MARKET VIEW

INTERNATIONAL EQUITIES: WHY SMALL CAPS ARE MAKING WAVES

Strong performance in the first half of 2017 underscores the attraction of this overlooked and undercovered asset class.

International small-cap equities (as represented by the S&P Developed Ex-U.S. SmallCap Index) was one of the strongest-performing asset classes in the first half of 2017, yet this opportunity continues to be overlooked by most U.S. investors. We review several reasons why international small caps might warrant consideration for a long-term allocation in investors’ portfolios.

1. ATTRACTIVE RISK-ADJUSTED RETURNS

Similar to results in the U.S. equity market, investors in the international equity markets historically have been rewarded for long-term allocations to the stocks of smaller companies. In fact, over the past 20 years, international small caps have outperformed large caps in 95% of the past rolling five-year periods and 100% of rolling 10-year time periods. (Of course, past performance is no guarantee of future results.)

While this persistent outperformance of small caps may not be surprising to investors who have captured this risk premium in the U.S. equity market (which is not predictive of future performance), the long-term advantages of an allocation to international small caps (as displayed in Table 1) may not be widely recognized. Over the past two decades, an investment in international small-cap equities has provided cumulative returns more than twice those of international large caps, without a substantial increase in volatility. Furthermore, the Sharpe ratio (a common measure of risk-adjusted returns) for international small caps is double that of international large caps.

Historically, investors searching for an engine of growth in their international equity allocations have turned to emerging markets, rather than small caps of developed countries outside the United States. However, Table 1 demonstrates that international small caps historically have outperformed emerging markets as well, with significantly lower volatility. The combination of higher returns and lower volatility results in a considerably higher Sharpe ratio relative to emerging-market stocks.

2. PORTFOLIO DIVERSIFICATION

U.S. investors commonly allocate to international large-cap equities in order to diversify their portfolios. International small caps historically have proven to be an equally effective, if not greater, tool for portfolio diversification. For the 20-year period ended June 30, 2017, the correlation of international small-cap equity returns (as represented by the S&P Developed Ex-U.S. SmallCap Index) to U.S. equity returns (as represented by the S&P 500 Index), for example, was 0.78, which is lower than the 0.85 correlation of international large-cap equity returns (as represented by the MSCI EAFE Index) to U.S. equity returns.

Why might international small caps enhance the diversification benefits of an allocation to international equities? International small-cap stocks provide more direct exposure to the economy of the company’s home country than their large-cap, multinational brethren. Just as many large-cap companies domiciled in the United States derive a significant portion of their revenue from overseas, many large-cap companies domiciled abroad have significant exposure to U.S. customers. Thus, large multinational companies may be exposed to many of the same factors, regardless of company domicile. Smaller companies, however, are more directly linked to the economic prospects of their home countries. An investor seeking to participate in the economic rejuvenation of a particular country or region, or simply looking for less-correlated return streams, might consider an allocation to international small-cap stocks. (Remember: no investment strategy, including diversification and asset allocation, guarantees a profit or protects against a loss.)
3. OPPORTUNITIES FOR ACTIVE MANAGEMENT

As noted above, international small-cap equities are often overlooked by investors. This is demonstrated by the lack of sell-side analyst coverage (as illustrated in Chart 1). About 90% of international companies with a market cap of less than $2 billion are covered by only one analyst or are completely uncovered, compared to only 6% of international companies with a market cap of greater than $10 billion.

The lack of analyst coverage may lead to inefficiencies that can be exploited by an active manager with deep, company-specific knowledge. As shown in Chart 2, actively managed portfolios of international small caps historically have, on average, outperformed their stated benchmarks by a wider margin than international large caps, while actively managed funds focused on emerging markets have, as a group, underperformed their indices.

**CHART 1. SCANT ANALYST COVERAGE OF INTERNATIONAL SMALL CAPS MAY OFFER OPPORTUNITIES**

**PERCENTAGE OF COMPANIES WITH LESS THAN TWO ANALYSTS, BY MARKET CAP**

<table>
<thead>
<tr>
<th>Market Cap &lt;$2 billion</th>
<th>Market Cap &gt;$10 billion</th>
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<tbody>
<tr>
<td>Stocks Covered by Less than 2 Analysts</td>
<td>Stocks Covered by 2 or More Analysts</td>
</tr>
</tbody>
</table>

Source: Bloomberg; data as of 06/30/17.

**CHART 2. ACTIVE MANAGEMENT HISTORICALLY HAS PROVIDED GREATER BENEFITS IN INTERNATIONAL SMALL CAPS**

**AVERAGE 10-YEAR EXCESS RETURNS (%) OF INTERNATIONAL SMALL-CAP MUTUAL FUNDS VERSUS INTERNATIONAL LARGE-CAP FUNDS AND EMERGING-MARKET FUNDS**

<table>
<thead>
<tr>
<th>Fund Category</th>
<th>Average 10 Year Excess Returns (%)</th>
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<tbody>
<tr>
<td>Emerging-Markets Funds</td>
<td>(0.43)</td>
</tr>
<tr>
<td>International Large-Cap Funds</td>
<td>0.06</td>
</tr>
<tr>
<td>International Small/Mid-Cap Funds</td>
<td>0.59</td>
</tr>
</tbody>
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Source: Morningstar; data as of 06/30/2017.

Past performance is not a reliable indicator or guarantee of future results. The historical data shown in the chart above are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment.

Emerging Markets Funds are represented by average of actively-managed funds in the Morningstar U.S. Fund Diversified Emerging Markets category. International Large Cap Funds are represented by average of actively-managed funds in the Morningstar U.S. Fund Foreign Large Blend, U.S. Fund Foreign Large Value, and U.S. Fund Foreign Large Growth categories. International Small/Mid Cap Funds are represented by average of actively-managed funds in the Morningstar U.S. Fund Foreign Small/Mid Blend, U.S. Fund Foreign Small/Mid Value, and U.S. Fund Foreign Small/Mid Growth categories. Excess returns calculated against each fund’s (within the Morningstar category) stated prospectus benchmark. Fund-level excess returns are average of all available share classes.
IMPORTANT INFORMATION

Note: Keep in mind equity securities are subject to market risk, which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. Investments in equity securities are generally more volatile than other types of securities.

Note: As with any new investment, know the risks before investing. Keep in mind equity securities are subject to market risk, which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. Unlike large-cap companies, small-cap companies tend to be less established, which means they are subject to more fluctuations in their businesses. Investing internationally also brings increased risks. What to keep in mind: Investments in international securities are subject to certain risks of overseas investing including currency fluctuations and changes in political and economic conditions, which could result in significant market fluctuations. These risks are magnified in emerging markets.

Keep in mind that all investments carry a certain amount of risk including possible loss of the principal amount invested. No investment strategy, including diversification and asset allocation, guarantees a profit or protects against a loss. Stock markets, especially international markets, and investments in individual stocks are volatile and can decline significantly in response to issuer, market, economic, industry, political, regulatory, geopolitical, and other conditions. Investments in smaller companies may involve greater risks than those in larger, more well known companies.

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Glossary of terms

Cumulative return is the aggregate amount an investment has gained or lost over time, independent of the period of time involved.

Standard deviation is a measure of volatility. Applied to an asset’s return, it provides a measure of the range of those returns. A higher standard deviation means a greater range of returns.

Sharpe ratio is a measure of risk-adjusted performance.

The S&P Developed ex US Small Cap Index measures the performance of the small-cap segment of global developed equity markets, excluding the United States, ranked by total market capitalization.

The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market-capitalization index that is designed to measure the equity market performance of developed markets, excluding the United States and Canada.

The MSCI Emerging Markets Index is a free float-adjusted market-capitalization index that is designed to measure equity market performance of emerging markets.

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