

International Small Cap Stocks – A New and Dynamic Asset Class

MARKET ANALYSIS

The international small cap asset class didn't exist a decade ago. Foreign countries with semi-socialist economies neglected rather than nurtured enterprise and opportunity. Banks were the only source of financing for most smaller companies and they were reluctant to bear the risk of backing new businesses — leaving entrepreneurs little capital to fund their ideas.¹

The end of the Cold War in 1989 signaled a fundamental change in the international business landscape. The Berlin Wall was torn down and so were numerous trade barriers. Europe began moving toward a single currency as part of a move to a single market for all goods and services. Many Asian countries continued their move toward Western-style capitalism. These changes, combined with continuing advancements in technology, had a profound effect on the international economic landscape and ushered in an era of innovation. Small companies have flourished in this environment, creating a new asset class for investors – international small cap.

This new asset class has begun to attract attention from a handful of investors. They are seeking asset classes that

possess the potential to generate high returns while providing an excellent source of diversification for their portfolios. The international small cap asset class offers both.

International Small Caps Trade At Lower Valuations Than Most Major Asset Classes

At a time when the S&P 500 Index and the Russell 1000 Index are trading at record levels and the valuations of individual stocks within those indices are skyrocketing, the valuations of international small

cap stocks have fallen. As shown in Exhibit A, the median price-earnings (PE) ratio for the MSCI EAFE Small Cap Index declined more than 7% between 1996 and 1999, while the PE ratio of the Russell 1000 increased by more than 40%. As a

result, at the end of 1999 the average stock in the Russell 1000 traded at an earnings multiple more than 24% higher than the average stock in the EAFE Small Cap.

There has also been a great deal of attention in the media concerning the undervaluation of U.S. small cap stocks relative to U.S. large cap stocks. For example, the median PE ratio for the average stock in the Russell 2000

Why Invest in International Small Cap Stocks

- ▶ Trade at lower valuations than most major asset classes
- ▶ Provide unmatched diversification to a portfolio
- ▶ Are not as volatile as many other asset classes

Exhibit A

Valuation of International Small Companies Declining Relative to Major Market Indices ²				
Median PE Ratios By Index				
Year End	Russell 1000	Russell 2000	MSCI EAFE*	MSCI EAFE Small Cap *
1995	17.4X	19.5X	17.2X	21.2X
1996	20.1X	22.2X	17.7X	22.4X
1997	22.3X	21.9X	19.0X	20.0X
1998	23.5X	20.0X	17.3X	15.8X
1999	24.5X	20.0X	23.0X	19.7X
Percent Change (1996-1999)	40.8%	2.6%	33.7%	(7.1)%

* based on company-by-company compilation of data from stocks in the index; data was not available for all stocks in the index

¹ Source: The Economist, Nov, 21, 1998

² Source: Prudential Securities, Inc., Unibank Securities and Morgan Stanley Capital International

At the end of 1999, the average stock in the Russell 1000 traded at an earnings multiple more than 24% higher than the average stock in the Small Cap

Index at the end of 1999 was 20.0 times earnings, substantially lower than the average large cap stock. Although U.S. small cap stocks have low valuations relative to large cap stocks, they still trade at a premium to international small cap stocks. As shown in Exhibit A, the average U.S. small cap stock had

a valuation 1.3% greater than the average international small cap stock at the end of 1999.

International small cap stocks also trade at low valuations relative to international large cap stocks. While international small cap stocks traded at a 23% premium to large caps four years ago, this trend has reversed and now the valuations of international large caps are 17% higher than small caps. Many investors believe this disparity has created a great buying opportunity, particularly with many U.S. indices at record levels.

The recent performance of this asset class suggests that individuals are beginning to try and capitalize on its low relative valuation. During the 12 months that ended January 31, the EAFE Small Cap's return was greater than the MSCI EAFE, the S&P 500, the Russell 1000 and the Russell 2000. Only the NASDAQ 100 among major U.S. indices greatly outperformed the EAFE Small Cap during that same period.

Index Returns (2/1/1999 - 1/31/2000) ³	
MSCI EAFE Small Cap	19.29%
MSCI EAFE	19.25%
Russell 2000	17.74%
Russell 1000	11.98%
S & P 500	10.35%

International Small Caps Provide Excellent Diversification to Portfolios

While international small cap stocks provide an attractive opportunity to investors from a valuation perspective, they also serve as an excellent diversifier for portfolios. This is particularly true for investors who use U.S. large cap stocks as the core portion of their portfolios.

Investors have historically relied upon a mix of large cap and small cap domestic stocks, large cap international stocks, and emerging markets equities when trying to build diversified portfolios. Such portfolio strategies have recently become less effective because the stock prices of large international and American companies now correlate together much more closely than they did earlier this decade. As shown in Exhibit B:

- The correlation of returns between the EAFE and the S&P 500 indices increased from 0.40 from January 1993 to December 1995 to 0.71 from January 1996 to December 1999.
- During the last four years, the Small Cap Index has had a correlation coefficient of 0.51 with the S&P 500 – much less than the Russell 2000's correlation of 0.77 with the S&P 500.

Exhibit B

Correlation of Returns Increasing Between Major Market Indices and S&P 500 Index⁴			
Monthly Correlation of Returns Between Index and S&P 500			
Index	Feb. 93-Dec. 95	Jan. 96-Dec. 99	Feb. 93-Dec. 99
MSCI EAFE Small Cap*	0.26	0.51	0.39
MSCI EAFE	0.40	0.71	0.59
Russell 2000	0.74	0.77	0.76
MSCI Emerging Markets	0.31	0.70	0.60
NASDAQ 100	0.76	0.81	0.80

* Data available for the index since February 1993

^{3,4} Source: Standard & Poor's Micropal and Unibank Securities, Inc.

Exhibit C

International Small Cap Asset Class Provides Excellent Diversification⁵

Monthly Correlation of Returns Between Major International and U.S. Indices (Feb. 1993-Dec. 1999)

Index	MSCI EAFE Small Cap	MSCI EAFE	S&P 500	Russell 2000	NASDAQ 100
MSC EAFEI Small Cap	--	0.85	0.39	0.45	0.33
MSCI EAFE	0.85	--	0.59	0.55	0.50
S&P 500	0.39	0.59	--	0.76	0.80
Russell 2000	0.45	0.55	0.76	--	0.84
MSCI Emerging Markets	0.54	0.60	0.60	0.61	0.55
NASDAQ 100	0.33	0.50	0.80	0.84	--

*Data available for the index since February 1993

More surprisingly, the returns of international small cap stocks correlate less with the S&P 500 than those of emerging market equities. From February 1993 through December 1999, the MSCI Emerging Markets Index had a 0.60 correlation with the S&P 500 – more than 50% higher than the correlation between the S&P 500 and international small cap stocks.

The low level of correlation of returns between international small cap stocks and other indices makes it an ideal asset class for investors trying to build diversified portfolios. This is particularly true for portfolios that rely on large allocations to technology-related stocks. As shown in Exhibit C, the EAFE Small Cap had a correlation coefficient of 0.33 to the NASDAQ 100 – the lowest level of correlation of all major indices.

International Small Caps Returns Are Not As Volatile As Many Other Asset Classes

One factor inhibiting some investors from using small international companies in their portfolios is the false perception that they are more risky and volatile investments than U. S. small cap or technology stocks or emerging markets equities. In fact, during the past four years, this asset class has been less volatile than most other asset classes.

CASE STUDY

Bellsystem24 Inc.

Bellsystem24 is the first public Japanese telemarketing firm. Since its initial public offering in December 1994, the company has expanded its services beyond phone calls and faxes to full-scale marketing programs. Today it has more than 850 employees and 10,000 telephone representatives, and is typical of many smaller international companies that have been able to capitalize on the deregulation of major industries in traditionally closed markets.⁶

Bellsystem24 provides telemarketing services to several recently deregulated financial services industries, such as banking, insurance and credit card. It has developed some of the most sophisticated call centers and databases in the industry and has adapted its marketing strategy to incorporate digital satellite television and other forms of multimedia. It has also developed an expertise in helping companies establish communication services through the internet.⁷

The company's commitment to capitalize on the rapidly changing environment for financial services companies in Japan has produced big benefits for its shareholders. Return on equity, sales and net income rose steadily this past decade, paving the way for the company to become listed on the Japanese stock exchange in 1997. Its stock price has risen ever since, climbing more than 508% from June 1997 to October 1999 alone, while the MSCI Japanese Index rose just 15.22% and the MSCI Pacific Small Cap Index declined 18.10%.⁸

⁵ Source: Standard & Poor's Micropal and Unibank Securities, Inc.
^{6,7,8} Source: Bellsystem24 Website

As shown in Exhibit D, the Small Cap EAFE's standard deviation of returns during the past four years has been about 20% less than the standard deviation of the Russell 2000. During this same period, the standard deviation of returns for the Small Cap EAFE has been considerably less than the NASDAQ 100 and emerging markets equities.

Exhibit D

International Small Cap Stocks Are Not As Volatile As Many Other Asset Classes ⁹		
Monthly Standard Deviation of Returns		
Index	Jan 96 - Dec. 99	Feb 93 - Dec. 99
MSCI EAFE Small Cap*	4.4%	4.7%
MSCI EAFE	4.2%	4.2%
S&P 500	4.4%	3.7%
Russell 2000	5.6%	4.7%
MSCI Emerging Markets	7.9%	6.9%
NASDAQ 100	7.3%	6.0%

*Data available for the index since February 1993

Summary

International small cap stocks as an asset class provide investors with the potential for high return and the ability to better diversify their portfolios. The stocks of the EAFE Small Cap trade at price-earnings multiples lower than nearly every other major index and the index's historical returns have been about as volatile as U.S. small cap stocks. Equally important, this asset class adds more diversity to an overall portfolio than U.S. small cap stocks or emerging markets equities. All these factors combine to create very attractive conditions for investing in international small cap stocks – conditions that are unlikely to persist indefinitely.

⁹ Source: Standard & Poor's Microcap

^{10,11,12} Source: SEZ Holding Website

¹³ Unibank Securities, Inc.

SEZ Holding AG

Innovation has made SEZ Holding AG, a small Austrian company, a major beneficiary of the continuing evolution in technology. It has developed a fast and nearly foolproof process for removing copper contamination from microchips, which has made it a prime vendor to most of the world's major microchip manufacturers. Founded in 1986, its clients now include 13 of the world's 15 largest microchip manufacturers.¹⁰

Today, SEZ Holding has more than 320 employees and offices on three continents. It is an excellent example of how small, international companies are able to dominate many of the niche businesses that developments in technology and the increasing shift to a single global market are creating.

While the company has developed a variety of new and innovative manufacturing processes, SEZ Holding has cemented its position as a vendor to the microchip industry through a strong client service oriented approach. It created a global presence during the 1990's by establishing marketing, sales and service operations in the U.S., Taiwan, Singapore, Japan, the U.K., Korea and France in anticipation of the increasing demand for its signature product.¹¹

SEZ Holding AG earned a listing on the Swiss stock exchange in 1996.¹² Its profits have since increased nearly 50% and its stock price has increased even more. During the final seven months of 1999 alone, the stock price rose nearly 120% while the MSCI Small Cap EAFE Index increased only 4% and the MSCI Europe Small Cap Index increased only 7.8%.¹³

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