

Going Small Overseas— Why It Makes Sense

While savvy investors know there's no free lunch, sometimes a good deal can be hiding in plain sight. That's why we think it's worth considering an allocation to smaller company stocks in foreign markets.

Our investment team has found that stocks of smaller foreign companies have, with few exceptions, delivered stronger returns—without added risks—than those of larger foreign companies over the last 20 years.

In this *Adviser Investments Special Report*, we focus on two main points: The opportunity for active managers to outperform in the foreign small- and mid-cap arena (s/mid-caps) and the attractive risk-return profile of these stocks over time.

A Rich Set of Global Opportunities

We believe that portfolio diversification demands investing in companies domiciled both in the U.S. and overseas. Doing so enables us to pursue a wider opportunity set of companies across economies, currencies and markets. (For more on why we believe in diversifying your investments around the world, please read our *Investing Globally: More Variety, More Opportunities* special report, available online at www.adviserinvestments.com/reports/investingglobally.pdf)

What makes foreign s/mid-cap companies so attractive for active managers is that they tend to be overlooked, under-researched and under-owned.

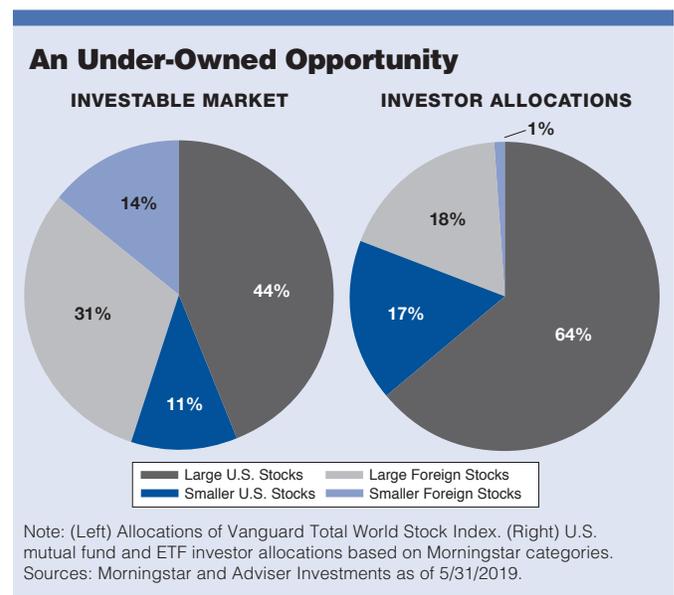
Remarkable Breadth. There are about 5,300 smaller companies outside the U.S.—more than three times the number found in the U.S. More stocks to pick through doesn't automatically translate into better investment results, but it does offer broader opportunity. Prospects are further enhanced when you spread those 5,300 stocks across 40 or so countries, each with its own local market.

Under-Researched. Given the large number of smaller companies overseas, it probably isn't surprising that these stocks are underfollowed and underrepresented in investor portfolios. While the average company in the U.S. is followed by 12 analysts, just five analysts typically cover a smaller foreign public company.

Under-Owned. As you can see in the charts below, while non-U.S. s/mid-caps make up 14% of the global markets by size, equity mutual fund and ETF investors typically allocate just 1% of their portfolios to these funds. By contrast, though the U.S. s/mid-cap market is smaller than its foreign equivalent (11% of the global market), investors collectively have 17% of their portfolios invested there.

Active Managers Make a Difference

It isn't just conjecture that active managers can have success investing in smaller foreign stocks. Consider that Vanguard's FTSE All-World ex-U.S. Small Cap Index fund has *trailed* 72% of its peers over the last five years and 89% of them over the last 10 years through June 2019, according to Morningstar. That's in stark contrast to the U.S. large-cap fund space, where Vanguard 500 Index has *beaten* about 85% of peers over the last five and 10 years.



We've never suggested that investors should buy the average fund manager, but the numbers—as surprising as they might be—suggest that even the average foreign s/mid-cap manager could be a better bet than an index fund focused on that portion of the market.

Surprising Risks

When investing our clients' portfolios, we always put mitigating risks ahead of managing returns. Aren't stocks of smaller companies risky—or at least more risky than large-cap stocks—and wouldn't that go double for foreign markets? Surprisingly, while U.S. small-cap stocks have historically been riskier than their larger brethren, this has not been the case for smaller foreign companies.

One measure of risk that all investors focus on, particularly when it's happening, is downside risk—how far stocks slide when markets are falling. In the table below, we show the severity of the declines of large-cap and s/mid-caps in the U.S. and abroad during the five bear markets since the end of 2000—a period that encompasses nearly 20 years and two full market cycles.

As you can see, smaller companies held up better than their larger siblings during the bursting of the tech bubble starting in 2001. But in two of the four more recent bear markets, foreign s/mid-cap stocks showed no greater downside than their larger siblings. On the other two occasions, foreign smaller companies only trailed by 3% to 4%.

Contrast that with the experience in the U.S. market, where s/mid-caps trailed large-cap stocks during each of

the past four bear markets by an average of 6%.

Now consider the return side of the equation. The final column in the table shows the returns generated by each class of stock over this nearly 20-year period. Yes, s/mid-caps beat large-caps in the U.S., but they exhibited more risk. What's more, the magnitude of outperformance of smaller stocks in the U.S. is narrower than that overseas.

In short, the data shows that foreign s/mid-caps delivered greater returns than their larger peers without taking on significantly more risk.

We believe this occurs in part due to earnings and dividends. Nearly nine out of 10 smaller foreign companies are profitable, while less than 70% of smaller U.S. companies are. As a result, foreign s/mid-cap companies are paying dividends more often than U.S. companies—80% of smaller foreign stocks pay dividends while less than half of those in the U.S. pay them.

Companies that generate profits and pay dividends tend to hold up better in bear markets than those that don't. (Read more about this phenomenon in our [Dividend Growth Stocks](#) special report: www.adviserinvestments.com/reports/dividend-growth-stocks.pdf.)

Good Things Come in Smaller Packages

In sum, we think smaller foreign stocks have been overlooked for years, which creates investment opportunity for active portfolio managers and investors like us.

If you have any questions about this piece or our services, please call us at (800) 492-6868 or email us at info@adviserinvestments.com.

Foreign Smaller Companies Hold Up in Bear Markets

	Tech Bubble: 2001–2003	Financial Crisis: 2007–2009	Euro Debt Crisis: 2011	Oil Prices Crash: 2015–2016	Trade War: 2018–2019	Total Annualized Return: 12/2000–6/2019
Foreign Large	-39.4%	-56.7%	-22.8%	-18.0%	-17.9%	4.1%
Foreign S/mid	-24.0%	-59.7%	-22.4%	-9.9%	-21.9%	8.1%
Difference (Large Minus S/mid)	-15.4%	3.0%	-0.4%	-8.1%	4.0%	-4.0%
U.S. Large	-38.9%	-50.9%	-16.3%	-8.4%	-13.5%	6.5%
U.S. Small	-28.2%	-53.8%	-24.5%	-15.4%	-19.6%	9.1%
Difference (Large Minus S/mid)	-10.7%	2.9%	8.2%	7.0%	6.1%	-2.6%

Note: Table shows total returns over the periods specified. Foreign large-caps represented by MSCI EAFE NR Index. Foreign s/mid-caps represented by MSCI EAFE Small Cap NR Index. U.S. large- and s/mid-caps are represented by the Vanguard 500 Index and Vanguard SmallCap Index funds. Source: Morningstar.

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