MEKETA

Foreign Small Cap Equity

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In this paper, we look at some of the differences between the small cap equity index and the large and midcap equity index in developed foreign markets. We review foreign small cap equity's historical risk, returns, and correlation and compare them to that of large and midcap foreign equity and US small cap equity. Finally, we examine active versus passive management in the space and discuss relevant implementation considerations.

Key takeaways

- Compared to traditional foreign (developed) equity, foreign (developed) small cap equity represents a significantly higher number of companies with much smaller market caps.
- Despite having the same opportunity set of countries, foreign large cap and foreign small cap equity differ in index composition, particularly in sector allocations and country weights.
- Since 2001, foreign small cap equity has outperformed foreign equity and underperformed US small cap equity. This is consistent with its higher volatility relative to foreign equity and lower volatility relative to US small cap equity.
- Active management has seen cyclical outperformance, but the trend is declining, with median outperformance decreasing in recent years.

What is foreign small cap equity?

Foreign small cap equity refers to investments in the shares of smaller companies based in developed markets outside the US. The primary differentiating factor between developed markets and emerging markets is the composition of countries within each. Developed market countries generally tend to be larger, more mature, and have more stable economies.[1] Meanwhile, emerging market countries tend to be smaller and have newer, less developed, and more volatile economies.[2]

Capitalization is a stock market measure that refers to the total market value of a company's eligible equity securities, calculated by multiplying the number of outstanding shares by the current stock price. Firms with relatively low total market value are considered small cap stocks.

[1] As of June 2024, the list of developed markets countries in the MSCI EAFE Index included: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the UK.

[2] As of June 2024, EM countries in the MSCI EM Index included: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Kuwait, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Saudi Arabia, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.

The MSCI EAFE index is one of the most popular indices used by investors to access developed foreign markets. As of June 2024, it represented large and midcap securities across 21 developed markets, excluding the US and Canada. The index represents roughly 85% of the free float adjusted market capitalization in each country.

The MSCI EAFE Small Cap Index represents the remaining ~14% of the investable foreign developed market opportunity set, as measured by market cap. It represents a significantly higher number of companies with much smaller market caps (see Figure 1 below). Throughout this paper, the MSCI EAFE Small Cap Index is used to represent foreign small cap equity unless otherwise stated.

	MSCI EAFE	MSCI EAFE Small Cap
Number of Constituents	741	2,112
Average Market Cap	$22.96B	$1.31B

FIGURE 1
Comparison of Sizes for EAFE and EAFE Small Cap

Source: MSCI EAFE Index Factsheet, as of July 31, 2024. MSCI EAFE Small Cap Index Factsheet, as of July 31, 2024.

Sector & country differences

There are a few meaningful differences in sector weights between the large cap and small cap indices. For example, as shown in Figure 2, foreign small cap is more heavily weighted in industrials and real estate, while large cap is more heavily weighted in financials and health care. These sector weight differences have the potential to translate into return differences.

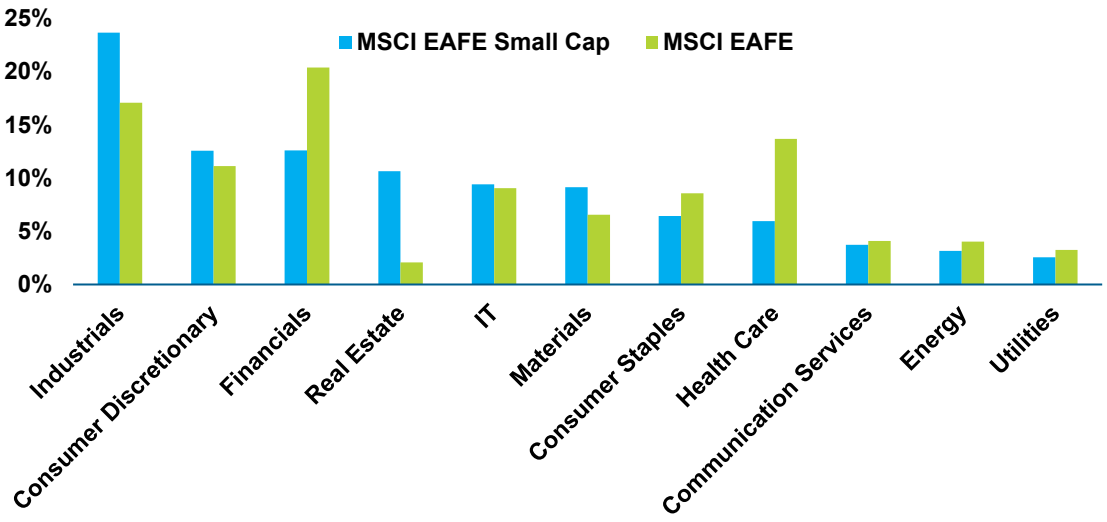

FIGURE 2
Sector Weights for MSCI EAFE and MSCI EAFE Small Cap

Sources: MSCI EAFE Index Factsheet, as of July 31, 2024. MSCI EAFE Small Cap Index Factsheet, as of July 31, 2024.

Another difference between the two indices is the breakdown of countries included, though both have the potential to include the same countries. Both the MSCI EAFE Small Cap and MSCI EAFE have the highest country representations in Japan and the UK, respectively (see Figure 3). Other country weights differ, with MSCI EAFE Small Cap's next largest country representations are Australia, Sweden, and Switzerland, while MSCI EAFE's are France, Switzerland, and Germany, respectively. These variations in country weights can also translate to differences in returns and return patterns.

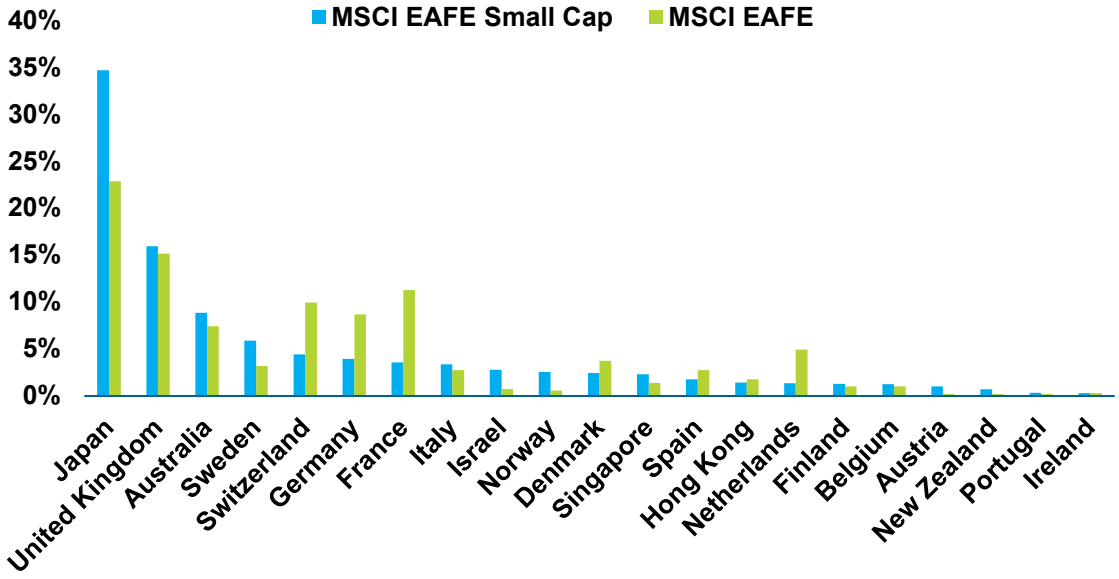

FIGURE 3
Countries in the MSCI EAFE and MSCI EAFE Small Cap Index by Weight

Source: FactSet, as of July 31, 2024. Indices: MSCI EAFE and MSCI EAFE Small Cap.

The MSCI EAFE Small Cap's country weights have held relatively constant over the past two decades (see Figure 4). Japan, the UK, and Australia have been the largest country weights throughout this period.

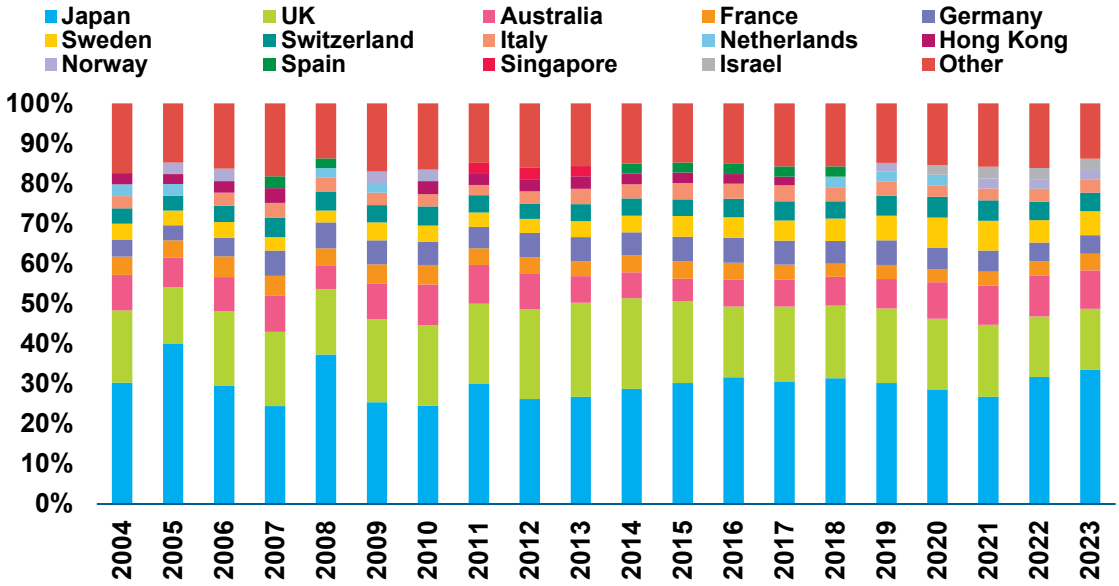

FIGURE 4
Top 10 Countries in the MSCI EAFE Small Cap Index by Weight

Source: FactSet, as of December 31, 2023. Indices: MSCI EAFE Small Cap.

Historical performance

Since the MSCI EAFE Small Cap Index began in 2001, foreign small cap equity has produced an annualized average return of 7.9%, higher than foreign equity's 5.2%, and below US small cap equity's 8.2%.[3] Foreign small cap's return placement relative to foreign equity and US small cap has held constant over both the 20- and 10-year periods. Figure 5 below shows how small cap foreign equity, foreign equity, and US small cap equity, have all followed generally similar returns patterns.

[3] Source: Investment Metrics, monthly returns as of July 31, 2024. Indices: MSCI EAFE Small Cap, MSCI EAFE, Russell 2000. For the period January 1, 2001 to July 31, 2024. All returns shown in USD terms.

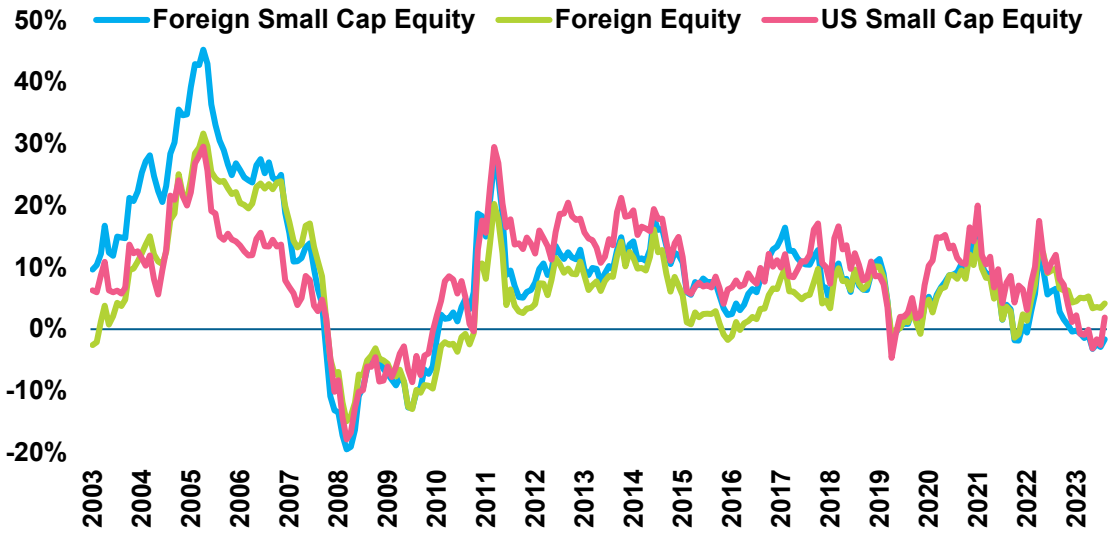

FIGURE 5
Rolling 3-Year Returns

Source: Investment Metrics, monthly returns as of July 31, 2024. Indices: MSCI EAFE Small Cap, MSCI EAFE, Russell 2000.

Interestingly, foreign small cap equity's long-term outperformance over foreign large cap is counter to the trend currently seen in the US. Over the past 20 years, US small cap has underperformed relative to US large cap. While foreign equity has not experienced this same phenomenon, foreign small cap's outperformance gap has narrowed over time. This may imply that foreign small cap's relative outperformance is declining, and may possibly even be following a similar trend as US small cap.

Volatility

Foreign small cap equities have exhibited higher volatility than large cap foreign equities. This should be expected, because smaller stocks are generally considered riskier in terms of their business prospects. However, foreign small cap equities have exhibited lower volatility than US small cap equities. Since 2001, foreign small cap equities exhibited an average annualized volatility of 18.1%, while the annualized average was 16.7% for large foreign equities and 20.1% for US small cap equities.[4]

[4] Source: Investment Metrics, monthly returns as of July 31, 2024. Indices: MSCI EAFE Small Cap, MSCI EAFE, Russell 2000. For the period January 1, 2001 to July 31, 2024. All returns shown in USD terms.

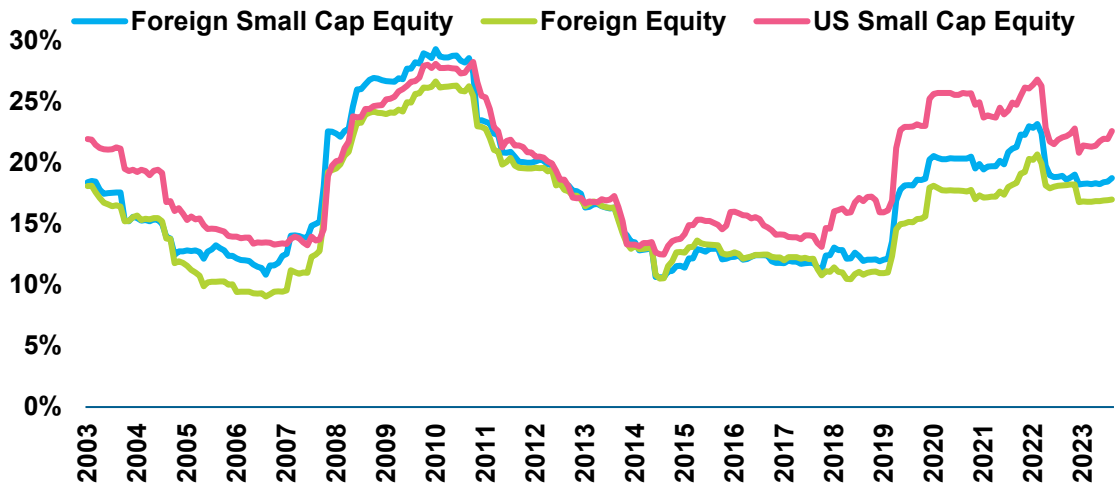

FIGURE 6
Rolling 3-Year Volatility

Source: Investment Metrics, monthly returns as of July 31, 2024. Indices: MSCI EAFE Small Cap, MSCI EAFE, Russell 2000.

The "small stock effect"

Historical studies have shown that over very long periods of time, small cap stocks have cumulatively outperformed larger cap stocks. This is most notably found in Fama and French's 1992 study, though many subsequent academic studies have likewise sought to explain this "small stock effect."[5] Four common theories have evolved from empirical studies as possible explanations for this anomaly. It is worth noting that not all of these explanations have to be true to justify the small cap effect, nor are they mutually exclusive.

- First, because smaller stocks are riskier (both in terms of business prospects and market volatility), investors demand extra return to compensate them for the increased risk of investing in small cap stocks.
- Second, the small cap market is much less efficient (e.g., professional analyst coverage is far more limited), allowing for greater mispricing.
- Third, because small stocks start at a lower base, there is higher potential earnings growth (in percentage terms) which leads to higher returns.
- Finally, some have argued that the size effect is really a "value" effect, in that small cap stocks tend to trade at lower price ratios than larger stocks.

Theoretically, the principles of the "small stock effect" may also apply to foreign stocks. Historical foreign returns (shown in the previous section) support this theory of a foreign "small stock effect". However, over the past 20 years, the US has seen a new trend where the "small stock effect" has flipped and domestic small cap stocks have underperformed large cap stocks. We leave the discussion about whether this domestic trend could also become present in foreign markets for a different research paper.

Active versus passive management

As shown in Figure 7 below, historical manager outperformance in the foreign small cap equity asset class has been somewhat cyclical. The median outperformance of the eVestment foreign small cap equity universe since inception (before fees) was 121 basis points.[6] However, this manager outperformance has dropped when looking at more recent time periods. Over the last ten years, median outperformance was 88 basis points. Even more recently, over the past five years, the median outperformance of foreign small cap equity managers further dropped to 80 basis points.

The median "rack rate" fee of 87 basis points may present a challenge for active management.[7] However, depending on the situation and size of the mandate, an investor may be able to negotiate a lower fee.[8]

[5] Fama, Eugene and French, Kenneth. "Size and Book-to-Market Factors in Earnings and Returns." Journal of Finance 50 (1992) 131-55. This followed the work of Rolf Banz in "The Relationship Between Return and Market Value of Common Stocks" published in the Journal of Financial Economics in 1981 and Richard Roll in "A Possible Explanation of the Small Firm Effect" published in The Journal of Finance in 1981.

[6] Source: Meketa analysis of data from eVestment Alliance. Outperformance represents geometric mean of manager returns over one year minus the benchmark return for the period where data is available. Inception date starts when there are at least 10 funds to evaluate and goes through December 31, 2023. For more information on alpha calculations, see Meketa's Manager Alpha Whitepaper.

[7] Source: eVestment Alliance. Median sliding fee on $100mn for all product types as of October 31, 2023. Backdated fee information is unavailable.

[8] Traditionally, active management fees are often much higher than passive management fees, so an active manager would have to outperform the benchmark by its higher fee for the investor to break even.

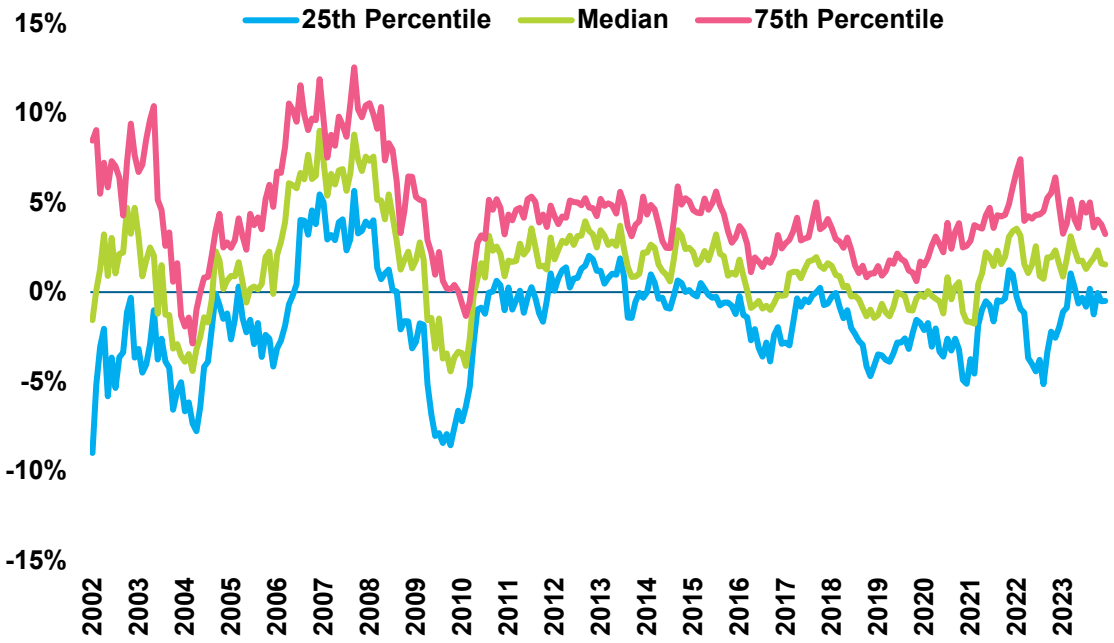

FIGURE 7
Rolling Median Outperformance

Source: Meketa analysis of data from eVestment Alliance. Data as of December 31, 2023. Gross of fees. Due to the small number of funds at inception, some of the asset classes' early year relative returns may be skewed. For more information on see Meketa's Manager Alpha Whitepaper.

Interquartile spreads can be interpreted as how much potential value lies in selecting superior active managers within each asset class. In the past ten years, foreign small cap equity's interquartile spread of 5.0% was lower than US small cap equity's 6.3% and slightly higher than foreign all cap's 4.2% (see Figure 8). This may imply that foreign small cap equity provides less opportunity to generate manager selection alpha compared to US small cap equity, but slightly more opportunity to generate alpha compared to the rest of the foreign all cap equity universe. However, it is worth noting that this higher interquartile spread may partially be due to the smaller number of funds in the foreign small cap asset class over the last 10 years.[9]

[9] Foreign Small Cap has a smaller average number of funds (53) than US small cap (171), US large cap (355), and foreign all cap (106) over the trailing 10 years.

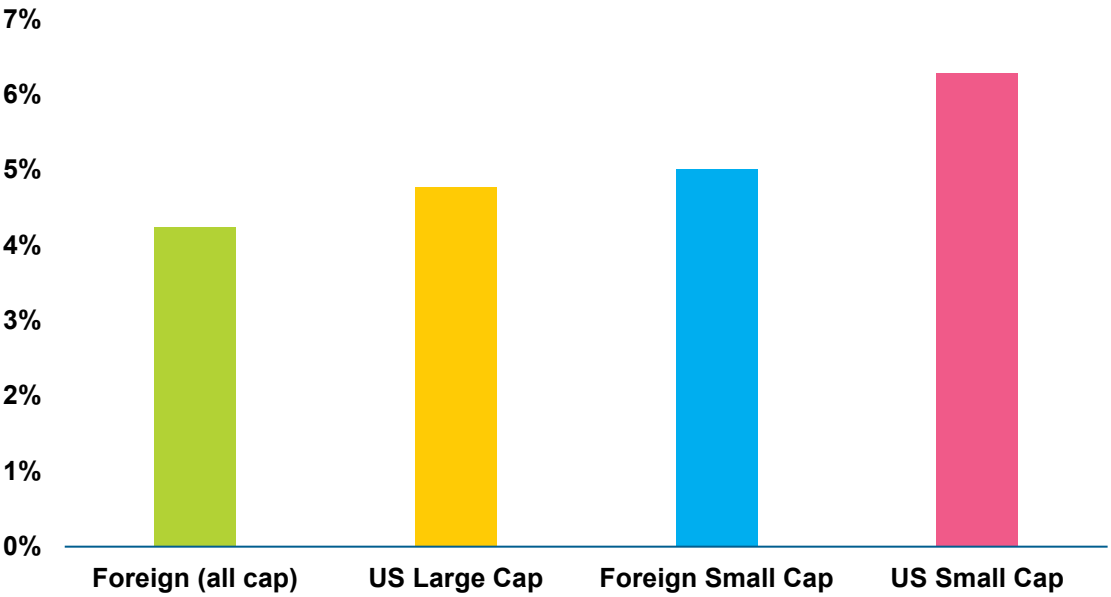

FIGURE 8
Trailing 10-Year Interquartile Spreads

Source: Meketa analysis of data from eVestment Alliance. Gross of fees. Data is for the trailing 10 years as of December 31, 2023. Interquartile spreads are evaluated by taking the difference between the geometric average of the 75th percentile return and the 25th percentile over a rolling 12-month period.

Does foreign small cap provide diversification benefits?

Since 2001, foreign small cap equity has exhibited a very high average correlation (0.94) with foreign equity and a slightly lower, though still high, average correlation with US small cap equity (0.80). Foreign small cap equity has had much lower correlations to US bonds, at 0.22 on average.[10]

[10] Source: Investment Metrics, monthly returns as of July 31, 2024. Indices: MSCI EAFE Small Cap, MSCI EAFE, Russell 2000, Bloomberg US Aggregate Bond Index. For the period January 1, 2001 to July 31, 2024.

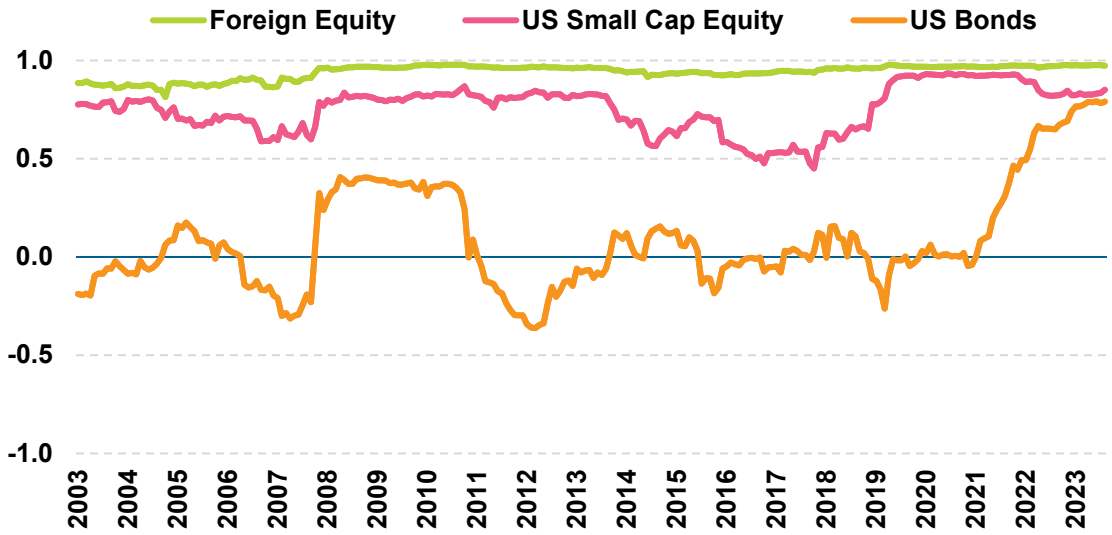

FIGURE 9
Rolling 3-Year Correlation to Small Cap Foreign Equity

Source: Investment Metrics, monthly returns as of July 31, 2024. Indices: MSCI EAFE Small Cap, MSCI EAFE, Russell 2000, Bloomberg US Aggregate Bond Index.

Throughout this period, foreign small cap equity has not provided diversification benefits that were meaningfully different than that of foreign equity. However, as shown in Figures 10 and 11 below, neither foreign small cap equity nor foreign equity have historically provided substantial downside or inflation protection relative to US equities. Foreign small cap equity and foreign equity's performance during both the negative inflationary periods and historical market downturns have been in line with - and sometimes even worse than - US small cap equity's performance.

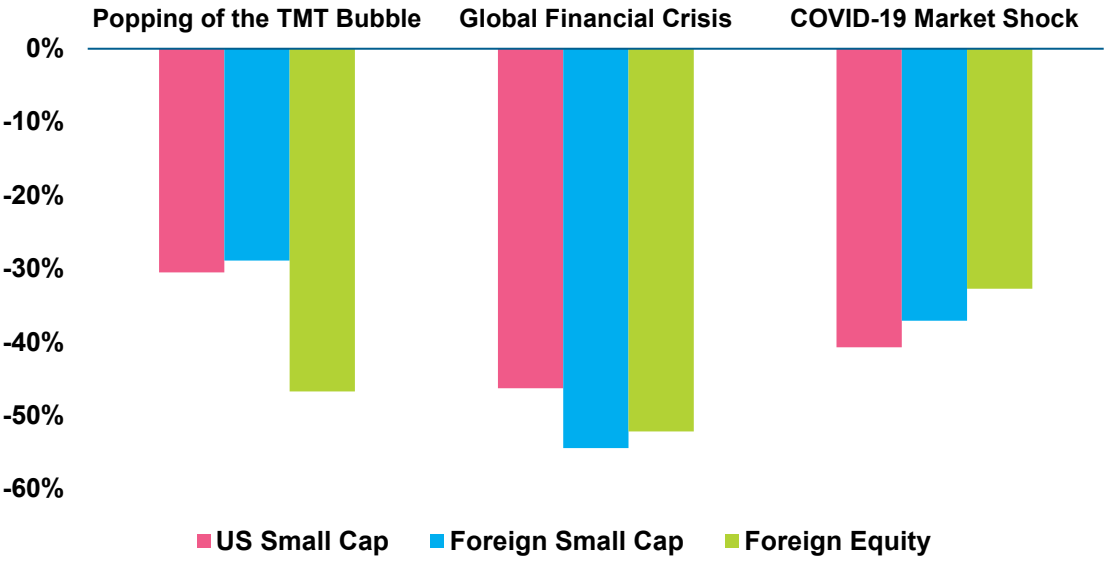

FIGURE 10
Negative Historical Scenarios

Source: Bloomberg and Meketa calculation. Returns are cumulative for the time period over which the scenario occurred. Market downturn dates are: Popping of TMT Bubble April 2000-September 2002, Global Financial Crisis October 2007-March 2009, COVID-19 Market Shock February 2020-March 2020.

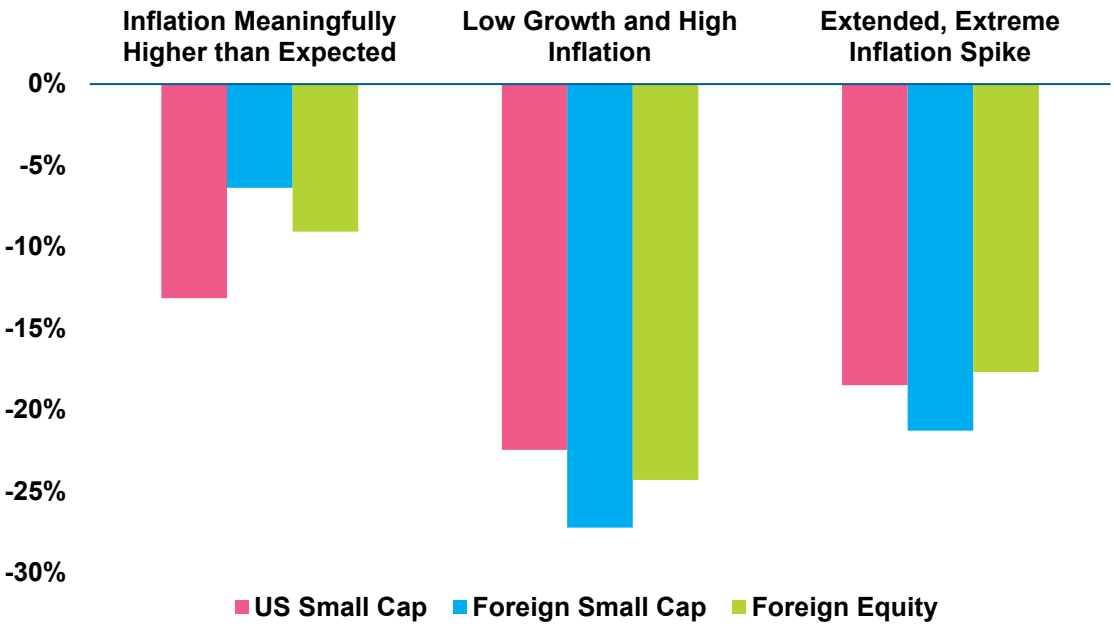

FIGURE 11
Inflationary Scenarios

Source: Reflects average, annualized asset class returns. These figures are from Meketa's scenario analysis based on data from Bloomberg and FRED from February 1973 to December 2023. See the appendix for more details on and descriptions of the inflationary periods included in Meketa's scenario analysis.

Implementation considerations

Investing in the foreign small cap equity space may bring unique implementation issues. The first of which stems from the nature of investing in smaller companies. Smaller stocks tend to be less liquid than larger stocks and thus are generally more expensive to trade. Similarly, management fees also tend to be higher for foreign small cap stocks.

We consider the closing of an actively managed product to new investors to be beneficial to the existing investors in a fund, as it helps mitigate the "asset bloat" effect. This is because as assets under management ("AUM") grows, trading activity will increasingly drive the prices of the securities in which it invests. This is especially true for securities with less liquidity, such as small cap stocks. Hence, a manager has little choice but to invest in either more stocks or in more liquid (i.e., larger cap) stocks, both of which will change the nature of the portfolio. By closing the product to new investors, the asset bloat effect can be somewhat mitigated, resulting in generally greater consistency with the portfolio's original nature.

Another potential challenge is that some managers close their products to new investors after reaching a certain size in AUM. Hence, many of the managers who have been the most successful historically may not accept new mandates.

Summary

Foreign small cap equity represents the smaller companies available in the investable foreign developed market opportunity set. The foreign small cap equity asset class has produced slightly higher annualized returns than large cap foreign equity. Correspondingly, it has also had annualized volatility levels higher than large cap foreign equity. Foreign small cap equity does not provide meaningful diversification benefits different than that of foreign equity, nor does it provide significant diversification benefits during market downturns or periods of high inflation.

Foreign small cap equity may provide investors with increased potential to generate returns above the benchmark. Over the last ten years, foreign small cap equity has provided more potential for alpha than all cap foreign equity, but less than US small cap equity (as measured by interquartile spreads). As always, investors should conduct careful due diligence to make sure that investments match their objectives and constraints.

Appendix

Meketa Scenario Analysis

- Meketa's Inflation Scenario Analysis is for the period February 1973 - December 2023.
- The Scenario Analysis is based on a generalized linear regression (GLS) model that estimates the effects of realized and surprise inflation on monthly asset returns, controlling for the economic environment. The GLS model assumes a residuals autocorrelation of 1. Quadratic independent variables are added to the regression model to account for potential non-linearity between an asset class and inflation. Estimated scenario returns at the asset class level are then calculated as the expected value of asset class returns, conditional on the inflation scenario.
- Inflation is the monthly change in CPI from the 3-month rolling average CPI, surprise inflation is the difference between this month and last month's inflation rate, and GDP Growth is the percent change in GDP from the previous quarter. Inflation and GDP data are taken from the St. Louis Federal Reserve Bank's FRED database. Meketa backdated all asset class returns whose inceptions were after February 1973 with the closest available proxies.
- Inflation meaningfully higher than expected is when surprise inflation is in the 75th percentile of positive, historical surprise inflation.
- Low Growth and High Inflation is when real GDP growth is the 25th percentile of historical GDP growth and inflation is in the 75th percentile of historical inflation.
- Extended, extreme inflation spike is when inflation is in the 95th percentile of historical inflation and lasts for 12+ months.
- Indices Used: MSCI EAFE Small Cap Net, MSCI EAFE Net, Russell 2000. All returns are in USD.

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