GRANDEUR PEAK ADVISORS
ELEVATED GLOBAL INVESTING℠

The Case for Global Small Cap Investing

EXECUTIVE SUMMARY

According to a 2010 study by the Organization for Economic Co-operation and Development (OECD),[i] there is a large and growing middle class outside of the United States. The projected growth of the middle class[a] is especially strong in the Asia/Pacific region and other developing countries. That the middle class center of gravity might be shifting away from the US could have important implications with regard to global consumption patterns, economic growth and equity markets.

Indeed, as of November 2011 the investible universe of companies outside the US outnumbered the available pool of US-listed companies by a factor of 5.6-to-1.[b] Furthermore, over the past decade the number of companies coming public outside of the US has outpaced the number of US Initial Public Offerings (IPOs) by more than 11-to-1.[c]

While there is some evidence that investors are widening the allocation of their equity portfolios to a broader global footprint,[ii] it would appear that most US-based investors are still heavily biasing their equity portfolios toward US markets.[iii, iv] Furthermore, there is evidence that investors are also under-allocated to the small cap segment of the market, especially foreign small caps. While a majority of US investors segment the US equity universe into large, mid and small capitalization buckets, few divide their foreign equity exposure up in the same fashion. MSCI believes that a majority of investors are underweight the small cap segment vis-à-vis its weight in the full global universe.[v]

Mark Siddoway, CFA, CAIA

msiddoway@grandeurpeakglobal.com

801.384.0010

www.grandeurpeakglobal.com

Should it matter that investors are underweighting the small cap segment in their global portfolios? Our view is that it matters a great deal for investors who are looking to grow their portfolios, rather than merely preserve their capital. In a low growth, low yield environment, we think the small and micro cap segment offers one of the best chances for growth simply by virtue of the law of large numbers—it's easier for a small company to grow significantly. For example, $50M in additional revenue is 50% growth for a $100 million revenue company but just 5% growth for a $1 billion revenue company. Further, the $100 million revenue company's growth prospects are likely to be less dependent on GDP growth than the larger company.

We believe that the biases toward US equities and large cap stocks have important implications with regard to equity market inefficiency across global markets, especially in the foreign universe. This belief has recently been supported by a Mercer study in which they found that active foreign small cap equity managers have generated some of the highest excess returns over time of any of traditional equity strategy.[vi]

In addition to the potential excess returns that can be harvested from this inefficient segment of the global equity markets, we believe that global small cap investments can provide diversification relative to the typical US large cap-biased equity portfolio. Although stock prices move at random in the short run (and can be highly correlated in volatile markets), we believe that over the long run the inherent value of small- and micro-cap companies are driven by the fundamental and idiosyncratic characteristics of their individual businesses. Because the drivers of growth and inherent value for small- and micro-cap stocks are very different from what drives returns for large cap companies,[v] we believe that global small- and micro-cap investing can provide good economic diversification.

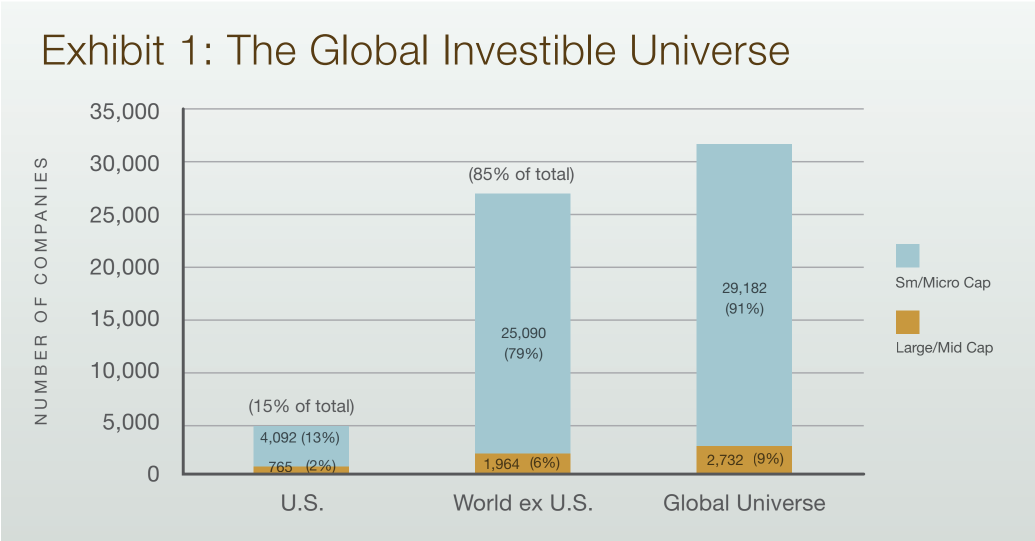
We also believe that the global small cap niche is likely to stay interesting and inefficient for the foreseeable future due to the structural impediments that keep most institutional investors out of this market segment.

We echo the findings of MSCI[v] that investors who ignore or underweight the global small cap universe are making a significant, although probably unintentional, active decision that may well be counter to their financial objectives.

GLOBAL SMALL CAP INVESTING

A MUCH LARGER OPPORTUNITY SET FOR ACTIVE STOCK PICKERS

The Small Cap segment has been defined in a variety of ways. In general, companies in the bottom 10% to 15% of the market capitalization are considered to be Small Cap by the leading index providers. Defined in this way, the number of Small Cap companies across the globe represents approximately 70% of the investible universe.[d] However, if instead of defining Small Cap as some percentage of the total global market capitalization we set absolute thresholds to define companies, the full opportunity set for the global small cap universe is about 91% of the investible universe when a company with a market cap below $2.5 billion is defined as Small Cap (see Exhibit 1).

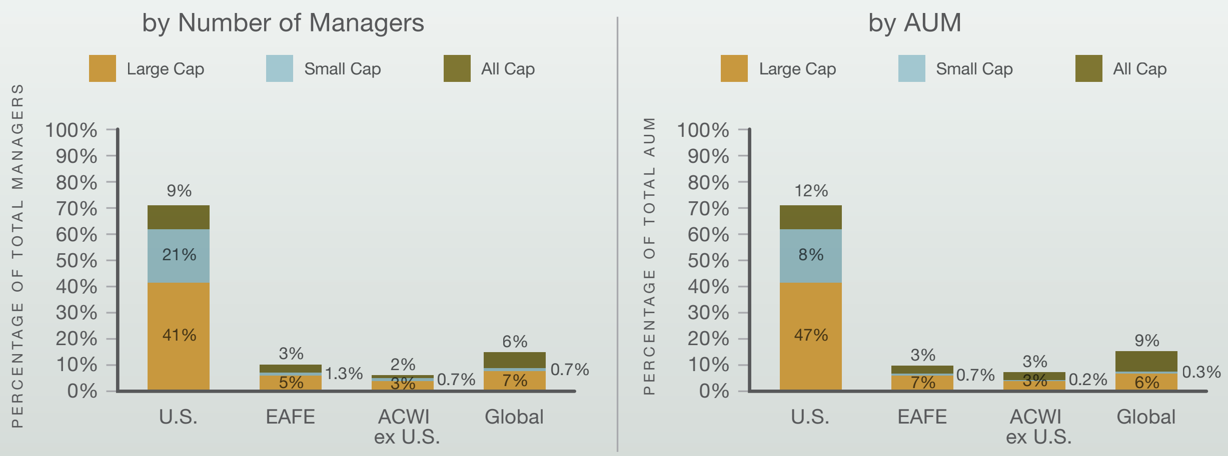


source: Bloomberg (as of 11/30/11). Large cap companies = market caps > $10 billion; mid caps = $2.5 - $10 billion; small caps = $500 - $2,500 million; micro caps = $10 - $500 million. Companies < $10 million or which had not traded in the last thirty days were excluded.

When the full opportunity set of the investible global equity universe is contemplated, it is quite remarkable that a vast majority of equity investment products are focused only on the US, or only 15% of the investible universe. As an interesting side note, since the turn of the millennium, the number of listed companies in the US has actually declined by about 43%, from over 9,000 in 2000 to under 5,000 in 2012.[e]

As shown in Exhibit 2 below, as of September 2011 the eVestment Alliance Database included almost 2,700 investment products with about $7,800 billion of assets under management (AUM).[f] Of that total, a little over 1,900, or 71%, are classified as US products, while only 395, or 15%, are classified as either EAFE or ACWI ex-US products; 385, or 14%, are classified as Global products. Even more incredible, a little over 1,100 products are classified as US Large Cap. That is, 41% of the investment products in the database limit their investment opportunity set to only 2.4% of the investible global equity universe. We will discuss the implications of this on the relative efficiency of the various segments of the global equity markets later in this paper.

Exhibit 2: Breakdown of the eVestment Alliance Database

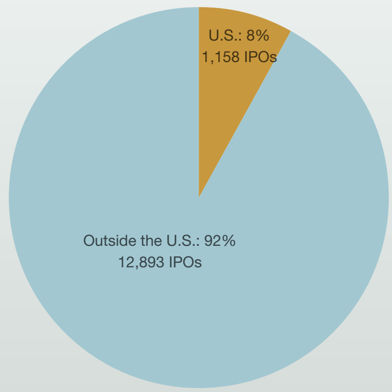


sources: eVestment; MSCI (as of 09/30/11). Only funds with at least USD 100 million AUM are counted.[v]

A LARGE OPPORTUNITY SET THAT SHOULD KEEP GROWING

Currently, about 85% of the investment opportunity set for investment managers is outside the US, with almost 79% of that foreign opportunity set in the small cap segment of the universe. Indeed, as shown in Exhibit 3, since 2000 there have been about 14,000 companies brought public via IPO across the globe. Of these, almost 13,000, or 92%, have been outside the US. We believe that the opportunity set of public investment ideas outside the US will continue to grow faster than inside the US.

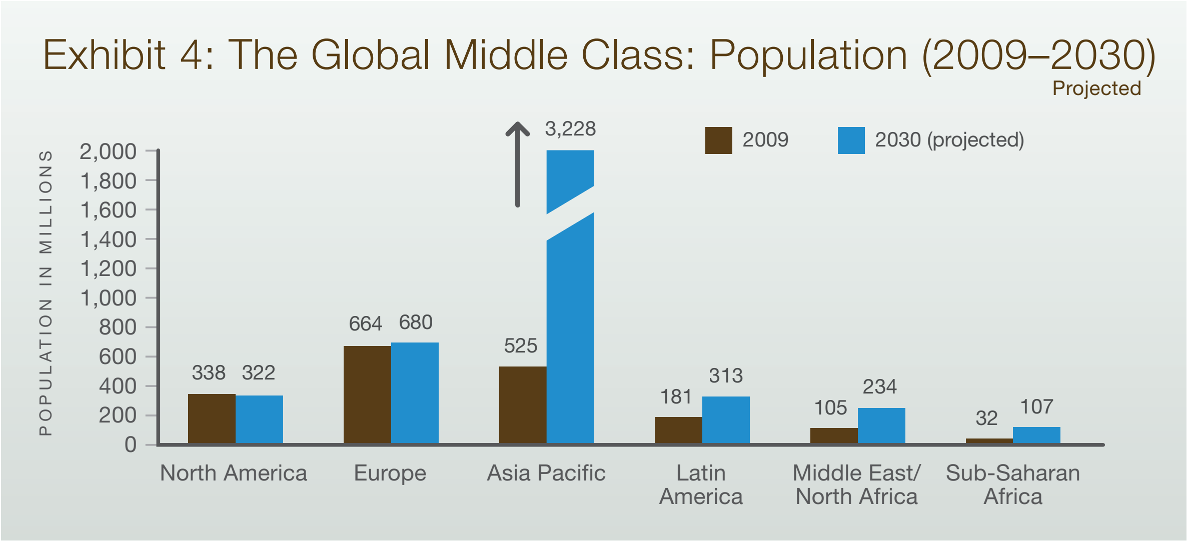
Exhibit 3: Foreign Initial Public Offerings (IPOs) have outpaced US IPOs by more than 11-to-1



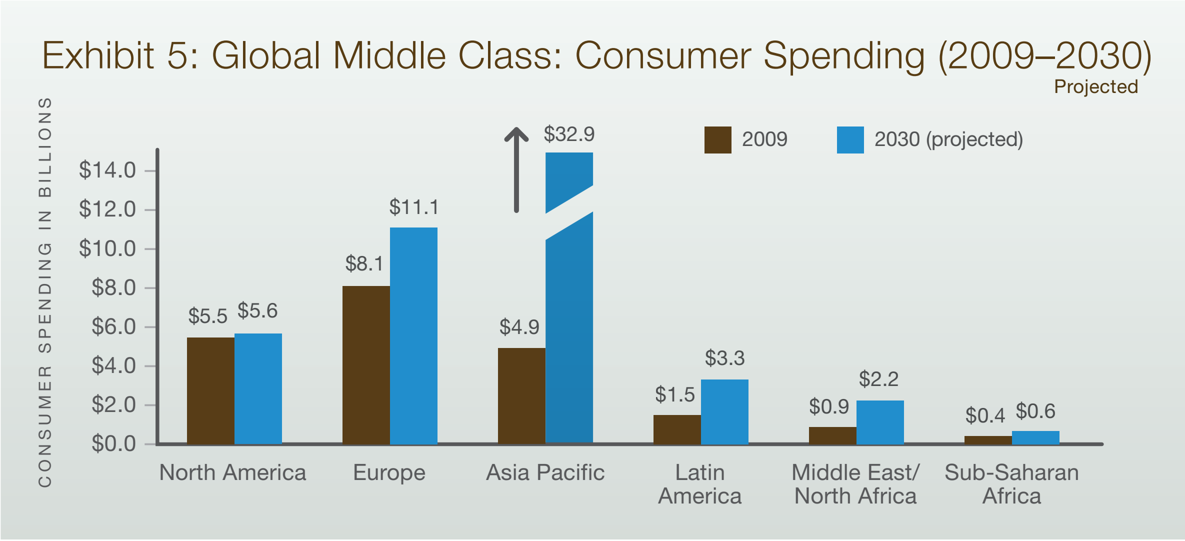
source: Bloomberg, data for the time period 1/1/00 – 11/30/11.

The Organization for Economic Co-operation and Development[i] concluded in a 2012 study that there is a large and growing middle class outside of the US, especially in developing countries. Exhibit 4 shows the geographical breakdown as of 2009 and projected growth of the global Middle Class by population. Exhibit 5 shows the geographical breakdown and projected growth of the global Middle Class by consumer spending.

The middle class center of gravity is shifting away from the US. This could have important implications with regard to global consumption patterns, economic growth and the future make-up of the global equity markets.



source: OECD, The Emerging Middle Class in Developing Countries (as of 01/31/10).



source: OECD, The Emerging Middle Class in Developing Countries (as of 01/31/10).

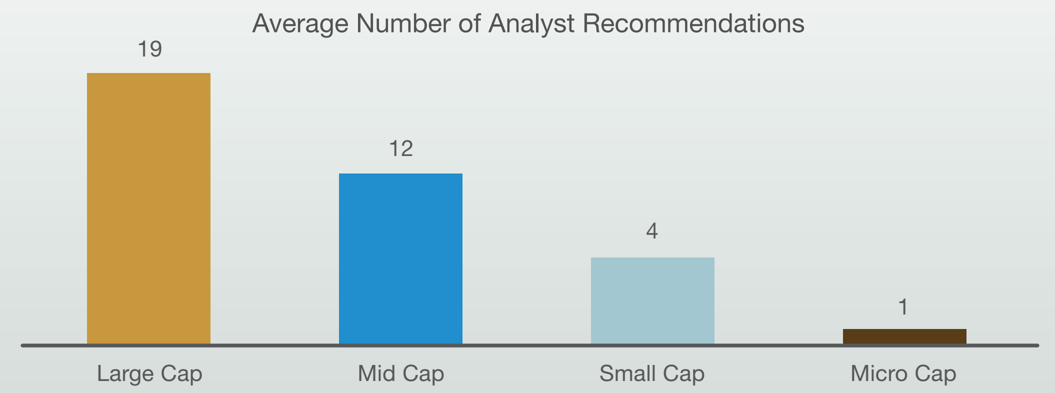
INTERNATIONAL SMALL CAP: A POTENTIALLY MORE INTERESTING AND LESS EFFICIENT MARKET

The level to which global equity markets are efficient is an ongoing debate. Opportunities to exploit market inefficiencies are typically rare in markets where there is a large community of investment analysts (e.g. large cap equities). Conversely, markets that have less institutional research coverage and fewer investors (e.g. foreign small cap) should offer the possibility for skilled investors to extract excess returns over index benchmarks. Because small cap stocks are more heavily impacted by company specific characteristics, and because information on small caps is less widely available, a good bottom-up research analyst should have an investment edge over a passive, indexed approach. We have already seen in Exhibit 2 that the majority of professional investment managers are focused on the US large cap space, while less than 3% of managers are focused on the foreign small cap space.

In terms of buy-side AUM (as shown in Exhibit 2), only 9.2% of the total AUM of the eVestment Alliance database is classified as small cap. 8% of the total database AUM is classified as US small cap while only 0.9% of the total database AUM is classified as foreign small cap, and only 0.3% of the total database AUM is classified as global small cap.

With regard to sell-side coverage, according to data from Factset, sell-side analyst coverage of global small and micro caps is considerably less than that of large and mid caps, as shown in Exhibit 6 below.

Exhibit 6: Average Analyst Coverage of Foreign Stocks

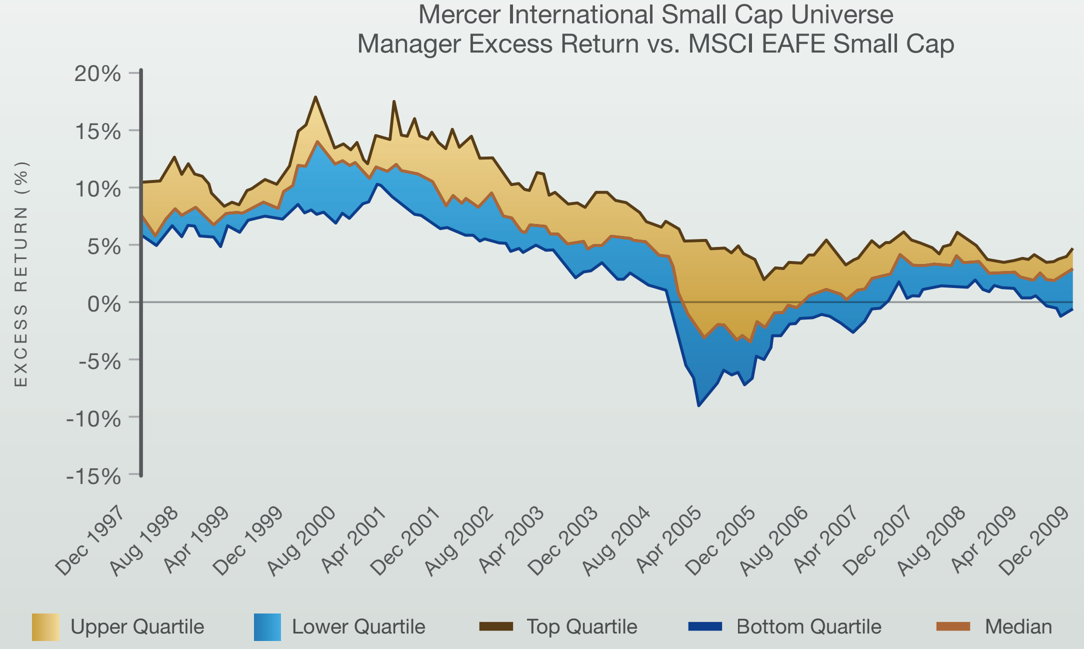


source: FactSet (10/31/10)

A variety of studies have hypothesized that stocks with lower analyst coverage should be less efficiently priced. That is, their prices are less likely to reflect their true value, which in turn creates investment opportunities for active managers.[vii, viii, ix]

Exhibit 7 is a chart compiled by Mercer[vi] and shows the performance of the Foreign Equity Small Cap Manager Universe of active managers compared to the returns of the MSCI EAFE Small Cap Index based on rolling five-year periods. The median returns of the database consistently exceeded the index, giving further evidence that the foreign small cap space has been a ripe universe for active management.

Exhibit 7: Outperformance of Active International Small Cap Managers

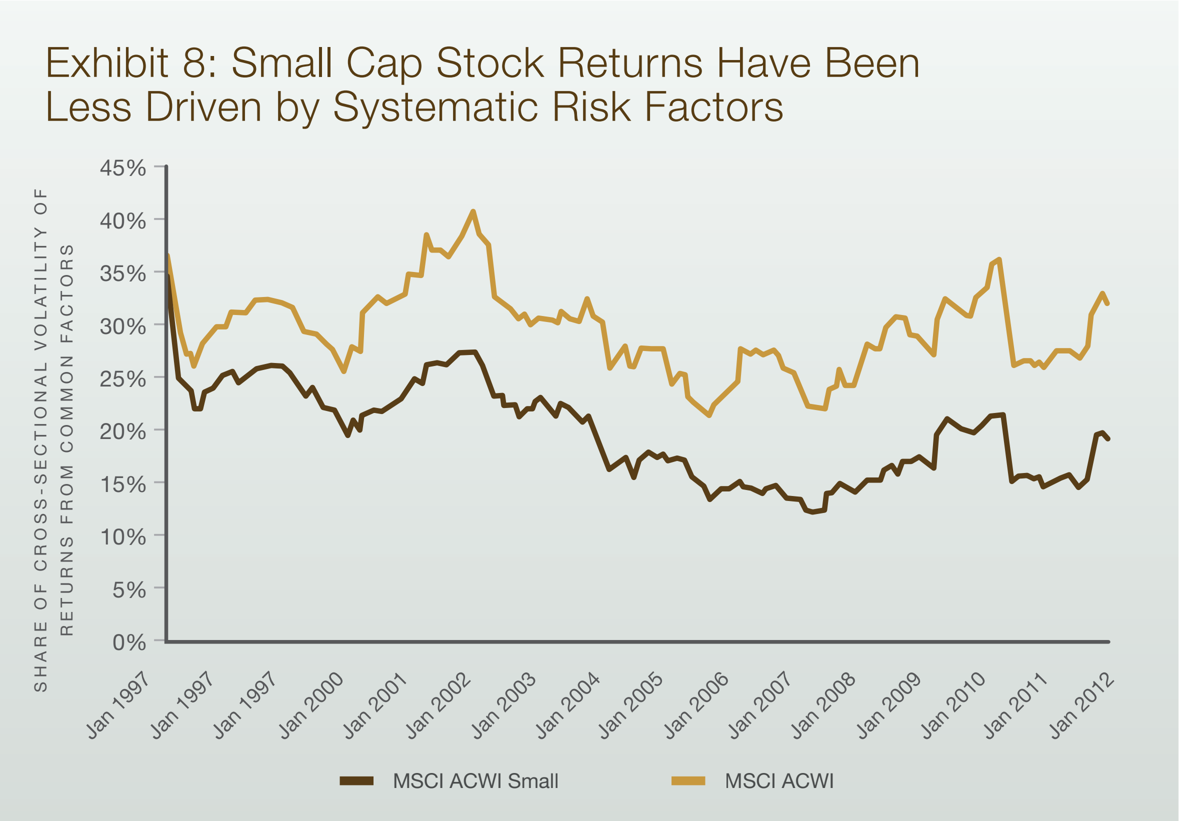


source: Mercer, Introduction to foreign small cap equity (05/31/10). Past performance does not guarantee future results.

POTENTIAL DIVERSIFICATION BENEFITS

According to MSCI, small cap stocks are more heavily impacted by company specific characteristics.[v] Exhibit 8 below, from the MSCI study on global small cap investing cited previously, shows the contribution to the cross-sectional dispersion of returns for the global large/mid cap universe versus the small cap universe. Cross-sectional dispersion is a measure of the volatility of stock returns around the mean return of a variety of risk factors over a defined time period. By regressing the returns of a stock against a variety of market-based risk factors (indexes), one can measure the extent to which a stock's returns have been driven by systematic risk factors vs. idiosyncratic/company specific risk.

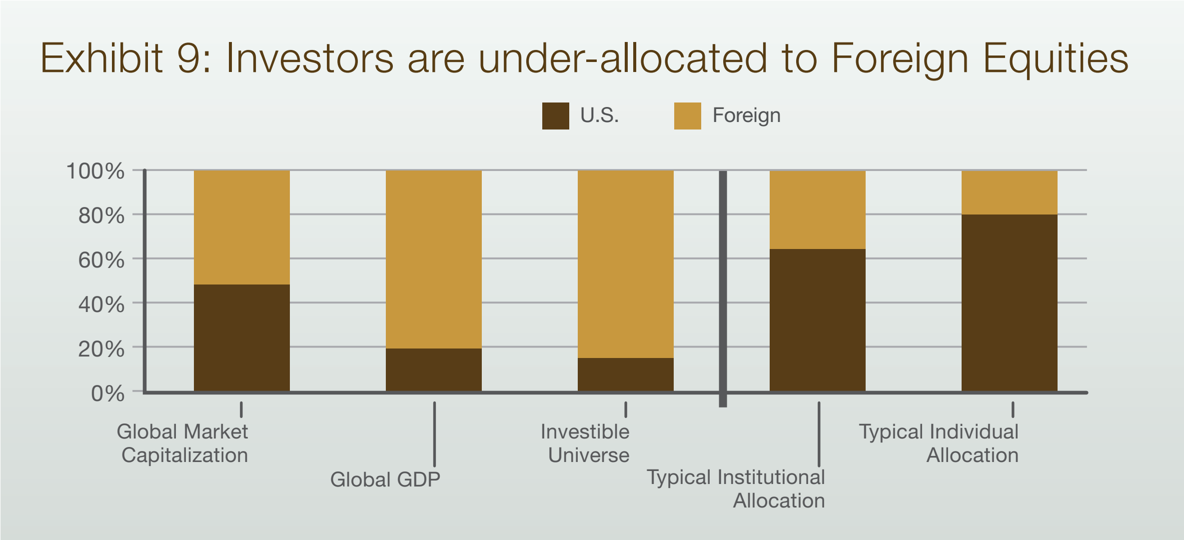
Exhibit 8 below shows that while the amount of overall market risk (systematic risk factors) that are driving stock returns varies over time, returns of small cap stocks (MSCI ACWI Small Cap Index) are less driven by the market and more driven by idiosyncratic (company specific) risk. That is, only about 20% (on average) of the overall returns of the small cap universe can be attributed to overall market risk (systematic factors).



source: MSCI, Small Caps – No Small Oversight (3/31/12). Past performance does not guarantee future results.

INVESTORS ARE UNDER-ALLOCATED

Given the statistics that have been laid out in this paper, it may seem logical that investors might want to broaden the footprint of their equity allocations. Yet while global investing has been gaining traction among investors more recently, there is still an inherent bias toward US large cap equities among institutional and individual investors.[iii, iv] The US economy represents just 19% of the world's GDP,[g] US companies represent only 15% of the global investible universe, and the US represents less than 50% of the global equity market capitalization;[h] yet the typical US institutional investor has 60% to 70% of its equity exposure allocated to US equities, and individual investors are typically around 80% domestic equities. This data is summarized in Exhibit 9 below.



source: IMF (03/31/12), Bloomberg (11/30/11), MSCI (4/31/12), BNY Mellon (12/31/12)

KEY CONSIDERATIONS IN TAPPING INTO THE OPPORTUNITY SET

DISCIPLINED, SYSTEMATIC RESEARCH

We believe that one of the key reasons that sell-side analysts and large institutional investors largely ignore the foreign small cap space is due to the challenges in covering such a large opportunity set, and the relatively small amount of capital that can ultimately be deployed here. We believe bottom-up, fundamental qualitative company research is a key component of small cap investing. Because the inherent risks driving the returns of small cap stocks are mostly company specific, small cap investors need to truly understand the business, strategy, and management teams of these companies, and this takes time and excessive amounts of work and travel. Because the universe of potential investments is so huge, we believe an effective screening and sourcing process is critical to rationalize the universe and to identify a manageable pool of companies on which to focus.

CAPACITY CONSTRAINTS AND DISCIPLINED CONTROL OF AUM

There is a widely held belief that small cap stocks should outperform over the long run.[x] This, coupled with the evidence that the small cap space is less efficient and offers potential diversification benefits, would suggest that broad equity managers would selectively invest in global small caps. In practice, however, large investment managers, no matter the strategy, are precluded from fully investing in the space. As of June 2012, the average market cap of the Russell Global Small Cap Index was $1,098 million; the median market cap was $524 million. If one were to assume an average market cap size of $1 billion across a portfolio of small cap stocks, a manager with more than $3 billion of AUM would have difficulty fully investing in the space. Exhibit 10 shows the percentage of a small cap company a hypothetical investment manager would own at each level of AUM and the position size of the company within the overall portfolio.

Exhibit 10: Percentage of Company Owned for a Corresponding Portfolio Weight

Hypothetical portfolio with an average market cap of $1 billion

	POSITION SIZE					
Fund AUM	**0.10%**	**0.25%**	**0.50%**	**1%**	**2%**	**5%**
$500 million	0.05%	0.13%	0.25%	0.50%	1.00%	2.50%
$1 billion	0.10%	0.25%	0.50%	1.00%	2.00%	5.00%
$2 billion	0.20%	0.50%	1.00%	2.00%	4.00%	10.0%
$3 billion	0.30%	0.75%	1.50%	3.00%	6.00%	15.0%
$5 billion	0.50%	1.25%	2.50%	5.00%	10.00%	25.0%
$10 billion	1.00%	2.50%	5.00%	10.00%	20.00%	50.0%
$20 billion	2.00%	5.00%	10.00%	20.00%	40.00%	100.0%

The table shows that if an investment manager with as little as $5 billion of AUM were to find a $1 billion market cap company that they really liked and wanted to take a 5% portfolio weight in, they would have to take a prohibitively large position in the company (25%). Even a $2 billion manager would end up with a 10% ownership stake in such a situation. We believe that the maximum amount of AUM a manager can have and still effectively manage a global portfolio of small-and micro-cap stocks is somewhere around $3 billion. The mathematics of Exhibit 10 will likely keep the foreign small cap segment underfollowed and inefficient because of the structural impediments that exist for large institutional investors.

SUMMARY AND CONCLUSIONS

In summary, we believe a strategic allocation to global small caps is appropriate for growth-oriented investors for the following reasons:

1. BREADTH OF THE GLOBAL SMALL CAP OPPORTUNITY SET – The vast size of the global small cap universe (~30,000 companies and growing) offers active managers a much more robust opportunity set from which to pick.

2. A GROWING OPPORTUNITY SET – A growing middle class outside of the US should lead to new capital formation and growth in the number of publicly listed companies outside of the US, especially in developing countries. In talking about his success as a hockey player, the great Wayne Gretzky said "I skate to where the puck is going, not where it's been,"[i] we believe the same philosophy applies to portfolio construction. With the huge shift in middle class incomes and consumer spending that is projected to take place over the next 20 years, we believe that the "puck" is frequently going to be in economies outside the United States, and that many small companies in these markets will be the beneficiaries.

3. INEFFICIENCY IN THE GLOBAL SMALL CAP SEGMENT – Less broker research and less institutional ownership and presence in the space allows for good, fundamental analysts to potentially gain an investment edge. Furthermore, this phenomenon is likely to persist due to capacity constraints of large investment managers.

4. PORTFOLIO DIVERSIFICATION – Because the returns of small and micro cap stocks are driven less by systematic factors and more by their own idiosyncratic fundamentals, a portfolio of Global Small Cap companies can offer economic diversification to the typical large cap equity portfolio.

RISKS: Investing in small and micro cap funds will be more volatile and loss of principal could be greater than investing in large cap or more diversified funds. Investing in foreign securities entails special risks, such as currency fluctuations and political uncertainties, which are described in more detail in the prospectus. Investments in emerging markets are subject to the same risks as other foreign securities and may be subject to greater risks than investments in foreign countries with more established economies and securities markets.

The MSCI ACWI Small Cap Index is designed to measure the equity performance of small cap stocks in developed and emerging market throughout the world. The MSCI ACWI Investible Market Index is designed to measure the equity performance of stocks of all market cap sizes in developed and emerging market throughout the world. The MSCI EAFE Small Cap Index is designed to measure the equity performance of small cap stocks in developed markets outside of North America. The Russell Global Small Cap Index is designed to measure the equity performance of small cap stocks in developed and emerging market throughout the world. You cannot invest directly in these or any indexes.

EAFE (Europe, Australia, and Far East) is a term frequently used to group together all developed countries outside of North America.

ACWI (All Country World Index) is used to describe all developed and emerging markets around the world.

Sell-Side is a term used to represent the part of the financial industry involved with the creation, promotion, analysis and sale of securities.

Buy-Side is a term used to represent investing institutions such as mutual funds, pension funds and insurance firms that tend to buy large portions of securities for money-management purposes.

Idiosyncratic/Company Specific Risks are risks that are specific to an individual firm.

Systematic Risks are broad macro risks that will impact many firms simultaneously.

CFA® is a trademark owned by CFA Institute.

References:
[i]Homi Kharas, The Emerging Middle Class in Developing Countries (Organization for Economic Co-operation and Development, Working Paper No. 285) January 2010: http://www.oecd.org/social/povertyreductionandsocialdevelopment/44457738.pdf
[ii]Global Financial Stability Report, International Monetary Fund, September 2011, Chapter 2: Long-Term Investors and Their Asset Allocation: Where are They Now?: http://www.imf.org/external/pubs/ft/gfsr/2011/02/pdf/ch2.pdf
[iii]John Houser and Connie Tackett, CFA, Trends In Asset Allocation: Institutions Respond to Changing Markets (BNY Mellon, Dec 2010): http://www.bnymellon.com/foresight/pdf/assetallocation.pdf
[iv]Wealth in America 2008, Northern Trust, January 2008, pg. 4: http://www.northerntrust.com/popups/popup_noprint.html?http://www-ac.northerntrust.com/content//media/attachment/data/white_paper/0801/document/wealth_america2008.pdf
[v]Jennifer Bender, Remy Briand, Giacomo Fachinotti and Sivananth Ramachandran, Small Caps – No Small Oversight (MSCI, Mar 2012): http://www.msci.com/resources/research_papers/small_caps_-_no_small_oversight.html
[vi]Jay Love, Tracy Teel, and Hugh Merkel, Introduction to Foreign Small Cap Equity (Mercer, May 2010): http://www.mercer.us/smallcapequity
[vii]B.A. Ajinkya and M.J. Gift, Dispersion of Financial Analysts' Earnings Forecasts and the (Option Model) Implied Standard Deviations of Stock Returns (The Journal of Finance, 40, 1985), pp. 1353-1365
[viii]A. Arbel and P. J. Strebel, Pay Attention to Neglected Firms (Journal of Portfolio Management 9, Winter 1983), pp. 37-42
[ix]Said Elfakhani and Tarek Zaher, Differential Information Hypothesis, Firm Neglect and the Small firm Size Effect (Journal of Financial and Strategic Decisions, Fall 1998), pp. 29 - 40
[x]Eugene F. Fama and Kenneth R. French, The Cross-Section of Expected Stock Returns, (The Journal of Finance, June 1992)

Endnotes:
[a]The OECD paper defines the Middle Class as households with daily expenditures between $10 – 100 per person in Purchasing Power Parity terms.
[b]source: Bloomberg, data as of 11/30/11
[c]source: Bloomberg, data for the time period 1/1/00 – 11/30/11
[d]For example, the Russell Global Index contains approximately 10,000 companies, 3,000 of which are defined as Large Cap and 7,000 of which are Small Cap.
[e]sources: The Demise of the IPO – and Ideas on How to Revive It, The Wall Street Journal (June 25, 2010); CapitalIQ; Sidoti & Company; Bloomberg
[f]source: eVestment, MSCI. Only funds with at least USD 100 million AUM are counted.
[g]International Monetary Fund World Economic Outlook database, April 2012: http://www.imf.org/external/pubs/ft/weo/2012/01/weodata/index.aspx
[h]As of June 2012, the US had a 48% weighting in the MSCI ACWI Investible Market Index (IMI).
[i]http://en.wikipedia.org/wiki/Wayne_Gretzky