

# Myths of International Small-Cap Investing

The objective of this paper is to examine and challenge a number of common misconceptions investors have about international small-cap investing. We aim to show that non-U.S. small stocks can be an effective source of diversification in a well-constructed and actively managed portfolio.

The premise of this paper is that diversification is desirable, based on the time-tested understanding that diversification in a portfolio could help capture greater returns and/or reduce risk, resulting in higher risk-adjusted performance.

We recognize that many investors are skeptical about international small caps in particular, even as they may be comfortable utilizing domestic small caps and international large caps. Investors also may be more willing to own emerging-market stocks expecting potentially greater degrees of both risk and return. In light of these considerations, any statistical analysis we conduct compares international small caps with international large caps and U.S. small caps, as well as emerging-market stocks.

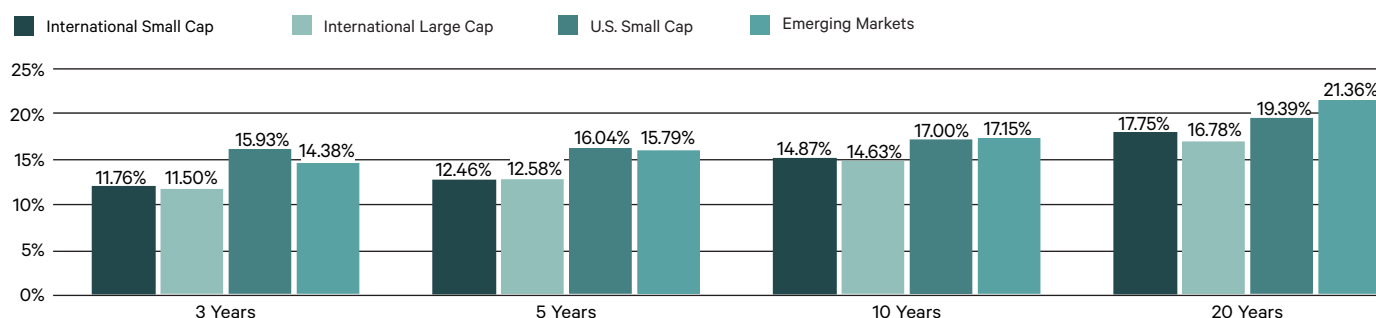
Below we observe a few common concerns about the international small-cap asset class and provide insight into how they may simply be misconceptions and how exposure to smaller foreign stocks may indeed be an important piece of a well-diversified portfolio.

## MYTH #1: International small cap is too risky

Investors, partly due to lack of familiarity, may believe that international small caps carry greater risk than do larger, better-recognized companies. However, an analysis of standard deviation—a measure of return volatility and a common gauge of risk—shows that international small caps are not necessarily riskier than international large caps, domestic small caps or emerging-market stocks. In fact, measures of international small-cap standard deviation are consistently lower than those of emerging-market stocks across all time periods observed and are lower than U.S. small caps over the long term.

By this measure, any investor comfortable with U.S. small caps or emerging-market stocks is essentially accepting greater risk than what would be found in international small caps. Similarly, any investor comfortable with international large caps would do well to know that international small-cap risk levels are in line with those of their larger counterpart. The international small-cap category does not inherently and necessarily pose higher risk than often assumed by investors.

**FIGURE 1: Historical Standard Deviation**



Data presented is for the periods ending December 31, 2019. International Small Cap is represented by the MSCI® ACWI ex-U.S. Small Cap Index; International Large Cap is represented by the MSCI® ACWI ex-U.S. Large Cap Index; U.S. Small Cap is represented by the Russell 2000® Index; and Emerging Markets is represented by the MSCI® Emerging Markets Index. Data is obtained from FactSet Research Systems and is assumed to be reliable. Past performance is no guarantee of future results.

### MYTH #2: I already have international large caps and emerging-market stocks, which should provide sufficient foreign exposure

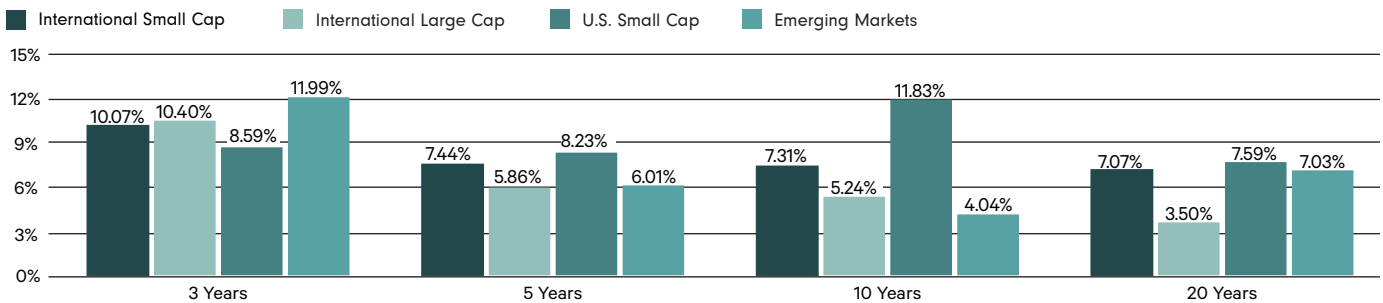
Investors may assume that ownership of international large caps and emerging-market stocks provides sufficient exposure to foreign markets. While “sufficient” is a relative term, and while there may be benefits to owning stocks of bigger enterprises, investors without a dedicated allocation to international small caps may be missing out on strong return and diversification possibilities. This is in part because the international small-cap strategy allows for greater “pure play” exposure to international investing, as it is more likely that its holdings are more closely linked to their local economies and

that their financials are driven more by idiosyncratic factors, attributes that are endemic to a particular asset and having little or no correlation with broader market factors.

The below graph shows that international small caps outperformed international large caps across 3 of the 4 time frames observed. They also outperformed emerging-market stocks for the 5-year and 10-year periods by meaningful margins, while managing to perform largely in line in the other time periods.

With largely lower standard deviation, as addressed in Myth 1, and greater historical performance than its comparable asset classes, the international small-cap category, in our view, merits an allocation to a well-diversified portfolio.

FIGURE 2: Historical Returns



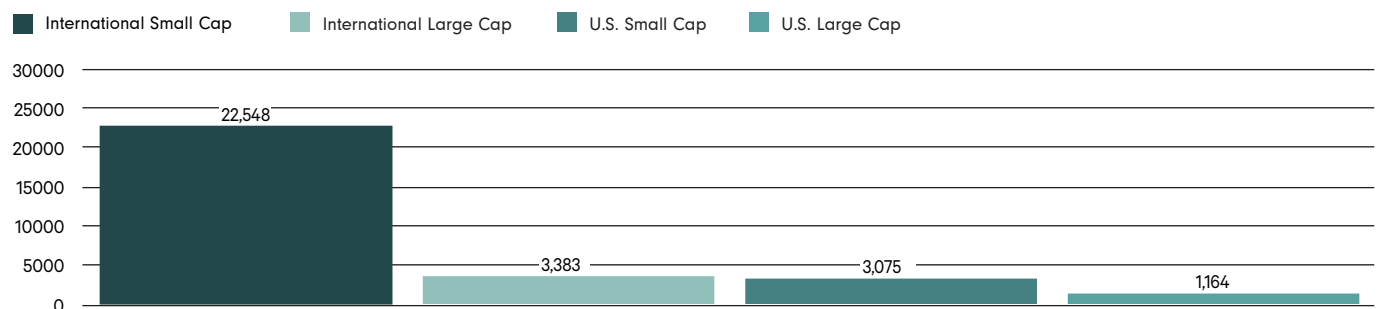
Data presented is for the periods ending December 31, 2019. International Small Cap is represented by the MSCI® ACWI ex-U.S. Small Cap Index; International Large Cap is represented by the MSCI® ACWI ex-U.S. Large Cap Index; U.S. Small Cap is represented by the Russell 2000® Index; and Emerging Markets is represented by the MSCI® Emerging Markets Index. Data is obtained from FactSet Research Systems and is assumed to be reliable. Past performance is no guarantee of future results.

### MYTH #3: I can get asset-class exposure through an ETF or index

The international small-cap opportunity set is greater in scope and less efficient than one might think. For instance, among U.S. stocks, small caps account for about \$1.8 trillion,

or 6.3%, of the overall investable universe. In the global market excluding the U.S., small caps account for about \$2.4 trillion, or 10.6%, of the investable universe<sup>1</sup>. Further, there are 3,075 companies in the U.S. small-cap category, whereas the international small-cap category comprises 22,548 companies, highlighting the breadth of the asset class.

FIGURE 3: Investable Universe - Number of Companies

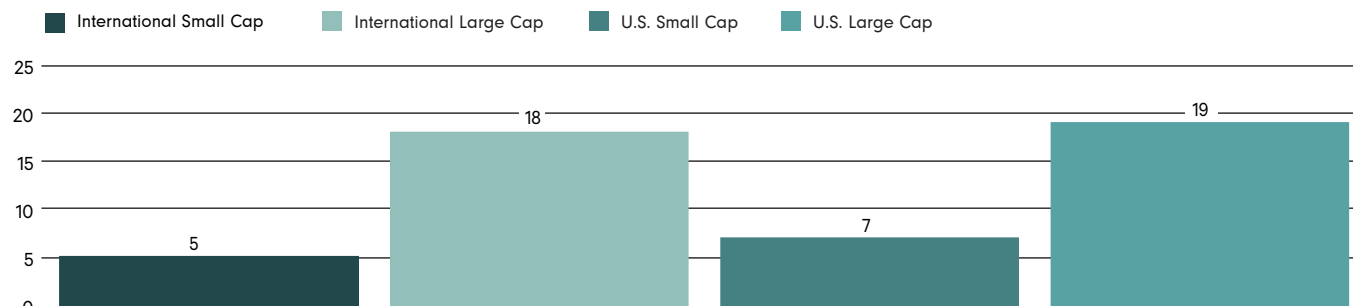


Data as of March 9, 2020. International Small Cap is represented by the MSCI® ACWI ex-U.S. Small Cap Index; International Large Cap is represented by the MSCI® ACWI ex-U.S. Index; U.S. Small Cap is represented by the Russell 2000® Index; and U.S. Large Cap is represented by the Russell 1000® Index. Data is obtained from FactSet Research Systems and is assumed to be reliable.

1. Data as of February 29, 2020. Data is obtained from Russell Profiles and MSCI Fact Sheets and is assumed to be reliable.

Not only that, the international small-cap space is also less efficient than its large-cap counterpart and U.S. market-cap categories, which is reflected in the average number of analysts covering individual stocks.

**FIGURE 4: Analyst Coverage - Average Number of Analysts Covering Individual Stocks**



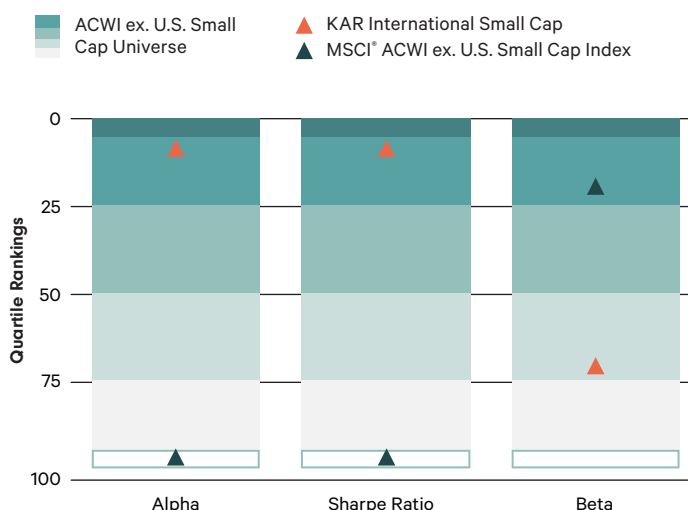
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### KAR INTERNATIONAL SMALL CAP STRATEGY

The Kayne Anderson Rudnick investment team strives to be exactly that—managers with research skills that can identify strong and competitive businesses. The KAR International Small Cap Strategy, in particular, can be said to have busted all the aforementioned myths and proven to have largely outperformed its peers and benchmark since inception in January 2012.

We believe that the below indicators of the strength and competitiveness of the KAR International Small Cap strategy are direct results of our strict research disciplines and longstanding commitment to selecting only the highest-quality companies. We continue to strive to be trustworthy stewards of our clients’ investment portfolios.

#### ACWI EX. U.S. SMALL CAP UNIVERSE COMPARISON



Data presented is for the period since inception of January 1, 2012 through December 31, 2019. Returns of the Kayne Anderson Rudnick composite are preliminary and gross of fees unless otherwise specified. For further details on the composite, please see the disclosure statement in this presentation. The ACWI ex. U.S. Small Cap Universe includes all managers categorized in the ACWI ex. U.S. small cap asset class by eVestment. Data is obtained from FactSet Research Systems and is assumed to be reliable. Past performance is no guarantee of future results.

#### PORTFOLIO CHARACTERISTICS

	KAR International Small Cap	MSCI® ACWI ex. U.S. Small Cap Index
<b>Quality</b>		
Return on Equity—Past 5 Years	27.2%	11.5%
Total Debt/EBITDA	1.1 x	4.7 x
Interest Expense Coverage	1.0 x	3.7 x
<b>Growth</b>		
Earnings Per Share Growth—Past 5 Years	24.4%	11.6%
Earnings Per Share Growth—Past 10 Years	11.6%	9.8%
Dividend Per Share Growth—Past 5 Years	13.5%	11.3%
Dividend Per Share Growth—Past 10 Years	12.5%	9.0%
<b>Value</b>		
P/E Ratio—Trailing 12 Months	21.1 x	19.9 x
Dividend Yield	2.3%	2.5%
<b>Market Characteristics</b>		
\$ Weighted Average Market Cap	\$2.9 B	\$2.5 B
Largest Market Cap	\$7.8 B	\$7.8 B

Data presented is for the period ending December 31, 2019. Data is obtained from FactSet Research Systems and 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.

## DISCLOSURE

Kayne Anderson Rudnick Investment Management, LLC claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS® standards. Kayne Anderson Rudnick Investment Management, LLC has been independently verified for the period from January 1, 1999 through December 31, 2018.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS® standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS® standards. The International Small Cap Composite has been examined for the period from January 1, 2012 through December 31, 2018. The verification and performance examination reports are available upon request.

Kayne Anderson Rudnick Investment Management, LLC, a wholly owned subsidiary of Virtus Investment Partners, Inc., is a registered investment advisor under the Investment Advisers Act of 1940. Registration of an Investment Advisor does not imply any level of skill or training. Kayne Anderson Rudnick Investment Management, LLC manages a variety of equity and fixed-income strategies focusing exclusively on securities the firm defines as high quality.

The composite includes all fully discretionary institutional and pooled International Small Cap Portfolios. International Small Cap Portfolios are invested in equity securities with market capitalizations in line with the MSCI® ACWI ex. U.S.A. Small Cap Index, that have market control, rising free cash flow, shareholder-oriented management, strong consistent profit growth and low-debt balance sheets. For comparison purposes, the composite is measured against the MSCI® ACWI ex. U.S.A. Small Cap Index (net). The MSCI® ACWI ex. U.S.A. Small Cap Index is a market capitalization-weighted index of small-capitalization stocks of the MSCI® Global Investable Market Indices Universe, excluding U.S. companies. The index is calculated on a total-return basis with dividends reinvested, net of withholding taxes. Benchmark returns are not covered by the report of the independent verifiers. The composite was created in January 2012. A list of composite descriptions and policies for valuing portfolios, calculating performance and preparing compliant presentations are available upon request.

The composite contained 100% non-fee-paying portfolios as of December 31, 2012, 12% non-fee-paying portfolios as of December 31, 2013, 12% non-fee-paying portfolios as of December 31, 2014, 7% non-fee-paying portfolios as of December 31, 2015 and December 31, 2016, 1.5% non-fee-paying portfolios as of December 31, 2017, and < 1% non-fee-paying portfolios as of December 31, 2018.

The standard management fee schedule currently in effect is as follows: 1.00% for the first \$100 million; 0.90% on the balance. Actual management fees charged may vary depending on applicable fee schedules and portfolio size, among other things. Additional information may be found in Part 2A of Form ADV, which is available on request. The performance information is supplied for reference. Past performance is no guarantee of future results. Results will vary among accounts. The U.S. dollar is the currency used to express performance. Returns are presented net of withholding taxes and net of transaction fees and include the reinvestment of all income. Gross returns will be reduced by investment management fees and other expenses that may be incurred in the management of the account. Model net returns have been calculated by deducting 1/12th of the highest tier of the standard management fee schedule in effect for the respective period from the gross composite returns on a monthly basis.

Internal dispersion is calculated using the asset-weighted standard deviation of annual gross returns for accounts in the composite for the entire year. For those years when less than five accounts were included for the full year, no dispersion measure is presented. The three-year annualized ex-post standard deviation, which measures the variability of the composite (using gross returns) and the benchmark for the 36-month period, is not presented for periods prior to 2014 because 36 monthly composite returns are not available.

3-Yr Annualized Standard Deviation (%)		
December 31	Composite	Benchmark
2014	11.99	13.33
2015	12.02	11.49
2016	13.26	12.31
2017	13.01	11.69
2018	12.39	12.52

Year	Total Firm Assets (\$ Millions)	Total Composite Assets (\$ Millions)	Accounts at Year End	Gross Annual Return (%)	Net Annual Return (%)	MSCI® ACWI ex. U.S.A. Small Cap Index (net) Annual Return (%)	Internal Dispersion
2012	6,545	4	< 5	24.87	23.66	18.52	N/A
2013	7,841	43	< 5	32.42	31.16	19.73	N/A
2014	7,989	42	< 5	(1.92)	(2.91)	(4.03)	N/A
2015	8,095	46	< 5	(0.28)	(1.25)	2.60	N/A
2016	9,989	55	< 5	22.81	21.61	3.91	N/A
2017	14,609	324	< 5	30.29	29.02	31.65	N/A
2018	17,840	905	< 5	(5.33)	(6.28)	(18.20)	N/A

The MSCI® ACWI ex. U.S.A. Small Cap Index is a trademark/service mark of MSCI®. MSCI® is a trademark of MSCI Inc.