

## THE CASE FOR EMERGING MARKETS SMALL CAP EQUITY

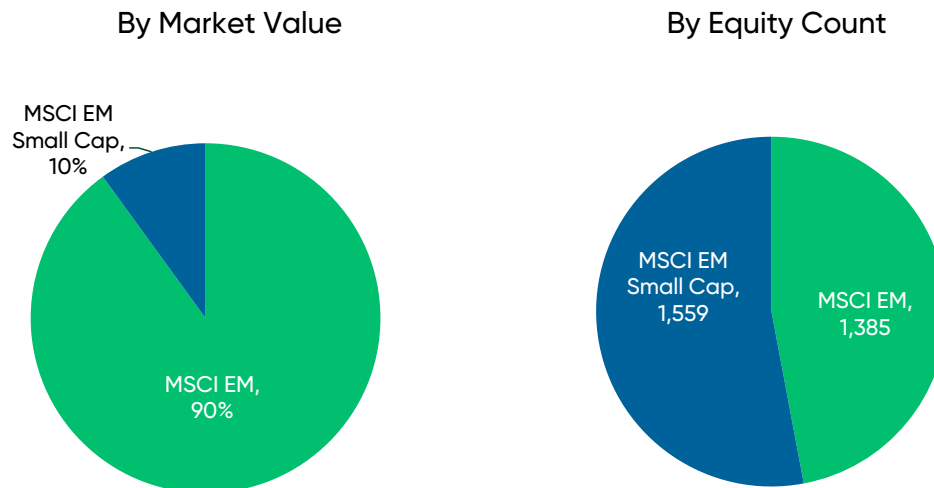
Most investors agree proper diversification entails having exposure to most major countries, geographic areas, sectors, sizes and styles. Yet many institutional investors do not diversify within these buckets. For example, while many have dedicated small cap mandates, these strategies are usually concentrated in the investor's home country. Many have Emerging Markets mandates, but these are often concentrated in large and mid-cap. Thus, a mandate devoted to the Emerging Markets small cap universe can improve diversification and provide exposure to otherwise missed opportunities.

### UNDERREPRESENTED ASSET CLASS

While definitions of small and large cap can vary among investors and index providers, MSCI's categorisations are widely accepted as a guide for portfolio mandates and construction. MSCI construct their small cap indices to cover approximately 14% of the free float-adjusted market capitalisation in each country.<sup>1</sup> The large & mid cap indices cover 85% of the market capitalization and 1% is reserved for micro-cap. However, actual percentages might deviate slightly from targets at any given time.

The MSCI Emerging Markets Small Cap Index contains 1,559 individual equities, with market caps up to around \$4 billion, none of which overlap with the MSCI Emerging Markets Index.<sup>2</sup> As a result, investors without a dedicated EM small cap allocation lose out on exposure to over half of the securities in the EM investible market universe.

Exhibit 1: MSCI EM Investible Market Index Breakdown



Source: FactSet as of 30/06/2020.

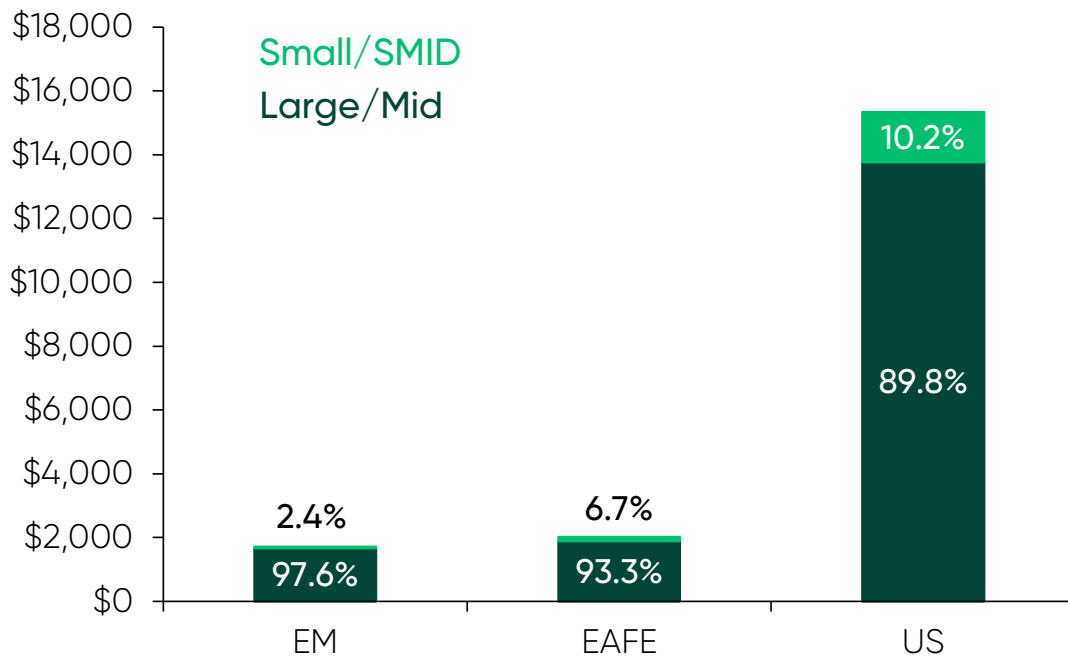
<sup>1</sup> MSCI.com, as of 30/06/2020

<sup>2</sup> FactSet as of 30/06/20

While institutional investors generally have significant exposure to small cap mandates in their home country, in aggregate, they have a rather large blind spot to global small cap equities. This lack of small cap exposure is even more pronounced in global developed ex-US as well as EM mandates. As shown in Exhibit 2, only 2.4% of institutional Emerging Markets AUM is allocated to small cap.

Exhibit 2: Institutional Asset Allocations in eVestment

### AUM Billions USD



Source: eVestment Alliance as of 31/12/2019. Percentages indicate the distribution of small/SMID versus large and mid-cap relative to the designated universe. Small cap strategies are defined as strategies defining their cap size as small or small/mid.

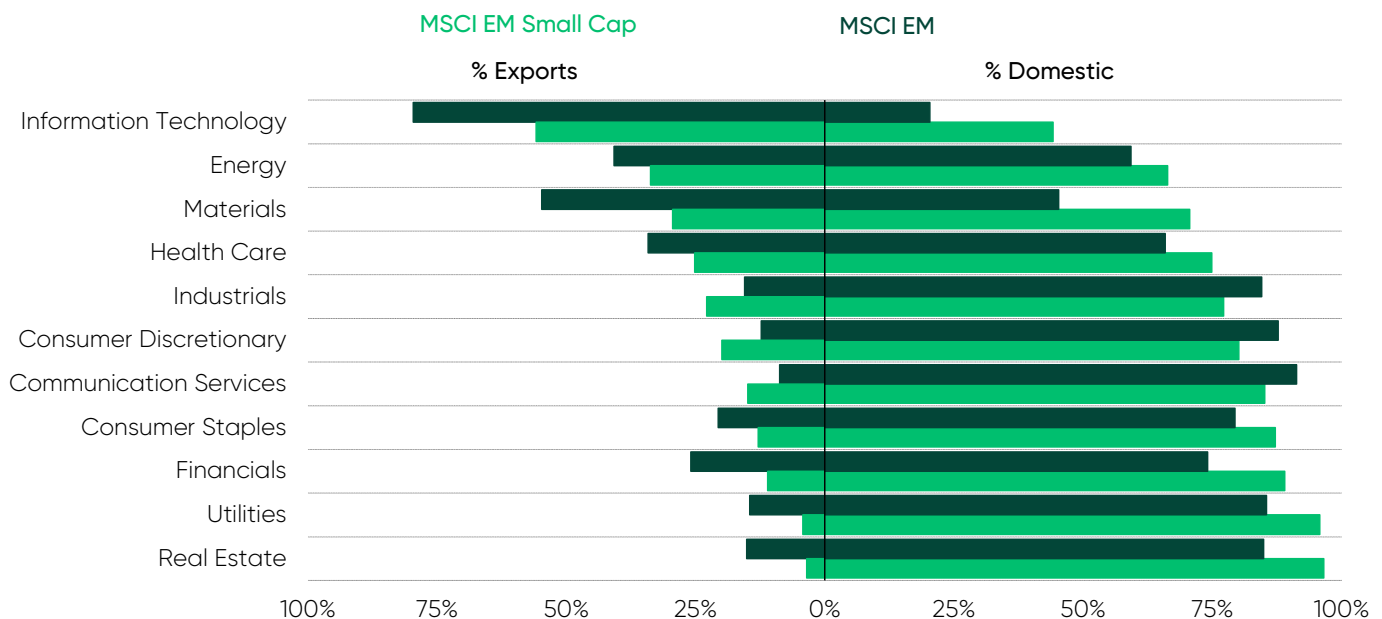
## EMERGING MARKETS SMALL CAP'S UNIQUE ATTRIBUTES AND DIVERSIFICATION BENEFITS

Investors stand to benefit from an allocation to Emerging Markets small cap because of the category's unique attributes and diversification benefits.

### DIRECT EXPOSURE

Like most small cap equities, Emerging Markets small cap firms see a greater percentage of their revenue derived domestically rather than abroad. As such, the category offers investors more direct exposure to a burgeoning trend: the rise of the Emerging Markets consumer. As Emerging Market countries transition to developed, increasing prosperity implies increased consumption from an emerging middle class—a market largely served by domestic firms. Exhibit 3 shows a sector-by-sector comparison of the MSCI EM Small Cap vs. the MSCI EM.

Exhibit 3: Revenue Exposure Comparison by Sector



Source: FactSet GeoRev as of 30/06/2020. Sector revenue exposure is provided using a weighted average.

## DIVERSIFICATION

While equities are inherently correlated, Emerging Markets small cap equities are *relatively* less correlated to other major equity indices—providing a potential diversification benefit to portfolios.

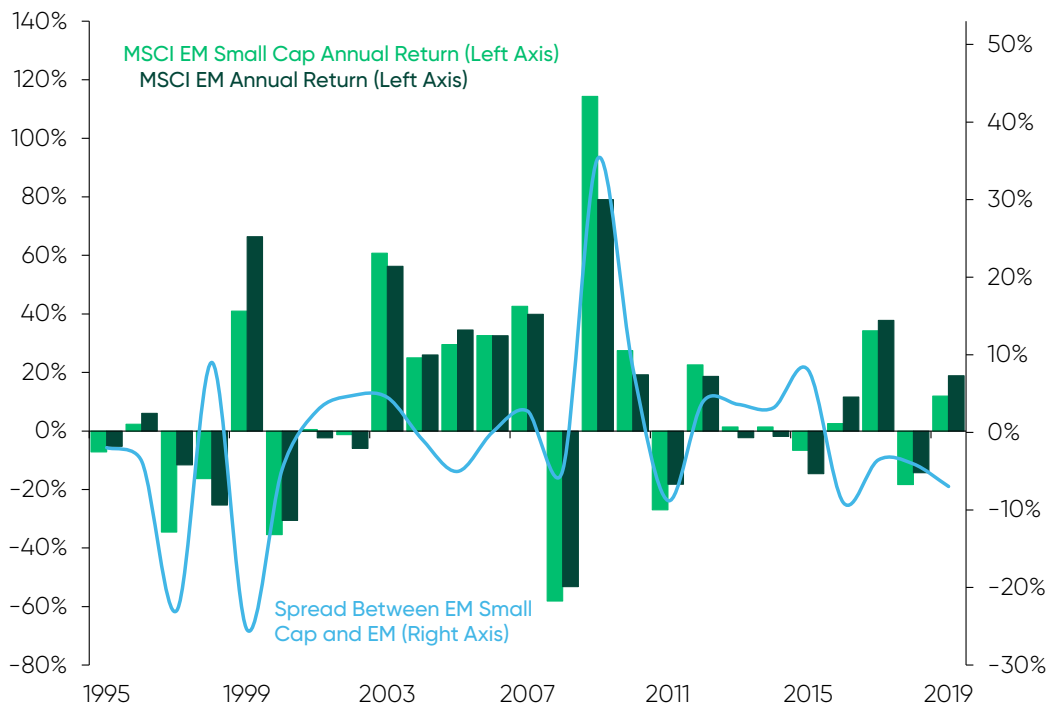
Exhibit 4: Correlation Matrix of Major Equity Indices

	MSCI EM Small Cap	MSCI EM	MSCI Europe	MSCI Europe Small Cap	S&P 500	Russell 2000	MSCI World	MSCI World Small Cap
MSCI EM Small Cap	1							
MSCI EM	0.94	1						
MSCI Europe	0.73	0.77	1					
MSCI Europe Small Cap	0.78	0.78	0.91	1				
S&P 500	0.67	0.73	0.83	0.74	1			
Russell 2000	0.66	0.70	0.74	0.76	0.83	1		
MSCI World	0.76	0.81	0.93	0.85	0.96	0.83	1	
MSCI World Small Cap	0.79	0.80	0.84	0.90	0.83	0.93	0.90	1

Source: FactSet as of 30/06/2020. Based on monthly price returns in USD from 01/06/1994 to 30/06/2020.

Emerging Markets small cap can also add a diversification benefit to a pre-existing allocation to Emerging Markets. No category of equities is inherently superior to another—countries, sectors, sizes and styles tend to trade leadership often and irregularly, just as Emerging Markets small cap has done since 1995, the earliest available full-year data (Exhibit 5).

Exhibit 5: Spread between EM Small Cap and EM Annual Returns

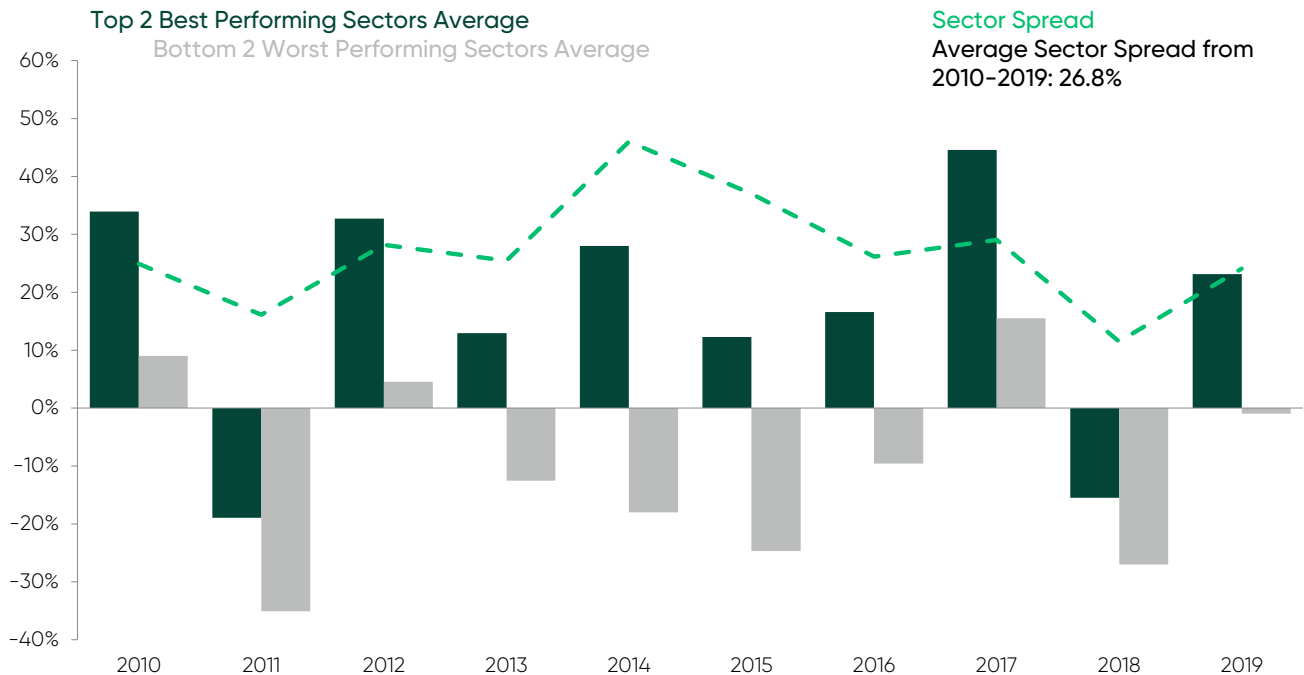


Source: FactSet as of 31/12/2019. Based on calendar year total returns in USD.

## WHY TOP-DOWN IN EM SMALL CAP?

Within a broad category, subcomponents also frequently trade leadership. In Emerging Markets small cap, relative performance of each sector and country varies over time. As shown in Exhibit 6, there is often a significant gap between the top- and bottom-performing sectors within the Emerging Markets small cap universe. This means there are ample opportunities for an active top-down manager to generate excess returns through sector allocation.

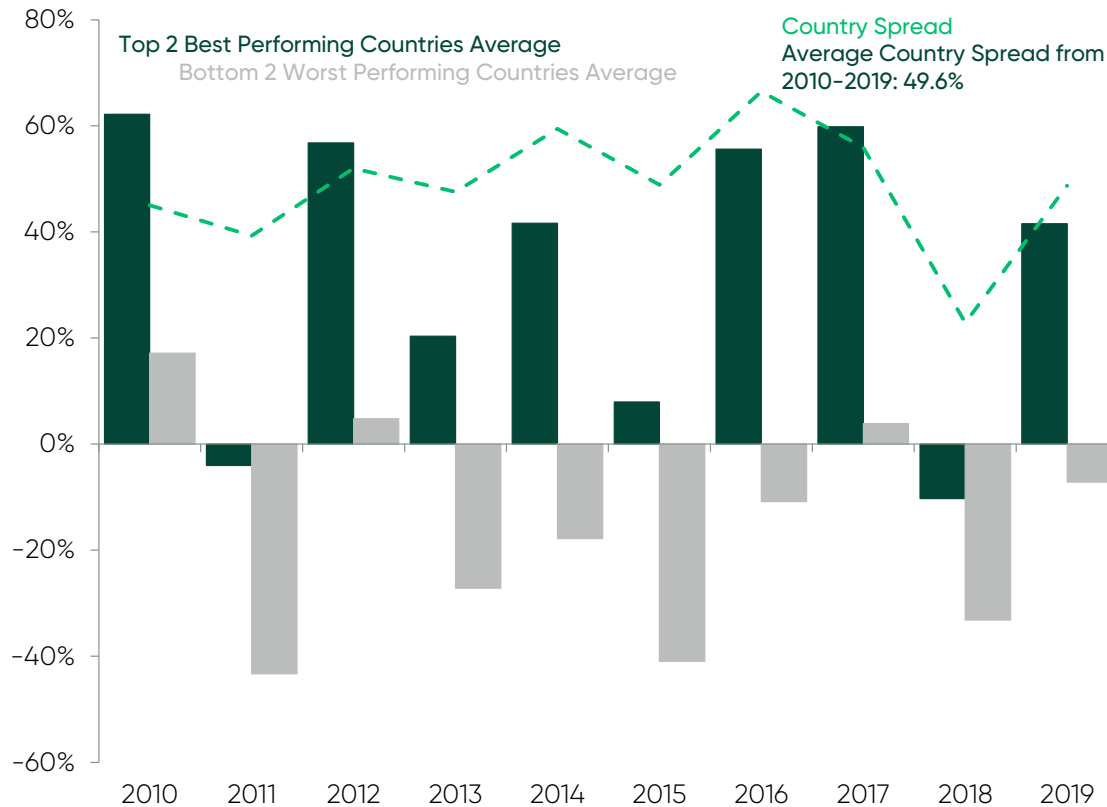
Exhibit 6: MSCI Emerging Markets Small Cap Sector Performance Spreads



The data set for a given year is the MSCI Emerging Markets Small Cap Index constituent list for each year end, and the returns used are price returns. "Outperforming Sectors" takes the arithmetic average of the performance of all sectors in the MSCI Emerging Markets Small Cap Index that outperformed the overall MSCI Emerging Markets Small Cap Index for a given year. The same concept is applied for "Underperforming Countries." The "Average Sector Spread" is the arithmetic average of the yearly spread between "Outperforming Sectors" and "Underperforming Sectors." Data in USD. Source: FactSet. As of 31/12/2019.

Because of the wide divergence in country weightings, annual returns at the country level are extremely variable—in countries such as the Czech Republic, Hungary and Colombia returns depend on fewer than 10 companies (or, in the Czech Republic's case, one), causing them to regularly be among the category's most extreme. However, even if you strip out these outliers and limit the analysis to countries regularly including 40 or more companies, annual performance spreads tend to be wide (Exhibit 7).

Exhibit 7: MSCI Emerging Markets Small Cap Select Country Performance



Source: FactSet as of 31/12/2019. Analysis based on annual returns in USD for the MSCI Brazil, China, India, Indonesia, Korea, Malaysia, South Africa, Thailand, Taiwan and Turkey Small Cap Indices. The Top 2 Best Performing data points are the average total returns of the top two performing countries for each given year. The Bottom 2 Worst performing data points are the average total returns of the bottom two performing countries for each given year. The Spread data points are the difference between the average of the top two and bottom two performing countries for each given year.

These wide performance spreads imply an active top-down approach is ideally suited for the space. Sector leadership trends change often and irregularly and so do country leadership trends. These shifts are usually driven by economic, political, and sentiment drivers which we continuously monitor to identify shifts and whether the market has discounted them yet. Leadership trends also typically last for a sufficiently long period for investors to be able to capitalise on them. Most investors have had a tendency to think of Emerging Markets as one broad category of nations, all with similar drivers. This, however, is no longer the case (if it was ever true). Drivers vary significantly around the world; Indonesia is not Taiwan, South Korea is not Malaysia or Peru. By assessing the political and economic conditions impacting each country and sector—and weighing whether sentiment reflects these features, we seek to capitalise on potential opportunities while managing potential risks—tactically overweighting the areas expected to lead and underweighting the areas expected to lag.

While most investors focus on equity selection, sector and country leadership trends significantly influence whether an equity out- or underperforms. Outperforming countries and sectors see a higher portion of their companies beat the benchmark compared to underperforming countries or sectors—making equity selection easier (Exhibits 8 and 9).

Exhibit 8: Outperforming Countries see more of their Companies Outperform

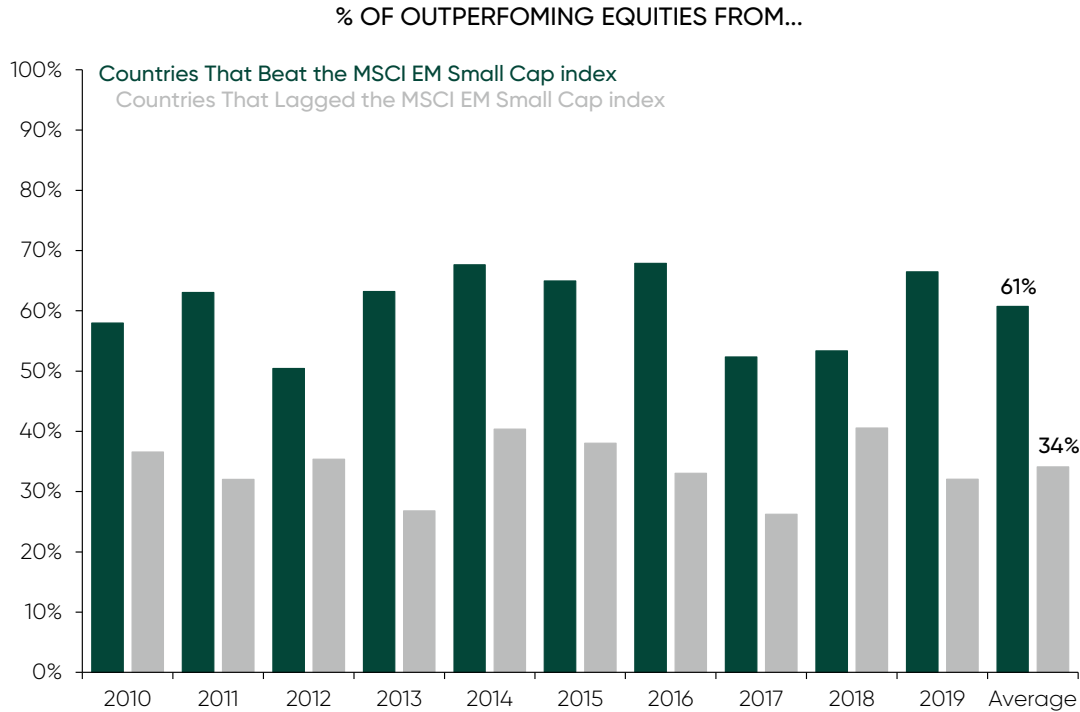
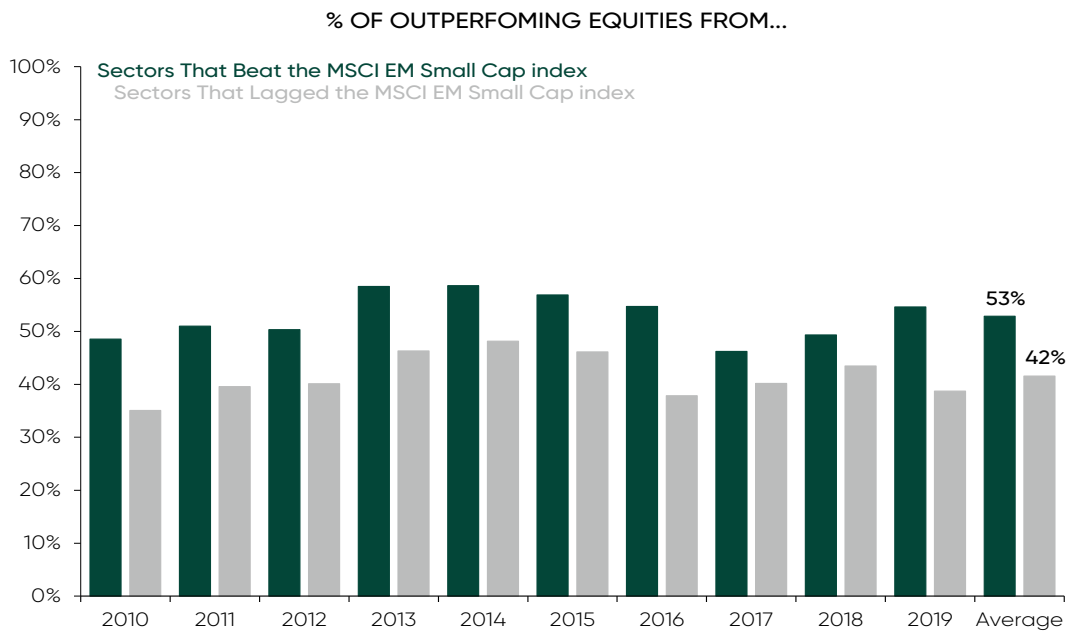


Exhibit 9: Outperforming Sectors see more of their Companies Outperform



Source: FactSet as of 31/12/2019, using calendar year returns of each index constituents. In USD.

## PROCESS DIVERSIFICATION WITH TOP-DOWN

Despite the impact top-down drivers have on Emerging Markets small cap, most investment managers in the space focus on equity selection. As tracked by eVestment, the small cap universe is dominated by Bottom Up and Combined Approach managers, positioning a Top Down strategy as a process diversifier within existing small cap allocations. (Exhibit 10)

Exhibit 10: Investment Manager Approach Across Different Asset Classes

	Bottom Up	Combined Approach	Top Down
US	2,525	473	214
EAFE	407	91	17
EM	443	145	36
<b>Total</b>	<b>3,375</b>	<b>709</b>	<b>267</b>

Source: eVestment Alliance as of 30/06/2020. Includes all equity managers in each universe that are reporting on their screening approach.

## SUMMARY

Given that small cap equities make up a sizable portion of Emerging Markets' market value and over half of the EM investable market universe by equity count, it should be an integral component in an investor's portfolio. In our view, most institutions are underexposed to Emerging Markets small cap, exposing themselves to significant opportunity cost given the category's unique attributes.

We believe a dedicated allocation to Emerging Markets Small Cap equity with a Top-Down investment approach can best capitalise on these opportunities. Further, a Top Down approach can be a valuable process diversifier within a multi-manager line-up.



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