Kayne Anderson Rudnick
Investment Management

The Case for Emerging Markets Small Cap

EMERGING MARKETS ACCOUNT FOR 85% OF THE WORLD'S POPULATION and 50% of global GDP, yet comprise only 12% of global market cap and less than 5% of global institutional investors' allocations. Over the past decade, investors have increased their allocation to emerging markets to benefit from their higher growth prospects, rising consumer spending, favorable demographics, and portfolio diversification benefits. However, to achieve this exposure, the vast majority of investor capital directed overseas has flowed to well-known large-cap companies. Unfortunately, many of these companies lack the prospects that investors originally sought. In fact, large-cap emerging markets are dominated by lower quality businesses including state-controlled firms in the financial, resources, and energy sectors, or companies that make the majority of their revenue outside of emerging markets. Conversely, emerging markets small-cap companies offer significantly greater exposure to businesses that are poised to benefit from their countries' strong secular-growth trends. Further, high-quality emerging markets small-cap companies have consistently outperformed their lower quality counterparts and the broad emerging markets small-cap index, indicating further opportunity in this subset of the asset class.

The Benefits of Emerging Markets Small Cap

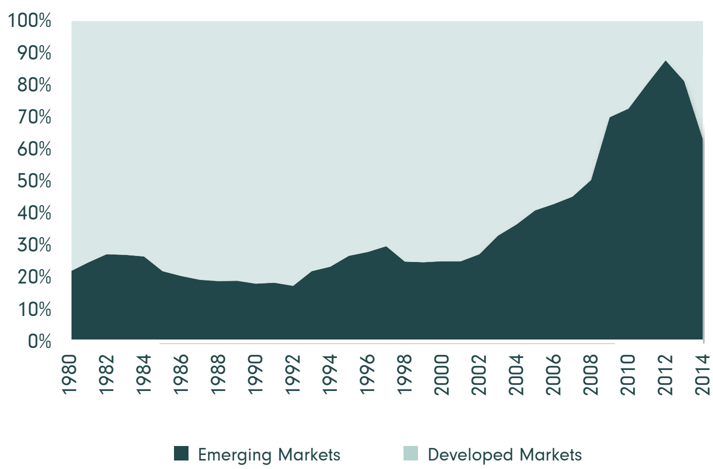
1. Higher Growth Propelled by and Emerging Middle Class

Over the past decade, emerging markets have been the primary engine of global growth, contributing 55% of total GDP global growth from 2003 to 2013, and 76% from 2009 to 2014. Further, emerging markets have grown over four times faster than developed markets, achieving a 6.0% compound annual growth rate (CAGR) versus a 1.4% CAGR for developed markets. This higher growth is the result of numerous factors, including rising urbanization, favorable demographics, and improved monetary stability.

Perhaps the strongest contributor to growth has been the rise of the emerging middle-class consumer. The Organization for Economic Co-operation and Development (OECD) anticipates that over the next decade the middle class in emerging markets will surpass in size that of developed markets. Specifically, the OECD estimates the emerging middle class will rise from 843 million people in 2009 to 2.2 billion people by 2020. To put this in context, this addition of 1.4 billion people to the emerging middle class is more than four times the size of the entire middle class in the United States today.

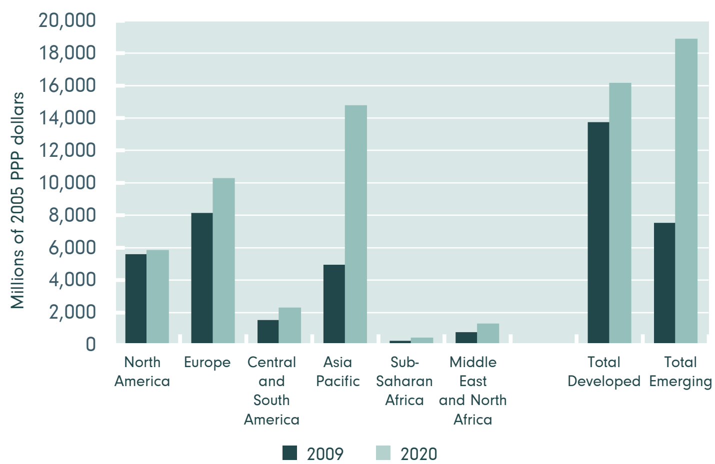
This monumental shift of the bulk of the global middle class from the U.S. and Western Europe to Asia, Africa, and Latin America will undoubtedly have important implications for global equity markets.

CONTRIBUTION TO GLOBAL GDP GROWTH:
5-Year Rolling Average



Data is obtained from FactSet Research Systems and is assumed to be reliable. Past performance is no guarantee of future results.

SPENDING BY THE GLOBAL MIDDLE CLASS
OECD Estimates



Data is obtained from the Wolfensohn Center for Development at the Brookings Institution via OECD and is assumed to be reliable. Past performance is no guarantee of future results.

2. Small Caps Better Capture the Growth in Emerging Markets

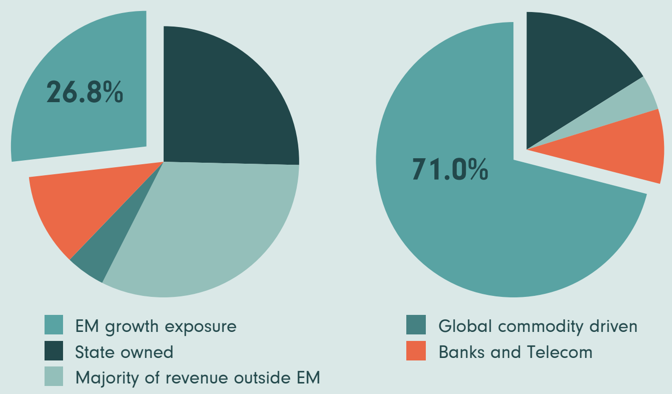
Traditionally, there are two reasons why investors choose to invest in emerging markets: 1) Higher growth prospects; and 2) diversification benefits. Yet, according to eVestment (the leading analytics database for institutional investors), 96% of investors are invested in international markets through large-cap rather than small-cap portfolios, and we believe this may not be the best approach. The emerging markets large-cap index, as measured by the MSCI Emerging Markets Large Cap Index, has a high concentration of state-owned firms, as well as companies within the sectors of energy, materials, banks, and telecom, whose prospects are more reliant on global risks and regulations than on a country's growth prospects. Additionally, the two largest holdings in the Index, Samsung Electronics and Taiwan Semiconductor Manufacturing Company (TSMC), which combined account for nearly 8% of the benchmark, generate the majority of their revenue from the U.S. and Western Europe.

History has shown the sectors that are most closely aligned to domestic demand during the development of a country are domestically-focused consumer staples, consumer discretionary, industrials, and health care. Using the largest 20 holdings in each benchmark as a proxy (the MSCI Emerging Markets Large Cap Index and the MSCI Emerging Markets Small Cap Index, respectively), companies that provide true emerging markets exposure comprise only 27% of large-cap emerging markets, whereas they compose 71% of small-cap emerging markets.

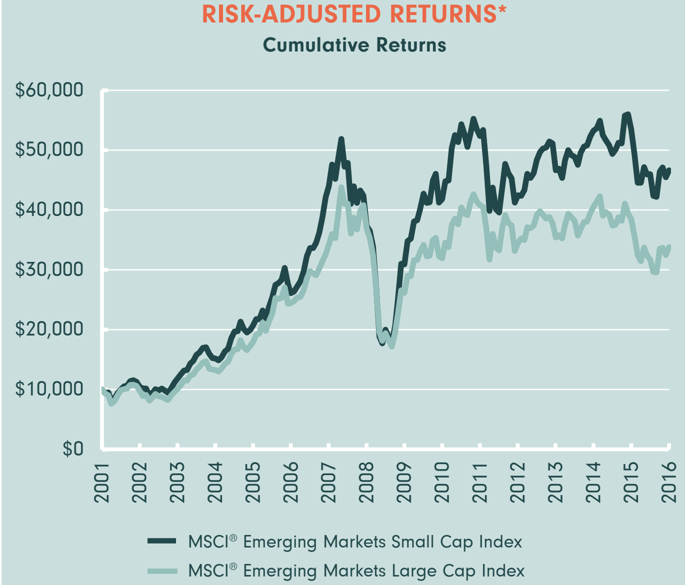
Recent history has exposed the disconnect between emerging markets secular growth and large-cap emerging markets stocks. In the past three years (2010-2013), even while emerging markets have grown above 4% per year, the largest state-owned and materials companies in the large-cap emerging markets benchmark (which comprise nine of the top 20 holdings) have collectively destroyed $222 billion of shareholder value (an 18% loss).

3. Strong Risk-Adjusted Performance

The more favorable secular-growth prospects of emerging markets small-cap stocks have resulted in higher returns. Over the past decade, emerging markets small-cap stocks have not only outperformed large-cap emerging markets but also domestic large and small-cap stocks. Importantly, because small-cap emerging market secular-growth trends are less correlated to global risk factors, these strong results have been achieved with comparable or less risk relative to emerging markets large cap companies. Subsequently, the asset class has achieved higher risk-adjusted returns, as measured by both alpha and Sharpe ratio, over the last 15 years.



Data as of December 31, 2015.
EM growth exposure defined as domestically oriented consumer staples, consumer discretionary, industrials, and health care.



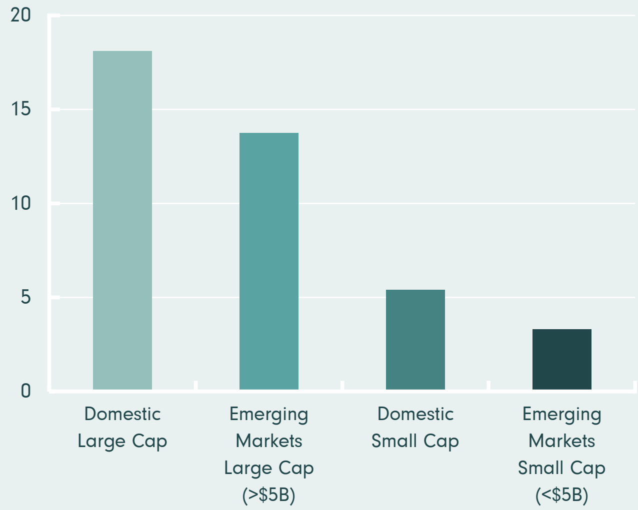
RISK-ADJUSTED PERFORMANE METRICS*

	MSCI® Emerging Markets Small Cap Index	MSCI® Emerging Markets Large Cap Index
Annualized Return	10.81	8.46
Alpha	2.55	0.00
Sharpe Ratio	0.40	0.31
Annualized Standard Deviation	23.46	22.63
Beta	0.98	1.00

**Data presented is for the fifteen years ending June 30, 2016.*
Data is obtained from FactSet Research Systems and is assumed to be reliable. Past performance is no guarantee of future results.

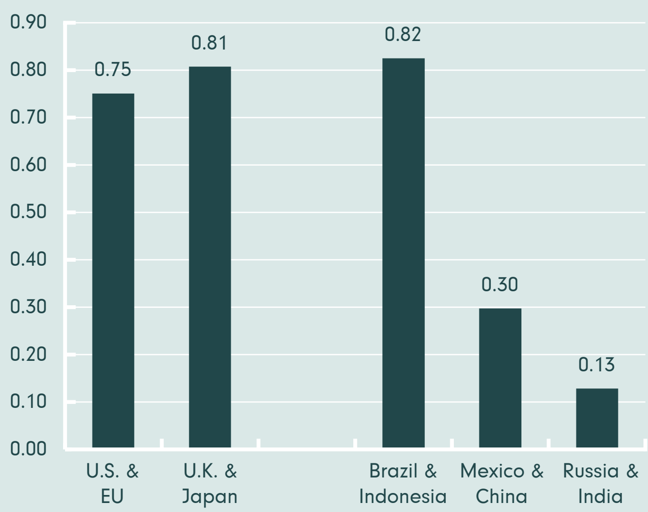
ANALYST COVERAGE

Average Number of Analysts Covering Individual stocks



CORRELATION BETWEEN REAL GDP GROWTH

2003–2013



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4. Large and Less Efficient Opportunity Set

The emerging market small-cap asset class is an enormous investible universe of over 14,000 companies, compared to the domestic small-cap universe of 6,000 companies or the emerging markets large-cap universe of about 1,000 companies. Consequently, the emerging markets small-cap universe is attractively untapped in terms of analyst attention and international ownership. This scarcity of coverage often leads to appealing pricing for a long-term investor. In fact, small-cap stocks in emerging markets still currently trade at over a 20% discount to the developed small-cap market despite their better risk and return metrics.

Data also suggests that the emerging markets small-cap universe is fertile territory for a skilled investment manager. According to eVestment, over the past five years, 57% of active managers have outperformed the MSCI Emerging Markets Small Cap Index and, over the past 10 years, 54% have outperformed the benchmark. This data indicates that a passive ETF or index approach is likely to yield inferior returns relative to an active manager.

5. Low Correlation Between Markets and Diversification Benefits

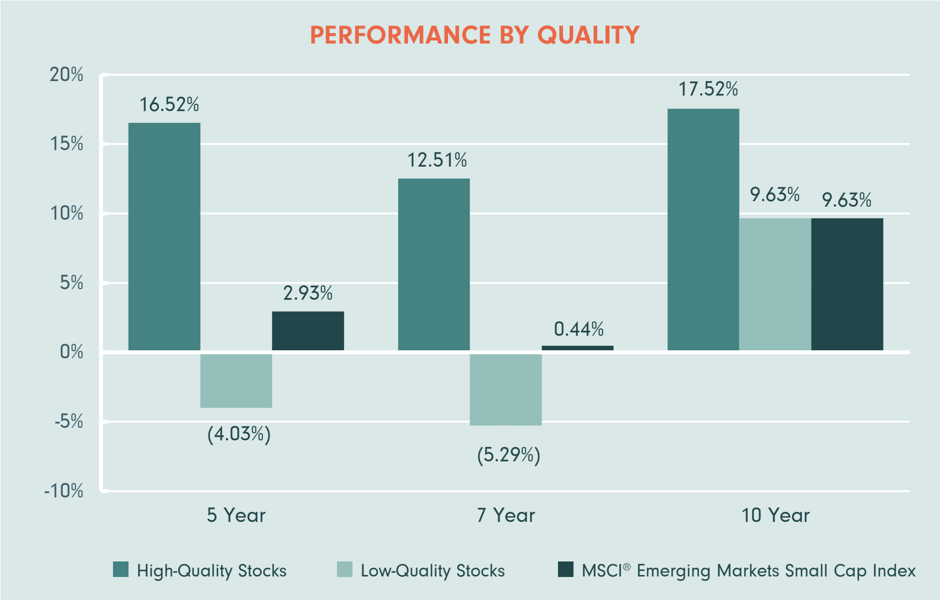
Emerging markets are often referred to as one entity, but each market is unique and has a low correlation to other emerging market countries and developed markets. For example, growth in Russia and growth in India is much less correlated than growth between the U.K. and Japan. This heterogeneity between emerging markets provides an opportunity for active investment managers to find compelling investment ideas that are less influenced by external global risk factors.

Also, as illustrated in the Correlation Matrix, emerging market small-cap stocks exhibit relatively low correlation to domestic large-cap and small-cap stocks. This further demonstrates the diversification benefits of this asset class.

CORRELATION MATRIX

	MSCI® Emerging Markets Small Cap Index	MSCI® Emerging Markets Large Cap Index	Russell 2000® Index	S&P 500® Index
MSCI® Emerging Markets Small Cap Index	1.00	0.95	0.70	0.76
MSCI® Emerging Markets Large Cap Index	0.95	1.00	0.72	0.79
Russell 2000® Index	0.70	0.72	1.00	0.92
S&P 500® Index	0.76	0.79	0.92	1.00

Data presented is for the ten years ending June 30, 2016.
Data is obtained from FactSet Research Systems and is assumed to be reliable. Past Performance is no guarantee of future results.



Periods ending December 31, 2014. Performance was calculated on emerging markets stocks with a market capitalization under $5 billion. High quality was defined as a return on equity (ROE) greater than 15% and debt-to-assets below 30%. Low quality was defined as a ROE less than 5% and debt-to-assets above 50%. The composites were rebalanced each calendar year. Holdings were equally weighted and returns were geometrically linked. Data is obtained from FactSet Research Systems and is assumed to be reliable. Past performance is no guarantee of future results.

6. High-Quality Small Cap Emerging Markets Stocks Have Outperformed

Although emerging markets small-cap companies offer better exposure to their countries' secular-growth trends, there are still a high number of sub-standard companies included in the benchmark. Currently, 10% of the companies in the index are unprofitable, indicating a filter for quality is both necessary and rewarding.

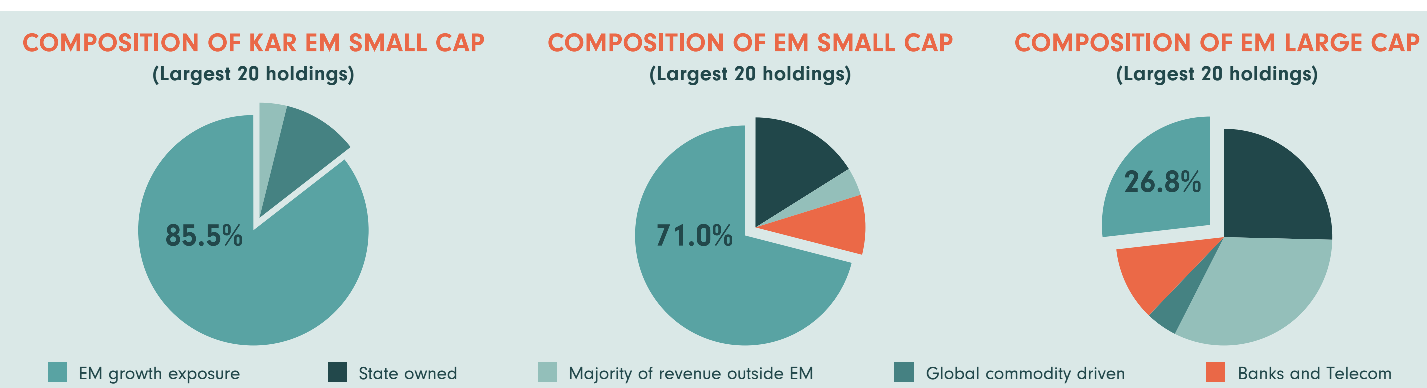
Data confirms that high-quality companies in emerging markets (defined as companies with high returns, strong balance sheets, and low earnings variance) have consistently outperformed the broad emerging markets small-cap index. Conversely, low-quality companies (defined as companies with low returns and leveraged balanced sheets) have underperformed the same index.

Kayne Anderson Rudnick

Building upon its success in the domestic small-cap markets, Kayne Anderson Rudnick is now applying the same rigorous, bottom-up fundamental research to identify the highest quality small-cap companies around the globe. The strong performance of the KAR International Small Cap strategy demonstrates that our quality bias serves us well overseas where market inefficiencies are generally higher. We will continue to identify companies with durable competitive advantages and strong, consistent growth that we are able to purchase at attractive valuations. We believe our 30 years of experience in the domestic small-cap markets will serve us well as we apply this time-tested process to the emerging markets small-cap universe.

	KAR Emerging Markets Small Cap	MSCI® Emerging Markets Small Cap Index
Earnings Per Share Growth – Past 10 Years	11.7%	9.4%
Earnings Variance – Past 10 Years	29.7%	45.6%
Dividend Per Share Growth – Past 10 Years	9.7%	9.1%
Return on Equity – Past 5 Years	21.2%	12.1%
Debt/Capital	17.4%	28.4%
P/E Ratio – Trailing 12 Months	13.6 x	18.8 x
Dividend Yield	3.9%	2.3%

Data as of June 30, 2016. Data is obtained from BNY Mellon and is assumed to be reliable. Other principal consultant firms may use different algorithms to calculate selected statistics. Estimates are based on certain assumptions and historical information. Past performance is no guarantee of future results.



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kayne.com
800.231.7414