caps \$100 million and \$1 billion median market capitalization of the MSCI World ex USA Small Cap Index, the principal benchmark for International Small Caps.*

**CHART 2:  
FLOAT VS TOTAL MARKET CAP  
(BILLIONS)**



Source: THB, MSCI. As of 12/31/2021.

## The Portfolio Management Team



### Christopher N. Cuesta, CFA

Chief Investment Officer & Portfolio Manager

> 27 Years Industry Experience

> 20 Years with THB



### Manish Maheshwari, CFA

Portfolio Manager

> 23 Years Industry Experience

> 11 Years with THB



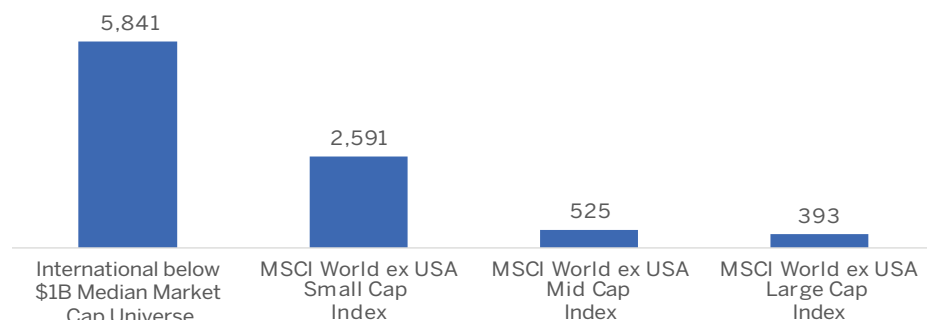
### Victoria Konstantinova, CFA

Assistant Portfolio Manager

> 11 Years Industry Experience

> 11 Years with THB

## CHART 3: MORE INTERNATIONAL SMALL CAP OPPORTUNITIES (BELOW \$1B MEDIAN MARKET CAP)



Source: THB, MSCI. As of 12/31/2021.

International below \$1B Median Market Cap Universe: international small caps below the \$1 billion median market capitalization of the MSCI World ex USA Small Cap Index, the principal benchmark for International Small Caps.

illustrated when companies below \$100 million market cap are also included in the universe. As shown in Chart 3, there are 5,841 international companies (ex U.S.) represented when the universe is expanded to include even smaller companies (i.e., those between \$0 and \$1B market cap) versus the 2,591 companies in the MSCI ex USA Small Cap Index. These numbers are significantly higher than the 393 companies in the MSCI World ex USA Large Cap Index and the 525 companies in the MSCI World ex USA Mid Cap Index.

## The Active Advantage

We believe there are numerous high-quality, well capitalized and undervalued securities within the universe of small international companies. The inherent inefficiencies within that universe create opportunities for active management to add value. For example, at the start of 2022, there were approximately 1,958 companies trading at less than 1.5x enterprise value-to-sales (used to understand a company's total valuation compared to its annual sales) and 922 companies with a return on invested capital (ROIC) of

greater than 10% (source: MSCI as of December 31, 2021). As a result of these inefficiencies, astute active managers can identify high-quality, growing companies well before they are discovered by a broader set of market participants.

This is supported by limited sell side coverage. Smaller-capitalization companies typically cannot generate the brokerage or investment banking economics needed to justify coverage from sell side brokerage firms. International small-cap companies have an average of less than two analysts per company, and 33% have no sell side coverage at all (source: MSCI & FactSet as of December 31, 2021). The lack of research coverage helps active managers find mispriced, undiscovered securities, creating potentially fertile ground for strong stock selection.

Another advantage for active managers in the international small-cap space is the inherently lower index concentration, certainly by comparison to their large-cap counterparts. Historically, large capitalization indices had a relatively high concentration among their top holdings.

Chart 4, for example, shows that the top 10 constituents of the MSCI World ex USA Large Cap Index accounted for more than 15% of the index as of December 31, 2021. This “crowding” effect may limit active management’s ability to diversify and add alpha versus the benchmark. By comparison, concentration within small cap was much lower, with the top 10 constituents representing only 2.4% of the benchmark. Not only does this make it an environment more apt to capture alpha, but high active share—a measure of how a manager’s portfolio differs from the benchmark—is much easier to achieve with lower levels of index concentration.

Finally, another key advantage for active management in the international small-cap equity universe is the lack of correlations, as shown in Chart 5. The sizable number of companies, the diversity of 22 different developed markets (ex U.S.), and multiple stock-specific drivers have historically lead to very low individual stock correlations. International small-cap equities have had some of the world’s lowest intra market pairwise correlations. Small-cap companies below the median market

capitalization (\$1B) exhibit pairwise correlations which are 29% lower than those in the MSCI Small Cap Emerging Markets Index. This is an environment with an unequal playing field, which could benefit skilled active managers.

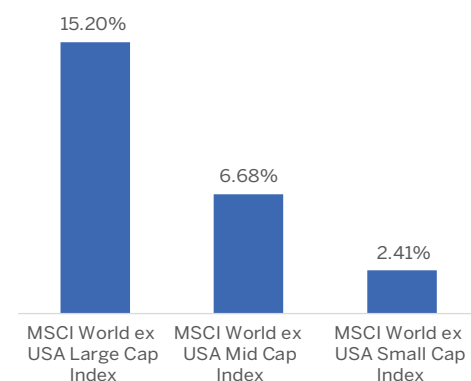
## The Portfolio Benefits

Given the expansive nature of the opportunity set, as well as the inherent characteristics that make it appealing for active management, there are ample potential portfolio benefits to allocating to international small-cap equities. These include:

### Heightened Diversification

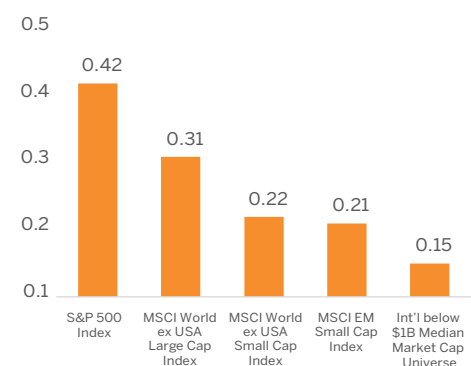
International small-capitalization companies can provide high levels of diversification through country, currency, domestic economic conditions and stock specific, idiosyncratic opportunities. As shown in Chart 6, small-cap companies tend to be primarily domestic in nature and have lower levels of international revenue when compared to larger, multinational corporations. This provides investors the purest form of country diversification benefits. Moreover, U.S. Dollar currency risk is reduced as smaller international companies tend to have a low percentage of exports to the U.S.

**CHART 4:  
TOP 10 HOLDINGS WEIGHTS**



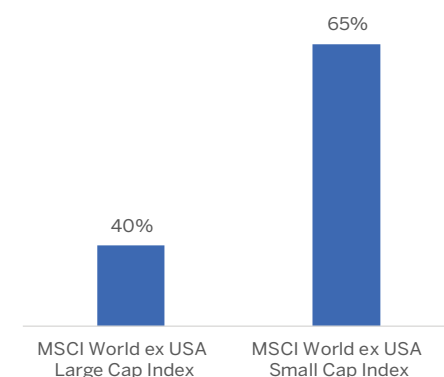
Source: MSCI. As of 12/31/2021.

**CHART 5:  
AVERAGE PAIRWISE CORRELATION**



Source: S&P, Russell, MSCI, THB. As of 12/31/2021.

**CHART 6:  
% OF DOMESTIC REVENUE**



Source: Bloomberg. As of 12/31/2021.

**CHART 7:  
MARKET CAP COMPARISON (\$ MILLION)**



Source: eVestment, MSCI. As of 12/31/2021.

## SIDEBAR

# International Small Caps: Hints of Private Equity

Private equity is witnessing increasing demand as many investors are eager to boost longer-term return potential with reasonable—or even lower levels—of risk associated with public equities, as defined by standard deviation of returns. Rising demand for private equity-like strategies from pension funds and other institutions is coming at a time when the number of listed equities on public equity markets is shrinking. Thus, allocating to private equity strategies can be a challenge.

One possible alternative is to mine the potential benefits of private equity through publicly traded international small-cap securities. These two asset types have many commonalities, both in terms of how they might generate similar returns, and in terms of how they function within a broadly diversified investment portfolio. For starters, consider that size (as defined by market capitalization or deal value), insider or founder ownership, domestic focus, a large investable universe, and inherent inefficiencies within many of these businesses are all characteristics that international small-cap listed companies share with certain private equity. Moreover, smaller, well capitalized, niche businesses can be attractive acquisition candidates or make acquisitions themselves. In fact, the well capitalized nature of many small, international companies affords them the opportunity to make acquisitions in order to enter new verticals, complete an existing product suite or consolidate market share. This is part of a typical playbook associated with private equity. It's also reasonable to expect that the increasing flow of money to private equity may lead to increased acquisition activity among international small cap companies. This could provide another tailwind to forward return expectations.

All this suggests that actively managed international small-cap strategies—depending on the investment philosophy of the individual manager—might be used as a reasonable surrogate for institutions looking to add to their private equity allocation. And all this comes with the added benefit of daily public market liquidity, which is something private equity investors typically give up in an effort to capture the returns of private equity.

## Completion of Existing Small-Cap Allocations

The average international small-cap manager has a weighted average market cap of \$3.6B, which is significantly higher than the median market capitalization of the larger developed market countries, as shown in Chart 7. Positive inflows have likely forced many existing small cap managers to bias towards larger capitalization stocks within their universe while avoiding less liquid, lower capitalization ones. This neglect enhances mispricings and investment opportunities.

## Alpha Potential

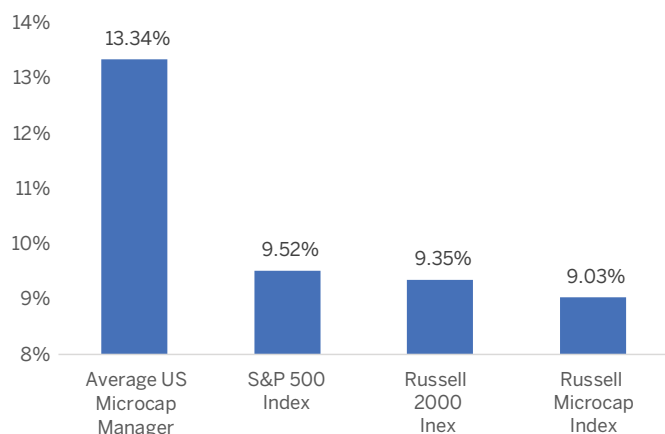
We've documented why the size and diversity of the small-cap universe is a perfect landscape for active managers, but it's important to reiterate that the complexity and nuances of the benchmark render simple asset allocation analysis less effective. Using benchmark returns and risk to weigh the merits of the asset class can negate the very reasons the asset class is very attractive. Elements, such as trading liquidity, product capacity and approach, impact how active managers construct their portfolios and their ability to deliver alpha.

To comprehensively investigate international small cap inclusion into a broader portfolio, an analysis of the asset class should include the returns and data from the existing set of active managers and other proxies, which may highlight the alpha potential.

U.S. micro cap stocks offer an interesting comparison and might be a reasonable proxy for international below median small cap due to their many shared attributes, such as

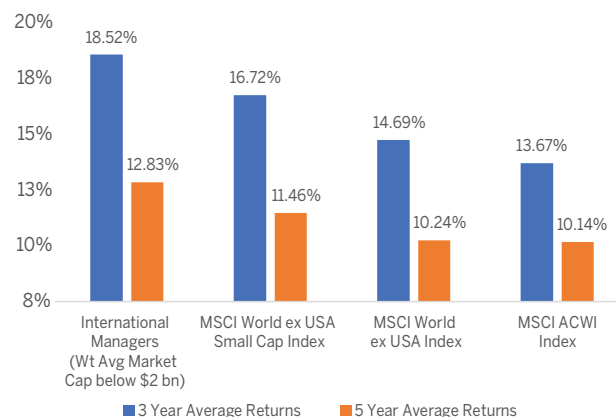


**CHART 8:  
20-YEAR RETURNS FOR MANAGERS  
BELOW \$2 BILLION**



Source: eVestment, Bloomberg, Factset.  
As of 12/31/2021.

**CHART 9:  
3- AND 5-YEAR AVERAGE RETURNS  
INTERNATIONAL SMALL CAP MANAGER  
WT AVG MARKET BELOW \$2 BILLION**



Source: eVestment, Bloomberg, Factset.  
As of 12/31/2021.

inefficiencies, limited sell side coverage, market cap size, trading liquidity and insider ownership. The longer-term (20 year), sustained alpha generation by U.S. micro cap managers, as shown in Chart 8, illustrates that a large, inefficient universe can provide high absolute and relative returns. It is also indicative of potential for active management to substantially outperform the stated benchmarks.

International small-cap active managers employ approaches across a wide range of market capitalizations. Analyzing all of them in one bracket ignores the nuances of their approaches. To further analyze the existing managers, we stratified the universe by market capitalization. Echoing the results of active U.S. micro cap managers, the strategies focused on lower market capitalization levels delivered strong absolute and relative returns.

A five-year analysis of the international small cap universe of managers shows results similar to the longer-

term results witnessed in the U.S. marketplace. As shown in Chart 9, active managers were able to add substantial alpha over the MSCI World ex USA Small Cap benchmark.

## An Enduring Opportunity

We believe that international small cap equities are an identifiable source of alpha that can offer investors diversification benefits and premium returns. As outlined, nuances of the benchmark construction method create an expanded opportunity set which is likely being ignored by a majority of existing managers. Investors looking to complete their existing international allocations or seeking a liquid alternative to private equity may find the asset class an attractive option. The size and quality of the international opportunity set, combined with a limited number of managers focused on the space, point to an enduring, target-rich environment for active managers. ■

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## **Past performance does not guarantee future results.**

### **Investing involves risk, including loss of principal.**

Investments in small- and mid-cap companies typically exhibit higher volatility. Investment concentrated in an industry or group of industries may face more risks and exhibit higher volatility than investments that are more broadly diversified over industries or sectors. The financial services industry is subject to extensive government regulation that affects the scope of their activities, the prices they can charge and capital maintenance. The industry is subject to severe competition and can be significantly affected by market conditions and activity. The value of your investment is also subject to geopolitical risks such as wars, terrorism, environmental disasters, and public health crises; the risk of technology malfunctions or disruptions; and the responses to such events by governments and/or individual companies.

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The MSCI World ex USA Large Cap Index captures large cap representation across 22 of 23 Developed Markets (DM) countries excluding the United States. With 390 constituents, the index covers approximately 70% of the free float-adjusted market capitalization in each country.

The MSCI World ex USA Small Cap Index captures small cap representation across 22 of 23 Developed Markets (DM) countries excluding the United States. With 2,588 constituents, the index covers approximately 14% of the free float-adjusted market capitalization in each country.

The MSCI World ex USA Micro Cap Index captures micro-cap representation across 22 of 23 Developed Markets (DM) countries excluding the United States. With 5,306 constituents, the index covers approximately 1% of the free float-adjusted market capitalization in each country.

The S&P 500® is widely regarded as the best single gauge of large-cap U.S. equities. According to our Annual Survey of Assets, an estimated USD 13.5 trillion is indexed or benchmarked to the index, with indexed assets comprising approximately USD 5.4 trillion of this total (as of Dec. 31, 2020). The index includes 500 leading companies and covers approximately 80% of available market capitalization.

The Russell 2000® Index is a market-capitalization-weighted index that measures the performance of the 2,000 smallest U.S. stocks by market capitalization in the Russell 3000® Index.

The Russell Microcap Index consists of the smallest 1,000 securities in the small-cap Russell 2000 Index, plus the next 1,000 smallest eligible securities based on a combination of their market capitalization and current index membership weight.

Index returns are provided to represent the investment environment during the periods shown. Index returns include the reinvestment of dividends and capital gains. Index returns do not include transaction costs, management fees or other costs.

Median U.S. Micro Cap Manager: per eVestment US Micro Cap Core Equity universe.

Median U.S. Large Cap Manager: per eVestment US Large Cap Core Equity universe.

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