

Spotlight on Emerging Markets Small Caps

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KEY POINTS

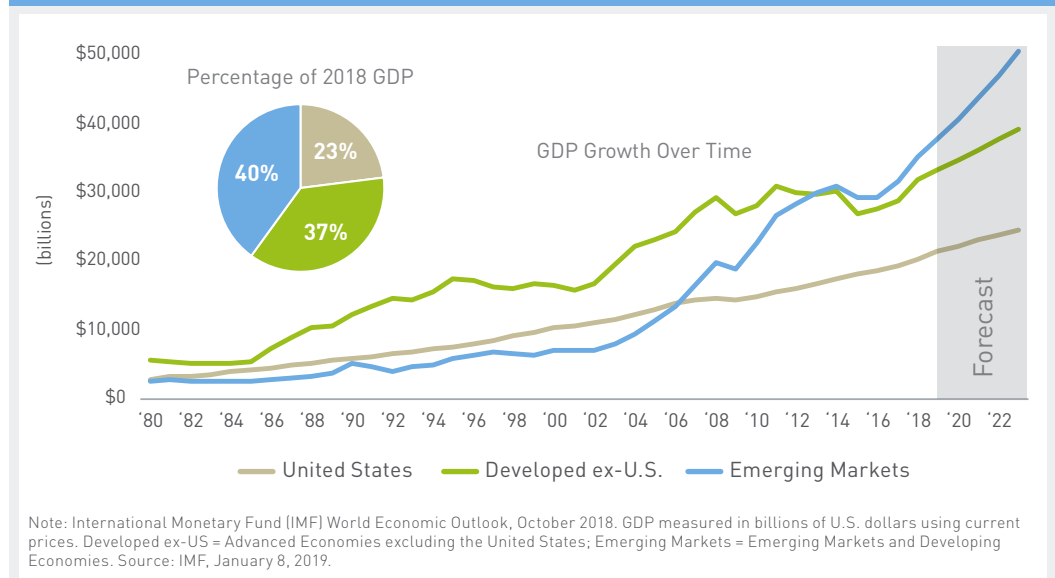
- Emerging markets (EM) small cap equities, while currently absent from many investors' portfolios, can provide a valuable addition to a traditional asset mix.
- EM small caps share similarities with U.S. and developed international small caps but offer additional unique and compelling characteristics.
- The broad set of investment opportunities in EM small cap equities can deliver new diversification and direct access to the growing economies of the emerging world.
- EM small caps may offer greater pricing inefficiencies than many asset classes and present an opportunity for active managers to provide additional excess returns.
- Although EM small caps struggled in 2018, we believe now is a compelling time to invest in EM small cap equities due to attractive valuations.

AN EXPANDED OPPORTUNITY SET

In recent decades, investors have sought to augment their U.S. large cap equity and bond portfolios by investing in new asset classes that can provide more diverse opportunities and the prospect of higher long-term returns. These goals have taken on even more urgency in the current era of low return expectations for many of the major asset classes. The ability to find market segments in which an investor may reasonably expect multiple percentage points of additional return can go a long way in helping institutions and individuals meet their return objectives. For many years, U.S. small cap stocks have been one such market segment. More recently, developed international small cap stocks have been more commonly used in search of both higher total portfolio returns as well as diversification. One of the newest areas that investors have discovered to provide these advantages is EM small cap stocks, which offer the potential for excess returns and greater diversification compared to U.S. or developed international small caps.

While EM small caps have only recently started attracting attention from many investors, these stocks provide a significant number of new and diversifying investment opportunities. With more than 1,500 stocks in 24 markets, EM small caps constitute over one quarter of the global small cap landscape.¹ Furthermore, the local economies in which these companies operate have grown to become a significantly larger part of the global economy, currently representing 40% of global GDP, as shown in the pie chart in Exhibit 1. This trend is expected to continue over the coming years, as shown in the line chart in Exhibit 1, due to both growth in emerging economy populations as well as their increasing prosperity.

EXHIBIT 1: WORLD GROSS DOMESTIC PRODUCT (GDP)

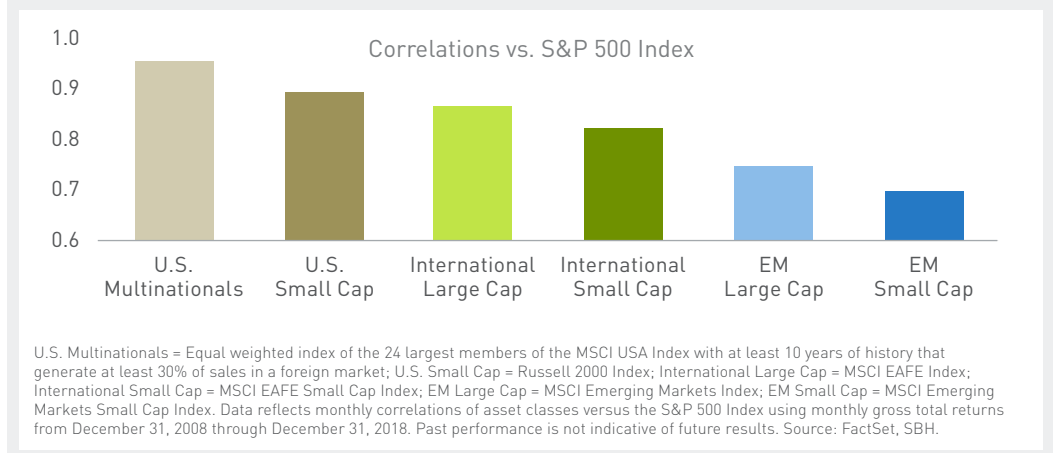


¹As of December 31, 2018, the 6,179 total number of global small cap stocks reflected 1,587 in the MSCI Emerging Markets Small Cap Index, 2,561 in the MSCI World ex-U.S. Small Cap Index and 2,031 in the Russell 2000 Index. Source: FactSet, MSCI, Russell.

DIVERSIFICATION BENEFITS OF EM SMALL CAPS

This large and expanding set of opportunities can be valuable for investors as EM small caps have also tended to deliver significantly different returns than standard U.S. large cap equity and even other small cap asset classes. Exhibit 2 shows the correlation of a number of different asset classes to the U.S. market. By moving “down” the cap spectrum to small caps and “out” the development spectrum to emerging markets, correlations continue to drop, yielding potentially greater diversification benefits. One component of EM small cap diversification is currency movement, in which U.S. dollar (USD) strength or weakness against EM currencies can, respectively, detract or enhance returns for U.S. investors.

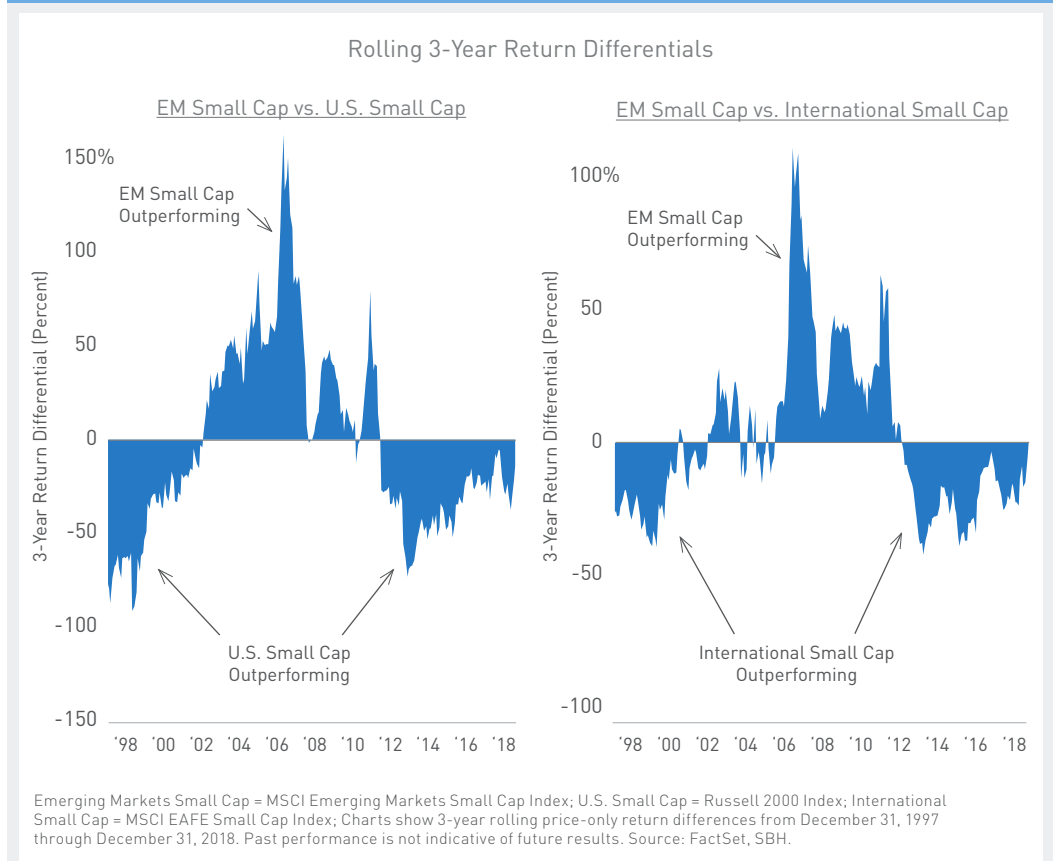
EXHIBIT 2: EM SMALL CAPS HAVE LOWER CORRELATIONS WITH U.S. LARGE CAPS



Emerging markets small cap stocks offer the potential for excess returns and diversification.

Exhibit 3 shows just how different returns can be between EM small caps and either U.S. or developed international small caps, even over periods as short as three years. As seen from this data, the three-year differential can be as much as 100% to 150%.

EXHIBIT 3: EM SMALL CAP PERFORMANCE CAN DIFFER SHARPLY



While EM small caps have had previous strong upswings versus both U.S. and international stocks, they have suffered a downswing (including the impact of a strong U.S. dollar) over recent years. EM small caps can exhibit higher volatility, and their recent weakness has dampened some investors' spirits on this asset class. However, reversals in the multi-year cycles between equity asset classes—as have happened before—give strong upside support to EM small caps for the coming years.

NOT ALL EM STOCKS ARE CREATED EQUAL

Although EM small caps differ from small caps in other parts of the world, they also provide a distinct investment opportunity as compared to large cap EM stocks. Exhibit 4 shows the variation in country and sector weights between the EM large cap and small cap indices. The large cap index has a significant China focus and is more concentrated in a handful of sectors. In contrast, the small cap index is more evenly balanced with respect to both countries and sectors. Exhibit 5 shows how much more diversified the small cap index is at the stock level. Within the small cap index, the top 10 holdings only account for approximately 3% of index weight, as opposed to the large cap index in which the top 10 holdings make up nearly 25% of index weight. This more diversified set of investment opportunities in EM small caps reduces the market's dependence on just a handful of stocks or market segments to drive performance.

The EM small cap index offers more balanced country and sector exposures than the EM large cap index.

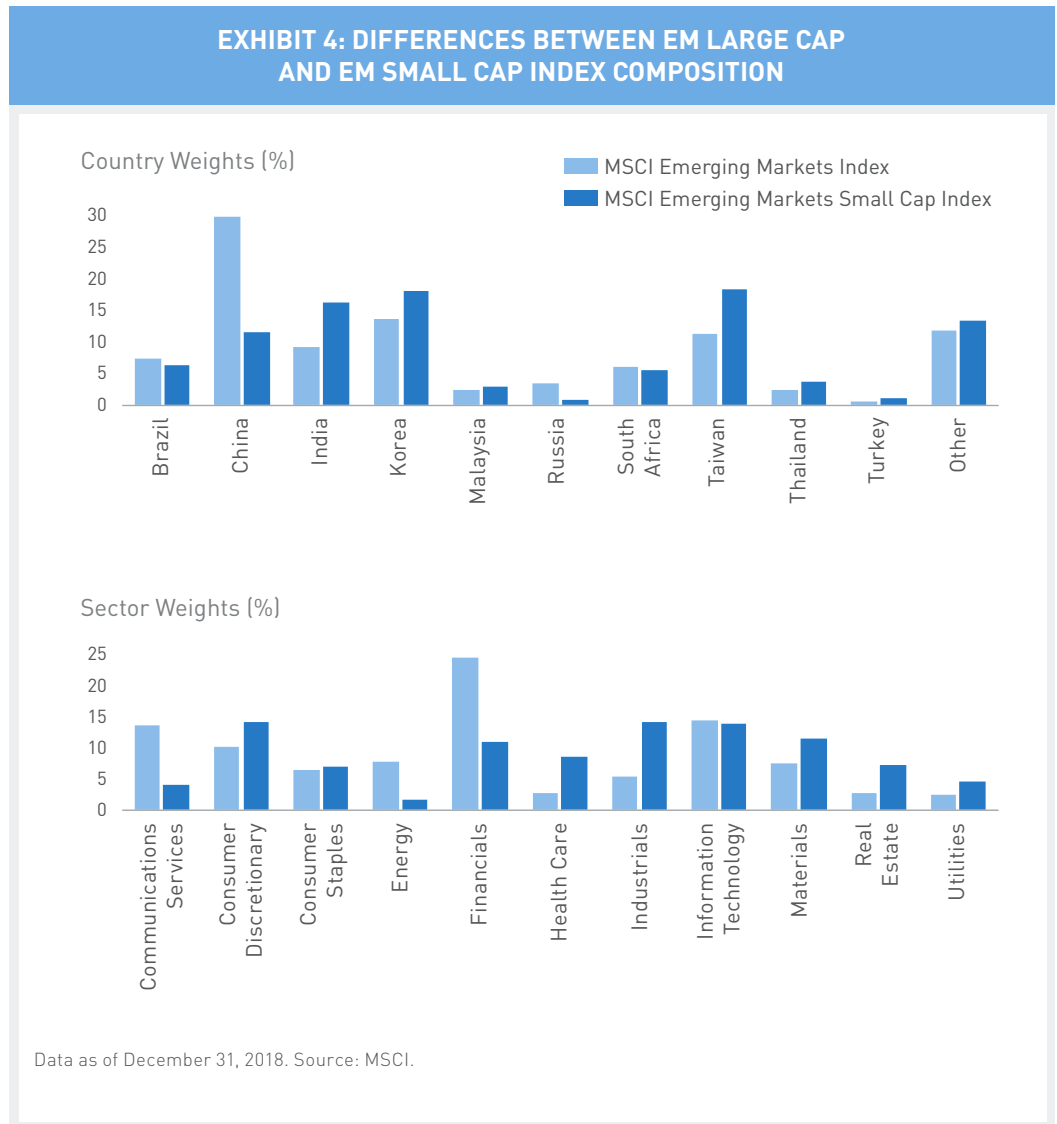


EXHIBIT 5: SIGNIFICANT DIFFERENCES BETWEEN EM LARGE CAP AND EM SMALL CAP INDEX CONCENTRATION

MSCI Emerging Markets Index

Stock	Country	Sector	Index Wgt (%)
Tencent Holdings Ltd.	 China	Communication Services	4.77
Taiwan Semiconductor Manufacturing Co., Ltd.	 Taiwan	Information Technology	3.76
Alibaba Group Holding Ltd. Sponsored ADR	 China	Consumer Discretionary	3.70
Samsung Electronics Co., Ltd.	 Korea	Information Technology	3.47
Naspers Limited Class N	 South Africa	Communication Services	1.83
China Construction Bank Corporation Class H	 China	Financials	1.65
China Mobile Limited	 China	Communication Services	1.23
Industrial and Commercial Bank of China Limited Class H	 China	Financials	1.03
Ping An Insurance (Group) Company of China, Ltd. Class H	 China	Financials	0.96
Reliance Industries Limited	 India	Energy	0.95
Total Weight of Top 10 Stocks			23.35

MSCI Emerging Markets Small Cap Index

Stock	Country	Sector	Index Wgt (%)
RBL Bank Ltd.	 India	Financials	0.40
AVI Limited Class Y	 South Africa	Consumer Staples	0.39
CVC Brasil Operadora e Agencia de Viagens SA	 Brazil	Consumer Discretionary	0.34
Federal Bank Ltd. (India)	 India	Financials	0.32
Li Ning Company Limited	 China	Consumer Discretionary	0.31
Bradespar SA Pfd	 Brazil	Materials	0.30
Impala Platinum Holdings Limited	 South Africa	Materials	0.29
Barloworld Limited	 South Africa	Industrials	0.28
Apollo Hospitals Enterprise Limited	 India	Health Care	0.27
Banco del Bajio SA	 Mexico	Financials	0.27
Total Weight of Top 10 Stocks			3.17

Data as of December 31, 2018. Source: MSCI.

Although the EM large cap index is highly concentrated in the top 10 stocks, the EM small cap index is much more diversified.

A SIGNIFICANT ALPHA OPPORTUNITY FOR ACTIVE MANAGERS

On top of the potential for diversification, one of the largest attractions of EM small caps is the ability of active managers to add significant excess returns over the benchmark in this space. Given today's scarcity of asset classes with high return expectations, the potential for adding extra percentage points of annual return in EM small caps can be compelling. The opportunity to add this extra return stems from the extensive pricing inefficiencies, one explanation of which is the smaller amount of institutional assets focused on the area. Although assets invested in EM small caps have increased over the past 10 years, they are still dwarfed by the amount invested in many other major equity asset classes. For example, as of September 30, 2018, EM small cap assets represented less than 1% of U.S. large cap assets and less than 5% of U.S. small cap assets.² And it is not just fewer investors focused on these stocks that creates opportunities, but also fewer sell-side analysts conducting research on these stocks. As shown in Exhibit 6, EM small cap has the smallest number of analysts covering each stock of any of the major equity asset classes. The resulting pricing inefficiencies have led to stronger and more consistent excess returns by active managers in the EM small cap space. Exhibit 7 shows that the typical EM small cap manager has in fact produced significant excess returns over the various time frames, outperforming the MSCI Emerging Markets Small Cap Index.

²As of September 30, 2018, the following totals represented the sum of manager assets in each respective universe: eVestment Global Emerging Mkts Small Cap Equity: \$39.8 billion; eVestment US Large Cap Equity: \$4.2 trillion; eVestment US Small Cap Equity: \$854.5 billion. Source: eVestment.

EXHIBIT 6: LIMITED SELL-SIDE COVERAGE OF EM SMALL CAPS CREATES INEFFICIENCIES

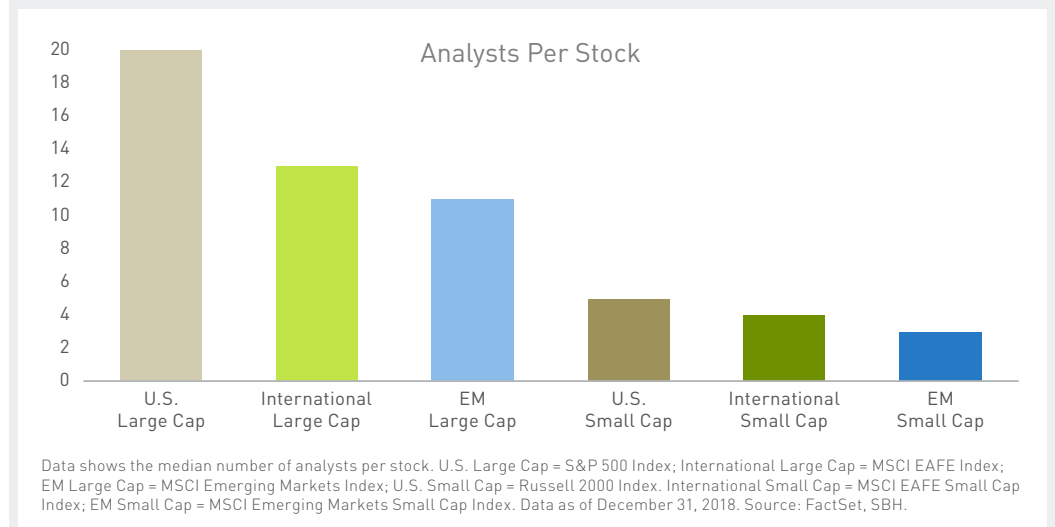
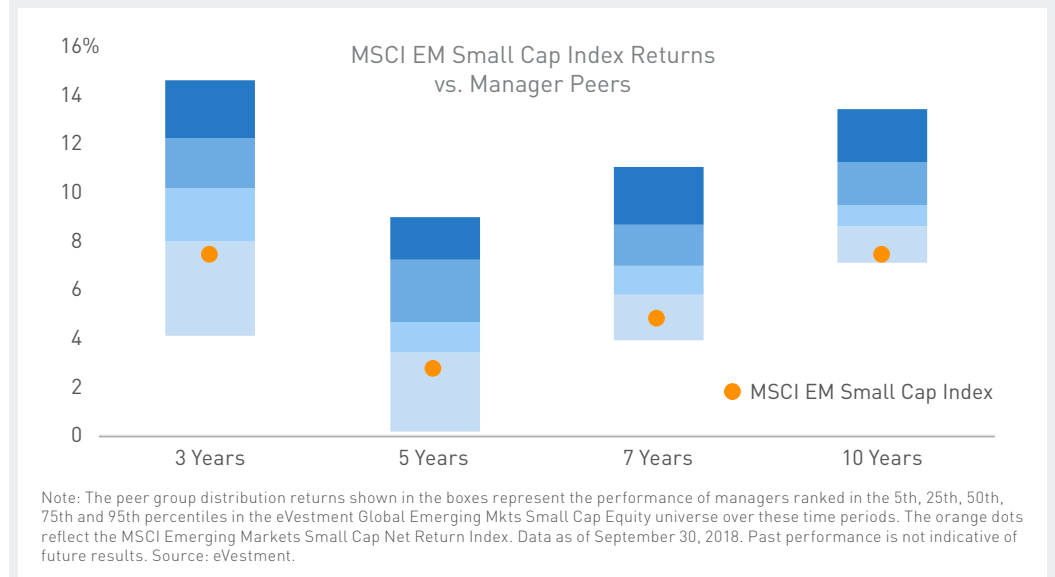


EXHIBIT 7: ACTIVE MANAGERS HAVE HISTORICALLY OUTPERFORMED THE EM SMALL CAP INDEX

EM small caps have offered significant opportunities for active managers to outperform.



A COMPELLING OPPORTUNITY

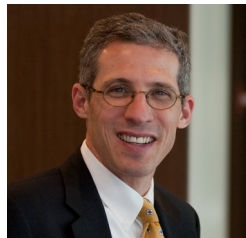
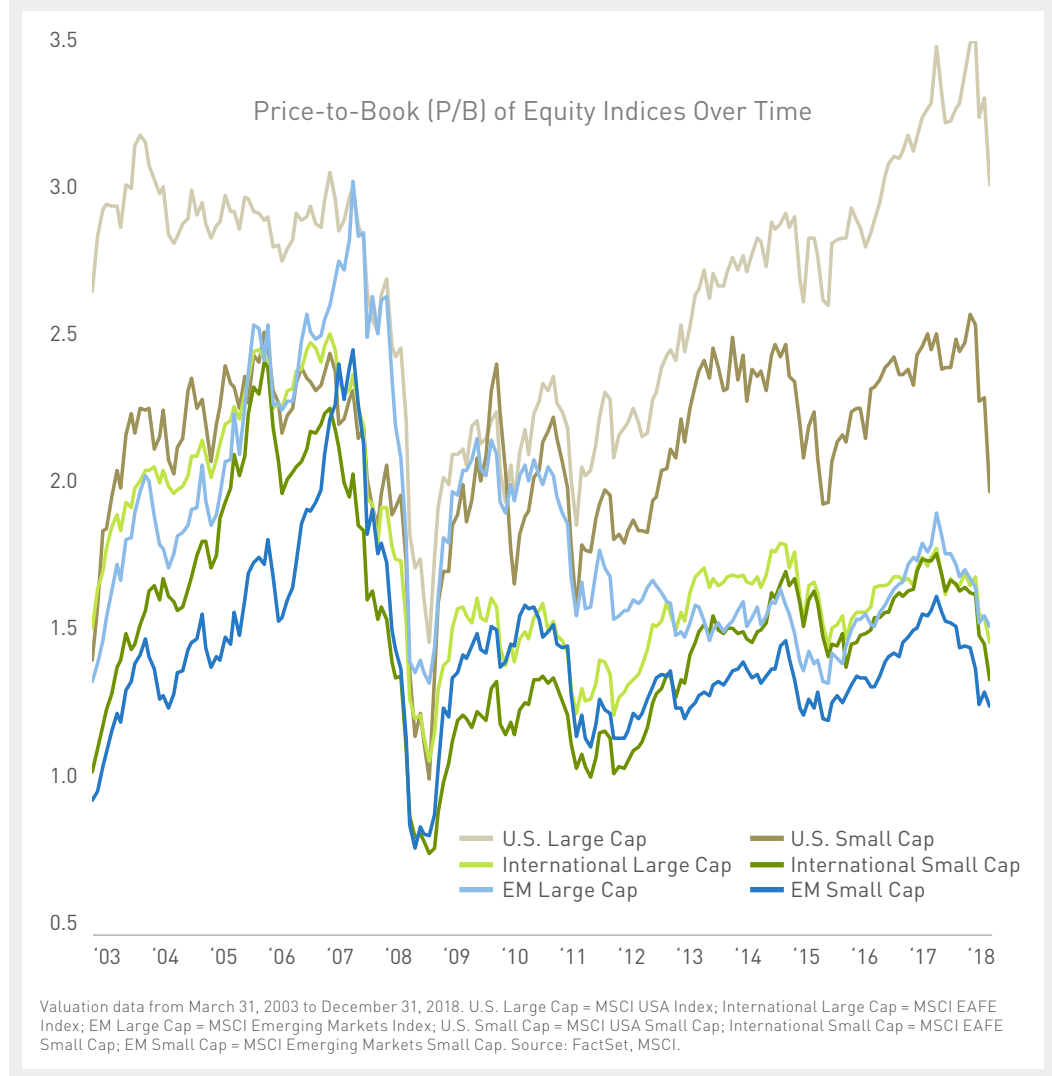
We believe now is a compelling time for investors to allocate to EM small caps. After being one of the top-performing asset classes in 2017, returning 33.8%, EM small caps declined by 18.6% in 2018.³ We believe the recent relatively weak performance of EM small caps has created an attractive entry point for investors with longer time horizons. Compared with other equity asset classes, EM small caps appear to be attractively valued in both absolute and relative terms (see Price-to-Book valuations in Exhibit 8). In fact, EM small caps have recently touched their largest valuation discounts versus U.S. large caps since the middle of 2003, near the end of the dot-com bubble. From those valuations levels, EM small caps massively outperformed both U.S. large caps and U.S. small caps over the next five years, beating each by more than 20% annually, with total outperformance by EM small caps of more than 250% during that time period.⁴ Along with long-term trends that should boost emerging economies over the coming years and decades, we think that many companies in the EM small cap space should have the potential for strong returns moving forward. With the sheer number of companies and inefficiencies in the asset class, active managers can help investors navigate this space and potentially provide significant alpha opportunities.

³Source: Returns are for MSCI Emerging Markets Small Cap Net Return Index. Source: Bloomberg.

⁴From December 31, 2002 to December 31, 2007, the S&P 500 Total Return, Russell 2000 Total Return and MSCI Emerging Markets Small Cap Net Return indices had cumulative (annualized) returns of 82.9% (12.8%), 112.0% (16.2%) and 386.6% (37.2%), respectively. Source: FactSet, Bloomberg.

EXHIBIT 8: EM SMALL CAPS APPEAR ATTRACTIVELY VALUED

EM small caps currently offer the cheapest price-to-book valuation discount versus U.S. large caps in more than 15 years.



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