HIDING IN PLAIN SIGHT: THE UNTAPPED POTENTIAL OF EMERGING MARKET SMALL CAPS
Investors have long debated the degree to which the applied skill of active portfolio managers can improve investment returns and generate enough alpha to justify active management fees. Indeed, alpha generation has become more difficult as investors have grown more sophisticated and the pool of unique investment opportunities has contracted. Nevertheless, evidence suggests that there are isolated areas of the market where the potential returns on investment knowledge and skill remain substantial.

In this paper, we discuss the alpha-generation potential of one such area of the market, emerging market small cap equity. With nearly ten times as many securities as the emerging market large cap universe, minimal analyst coverage, a general lack of investor interest, and ample relative value opportunities, emerging market small caps offer investors an unusually attractive combination of strong investment performance and relatively low return volatility. We expect to see this compelling but often overlooked asset class among the top performers as information becomes more accessible and growing liquidity attracts more investors.
Evidence suggests that in aggregate, it is becoming increasingly difficult for active managers to beat their benchmarks. Moreover, the median excess return of those managers that have outperformed has been declining for the past two decades (Exhibit 1).

While this issue is complex, we believe that two important factors have contributed to the structural decline in alpha across most markets:

1) Investors have gotten smarter. Today’s investors are highly educated and more talented than ever before. Approximately 90% of trades on listed stocks are now executed by full-time professionals who are constantly seeking an information advantage (that’s up from just 10% fifty years ago). Additionally, trading costs in terms of both brokerage fees and liquidity impacts have fallen and investors have ready access to more robust data, market information and investment research than they could possibly use. The industrialization of the asset management business has generally reduced (if not eliminated) the ability of most asset managers to generate levels of alpha that justify the fees they charge to clients.

2) The investment opportunity set has gotten smaller. The growth of the asset management industry in terms of both the number of participants and assets under management has caused many investors to focus on larger, highly liquid companies that are already known to the marketplace. With fewer stones unturned and increased competition for alpha, the number of unique investment opportunities has narrowed in most markets and position crowding is now prevalent.

Areas of Interest

Though research confirms that alpha levels are diminishing in most markets, it also points to isolated areas where the potential return on investor knowledge and skill is still substantial. Consider emerging market small cap equities, an asset class where the heightened competition and informational efficiencies that prevail in larger cap markets have yet to manifest. The opportunity set within the emerging market small cap investment universe is significantly larger (and manager competition within emerging market small caps is significantly lower) relative to other asset classes. This makes fertile ground for sophisticated investors seeking to capitalize on their intellectual capital and stock picking abilities (Exhibit 2).
Strength in Numbers

Because the emerging market small cap equity universe has considerably more securities than the larger cap emerging market equity universe, it tends to offer a greater number of unique investment opportunities. In fact, the pool of emerging market small cap stocks is approximately 10 times the size of the emerging market large cap universe. Indeed, companies with a market cap below US$5 billion account for more than 90% of the 8,800+ securities that are listed and traded in emerging markets.

The MSCI EM Small Cap Index has nearly twice the constituents (1,800+) of the MSCI EM Index, which is dominated by just a handful of very large companies. The 10 largest stocks in the MSCI EM Index comprise more than 16% of its overall market value, while the 10 largest stocks in the MSCI EM Small Cap Index account for only 3.4%. In fact, the market capitalization of the largest stock in the MSCI EM Index, Korean electronics giant, Samsung, has a market cap of more than US$150 billion—8 times the combined market cap of the top 10 stocks in the MSCI EM Small Cap Index.

Untapped Alpha Potential

Due in part to the sheer size of the investment universe, emerging market small cap equity is a largely unexplored asset class. With minimal coverage from sell side analysts, the existence of high quality, undervalued investments that have yet to be discovered and exploited by active investors is more likely. As of this writing, 70% of emerging market large cap stocks are covered by at least 10 analysts, while nearly 45% of emerging market small cap stocks receive no coverage at all (Exhibit 3).

There are also few investment products that are dedicated to emerging market small cap stocks. This lack of institutional investment in the asset class leaves abundant, untouched opportunities to invest in high quality businesses with rapid growth prospects and attractive valuations.

In an attempt to quantify this broad-based underinvestment in emerging market small cap companies, we examined the number of emerging market small cap products in the eVestment Alliance database (www.evestment.com) against the total number of reporting managers in the emerging market equity category. According to eVestment, less than 7% of the 486 emerging market products that reported as of March 31, 2014 identified with running small-cap products. Moreover, about 75% of those that did had less than US$500 million in assets under management (Exhibit 4).

Given so many opportunities and so few analysts and investors focusing on emerging market small cap stocks, potential alpha capture within the asset class is and will likely remain strong for some time.
Relative Value Opportunities

Historically, the range of returns within small cap equities has been much wider than the range of returns within large cap equities, indicating that the former offers more relative value opportunities (both in number and magnitude). Exhibits 5 and 6 show the annual performance spreads between the best and worst performing stocks in global and emerging market equities, respectively, for small and large cap companies.

The average monthly difference between the top- and bottom-performing quintiles shows the magnitude of small and large cap return ranges over a 23 year period. The monthly spread between the top and bottom performers for global and emerging market small cap stocks stood around 125 and 143 basis points, respectively, while the same measure for global and emerging market large caps stands well below those levels at about 82 and 92 basis points, respectively.

Source: Bloomberg, Datastream, FactSet, JPMorgan as of 12.31.14
Diversification Benefits

Over time, emerging market small cap companies have shown an unusually attractive combination of strong performance and relatively low volatility (Exhibit 7). Smaller company investing also tends to complement larger company investing, thus offering significant diversification benefits. Indeed, the correlation and beta of the MSCI EM Small Cap Index in relation to the MSCI World Index are much lower than those of the larger cap MSCI EM Index and the MSCI World Index. While this may seem counterintuitive, recall that in emerging markets, small and large cap share prices behave quite differently. The former are more exposed to emerging market domestic consumer spending and often operate in niche areas that have the potential to deliver strong earnings growth independent of the broader economy. The latter tend to be heavily weighted toward energy, materials and financial sectors, all of which are highly sensitive to global macroeconomic trends and state-owned enterprises.

Source: FactSet, 10.31.14

The MSCI EM Index and the MSCI EM Small Cap Index reported average market capitalizations of $4.6 billion (USD) and $321 million (USD), respectively, as of December 31, 2014.
Conclusion

Emerging market small cap equity is one of the most compelling asset classes available to investors today, but it is also frequently overlooked. Despite its strong performance, improved excess return opportunities and superior diversification potential, most retail and institutional investors have yet to incorporate emerging market small caps into their overall asset allocation strategies. Though coverage of these small emerging market stocks remains light, it is already stronger than it was just a few years ago. With managers and analysts ramping up their research efforts to meet increasing demand for alpha, we doubt that these hidden gems will remain unnoticed for much longer. As informational efficiency and liquidity within the asset class improve, we expect more investors to respond to the diminishing supply of alpha in other markets by exploiting the breadth of unique opportunities that the emerging market small cap equity universe has to offer.

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