INTERNATIONAL SMALL CAPS: EAFE's Promise Fulfilled

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EXECUTIVE SUMMARY

Investors are reevaluating long-held beliefs as a result of dramatic changes in the global equity markets. Stimulated by the diminishing diversification benefits from international large cap equities and challenging portfolio return expectations, investors have developed a growing and serious interest in international small capitalization stocks.

This paper examines the potential impact and contribution of the asset class as a component of an overall investment strategy. In this context, we analyze the return proposition, diversification benefits, risk considerations and the current environment for international small caps.

Our findings conclude that investors with a medium- to long-term time horizon should consider the greater alpha generation potential and superior diversification characteristics of international small cap equities.

Greater Potential Returns

International small cap has generally outperformed international large over the short-, medium- and long-term periods.

While index returns provide a compelling story, they fail to accurately depict the long-term return proposition of the asset class.

Market inefficiencies unique to the small cap space create an environment with the potential to generate alpha.

Historical returns of active managers have demonstrated significant alpha generation.

Better Diversification

While the correlation of international large cap stocks has demonstrated a pattern of convergence with U.S. equity markets, international small caps continue to maintain a favorable correlation spread to U.S. markets.

Both the sector and regional allocations of the international small cap indices complement the weightings of the international large cap universe.

Risks

The benefits of the asset class are not divorced from unique challenges and risks such as liquidity risk, business risk, corporate governance and transparency.

Fundamental bottom-up analysis and continuous on-the-ground research are two of the best ways to mitigate these risks.

Surprisingly, the volatility of the asset class is much lower than alleged – it is, in fact, in line with international and domestic large cap equities.

Regional Highlights

While common investment trends exist across the entire international small cap universe, each region has its own set of unique challenges and opportunities:

Japan: A mature market in the midst of a turnaround.
Europe: An expanding "local market."
Southeast Asia: A growth engine.

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The Evolution of the International Asset Class

Following the tenets of Modern Portfolio Theory, U.S. investors were drawn to international equities in the 1980s due to the low correlation coefficients between the U.S. and foreign equity markets. At the time, investors embraced the favorable cross-border correlation climate as a means to improve the overall risk/reward characteristics of domestic portfolios. Further encouraging the move to international investing was the perception that foreign economies would yield stronger growth rates, and that the inefficiency in foreign equity markets would lead to higher returns than could be realized in the more efficient U.S. marketplace.

This investment premise went mostly uncontested through the mid-1990s. However, as the 20th century drew to a close, investors faced an environment that challenged the two main rationales that supported an allocation to international equities. First, from a return standpoint, the unprecedented absolute returns produced by U.S. equity markets lessened the prospect of higher expected returns from foreign equities. Second, a dramatic increase in correlation between U.S. and foreign markets brought on by the globalization of national economies, corporate structures and cross-border financial markets cast doubt on the diversification benefits of international equities.

As a result, investor interest in international equities has waned, triggering a search for a surrogate asset class with risk/return characteristics similar to those once promised by international large cap equities.

The Globalization of the Equity Markets

Globalization has drastically changed the behavior and operating environment of national economies, industries and capital markets worldwide. In the equity markets, this phenomenon has had a greater impact on large, export-driven, multinational corporations, with multiple sources of revenues, than on international small companies, which tend to derive their revenue from their domestic markets. As we will explore later in this paper, this "homogenization" of international large cap equities has led to greater correlation between the performance of U.S. and international large cap equities, while the correlation between the broad U.S. market and international small cap equities remains comparatively low. Thus, the low correlation argument that persuaded U.S. investors to invest in foreign equities during the 1980s is relevant today for international small caps.

Defining International Small Cap

Although international small caps are gaining notoriety, the primary characterization of the asset class–market capitalization–is not universally defined. An examination of the definition of the asset class by leading index providers, namely the MSCI EAFE Small Cap Index (MSCI EAFE Small), the Citigroup World ex-U.S. EMI Index (Citi Int'l Small), and the HSBC World ex-U.S. Small Cap Index (HSBC Int'l Small), illustrates this point.

MSCI defines international small companies as those with a total market capitalization of US $200-$1,500 million. This band targets approximately 40% of the eligible international small cap universe within each industry group and within each country, and translates into roughly 950 stocks with a total market cap of US $629 billion[1]. Citigroup uses a carve-out of its Broad Market Index, which represents more than 95% of the total available market value of worldwide listed equities. In constructing the index, Citigroup ranks all eligible companies by total market capitalization and then defines the small cap universe as the companies that make up the bottom 20% of the cumulative available capital. Relative to MSCI, Citigroup's methodology translates into a larger investment universe with approximately 3,000 issues and a total market cap of US $2,710 billion[2]. Lastly, the HSBC Int'l Small comprises a fixed number of 1,200 constituents at all times, whose market capitalizations range from US $52-$2,395 million with a total market cap of US $553 billion[1].

As a result of these differing index methodologies and construction processes, it is challenging to definitively classify the investment universe. Regardless of its relative size or the various indices it may or may not fall into, we believe that a compelling international small cap equity is a smaller company that has a superior competitive advantage and is potentially poised to deliver above-average returns.

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1 As of December 31, 2003
2 As of March 18, 2004

THE QUEST FOR ALPHA

To best appreciate the wide-reaching alpha generation potential of the asset class, one must assess historical returns, examine the index characteristics that distort those returns, explore market inefficiencies, and analyze the excess return potential of active management.

Historical Index Returns - A Myopic View

Over the past decade, international small capitalization equities have delivered superior returns relative to their large cap counterparts as measured by the MSCI EAFE Index [See Exhibit 1].

EXHIBIT 1 **COMPARATIVE RETURNS**
Annualized as of December 31, 2003

	Citi Int'l Small	HSBC Int'l Small	MSCI EAFE Small[3]	MSCI EAFE	S&P 500
1 year	53.73%	64.56%	62.14%	39.17%	28.69%
2 year	19.39%	24.30%	22.50%	8.34%	0.13%
3 year	6.31%	9.67%	9.67%	-2.57%	-4.05%
5 year	5.88%	9.49%	7.10%	0.26%	-0.57%
7 year	4.40%	5.90%	1.62%	3.17%	7.57%
10 year	5.17%	6.55%	1.72%	4.78%	11.07%
11 year	7.30%	9.48%	4.53%	7.07%	10.98%

When comparing the results of the three main international small cap indices over an 11-year period[4], the Citi Int'l Small and the HSBC Int'l Small indices consistently delivered returns in excess of the MSCI EAFE over the short, medium and long term. While the MSCI EAFE Small posted superior returns over its large cap counterpart in the short to medium term, it underperformed MSCI EAFE in the long-term for reasons we will explore later.

Although the returns for all three major international small cap indices offer a broad analysis of the asset class' historical performance, the dramatic return divergences among them warrant a deeper examination of index limitations and other factors underlying these returns.

[3] From its inception date in January 1993 to January 2001, the MSCI EAFE Small Cap Index measured returns by price alone. This methodology, in effect, excluded any current income from companies with dividend payout programs from 1993-2000. It is worthy to note that from January 2001 to December 2003, the MSCI EAFE Small averaged a monthly dividend yield of .21%. Effective after the close of trading on September 28, 2001, MSCI broadened the full market capitalization of eligible companies from US $200-800MM to US $200-1,500MM. At the same time, MSCI adjusted the index to include the effects of free float on total returns. Throughout this paper, MSCI EAFE Small data is comprised of price-only from January 1993 to December 2000 and total returns from January 2001 to December 2003.

[4] Throughout this document, long-term observations have been principally derived from a time period encompassing 1993-2003, an 11-year time series that captures all three primary international small cap benchmarks.

Index Deficiencies - Removing the Blinders

While investors can generally rely on large cap benchmarks to depict the long-term return proposition of an asset class, the same cannot be said of international small cap indices. Due to their nascent nature, these indices suffer from various methodology and construction issues that limit their ability to accurately represent the asset class' potential.

Various methodology issues plague recognized international small cap benchmarks, creating performance disparities and large variations in returns. First and foremost, as explained earlier, there is no single definition of "small cap" as measured by market capitalization. This leads to the creation of distinct investment universes because the eligibility of companies is a subjective exercise left to the discretion of the major index providers. Finally, the lack of free-float adjustments and the exclusion of current income embedded in early index methodologies further distort the asset class' historical performance.

An analysis of the asset class' returns during the Asian crisis offers an example of the dramatic adverse effect of early index methodologies and the subsequent long-term 'hangover' on historical returns. In 1997, the MSCI EAFE Small returned -24.64%. At the time, this index had a healthy allocation to countries in Asia populated by companies with limited float, but employed no free-float adjustment. In contrast, the Citi Int'l Small and HSBC Int'l Small, both of which employed a form of free-float adjustment, produced -9.40% and -10.60%, respectively. This considerable single calendar year underperformance will remain embedded in long-term measurements published for the MSCI EAFE Small.

In addition, international small cap index constituents include companies that were once larger enterprises before deterioration in their business models forced their market cap downward, as well as stocks with inherently size-restricted markets that do not translate into long-term growth potential. This has the effect of diminishing the impact of higher-quality international small companies on index-related performance.

Consequently, investors should recognize that some elements of early index methodologies may dramatically under-represent the asset class' upside, while accentuating its downside.

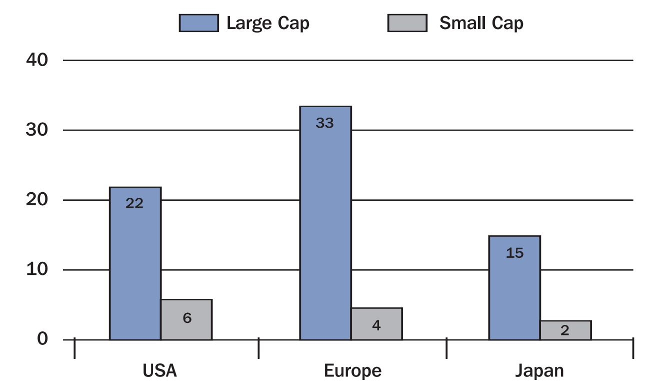
Market Inefficiencies Create Opportunity

The ability to extract value in excess of a benchmark is rooted in an investor's ability to exploit market inefficiencies. While this has become increasingly difficult to achieve in the broader international equity market, the international small cap space provides an investment environment with the potential to generate significant alpha.

The large cap markets are scrutinized by an army of analysts with access to copious information about any given company. In contrast to the considerable research resources allocated to larger concerns, economic realities prevent a similar commitment by the sell-side to small capitalization equities. Exhibit 2 illustrates the significant disparity in analyst coverage between large and small cap equities in developed markets.

EXHIBIT 2

AVERAGE NUMBER OF ANALYSTS PER STOCK
Source: Bloomberg as of May 12, 2004[5]



5 Regional large/small cap markets represented by; US: S&P 500 and Russell 2000; Europe: MSCI Europe and HSBC Smaller Europe (Inc UK); Japan: Nikkei 225 and TSE Second Section.

This lack of comprehensive coverage presents an opportunity for investors with resources dedicated to small cap analysis. Futhermore, the analysis is best done by those who have analysts on-site and are in a superior position to judge the accuracy and relevance of the information they uncover. In the end, the best analysis is typically propriety and the information advantage helps identify market inefficiencies that can be exploited to generate potential excess returns.

Alpha Generation by Active Management

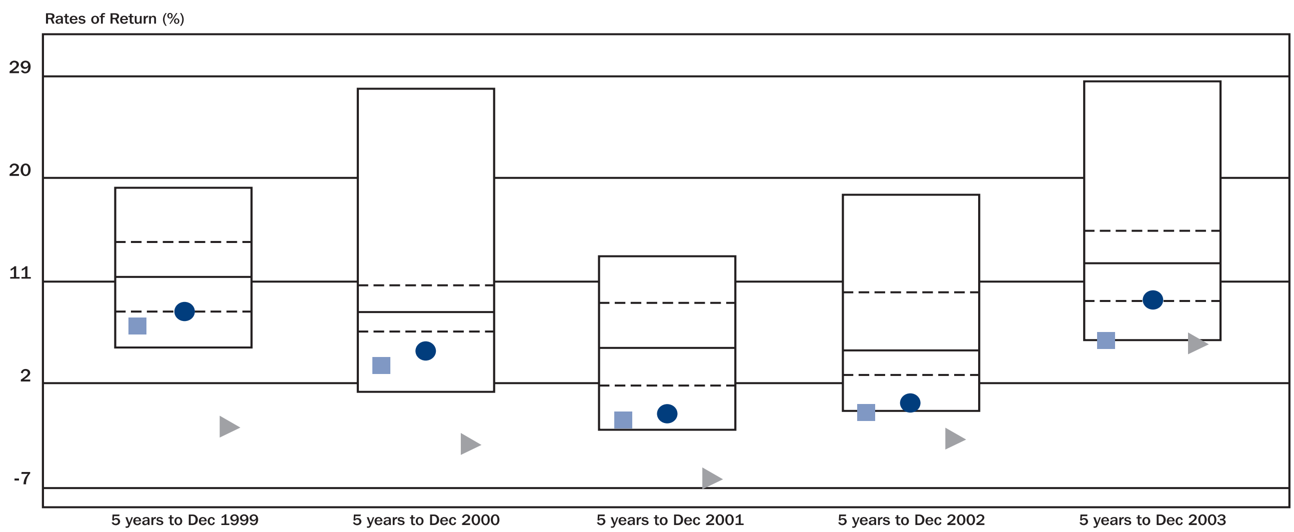
The disparities between actual manager performance and the international small cap indices indicate that the potential to generate alpha through active investment management exists. Based on the rolling five-year monthly returns ending December 31, 2003 in the International Small Cap Universe tracked by Mercer Investment Consulting, the greater overall returns available through active management are particularly true of median and upper quartile managers, who generally gained far more and lost far less than the MSCI, HSBC and Citi indices as illustrated in Exhibit 3. While top quartile managers outperformed the indices by substantial margins, average managers also posted impressive returns relative to the indices in all of these periods.

We believe these results show that indices under-represent the medium- to long-term performance of the international small cap asset class. Better still, active portfolio management enables investors to take advantage of small cap market inefficiencies and capture alpha without necessarily increasing portfolio volatility, as we will explore later.

EXHIBIT 3

PEER UNIVERSE RETURNS
Annualized Rolling 5-Year Periods as of December 31, 2003

Source: MERCER Investment Consulting



	5 years to Dec 1999	5 years to Dec 2000	5 years to Dec 2001	5 years to Dec 2002	5 years to Dec 2003
MSCI EAFE Small ■	7.2	3.8	-1.0	-0.6	5.9
HSBC Int'l Small ●	8.4	4.9	-0.7	-0.3	9.5
Citi Int'l Small ▶	-1.8	-3.3	-6.2	-2.7	5.5
5th Percentile	19.1	27.9	13.2	18.5	28.5
Upper Quartile	14.5	20.8	9.2	10.1	15.5
Median	11.2	8.3	5.2	5.1	12.6
Lower Quartile	8.4	6.6	2.0	2.9	9.4
95th Percentile	5.1	1.3	-2.1	-0.3	5.8
Number of Funds	16	19	24	31	29

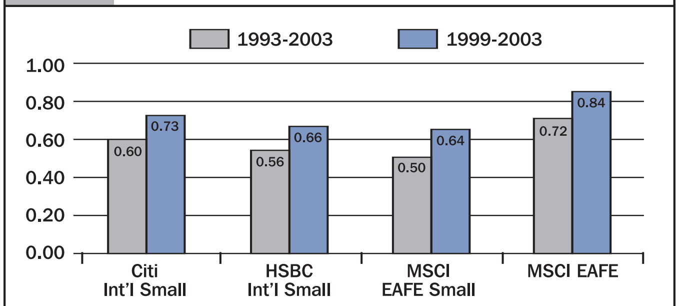
ENHANCED DIVERSIFICATION BENEFITS OF INTERNATIONAL SMALL CAPS

Regardless of where one stands on index-related performance or the potential to uncover value in excess of benchmarks, international small caps provide significant diversification benefits in a total portfolio context.

More Favorable Correlation Coefficients

The favorable correlation coefficients between the U.S. and international equity markets that led to the globalization of domestic portfolios in the 1980s still exist, but at significantly lower and diminishing levels than in the past.

EXHIBIT 4 CORRELATION
To S&P 500

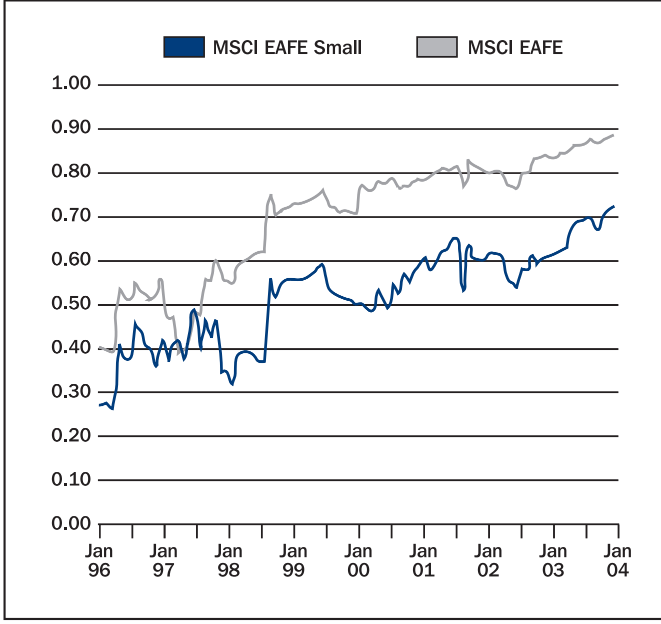


As Exhibit 4 illustrates, the past several years have exhibited a dampening effect on the diversification benefits of foreign large cap equities. For example, the correlation coefficient between the MSCI EAFE and the S&P 500 has increased from 0.72 for the entire length of the analysis (11 years) to 0.84 in 1999-2003, a sample period that is sufficiently robust and recent enough to capture the rapidly changing diversification characteristics of international investing. Thus, it appears that MSCI EAFE and the S&P 500 are slowly converging, suggesting a correlation tightening that lessens the long-term diversification benefits derived from non-U.S. large cap assets.

While the MSCI EAFE Small experienced a similar pattern of correlation convergence with the S&P 500, going from 0.50 over the last 11 years to 0.64 in the five year period ending 2003, it still maintains a greater diversification benefit than its large cap counterpart.

An even more compelling case lies in an examination of rolling three-year correlation of monthly returns. Exhibit 5 points to a dramatic increase in correlation between the S&P 500 and MSCI EAFE, which at the end of December 2003 peaked at roughly 0.90, just short of being perfectly correlated to the S&P 500. In contrast, the chart illustrates that an appreciable correlation spread still exists between the S&P 500 and the MSCI EAFE Small.

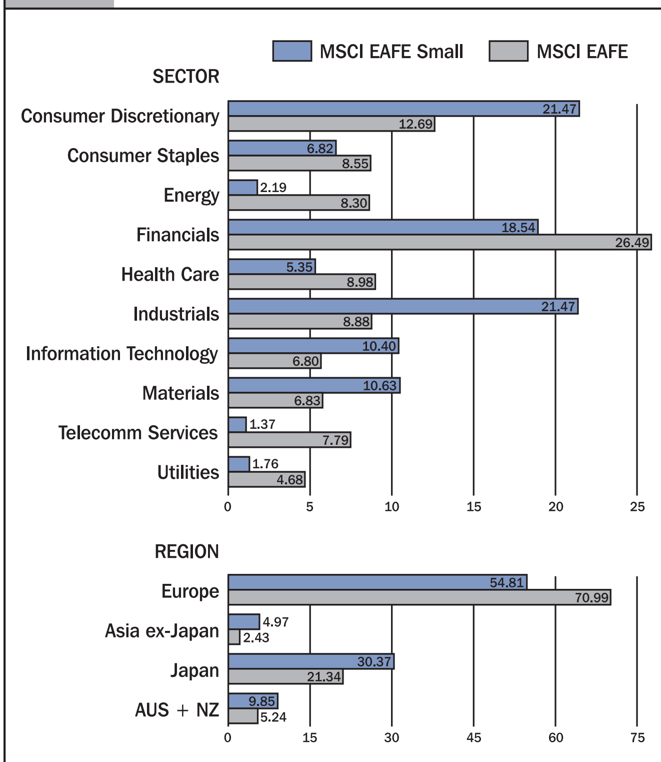
EXHIBIT 5 CORRELATION TO S&P 500
Rolling 3-Year



Diversification Influences

An examination of sector and regional allocations provides further insight into the diversification benefits of international small cap equities relative to their large cap brethren.

EXHIBIT 6 SECTOR AND REGION BREAKDOWN
As of December 31, 2003



Using the MSCI EAFE Small as a proxy, we can see in Exhibit 6 that international small caps place a greater emphasis on sectors that have traditionally been characterized as high-growth or developing (e.g. Information Technology, Consumer Discretionary, Materials) at the expense of more mature sectors, such as Financials, Utilities, Energy and other sectors that dominate the MSCI EAFE.

Regional influences of the MSCI EAFE Small similarly counter-balance the MSCI EAFE by underweighting Europe in favor of less developed regions with significant growth potential, specifically Asia and the Pacific Rim. This difference extends to the country level, where the MSCI EAFE Small tends to underweight European developed markets (United Kingdom, France, Germany, etc.) in favor of generally under-researched, but viable markets, such as Australia, Singapore and others (see Exhibit 7)

EXHIBIT 7 **COUNTRY WEIGHTINGS**
As of December 31, 2003

	MSCI EAFE Small	MSCI EAFE
Australia	8.52	5.02
Austria	0.78	0.22
Belgium	1.35	1.05
Denmark	1.94	0.75
Finland	2.94	1.67
France	4.26	9.88
Germany	4.86	7.19
Greece	1.37	0.45
Hong Kong	3.12	1.61
Ireland	1.24	0.73
Italy	3.55	3.82
Japan	30.37	21.34
Netherlands	3.12	5.17
New Zealand	1.33	0.22
Norway	1.35	0.49
Portugal	0.29	0.36
Singapore	1.85	0.82
Spain	2.88	3.68
Sweden	3.52	2.27
Switzerland	3.55	7.39
United Kingdom	17.83	25.87
Total	**100.00**	**100.00**

The harmonization of global equity markets has diminished the portfolio diversification effects of international equities. Thus, those investors who presently invest in international large caps for the perceived diversification benefit would do well to consider the greater diversification benefit inherent in the international small cap asset class.

RISK CONSIDERATIONS

While portfolio diversification may be considered the only remaining "free lunch" in portfolio management, there are special risks that must be fully appreciated when considering an investment in any asset class, and international small cap equities are no exception.

Liquidity Risk

International small cap equities may introduce investors to levels of illiquidity not previously experienced in broader large cap sectors or even U.S. small cap equities. Equity markets and individual stocks with low daily trading volumes can partially offset the potential to generate superior returns. As in general capital markets, an inverse relationship exists between liquidity risk and demand for the asset class. As international small caps have gained greater recognition, fluidity in the marketplace has improved. Nevertheless, periods of crisis can test the resiliency of liquidity premiums, which would have a greater impact on international small cap versus its large cap counterparts.

Business Risk

The opportunity associated with companies in high growth ventures is accompanied by a greater level of business risk. On an individual company level, the potential for rapid growth may never be realized if the company's business strategy does not translate well in the "real" world. In other cases, the new and innovative products and services offered by smaller companies simply may not have the market appeal envisioned by backers.

Corporate Governance and Transparency

Another consideration in the small cap space is the absence of an efficient market for control. In Continental Europe and Japan, some smaller listed companies may be controlled by founding family members or entrenched management. In such cases, minority shareholder rights may not always provide adequate protection against the self-serving actions of majority controlling interests.

The transparency of financial reports, or the lack thereof, is another consideration. While there is a global movement toward the adoption of GAAP standards, the acceptance is far from universal. As we have seen in the U.S., even large companies in highly developed markets are subject to the abuses of "creative accounting." It would be imprudent to ignore the potential for such abuses in smaller companies, especially those in smaller markets where standardized financial reporting is more of a hoped-for future development than a generally accepted way of doing business.

The benefits of the asset class are not divorced from unique challenges and risks. Fundamental bottom-up analysis and on-the-ground research are, in our view, two of the best ways to mitigate these risks when investing in international small caps.

Discrediting the Myth of Increased Volatility

Surprisingly, at least to those leery of investing in smaller companies owing to their alleged greater risk, volatility is no more an issue for investors in smaller companies than it is for those who invest in large caps. Historical data shows that the long-term volatility[6] of the asset class is in line with the variability in returns of large cap equity markets. Both the Citi Int'l Small and HSBC Int'l Small indices exhibit risk characteristics that are marginally lower than the MSCI EAFE Index and, in the case of the Citi benchmark, even lower than the S&P 500 (see Exhibit 8).

EXHIBIT 8

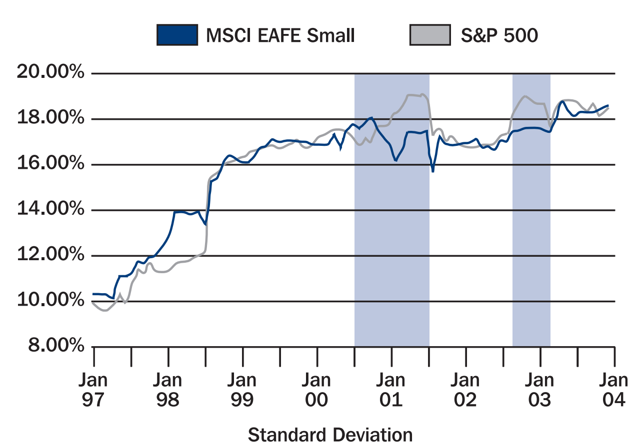
COMPARATIVE VOLATILITY
Annualized Standard Deviation 1993 - 2003

Citi Int'l Small	HSBC Int'l Small	MSCI EAFE Small	MSCI EAFE	S&P 500
14.91%	15.43%	16.85%	15.58%	15.20%

More recently, international small caps have not only experienced volatility levels comparable to large caps, but they have also demonstrated lower risk characteristics during periods of drastic volatility swings in the U.S. marketplace. Exhibit 9 illustrates this point. Specifically, the U.S. equity market experienced a spike in volatility from 17% in mid-2000 to 19% though the middle of 2001. During this same period, the variability of returns for the MSCI EAFE Small moved in the opposite direction to levels below 17%. A similar pattern can be observed in mid-2002 when there was a wide volatility gap between the S&P 500 and the MSCI EAFE Small.

EXHIBIT 9

COMPARATIVE VOLATILITY
Annualized Rolling 3-Year Periods



6 Measured by the annualized standard deviation of monthly returns.

THE OPTIMAL ASSET ALLOCATION

As international small cap equities continue to gain credibility as a stand-alone asset class, investors face the task of identifying the optimal capital allocation to the asset class.

In many cases, investors may already have exposure to the asset class–albeit unknowingly–through existing EAFE managers whose quest for alpha leads them to the small cap market. In other situations, investors have opted to test the waters through sanctioned EAFE+ mandates that attempt to identify optimal entry and exit points. Barring reliance on market timing or other opportunistic measures, the benefits of international small cap equities in the context of a total portfolio are best realized with a steadfast commitment to the asset class as a relevant component of an investment strategy.

Investment objectives are diverse and vary from investor to investor. As such, an allocation to the asset class may offer distinct advantages and unique considerations to different investors. For instance, some may find the asset class' diversification benefit sufficiently appealing to decrease portfolio beta while maintaining the same level of expected returns. Others may view this as an opportunity to seek more portfolio alpha while keeping risk budgets unchanged. We recommend that investors who appreciate the asset class' alpha generation potential and diversification benefits consider an allocation to the asset class in the context of their own unique total portfolio return objectives and risk appetite.

REGIONAL PERSPECTIVES

While common investment trends exist across the entire international small cap universe, each region has its own set of unique challenges and opportunities.

Japan

The vast universe of small capitalization companies in Japan makes it one of the most challenging markets for small cap investors, with limited research coverage providing more opportunity to create value. Analyst coverage per small company is spotty – only a fraction of the European and U.S. standards (see Exhibit 2). Furthermore, small cap investors are typically individuals and trading syndicates whose emotional trading habits enable disciplined, long-term investors to capitalize when others react too strongly.

Japan's small cap market has always been comprised of two distinctly different groups. The first consists of a few dynamic, newly listed companies with young management and growth niches in services. The other, much larger group is the wasteland of moribund manufacturing companies that are typically part of a family-controlled business or a large conglomerate. This second group has historically been much less focused on their shareholders, though this has begun to change as traditional Japanese companies are beginning to see hostile M&A actions, which in a few cases have released a great deal of trapped value. Even better news is that as new technologies and services emerge or are imported into Japan as entrepreneurship gains popularity, and the pre-IPO venture capital industry matures, the first group is steadily growing in numbers.

Japan's long economic downturn resulted in the tightening of lending policies, with some small companies being cut off from financing altogether. This forced many small companies to run lean operations, which will enable them to benefit from Japan's recovery to a much greater degree than some of their large, inefficient counterparts. We expect profit growth to accelerate as signs of general economic and sales recovery are seen in Japan. The easing of the banking crisis finally should loosen up lending, so for the small companies whose debt levels have been reduced dramatically, the higher interest rates as the economy recovers should not squeeze earnings as they might have a decade ago.

Europe

As previously mentioned, the success of a smaller company is more affected by its local economy than the global economic environment. This is especially evident in Europe, where the gradual expansion of the European Union (EU) and the introduction of the Euro have increased the size of the addressable local market. As a result, the definition of "local market" in Europe has evolved from a single country to the entirety of the EU. This evolution has been helped in part by the reduction of transaction costs, such as foreign exchange spreads and import duties, and currency risks. Since these costs and risks can weigh disproportionately higher on smaller companies, these structural changes have been highly beneficial to the universe of small companies.

An important change in the European market is the mandate by the EU that all member countries must comply with the International Financial Reporting Standards (IFRS) beginning in 2005. The IFRS are profit-based accounting standards, a change from the tax-based accounting that many European countries have used historically. This standardization will further increase the level of corporate transparency and improve the comparability of companies between countries. This is particularly important for smaller companies, since in many cases there are few, if any, sell-side analysts covering the stock, so increased comparability and reliability of financial statements is imperative. The lack of analyst coverage makes it possible for small cap investors to discover excellent businesses with superior growth prospects at attractive valuations which have not been recognized by the broader market.

Many smaller companies in Europe are still majority owned by a founding family or management team. Historically, the interests of the family and investors may not have been aligned, but that is rapidly changing as companies increasingly need to directly access the capital markets to raise the required financing to develop their business.

Southeast Asia

The landscape in Asia has changed dramatically. The number of companies in the small cap universe rose steadily through the Asian Crisis of 1997 and now totals more than 2500. This larger universe has helped to create a more dynamic small cap market in Asia, with many opportunities to find and create value.

The Asian crisis was a grueling lesson for investors. The magnitude of the crisis and its aftermath should not be underestimated. The authorities and governments are taking great caution to avoid repeating this fiasco and as a result, listing rules and disclosure requirements have become more stringent. These changes are extremely important and useful to small cap investors as they help to ensure that the investable universe in Asia is now more transparent and of higher quality than it was historically.

As with other regions, many of the smaller companies in Asia are under-researched. While investment banks have instituted more small cap research over the years, the resources allocated to this segment of the market are still limited. Hence, investment professionals on the ground in Southeast Asia are uniquely positioned in that they are able to see the companies first and do their due diligence before the stock becomes a household name. This provides the opportunity to gain early entrance into hidden gems.

CONCLUSION

In the 1980s and 90s, EAFE investing was touted as the best way to achieve greater returns and portfolio diversification. Recently, however, EAFE has not delivered on this promise – but international small cap has. An allocation to international small cap is a compelling addition to a portfolio as it provides better diversification with less of the perceived risk.

Active management has proven to deliver returns beyond those of published indices. Managers with on-the-ground, local research teams are best positioned to exploit and capitalize on the asset class' inherent inefficiencies.

In short, investors with a medium- to long-term time horizon should consider the greater alpha generation potential and superior diversification characteristics of international small cap equities.

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