International Small Caps: A Well-Kept Secret

Executive Summary

International small cap stocks\(^1\) represent a vast opportunity, yet many investors often overlook them. A portfolio receiving its only small cap exposure from domestic stocks may be missing out on the potential benefits of investing in small caps internationally and ignoring over a third of developed global equities. Historically, many investors have taken great care to diversify their domestic holdings, but when looking outside of the U.S., a single international sleeve seemed to suffice. This is evident when looking at total assets in international mutual funds – assets in developed foreign large cap funds outweigh their small- and mid-size counterparts by more than 14 to 1.\(^2\) This is changing, as more investors begin to realize the opportunity presented by international small cap stocks.

\(^1\)For the purposes of this document, international small cap stocks will be limited to those in developed markets — excluding those small cap stocks within emerging markets.

\(^2\)Morningstar as of 12/31/17
The Opportunity

While asset levels suggest they are underrepresented in many investor portfolios, international small caps represent about 38.5% of all stocks in the developed universe. By overlooking this opportunity, investors may be missing the largest opportunity set in the developed world.

Exhibit 1

<table>
<thead>
<tr>
<th>Region/Market Cap</th>
<th>Market Cap Range (Millions USD)</th>
<th>Number of Stocks</th>
<th>Percent of Total Stocks</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S Large</td>
<td>&gt; $15,000</td>
<td>318</td>
<td>4.4%</td>
</tr>
<tr>
<td>U.S. Mid</td>
<td>$2,000 – $15,000</td>
<td>942</td>
<td>13.2%</td>
</tr>
<tr>
<td>U.S. Small</td>
<td>&lt; $2,000</td>
<td>1,700</td>
<td>23.8%</td>
</tr>
<tr>
<td>Developed Foreign Large</td>
<td>&gt; $15,000</td>
<td>271</td>
<td>3.8%</td>
</tr>
<tr>
<td>Developed Foreign Mid</td>
<td>$2,000 – $15,000</td>
<td>1,165</td>
<td>16.3%</td>
</tr>
<tr>
<td>Developed Foreign Small</td>
<td>&lt; $2,000</td>
<td>2,752</td>
<td>38.5%</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>7,148</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: Morningstar Direct as of 12/31/17

Moreover, due to the size of the international small cap universe, potential inefficiencies may be exploited through the selection of individual securities. International small cap stocks tend to be under-researched by Wall Street analysts. Stocks with less analyst coverage may not fully reflect all relevant company data and therefore may be mispriced. These gaps in research coverage may create opportunities for portfolio managers and analysts to identify and exploit information inefficiencies for potentially promising companies experiencing significant growth. Inefficient market coverage can also subject investors to additional risks, such as heightened liquidity risk, and the possibility that company-specific issues may not be uncovered in a timely manner.

Due to their size, international small cap companies are more likely to be single-product or single-market focused, and therefore potentially less susceptible to the impact of economic events relative to larger firms that operate on a more global scale. However, the size of these companies can also cause them to be subject to more erratic price movements than those of larger, more established companies. These factors reinforce the need for active management in the space, because a portfolio manager must understand not only the companies, but also the markets in which these firms are operating in order to invest successfully.

3Defined domestically by the Russell 3000® Index and internationally by the Russell Developed ex-U.S. Index.
The Benefits

Diversification

Beyond the sheer size of the opportunity set represented by international small cap stocks, there may be diversification benefits that are typically not found in the international large cap asset class. Correlation is a commonly referenced statistic used to determine how closely two securities move in relation to one another. Exhibit 2 displays the correlations of the S&P 500 Index to large-, mid- and small-cap companies, both domestically and internationally, based on their corresponding Russell indices. Historically, international small caps have provided the lowest correlation to the S&P 500 Index of any developed equity asset class — and that correlation has decreased recently. And while investing internationally has often been viewed from a diversification perspective, international large caps have historically had a high correlation to domestic large caps.

Exhibit 2

Historical 12-Month Correlations to the S&P 500
August 1, 1996 – December 31, 2017

<table>
<thead>
<tr>
<th></th>
<th>Average (from 08/01/96)</th>
<th>Current (as of 12/31/17)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russell 1000® Index</td>
<td>1.00</td>
<td>1.00</td>
</tr>
<tr>
<td>Russell Midcap® Index</td>
<td>0.92</td>
<td>0.88</td>
</tr>
<tr>
<td>Russell 2000® Index</td>
<td>0.81</td>
<td>0.35</td>
</tr>
<tr>
<td>Russell Developed xUS LC Index</td>
<td>0.81</td>
<td>0.04</td>
</tr>
<tr>
<td>Russell Developed xUS MC Index</td>
<td>0.77</td>
<td>0.06</td>
</tr>
<tr>
<td>Russell Developed xUS SC Index</td>
<td>0.67</td>
<td><strong>0.15</strong></td>
</tr>
</tbody>
</table>

Source: Morningstar Direct

As international small cap mutual funds grow in assets, it is possible that their exposure to small caps will wane and drift into larger cap stocks — the same issue that can be observed domestically. Notice the lower correlations attributed to smaller stocks in the previous exhibit. These lower correlations support the notion that identifying funds that are disciplined in regard to their small cap exposures is an important factor to consider. International mutual funds that fail to maintain disciplined small cap exposure may not provide the key diversification benefits available. Diversification does not ensure a profit or protect against a loss.

Market Measures

**S&P 500® Index** is a group of 500 widely held stocks and is commonly regarded to be representative of the large capitalization stock universe.

**Russell 1000® Index** measures the performance of the large-cap segment of the U.S. equity universe.

**Russell Midcap® Index** measures the performance of the mid-cap segment of the U.S. equity universe.

**Russell 2000® Index** measures the performance of the small-cap segment of the U.S. equity universe.

**Russell Developed xU.S. Large Cap Index** is an unmanaged index of large-cap stocks from developed countries, excluding the United States.

**Russell Developed xU.S. Mid Cap Index** is an unmanaged index of mid-cap stocks from developed countries, excluding the United States.

**Russell Developed xU.S. Small Cap Index** is an unmanaged index of small-cap stocks from developed countries, excluding the United States.

The indexes illustrated are unmanaged statistical composites of stock market performance. Index performance is not indicative of fund performance. Investing in an index is not possible.
Historical Performance

As mentioned previously, many investors approach international equity investing by simply utilizing a single blended fund. By asset size, the Foreign Large Blend Morningstar Category ranked as the fifth largest category with $923 billion in assets. While we have discussed the diversification benefits of including international small caps in a portfolio, historic returns for the category should also be considered. Exhibit 3 illustrates the hypothetical growth of a $10,000 investment since common inception of the representative indices. Performance for international small caps represented by the Russell Developed xU.S. Small Cap Index outpaced that of international large caps represented by the Russell Developed xU.S. Large Cap Index.

Exhibit 3

![Graph showing hypothetical growth of $10,000 investment from 1996 to 2017, comparing Russell Developed xUS LC TR USD and Russell Developed xUS SC TR USD.]

Source: Morningstar Direct

The indexes illustrated are unmanaged statistical composites of stock market performance. Index performance is not indicative of fund performance. Investing in an index is not possible. Performance data quoted represents past performance, which is no guarantee of future results.

Risk-Adjusted Returns

Risk-adjusted returns allow for the comparison of investment returns while accounting for the risk involved in producing that return. Many investors associate international small cap stocks with higher risk and increased volatility relative to other asset classes. While international small caps have displayed more volatility than their large cap counterparts, the asset class has historically been less volatile than domestic small caps. Standard deviation is a common measure of risk which quantifies the volatility associated with returns. Over the 10-year period ended December 31, 2017, international small caps exhibited a lower standard deviation than domestic small caps (16.82% vs. 19.53%) based on representative indices.

Sharpe ratios commonly are used to compare risk adjusted returns, as they measure excess return per unit of risk. Since common inception of the indices, the Sharpe ratio for international small caps has been consistently higher than that of international large caps. In fact, 77% of the five-year rolling periods saw international small caps with stronger risk-adjusted returns relative to international large caps according to their representative indices.

The volatility that can be observed in some international small cap funds can at least partially be attributed to emerging markets exposure. Some international small cap mutual funds have been known to dip into emerging markets in an attempt to enhance returns. While doing so may at times provide more upside potential, emerging markets historically have produced more volatility relative to developed markets.

4Morningstar 12/31/17
Over the period from common inception (August 1, 1996) through December 31, 2017, emerging markets have exhibited a standard deviation more than 6% higher than developed markets (xU.S.) small caps (23.09% vs. 16.82%) based on representative indices. Exhibit 4 displays the rolling five-year standard deviations since common inception of the indices.

Exhibit 4

<table>
<thead>
<tr>
<th>Year</th>
<th>Russell Developed xUS SC TR USD</th>
<th>Russell Emerging Markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>25.0</td>
<td>30.0</td>
</tr>
<tr>
<td>2002</td>
<td>26.0</td>
<td>31.0</td>
</tr>
<tr>
<td>2003</td>
<td>27.0</td>
<td>32.0</td>
</tr>
<tr>
<td>2004</td>
<td>28.0</td>
<td>33.0</td>
</tr>
<tr>
<td>2005</td>
<td>29.0</td>
<td>34.0</td>
</tr>
<tr>
<td>2006</td>
<td>30.0</td>
<td>35.0</td>
</tr>
<tr>
<td>2007</td>
<td>31.0</td>
<td>36.0</td>
</tr>
<tr>
<td>2008</td>
<td>32.0</td>
<td>37.0</td>
</tr>
<tr>
<td>2009</td>
<td>33.0</td>
<td>38.0</td>
</tr>
<tr>
<td>2010</td>
<td>34.0</td>
<td>39.0</td>
</tr>
<tr>
<td>2011</td>
<td>35.0</td>
<td>40.0</td>
</tr>
<tr>
<td>2012</td>
<td>36.0</td>
<td>41.0</td>
</tr>
<tr>
<td>2013</td>
<td>37.0</td>
<td>42.0</td>
</tr>
<tr>
<td>2014</td>
<td>38.0</td>
<td>43.0</td>
</tr>
<tr>
<td>2015</td>
<td>39.0</td>
<td>44.0</td>
</tr>
<tr>
<td>2016</td>
<td>40.0</td>
<td>45.0</td>
</tr>
<tr>
<td>2017</td>
<td>41.0</td>
<td>46.0</td>
</tr>
</tbody>
</table>

Source: Morningstar Direct

While this is not a statement for or against investing in emerging markets, it is critical to understand an international fund's emerging market exposure and how it potentially could impact portfolio volatility. Emerging markets carry their own unique set of risks, including greater volatility and a greater likelihood of experiencing turmoil or rapid changes in market or economic conditions relative to developed countries. When grouped with international small cap stocks, emerging market stocks have the potential to alter the risk-return characteristics of a fund.

Why Now?

Based upon the information presented surrounding international small cap investing, a logical question may be “Why now?” Given the recent performance of domestic stocks over the past several years, many valuation metrics – measurements of relative price – are beginning to look comparatively expensive. International small caps, based on price-to-earnings ratios – or the price being paid per dollar of earnings – are currently the least expensive of the developed markets, as shown by the orange line in Exhibit 5.

Exhibit 5

<table>
<thead>
<tr>
<th>Year</th>
<th>Russell 1000 TR USD</th>
<th>Russell 2000 TR USD</th>
<th>Russell Developed xUS SC TR USD</th>
<th>Russell Developed xUS LC TR USD</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>9.5</td>
<td>12.0</td>
<td>15.5</td>
<td>18.0</td>
</tr>
<tr>
<td>2010</td>
<td>11.5</td>
<td>14.0</td>
<td>17.5</td>
<td>20.0</td>
</tr>
<tr>
<td>2011</td>
<td>13.5</td>
<td>16.0</td>
<td>19.5</td>
<td>22.0</td>
</tr>
<tr>
<td>2012</td>
<td>15.5</td>
<td>18.0</td>
<td>21.5</td>
<td>24.0</td>
</tr>
<tr>
<td>2013</td>
<td>17.5</td>
<td>20.0</td>
<td>23.5</td>
<td>26.0</td>
</tr>
<tr>
<td>2014</td>
<td>19.5</td>
<td>22.0</td>
<td>25.5</td>
<td>28.0</td>
</tr>
<tr>
<td>2015</td>
<td>21.5</td>
<td>24.0</td>
<td>27.5</td>
<td>30.0</td>
</tr>
<tr>
<td>2016</td>
<td>23.5</td>
<td>26.0</td>
<td>29.5</td>
<td>32.0</td>
</tr>
<tr>
<td>2017</td>
<td>25.5</td>
<td>28.0</td>
<td>31.5</td>
<td>34.0</td>
</tr>
</tbody>
</table>

Source: Morningstar Direct

The indexes illustrated are unmanaged statistical composites of stock market performance. Index performance is not indicative of fund performance. Investing in an index is not possible. Performance data quoted represents past performance, which is no guarantee of future results.
The same conclusion holds true when examined from the perspective of price-to-book ratios – the stock price divided by the total assets minus intangible assets and liabilities – again illustrated by the orange line in the following chart.

Exhibit 6

Exhibit 7

In addition, if one subscribes to the notion that small caps lead economies out of recessions and into recoveries – as has been the case in recent years domestically – international small caps could be positioned well, given that international economies have lagged the U.S. in their recoveries from the most recent economic recession. The following chart, Exhibit 7, shows gross domestic product (GDP) growth over the past five years for the United States and the three largest developed international regions – Japan, the United Kingdom (U.K.) and the eurozone. If other developed economies follow the path set by the domestic recovery, international small caps could be an attractive asset class in the coming years.

Source: Bloomberg Direct

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Conclusion

International small caps are often neglected, but it is clear that the potential benefits of investing in this asset class deserve closer consideration. When selecting a mutual fund in the international small cap space, it is essential that the management team possesses sufficient experience to grasp the intricacies of the investment universe. Additionally, it is important for an investor to understand the composition of a fund in regard to market cap size and emerging market exposure — both of which can skew the risk-return profile.

While there are risks associated with investing in this more volatile asset class, when properly executed, the addition of an international small cap fund to a portfolio can be beneficial.

Performance as of December 31, 2017

<table>
<thead>
<tr>
<th>Name</th>
<th>Inception Date</th>
<th>1-Year Return</th>
<th>3-Year Return</th>
<th>5-Year Return</th>
<th>10-Year Return</th>
<th>Total Return Since Inception</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500® TR USD</td>
<td>01/30/1970</td>
<td>21.83</td>
<td>11.41</td>
<td>15.79</td>
<td>8.50</td>
<td>10.73</td>
</tr>
<tr>
<td>Russell Midcap® TR USD</td>
<td>1/31/1979</td>
<td>18.52</td>
<td>9.58</td>
<td>14.96</td>
<td>9.11</td>
<td>13.43</td>
</tr>
<tr>
<td>Russell Developed xUS LC TR USD</td>
<td>6/28/1996</td>
<td>25.46</td>
<td>8.19</td>
<td>8.40</td>
<td>2.74</td>
<td>6.27</td>
</tr>
<tr>
<td>Russell Emerging Mkts TR USD</td>
<td>6/28/1996</td>
<td>36.77</td>
<td>9.76</td>
<td>5.50</td>
<td>2.33</td>
<td>6.57</td>
</tr>
</tbody>
</table>

Performance data quoted represents past performance, which is no guarantee of future results. The investment return and principal value of an investment in a Fund will fluctuate so that an investor’s shares, when redeemed, may be worth more or less than their original cost. Current performance may be higher or lower than performance data given.

Page 7 of 8. Not valid without all pages.
A Word About Risk

International small cap stocks are subject to market volatility and loss. Foreign securities and foreign depositary receipts carry the associated risks of economic and political instability, market liquidity, currency volatility and differences in accounting standards. Emerging markets securities are more likely to experience turmoil or rapid changes in market or economic conditions than developed countries. Stocks of small-cap companies may be subject to more erratic market movements than stocks of larger, more established companies.

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