WORLD VIEW:

Your Guide to Global Investing

Opportunities in small cap equities

By Peter Muldowney

IMAGE: GETTY IMAGES

Canadian pension plan sponsors have embraced a global approach to large cap non-domestic equity investing. In some cases, a global approach has replaced separate U.S. and non-North American mandates. In other cases, a global approach has been added to complement the separate regional mandates. Pension plans can benefit from extending this global shift to small cap equities, gaining enhanced portfolio diversification and better odds of beating the index benchmark.

There are different definitions of global small cap. According to the MSCI World Small Cap Index, *small cap* is stocks in the US$100 million to US$5 billion range, with a median company size of US$1.4 billion. Many of the stocks in the global small cap universe are household names in their local market; some even have a global brand, such as Abercrombie & Fitch (U.S.), Flight Centre (Australia) and Vitasoy (Hong Kong).

In a global context, though, small cap is not that small: there are more than 1,800 companies with a market capitalization greater than US$1 billion to choose from in the index. (There are only 240 such companies in the S&P/TSX Composite Index and 111 companies in the S&P/TSX Small Cap Index.)

The largest individual stock in the global small cap index represents only 0.17% of the index. In contrast, the largest individual stock in the S&P/TSX Composite Index represents 4.25% of its index, and the largest 15 stocks account for 43% of the index. To achieve a similar representation in a global small cap context, you would need to invest in 680 companies, which highlights the broad investment opportunity set of the global small cap universe.

The diversification benefits of global small cap go beyond individual stocks. While the major Canadian indexes are heavily skewed to the energy, materials and financials sectors (see Sector Comparison Across Indexes, page 48), the global small cap market provides representation across a much broader range of sectors, including higher exposure to healthcare and consumer discretionary (i.e., companies in the restaurant, luxury goods and travel industries). When Canadian plan sponsors have looked to improve diversification of their non-domestic equity investments, they have historically added a dedicated allocation to emerging market equities. The global small cap market provides similar diversification benefits relative to emerging equity markets.

The diversification benefits of global small cap go beyond individual stocks

SECTOR COMPARISON ACROSS INDEXES

GIC Sector	MSCI World Small Cap Index	MSCI Emerging Markets Index	S&P/TSX Composite Index	S&P/TSX Small Cap Index
Energy	7.6%	14.4%	26.6%	18.2%
Materials	10.5%	14.4%	24.1%	39.5%
Industrials	17.8%	7.3%	5.5%	10.2%
Consumer Discretionary	15.2%	7.1%	4.5%	7.6%
Consumer Staples	4.1%	6.7%	2.5%	3.5%
Healthcare	8.3%	1.0%	0.8%	1.7%
Financials	19.3%	24.2%	27.9%	14.0%
Information Technology	13.2%	13.3%	2.4%	2.4%
Telecommunication Services	0.8%	7.8%	4.0%	0.0%
Utilities	3.2%	3.8%	1.7%	2.9%

Source: MSCI and Datastream

Possible Rewards

While global small cap represents a different opportunity set, does "different" imply a good opportunity? Consider the following three potential benefits:

Growth opportunity – The most basic premise supporting an allocation to small cap equities is that large companies start small. If you can find the next generation of small companies that will grow faster and graduate into the large cap segment, the reward can be significant. It may be hard to believe, but as recently as November 2004, Apple Inc. graduated into the MSCI U.S. Large Cap Index. Global small cap companies tend to have a more focused line of business and higher insider ownership, resulting in greater alignment of interests between owners and shareholders.

Sector opportunity – Plan sponsors can benefit from the higher consumer discretionary and healthcare sectors representation offered by the global small cap index relative to other major indexes. The spending patterns in developed and emerging markets should see the consumer discretionary sector perform well over the long term. The healthcare sector should also benefit from aging baby boomers in the developed world and from demands in emerging markets for better healthcare services.

Active opportunity – Small cap companies also tend to be less externally researched by the analyst community. As a result, active managers have a greater opportunity to outperform their index benchmark by identifying companies whose share price does not fully reflect their intrinsic value or growth prospects. For example, according to eVestment Alliance, active managers over the five years ending Dec. 31, 2010, have delivered, on average, 1.7% per annum added value over the MSCI World Small Cap Index.

Not Without Risk

Global small cap equities are not without their challenges, however. While active managers can mitigate some of the risks through research and careful selection of individual stocks, investors should consider the following:

Liquidity risk – It can take longer to trade small cap stocks than large cap stocks. Small cap stocks also tend to be more sensitive to changes in market sentiment (such as a change from a bullish to a bearish outlook for a particular sector), which can contribute to greater volatility.

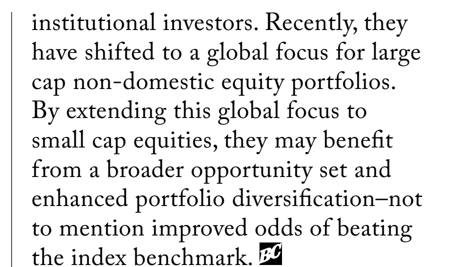
Limited information flow – While higher insider ownership aligns with the interests of investors, it can also lead to a lack of transparency and flow of information, which is commonly found with large cap investments.

Threats from large competitors – Due to their size, small companies do not have the same access to credit markets as larger companies. This may limit a small company from realizing its potential, to the benefit of a larger competitor.

One Small Step for Investors

For plan sponsors wishing to pursue a global small cap equity investment, the process is the same as for other asset classes. The consulting community maintains databases on global small cap managers in Canada and abroad, and it adopts the same due diligence approach for researching global small cap managers as for other mandates. An important consideration, however, is to understand a portfolio team's specific tenure with global small cap investing.

The need for growth while being ever-mindful of total portfolio risk is still at the forefront of the minds of institutional investors. Recently, they have shifted to a global focus for large cap non-domestic equity portfolios. By extending this global focus to small cap equities, they may benefit from a broader opportunity set and enhanced portfolio diversification—not to mention improved odds of beating the index benchmark.



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CAPS OFF: A CASE STUDY

A Canadian pension plan sponsor with a 60% equity/40% bond portfolio was interested in options for diversifying its global large cap equity portfolio. Following a review of the merits of emerging market (EM) and global small cap equity, it looked at alternative asset mixes. The objective was to maintain the plan's 40% long bond allocation and assess the merits of diversifying the 60% equity component.

The plan's equity component was 45% global large cap equity and 15% Canadian equity. In each of the following three proposed scenarios, there was no change to the 15% Canadian equity allocation, the global large cap equity allocation was reduced to 35%, and the remaining 10% was invested as follows:

Scenario 1: 10% EM equity
Scenario 2: 10% global small cap equity
Scenario 3: 5% EM and 5% global small cap equity

The table below shows the total portfolio risk and return analysis for the three scenarios for the five- and 10-year periods ending Dec. 31, 2010. The total portfolio returns are based on the relevant market index returns and asset class allocation for the different asset mixes. An allocation to EM, global small cap equity or a combination of the two resulted in a higher total portfolio return relative to the current portfolio mix, albeit with slightly higher volatility. The analysis did not take into account added value or lower volatility potential from active management.

HISTORICAL TOTAL PORTFOLIO ANALYSIS (as of Dec. 31, 2010)

	5 years		10 years	
Scenario	Return	Volatility	Return	Volatility
1 - EM equity	4.4%	9.5%	5.1%	8.8%
2 - Global small cap equity	3.6%	9.3%	4.4%	8.5%
3 - Equal combination	4.0%	9.4%	4.7%	8.7%
Current mix	3.3%	9.0%	3.7%	8.4%

Source: Connor, Clark & Lunn Financial Group and Datastream

For both the five- and 10-year periods, a 10% allocation to EM equities (and 35% global large cap equity allocation) was expected to deliver the highest return. However, when analyzing the quarterly relative returns over the 10-year period, the 5% allocation to both EM and global small cap (Scenario 3) offered the most consistent added value frequency in both up and down markets.

Many factors go into the asset mix decision. Recognizing the uncertainty associated with investing in equity markets, the proposed approach was to diversify the sources of return through exposure to both global small cap and EM equities.

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Diversification potential of emerging market debt

By Jean Charbonneau

According to an April 2010 report by Goldman Sachs Asset Management, emerging market (EM) economies have grown dramatically and now account for 43% of global GDP. By far the biggest driver is demographics, such as massive population growth and the rise of a robust and savings-oriented middle class.

EM Debt as a Core Asset

EM debt has been largely overlooked as an asset class. However, according to Pyramis Global Advisors' 2010 *Global Defined Benefit Survey,* many institutional investors are increasing their exposure to EM equities. As a result, investing in EM debt may soon become a core strategy for diversifying a portfolio with EM equities and Canadian bonds.

Following are five reasons why plan sponsors should consider EM debt in their asset allocation decisions.

1 | Attractive correlations

Emerging markets represent a unique opportunity to diversify, manage risk and achieve excess relative returns throughout various market conditions. Correlations between emerging markets and their developed market peers are still low, providing a key benefit for investors seeking diversification in an increasingly correlated global marketplace.

2 | EM bonds do not equal junk bonds

Investors often compare EM bonds with high-yield bonds (those with a rating below BBB-), but the comparison can be misleading. According to June 2010 data from the International Monetary Fund—and to the surprise of many investors—56.4% of EM bonds are now rated investment grade, compared with only 16.5% in 1998.

3 | More sustainable debt levels

There has been increased concern over sovereign debt default (the risk that a country will default on its debt obligations) in a number of developed countries. Excessive consumption levels have created significant fiscal imbalances and unsustainable debt levels within these countries. In comparison, EM countries have more sustainable debt levels and are expected to decrease debt as a percentage of GDP over the next five years (see Debt-to-GDP Ratio: Country Comparison).

4 | Strong yields favour emerging markets

EM government bond yields are typically higher than those offered by other sovereign bonds, and the fundamentals that have led to growth and stability in emerging markets (i.e., high savings rates, better regulation and a growing middle class) have significantly decreased the risk premium. The risk premium is expected to continue to narrow as EM and developed market yields converge.

DEBT-TO-GDP RATIO: COUNTRY COMPARISON

World Rank	Country	Debt-to-GDP Ratio
2	Japan	189.3
6	Italy	115.2
7	Greece	113.4
18	Canada	75.4
30	**Brazil**	**60.0**
34	**India**	**58.0**
47	U.S.	52.9
55	**Thailand**	**45.9**
87	**South Africa**	**29.5**
109	**China**	**16.9**

Source: *The World Fact Book 2011*, Central Intelligence Agency, 2009 estimates

IMAGE: GETTY IMAGES

5 | Rise of local currency debt
Historically, EM debt was issued only in hard currencies, such as the U.S. dollar (i.e., external debt). Since liquidity and transparency have improved dramatically—and, more importantly, because these countries have fewer financing needs in external currencies—more and more EM countries have issued debt in local currencies. Demand for local currency-denominated debt has also grown rapidly from rising investor demand, both externally and within the countries themselves.

External and local currency EM debt, both issued by the same country, are different asset classes differentiated by their underlying risks. External debt is measured by the spread over U.S. treasuries and tied to U.S. monetary policy. Local currency debt (currently the largest and fastest-growing part of the EM debt market) has two different sources of return—currency and duration risk—and is tied to the monetary policy of the country of issue.

EM bonds have produced consistently strong total returns over the last several years, and the market today is larger and less risky than it was 10 years ago

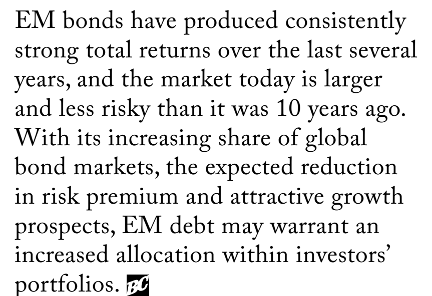
Risks and Opportunities

Investing in EM debt does not come without risk. Risks associated with investing in emerging markets include political, credit, interest rate, currency and inflationary risks, to name a few.

Interest rate differentials between developed and EM countries generally remain attractive. However, inflation and currency risks are still a threat. With regard to currency risk, a significant portion of return for an unhedged portfolio will come from currency. Diversified currency exposure—including diversification away from the U.S. dollar and the euro—can enhance returns.

Rising inflationary pressure is the inevitable consequence of rapid expansion. Recent EM performance reflects mounting concerns of a slowdown in growth rates from tightening policies. Inflation, while still a concern, is showing signs of stabilizing in many countries.

EM governments have learned valuable lessons from the sovereign debt crises and currency devaluations of the mid- to late-1980s and have since transformed their fiscal situations. Most have introduced flexible currency exchange rates, accumulated vast reserves of foreign currencies and reduced their debt levels, resulting in a structural improvement in creditworthiness of their markets, and have considerably reduced volatility.



EM bonds have produced consistently strong total returns over the last several years, and the market today is larger and less risky than it was 10 years ago. With its increasing share of global bond markets, the expected reduction in risk premium and attractive growth prospects, EM debt may warrant an increased allocation within investors' portfolios.

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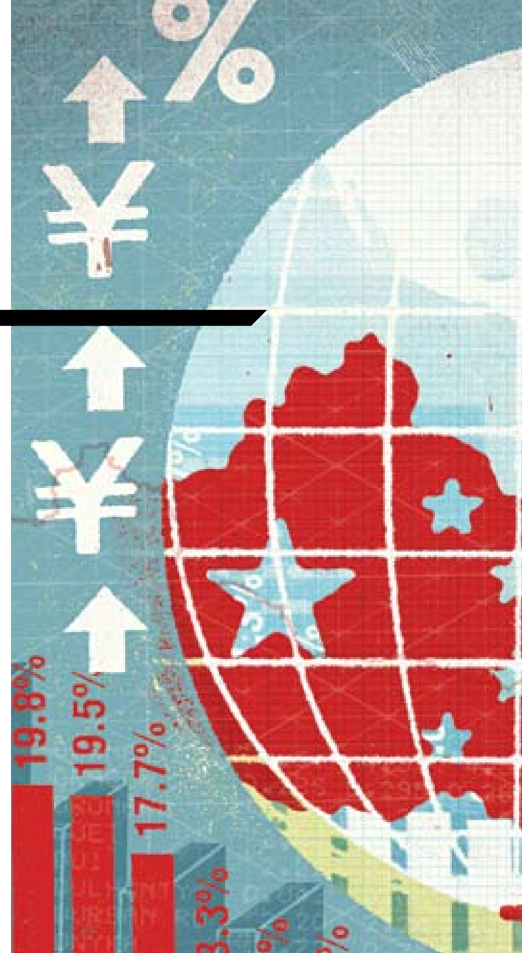


The microfinance movement

By James Clark

How can Canadian pension plans promote economic growth in the developing world while still meeting their obligations as pension fiduciaries? Until now, many plans have been buying emerging market debt and equities, but there is an alternative: investment in a microfinance fund.

Microfinance lending has been around since the 1970s. According to a Deutsche Bank report, an estimated $25 billion was at work in microfinance in 2006. More recent research shows that the market for microfinance has grown further and could potentially reach $100 billion. Major European pension funds are investing in this emerging opportunity—for example, prominent Dutch pension funds have been investing in microfinance for a number of years.

Following is a look at the potential benefits and challenges of microfinance, the investing approach and how it fits with other asset classes.

How Microfinance Works

Microfinance is the process of providing small, short-term loans to entrepreneurs in emerging and frontier markets. If a local business in East Africa needs a small loan (say, $500) to buy inventory, for example, it can borrow from a microfinance institution (MFI). Think of an MFI as a specialized type of bank: it raises money from investors mainly by issuing debentures and sometimes by issuing share capital. It then lends that money out to micro entrepreneurs. There are more than 3,000 MFIs operating across the globe, each responsible for lending, credit and collection activities in its own market.

A microfinance fund—which raises investment capital from pension funds, endowments, foundations and retail investors mainly in developed markets—researches and evaluates the universe of MFIs and makes loans (and sometimes equity investments) to support those MFIs that are "investment-ready."

A typical microfinance fund holds a portfolio of short- to medium-term loans denominated in hard currencies (U.S. dollars and euros) and some local currencies, with equity exposure used in some funds. A well-constructed portfolio has a diversified term structure, which ensures that there is appropriate liquidity for investors even though virtually no secondary market for loans to MFIs exists at this stage. With these characteristics, microfinance funds can be a good diversifier from traditional equity and fixed income investments and may be useful to include in the absolute return bucket of the asset allocation process.

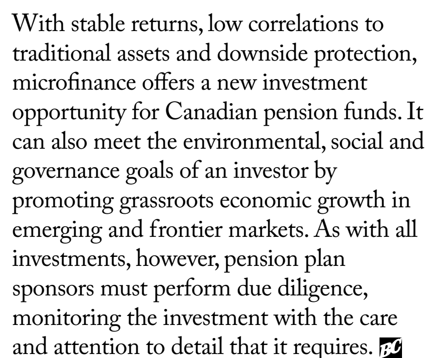
Key Considerations

All Canadian pension funds and endowments seek consistent annual returns with low levels of volatility and good downside protection. A microfinance fund can provide these returns and protection by investing in a portfolio of loans and related securities to a diversified group of high-quality MFIs in a wide range of countries.

Because of the "micro" nature of the economic growth being promoted, microfinance funds were relatively de-correlated from the 2008 financial crisis in the developed markets. An investment in a microfinance fund also has the benefit of supporting developing economies in a tangible and practical way—a laudable goal, provided that the pension plan can meet its fiduciary duties.

While microfinance lending is a well-established practice, with more than 15 years of experience at some MFIs, it does have its challenges. Some recent press coverage has questioned the impact of microfinance investments on poverty alleviation, calling for a more in-depth commitment of industry practitioners on measuring achievement of its objectives. However, microfinance continues to be an important driver of economic development in emerging and frontier economies, where financial inclusion and access to fair, transparent and properly regulated financial services are still limited.

Pension plan sponsors should approach investing in microfinance funds as they would any investment manager search: follow the traditional Four P's of people, philosophy, process and performance. Some of the specific questions will have to be tailored to microfinance—for example, the process by which the investment manager researches and monitors the activities of the MFIs in which they invest. Plan sponsors will also need to understand the historical experience of the investment manager and any liquidity constraints that may exist.



With stable returns, low correlations to traditional assets and downside protection, microfinance offers a new investment opportunity for Canadian pension funds. It can also meet the environmental, social and governance goals of an investor by promoting grassroots economic growth in emerging and frontier markets. As with all investments, however, pension plan sponsors must perform due diligence, monitoring the investment with the care and attention to detail that it requires. BC

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IMAGE: GETTY IMAGES