



# Small Caps, Large Opportunity

## The Case for Global and International Small-Cap Equity

Academic studies have consistently demonstrated that small-cap equities have outperformed their large-cap peers over time. These studies have also discovered that small-cap equities behave differently than large-cap equities. Small-cap active managers appear to have a better record of adding value than their large-cap counterparts. These findings are consistent in the United States and across the globe. The Lazard Global and International Small Cap Equity teams suggest some potential explanations for small-cap outperformance and show how an active approach is well-suited for small-cap equity investing.



## The Small-Cap Effect

Since the 1980s, a number of studies have shown that small-cap equities have historically outperformed large-cap equities on a risk-adjusted basis. Rolf Banz's 1981 study was one of the first to highlight this.<sup>1</sup> These results challenged the Capital Asset Pricing Model (CAPM), where an asset's return is explained by one variable—its systematic risk. In the model, company size is not a variable that could explain outperformance. The academic consensus progressed toward introducing additional elements of risk to explain equity returns.

In their seminal paper,<sup>2</sup> Professors Fama and French suggested size and value as additional factors to describe asset returns, as these two factors have consistently performed better than the overall market. They combined beta (systematic risk), company size (market capitalization), and value (as defined by book-to-market ratio) in a three-factor model to explain equity returns. In their view, the outperformance of small caps over large caps was due to an element of risk unique to small caps (i.e., investors are compensated for undertaking additional risk). There seems to be some credence to this view, as small-cap companies frequently do not have the same funding options as larger companies, such as commercial paper, high-yield bonds, or private placements. Small-cap companies are therefore more dependent on bank and equity financing. However, small-cap outperformance can also be attributed to market inefficiency and not just compensation for additional risk—favoring an active stock selection approach.

Davenport and Meissner concluded that small-cap outperformance in the United States was positively correlated with rising GDP and a reduction in unemployment (though the latter was not deemed statistically significant).<sup>3</sup> They found that, since 1948, at the tail-end of recessions, small caps outperformed large caps in nine out of ten samples. Recent J.P. Morgan research also noted the economic sensitivity of small caps. The study showed that since 1990, the revenue growth rate of European small- and mid-cap stocks has been 2.2 times nominal GDP growth.<sup>4</sup>

The phenomenon of small-cap outperformance is valid across the globe. The excess returns of small caps have been too consistent to be dismissed (Exhibit 1). The Fama-French factors and benchmark portfolios confirm that this dynamic has existed for a significantly long period in the United States and for a shorter time frame everywhere else, where data were available (Exhibit 2).

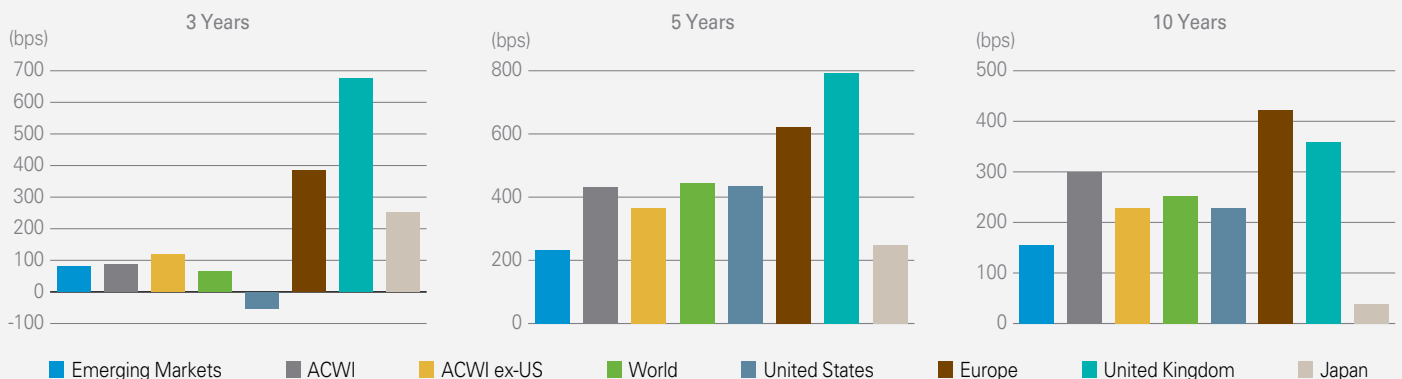
Small-cap outperformance may be particularly acute in periods when some or all of the following conditions occur: increasing credit availability, strengthening forward economic indicators, positive economic growth, rising earnings estimates, and ample merger-and-acquisition activity. On the other hand, small caps tend to underperform when those conditions are reversed (Exhibit 3).

## The Case for Active Management in Small Caps

Banz suggests some potential reasons for small caps' superior risk-adjusted returns. Given the lack of liquidity, less information available, and other constraints in small caps, he argues many investors may be deterred from investing in the asset class. In his analysis, companies that are sought only by a subset of investors have higher risk-adjusted returns. We believe it is reasonable to assume the information about a security is proportional to its size. With less information available, many market participants may exclude small caps from their model portfolio opportunity sets because they may not be able to accurately assess the risks.

Policy constraints may preclude many large institutional investors from allocating to this asset class in any meaningful way. Thus, brokerages cannot dependably benefit from trading commissions on small caps, which diminishes their incentive to provide broad research coverage of small caps, creating a lower level of market efficiency. For instance, a Swiss company with a CHF400 million market cap and a 50% free float will have far less information flow and market attention than a US large-cap company. Exhibit 4 (page 4) illustrates this

Exhibit 1  
**The Small-Cap Effect—Evidence from Global Indices**  
(Comparison of Returns — Small-Cap vs. Large-Cap Indices)



As of 30 June 2014

Represents MSCI regional/country small-cap and large-cap indices, as noted. All data in USD. The performance quoted represents past performance. Past performance is not a reliable indicator of future results.

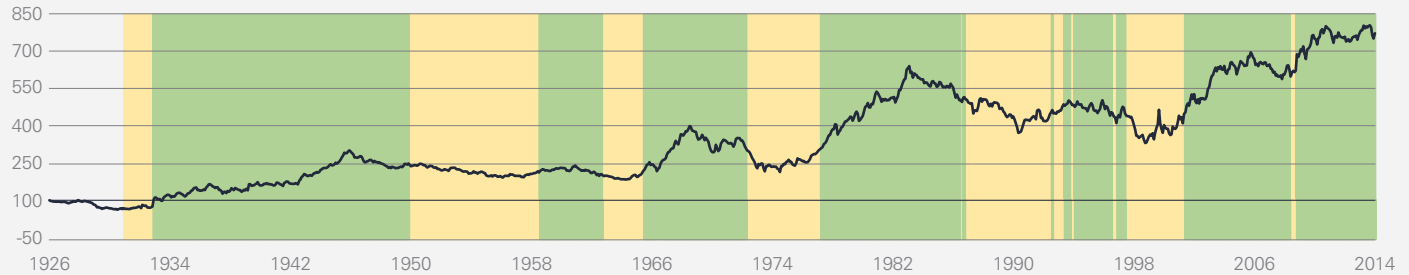
For illustrative purposes only. This information does not represent any product or strategy managed by Lazard. The indices are unmanaged and have no fees. One cannot invest directly in an index.

Source: MSCI

## Exhibit 2 The Small-Cap Effect—Evidence from the Fama-French Data

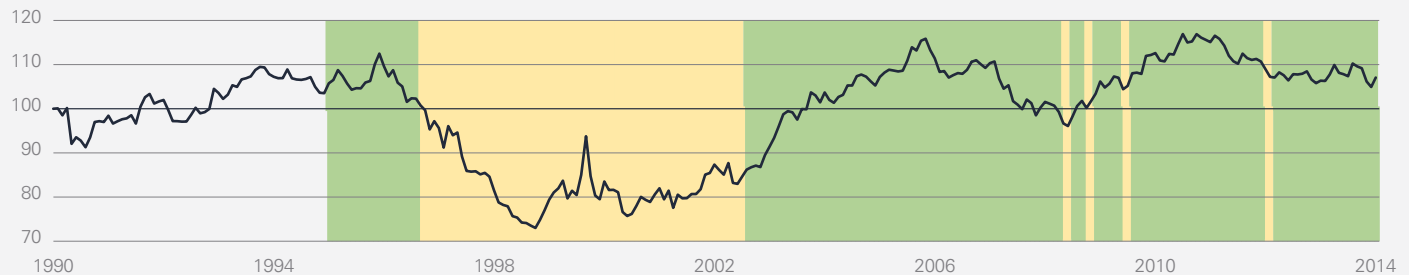
United States

Cumulative Performance, June 1926 = 100



Global

Cumulative Performance, June 1990 = 100



Small Cap Underperforms (5-Year Rolling Periods)    Small Cap Outperforms (5-Year Rolling Periods)    — SMB

As of 30 June 2014

SMB is the average return on small cap minus large cap based on the portfolios constructed using the methodology outlined by Fama and French and described in Kenneth French's data library (link below). The performance quoted represents past performance. Past performance is not a reliable indicator of future results. This information is for illustrative purposes only and does not represent any product or strategy managed by Lazard.

Source: Ken French data library [http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data\\_library.html](http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html)

inefficiency by showing the number of sell-side analysts covering small caps versus large caps. The “Street” is significantly more active with large-cap coverage. Globally, roughly 20% of small-cap stocks do not have any sell-side coverage, which would be unthinkable in large- or mega-cap equities.

The opportunity in small-cap companies significantly expands when global or international companies are considered.<sup>5</sup> International strategies oriented toward large-cap stocks outnumber those of small-cap stocks nearly tenfold.<sup>6</sup> If there are “dusty corners” in present-day equity markets, we can expect that some of the cobwebs may be aggregating in small caps.

Another reason why small caps have significantly less sell-side coverage than large caps is due to their greater numbers. Their total is more than three times that of mid and large caps (Exhibit 5). The combination of a larger opportunity set within a volatile and less efficient asset class, provides active managers with more opportunity to find value.

Investors, or the “buy side,” have also been slow to take advantage of the small-cap equity universe. This asset class only began to be acknowledged among global and international investors in 1998, when MSCI created a small-cap index, nearly 28 years after its EAFE large-cap index was created in 1970.

## Exhibit 3 Drivers of Small-Cap Performance

### Typical small-cap outperformance

- Earnings upgrades
- Declining interest rates
- Rising liquidity
- Increasing risk appetite
- Rising economic activity
- Credit readily available
- M&A active in the market

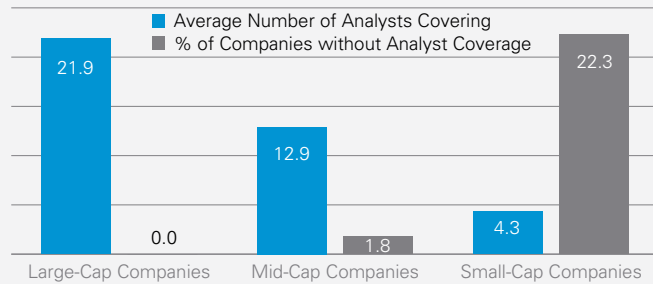
### Typical large-cap outperformance

- Earnings downgrades
- Rising interest rates
- Falling liquidity
- Decreasing risk appetite
- Falling economic activity
- Credit-constrained market
- Limited M&A environment

This information is for illustrative purposes only.

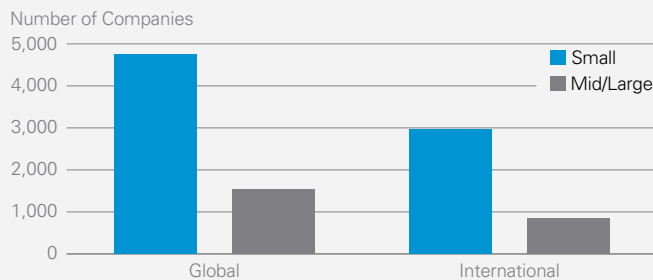
Given the wider opportunity set, and the lower level of attention from both the buy and sell sides, it is not surprising that, over the past ten years, the average MSCI EAFE Small Cap active manager has added a further 159 basis points (bps) per year to the index's return, as opposed to the 64 bps of added return by the average MSCI EAFE Large Cap manager (Exhibit 6). Results are strikingly similar for the US universe.

**Exhibit 4**  
**Sell-Side Analyst Coverage Dwindles with Size**



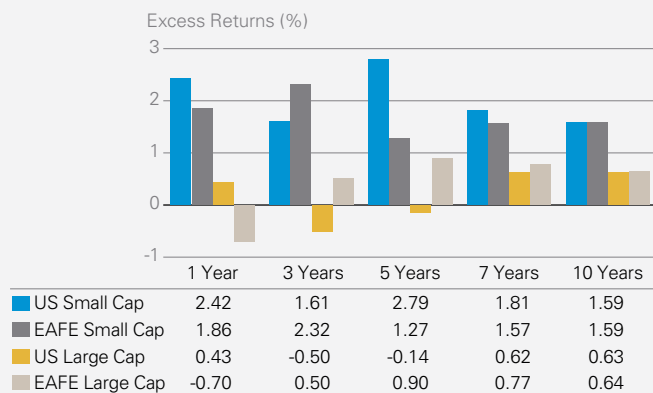
As of March 2012  
Data are based on Russell Global Developed ex-US indices  
Source: Thomson Reuters, Credit Suisse Research

**Exhibit 5**  
**A Large Opportunity Set**



As of 14 August 2014  
Data are based on country constituents for developed markets.  
Source: Bloomberg

**Exhibit 6**  
**Small-Cap Managers Have Added More Value than their Large-Cap Peers**



As of 31 December 2013  
Data are based on eVestment manager universes. Small cap benchmarks are MSCI EAFE Small Cap Index and Russell 2000 Index for international and US respectively. Large cap benchmarks are MSCI EAFE Index and Russell 1000 Index for international and US respectively. The performance quoted represents past performance. Past performance is not a reliable indicator of future results. This information is for illustrative purposes only and does not represent any product or strategy managed by Lazard.  
Source: eVestment, MSCI, Russell Investments

## Sector Composition and Valuation

Small- and large-cap valuations oscillate and, at different points in time, one asset class can seem much more attractively valued than the other. However, valuation comparisons can be misleading when made between asset classes, especially without regard for nuance. Large-cap and small-cap indices do not have the same sector exposures, and valuation comparisons between the two will not account for these differences. Put another way, while a basket of groceries from store A may be cheaper than a basket of groceries from store B, any meaningful conclusions about value are premature until the contents of each basket are known. After all, the more expensive basket may contain fresh produce and the other may be full of canned peas. As of June 2014, the composition of the MSCI EAFE Large Cap Index varied significantly versus the MSCI EAFE Small Cap index, which is also true for the MSCI World Index (Exhibit 7).

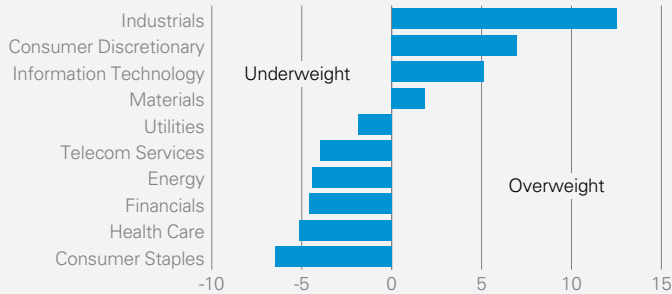
Defensive companies, such as those in the consumer staples, health care, telecom services, and utilities sectors, accounted for only 16% of the MSCI EAFE Small Cap Index, as opposed to 33% of the MSCI EAFE Large Cap Index (with similar results in the MSCI World Index versions), as of 30 June 2014. The defensive sectors of large-cap indices are populated with former growth companies that have regulated or capped returns, such as utilities, large-cap pharmaceuticals, tobacco, or telecom operators. These low-multiple companies are scarcely present in small-cap indices. On the other hand, small-cap indices have many more early-stage companies that are still unprofitable, which would tilt the scales in favor of large-cap indices in any comparison of earnings-based metrics (e.g., price-to-earnings [P/E] ratios and earnings yield).

Small-cap indices have a higher weight in cyclical sectors, such as industrials, technology, and consumer discretionary. As a result there will be certain periods in the economic cycle when small-cap earnings may be depressed, making these stocks appear expensive. At the same time, these sectors may be heading into a cyclical upswing, which would be a very rewarding time to buy small-cap equities.

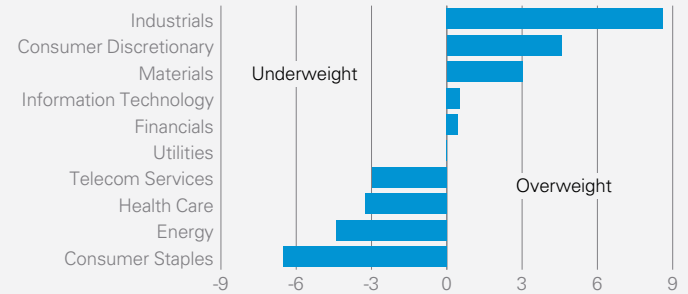
As of the third quarter of 2014, small-cap stocks are more expensive than their large-cap peers in most markets, on a P/E basis. However, given the faster earnings growth of small caps and their more cyclical nature, that valuation gap may be overstated. After years of balance sheet repair, corporations have unprecedented amounts of liquidity in the form of cash on the balance sheet or low-interest debt available via banks or the public markets. We believe corporate managers and boards may now have the confidence to spend some of their cash reserves or take on debt as they struggle to advance earnings in a low-growth economy. The cash on large-cap balance sheets alone represents about 40% of the aggregate market cap of small caps globally (in Europe this number is about 72%, and it is 56% in the United States and Canada).<sup>7</sup> We believe the current backdrop is conducive to large caps increasing activity on acquiring small caps. At the same time, small caps have low levels of leverage, leaving ample room for more borrowing. As such, we also anticipate more acquisitions or consolidation within the asset class. This adds another outlet for value to be realized, as an acquisition target generally receives a premium to the market price.

## Exhibit 7 Sector Composition of International/Global Large and Small-Cap Indices

Relative Sector Weights MSCI EAFE Small Cap Index vs. Large Cap Index (%)



Relative Sector Weights MSCI World Small Cap Index vs. Large Cap Index (%)



MSCI EAFE Index Weights (%)

Style	Sector	Large Cap	Small Cap	Small minus Large
Cyclical	Consumer Discretionary	10.8	17.7	7.0
	Industrials	10.2	22.7	12.5
	Information Technology	3.9	9.0	5.1
	Materials	7.6	9.5	1.8
Defensive	Consumer Staples	12.4	5.9	-6.5
	Health Care	11.7	6.5	-5.1
	Telecom Services	5.4	1.4	-4.0
	Utilities	3.8	1.9	-1.9
Neutral	Energy	8.4	3.9	-4.4
	Financials	25.9	21.4	-4.6

As of 30 June 2014  
Source: FactSet, MSCI

MSCI World Index Weights (%)

Style	Sector	Large Cap	Small Cap	Small minus Large
Cyclical	Consumer Discretionary	10.6	15.1	4.6
	Industrials	9.8	18.4	8.6
	Information Technology	12.6	13.2	0.5
	Materials	5.2	8.2	3.0
Defensive	Consumer Staples	10.6	4.1	-6.5
	Health Care	12.6	9.3	-3.2
	Telecom Services	3.8	0.9	-3.0
	Utilities	3.0	3.0	0.0
Neutral	Energy	10.8	6.4	-4.4
	Financials	21.0	21.4	0.4

## Asset Class Correlations

International small-cap stocks have historically provided superior returns relative to large-cap stocks, and can also provide benefits in terms of total portfolio construction. For example, an investor with significant exposure to US large-cap equities can obtain better diversification from international small-cap companies than from large caps. In general, small-cap companies are more domestically oriented than large-cap companies (such as multinational firms Danone and Unilever). This results in less overlap in geographic exposures when investing in small-cap stocks, thereby providing better diversification than the global footprint exposure of large caps.

Over the past fifteen years, the correlation between US large-cap stocks and international and global small caps has been 0.76 and 0.84, respectively (despite US stocks being a large proportion of the global universe). In comparison, the correlation of US equities with large- and mid-cap stocks was much stronger at 0.87 and 0.97 (international and global respectively).<sup>8</sup>

Investors are more likely to gain economic exposure to a particular region by investing in small caps, since large-cap companies are more likely to generate a greater proportion of their revenue from abroad. In fact, in 2010, 49% of revenues generated by global large-cap companies were from overseas operations as opposed to only 32% for global small caps (Exhibit 8).

## Exhibit 8 Global Small Caps Have More Local Exposure than Larger Caps

Percentage of a Company's Revenues that are Foreign

		Mid/Large (%)	Small (%)
Global	2002	41	27
	2010	49	32
North America	2002	29	18
	2010	41	24
Europe	2002	68	52
	2010	77	61
Asia Pacific	2002	35	24
	2010	42	28
Emerging Markets	2002	30	24
	2010	31	24

Foreign sales are aggregated for constituents of the various regions. The data are as of 31 December for the years shown.  
Source: MSCI, Worldscope

## Our Small-Cap Approach

Lazard's Global and International Small Cap Equity teams employ a relative-value approach. In doing so, we assess the trade-off between small-cap companies' financial productivity and their valuation. Financial productivity can be measured by a company's cash-flow-based return on equity and return on total invested capital. We favor small-cap companies with strong returns on invested capital as we believe that companies that rate highly on this measure typically compound their advantages over time. There is support for this idea in contemporary financial literature. Popular investing books, such as *The Little Book That Beats the Market*,<sup>9</sup> have supported the notion that firms with superior returns on capital outperform firms that fail to earn back their cost of capital. As a result of our emphasis on financial productivity, our analysts constantly screen the global investment universe for small-cap companies with high or improving returns on invested capital and that are also trading at an attractive price (i.e., high earnings yield). The vitality of this strategy has been documented in a paper by Louis Florentin-Lee of Lazard, where he confirms that return on capital and subsequent stock market performance are positively correlated.<sup>10</sup> Florentin-Lee's paper was focused on large caps, but this method also drives our approach to small-cap investments.

There is little to prevent investors from constructing a basket of companies with high or improving returns, as well as high earnings yields. Indeed, there are so-called fundamentally enhanced passive indices that allow just that. However, such strategies are not capable of identifying discrepancies in a company's financial reporting that could result in a false impression of their financial standing.

Importantly, our analysts engage in accounting validation as a precautionary step that is designed to cull companies whose financial returns are inconsistent. This analysis is further supported by qualitative research. We spend considerable time with managers of companies under consideration for inclusion in our portfolios. Among other things, during our interactions, we seek to assess capital allocation frameworks to ensure productive use of high or improving returns, whether through reinvestment or as a payout to shareholders.

Small-cap management teams may not necessarily have the best interests of all shareholders in mind—as some run their companies as “lifestyle” enterprises. Thus, assessing overall management quality and incentives is an essential step in our process. Our dedicated small-cap teams partner with our sector research specialists to engage in this qualitative and quantitative analysis. Furthermore, in conjunction with our quantitative teams, the sector analysts assist in the valuation process by highlighting the most relevant metrics in a given industry. As many small-cap markets are still localized in terms of investors and sell-side research providers, a global view on a given industry is a source of insight.

We are dedicated to constructing small-cap portfolios that comprise high-quality companies with attractive valuations and, as a result of portfolio composition, we have been able to deliver a predictable pattern of returns. Enterprises that have sustainable competitive advantages and high barriers to entry, which help to protect their super-normal profits, typically defend well in times of market contraction. Companies with a high return on equity coupled with inexpensive valuations are also well-positioned to defend in fundamentally driven markets. As Warren Buffet has quipped, when the tide goes out, you see who has been swimming without a bathing suit. Cascading markets are the great humiliators of growth, momentum, and “concept stock investors.” When the inevitable periods of pessimism arise, the tide of “benefit of the doubt” recedes, risk premium increases, and unless investments are clothed in garments of high returns and/or a towel of defensible valuation, they will be exposed. This downside protection afforded by a high return and high earnings yield portfolio, coupled with upside participation in rising markets should continue to generate a favorable pattern of performance over the long run.

## Conclusion

The favorable historical outperformance of small caps over large caps is a well-established phenomenon of the capital markets. Multiple studies from academics and practitioners have validated these results, and the less-efficient structure of the small-cap equity market is one potential explanation, in our view. Globally, the small-cap opportunity set is vast and at the same time is thinly covered by analysts. As such, we believe the asset class remains a fertile ground for active stock pickers.

The “bottom-up” style of investing allows us to allocate capital where we find the most compelling trade-off between financial productivity and valuation. Strategies that allow managers to have ample room with country and sector deviations to the benchmark should be able to avoid areas of the market that are not attractive. We believe giving managers the freedom to deviate from benchmarks allows the portfolio to keep truer to its mandate of searching the world for the best ideas.

As active managers within the global small-cap space, we have a vast opportunity set of stocks from which to choose. Distilling that universe down to a portfolio of less than ninety selections is an act of Darwinian survival. Keeping the portfolio focused allows for only the best ideas to receive a very precious resource: the hard-earned capital of those that have entrusted our teams to invest according to a very well-defined and rigorously applied investment style, one that has a proven track record of success for the long run.

## About the Teams

Lazard's Global and International Small Cap Equity teams believe the breadth and depth of the small-cap universe is a fertile ground for uncovering opportunities. The teams adhere to the philosophy of "relative value" investing. This method focuses on evaluating the trade-off between valuations and financial productivity. Companies with high returns on capital have attractive features but these would only add value if purchased at attractive valuations.

The teams follow a disciplined bottom-up approach to stock selection seeking to exploit price inefficiencies in small-cap companies. All members of the International Small Cap Equity team are also part of the Global team. However, the Global Small Cap Equity team counts with one additional member. On average, investment professionals on both teams have twenty-one years of experience in small-cap equity investments.

## Notes

- 1 Banz, Rolf. "The Relationship Between Return and Market Value of Common Stocks." *Journal of Financial Economics*, 1981.
- 2 Fama, Eugene F. and French, Kenneth R. "The Cross-Section of Expected Stock Returns." *The Journal of Finance*, June 1992.
- 3 Davenport, John and Fred Meissner. "Exploiting the Relative Outperformance of Small-Cap Stocks." *American Association of Individual Investors Journal*, January 2014.
- 4 Lecubbari, Eduardo. "The Global SMid View." *J.P. Morgan Global Equity Research*, July 2014.
- 5 The distinction of global and international strategies is from the point of view of the investor's home country. For example, "international" for a US investor would cover the rest of the world excluding the United States; "global" would include the United States.
- 6 Tessin, Chris. "International Small Cap a Missed Opportunity." *Pensions & Investments*, 30 September 2013.
- 7 Data are based on J.P. Morgan's global equity universe, as of 3 July 2014. Source: Bloomberg, Datastream, FactSet, J.P. Morgan calculations.
- 8 For the period January 1999 to June 2014. US large cap stocks represented by the S&P 500 Total Return Index. International and global stocks represented by the MSCI EAFE Index (Net) and MSCI World Index (Net) in their standard and small cap variants. Source: Standard & Poor's, MSCI, Haver Analytics
- 9 Greenblatt, Joel. "The Little Book That Beats the Market." 2006. Hoboken, NJ: John Wiley & Sons.
- 10 Florentin-Lee, Louis. "Relative Value Investing." *Lazard Investment Research*, October 2013.

## Important Information

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