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April 3, 2009

It's a Small World After All

Fidelity has two funds fishing the international seas for small cap companies: **International SmallCap** (since 2002) and **International SmallCap Opportunities** (since 2005). As of April 2nd, Vanguard's joining that hunt with its newest international offering, **World ex-US SmallCap Index**. The fund is available in investor, institutional and ETF shares, and will attempt to track the FTSE Global Small Cap ex US Index of approximately 3,300 stocks in nearly 50 countries worldwide.

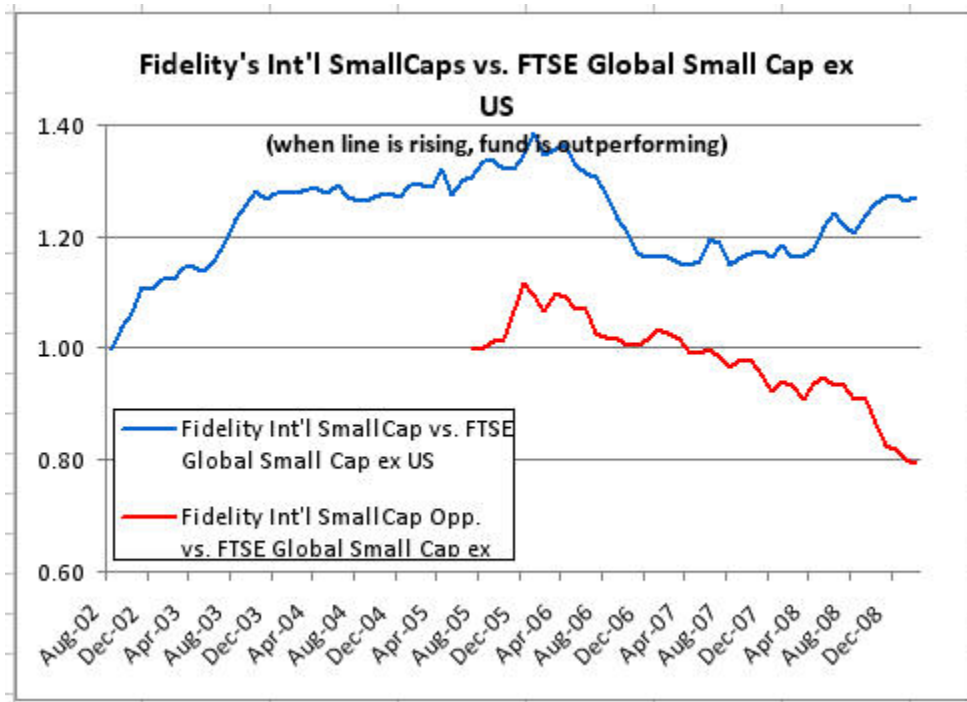
Since this is Vanguard's first international small-cap index fund, we'll check its net first, and then look at the Fidelity veterans of the fleet below.

The World ex-US SmallCap Index will probably be most popular in the ETF share class (ticker: VSS), which has an estimated expense ratio of 0.38% (plus standard brokerage fees), while its investor class (VFSVX) charges 0.60% in expenses and will also clip investors for 0.75% front- and back-end loads, with a minimum initial investment of \$3,000.

It will be interesting to see how World ex-US SmallCap competes with International Explorer, Vanguard's excellent managed small-cap international fund. While smaller foreign companies have suffered of late, and International Explorer along with them, the management team at Schroder Investment Management has run circles around World ex-US SmallCap's bogey in the past. If you take a look at the chart below, you can see the managed fund's absolute dominance up to about the beginning of 2000, followed by three years of index-lagging performance. From 2003 up to early 2007, it was about a wash, with International Explorer falling off a bit in 2007 and 2008, although relative performance did sway back to the managed fund's favor more recently.



How have the two Fidelity funds fishing similar seas fared? As you can see in the chart below, International SmallCap has outperformed the FTSE bogey consistently since inception, with one brief bout of underperformance in 2006. While International SmallCap Opportunities' early performance against the FTSE Global Small Cap ex US was similar to its sibling fund, it failed to make its big brother's turn into positive relative performance territory in 2007. One reason for the disparity could be International SmallCap Opportunities' more aggressive, concentrated portfolio. The younger fund has just over a fourth of the holdings of International SmallCap—93 vs. 354—through February. International SmallCap also has been more conservative with its bets in the financial sector of late, and has relied more heavily on the established markets of Europe and Asia than International SmallCap Opportunities, with its heavier allocation to US companies.



The determining factor for many investors choosing among these funds may be the entry fee—Vanguard International Explorer requires a rather hefty \$25,000 minimum initial investment, which could be an obstacle for some, while Fidelity International SmallCap is currently closed to new investors. Fidelity International SmallCap Opportunities only requires a \$2,500 investment to get in the door, but its performance history since inception has hardly been confidence-inspiring. For those seeking an international small-cap fund for their portfolio, we would give the nod to Vanguard's International Explorer (or if it reopens, Fidelity International SmallCap). The team at Schroder's has proven that they can beat the index over multi-year periods, and we feel it's only a matter of time before they outperform again.

Fewer Funds of Funds

In other international fund news at Vanguard, Total International Index's transition from a fund-of-funds to a directly invested equity fund, begun six months ago, is reportedly now complete. The fund once split its assets among Emerging Markets Index, European Index and Pacific Index, but the fund now exclusively invests in stocks from those three regions instead.

Why the change? Vanguard has said that they feel that being directly invested in stocks allows greater flexibility in trading and tracking the fund's benchmark. The setup also allows investors to apply the foreign tax credit on their tax returns, something previously denied them under the fund-of-funds setup.

Vanguard recently announced that it would be making a similar change to Developed Markets Index's structure—transitioning it from investing in European Index and Pacific Index to directly investing in stocks in those regions instead, starting in June. There's no expected change in the fund's expense ratio or that of the underlying funds as a result.

Fidelity Manager Moves

Fidelity made a few manager changes as of April 1st, none of which should be of concern to investors.

Matthew M. Fruhan was appointed manager of Mega Cap Stock, succeeding Richard R. Mace Jr., who has retired after 22 years at Fidelity. Fruhan will continue to manage Large Cap Stock (and its Advisor shares), which he has managed since 2005. He got his start with the firm in 1995, and began managing a variety of Select funds in 1999. According to Jim Lowell's year-end 2008 proprietary Manager Rankings, Fruhan is a bit of a step down from Mace as a manager. Mace ranked 10th out of 39 broad domestic equity fund managers, while Fruhan came in at 26th for his performance on Large Cap Stock. While Mega Cap Stock could fit the bill for investors seeking a fund covering the large- to mega-cap market segment, we would suggest that one consider Magellan instead, which has some overlap with Mega Cap Stock, but takes a more global and capitalization diversified approach.

John Mirshekari was named manager of Select Air Transportation and John Sheehy is now manager of Select Defense and Aerospace, both succeeding Maurice FitzMaurice. Mirshekari will continue to manage Select Transportation, for which he assumed responsibility in 2009. He's been with Fidelity since 2003, getting his feet wet as an equity research analyst, where he, appropriately enough for his current postings, followed transportation-related industries.

Sheehy currently manages Select Paper and Forest Products, which he took on in 2008. He's been with Fidelity since 2007, following companies in the paper, forest products and packaging sectors. Prior to joining the firm, Sheehy was an audit manager from 1998 until 2005 for Deloitte LLP.


We would not recommend either of these sector funds to a vast majority of investors, as we feel that the risks in very specific, niche sector investing outweigh the rewards. We prefer to let our chosen managers, who take a broader, more diversified approach, make sector bets within their portfolios instead.

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