A Time for International Small Cap Stocks to Shine Again?

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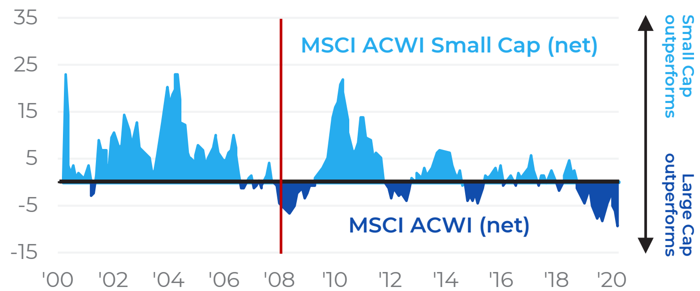
- Small caps have enjoyed a structural size premium (**Chart 1** and **Chart 2**). Moreover, we have long maintained that high active share strategies are best deployed in less efficient market segments such as global small cap stocks, which are not as widely covered as large cap stocks by research analysts. One way of measuring the opportunity for stock selection is through stock return dispersion, which currently is at a secular high (**Chart 3**).

- International small cap stocks' greater exposure to cyclical sectors (**Table 1** on bottom of **Page 2**), has historically boosted their performance during post-recession, early cycle rallies, whereas large cap international stocks typically outperform in late expansion markets, such as mid-2007 to mid-2008 during the GFC, and from early 2018 until now. In light of the extraordinary global policy support to combat the economic fallout from COVID-19, small cap stocks should therefore disproportionately benefit from a cyclical rally.

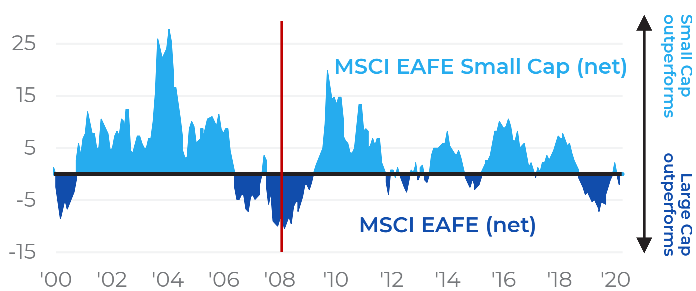
Chart 1 | **Monthly Rolling 1 Year Rolling Return Difference** 1/1/2019-3/31/2020, %



Mean	3.6%	High	24.2%
Median	2.4%	Low	-11.8%
St. Dev.	6.6%	% Sm. > Lg.	68.4%

Source: Hillsdale Investment Management

Chart 2 | **Monthly Rolling 1 Year Rolling Return Difference** 1/31/2019-3/31/2020, %



Mean	4.1%	High	29.3%
Median	4.3%	Low	-10.6%
St. Dev.	7.4%	% Sm. > Lg.	68.9%

Source: Hillsdale Investment Management

Chart 3 | **Return Dispersion of STOXX Small vs. Large**

Source: Datastream, Goldman Sachs Global Investment Research

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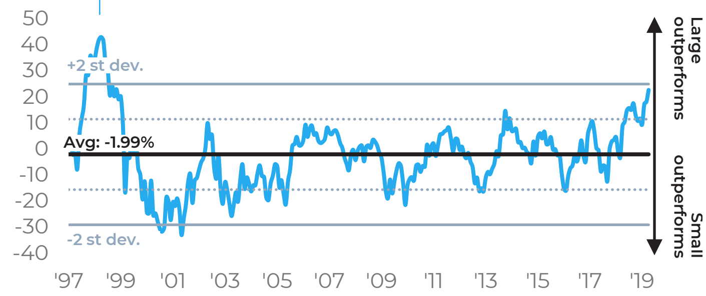
- Small cap stocks are attractively valued. (**Chart 4**). M&A activity could turbo charge the performance of small cap stocks that tend to be the "targets" and enjoy a bid premium.

- COVID-19's likely acceleration of de-globalization would be expected to impair mega-cap companies that have most benefitted from global supply chains and customers. Small cap stocks are by their very nature domestic, especially in Europe. European small caps generate 85% of their revenues domestically vs. 30% for the region's large cap names.

Chart 4 **Rolling 12 Month Return: S&P 100 vs. S&P 600**
12/31/1997 to 3/31/2020



Source: Xponance professional estimates and FactSet

- However, both solvency and deflationary concerns associated with COVID-19 uncertainty could undermine a durable rally in global small cap stocks in the near-to-medium term future. Cyclical stocks have underperformed defensive equities by their greatest extent since the great recession of 2008. A key driver of their underperformance has been the expanding deflationary fears engulfing the global economy. With rates already at rock bottom levels, it is unclear whether households will ramp up discretionary spending activity, even if their incomes have been sustained by fiscal support. In China and other countries that are ahead of the US in containing the virus, lingering concerns about public health risks have significantly limited households' desire to restart spending again as consumers remain concerned about catching COVID-19, and apprehensive about their incomes.

- Bottom line — Global small caps (and value stocks) are poised to benefit from powerful cyclical and secular tail winds. The current level of stock dispersion among global small caps relative to large caps suggests an even greater alpha opportunity for active managers. However lingering deflation and solvency risks could lead to nasty air pockets in the near to medium term.

Table 1 **Revenue Exposure by Sector / Industry**
% Exposure

MSCI EAFE Large	
Finance	20.82
Healthcare	16.09
Consumer non-Cyclicals	14.84
Industrials	9.96
Technology	8.84
Consumer Cyclicals	7.35
Non-Energy Materials	6.51
Energy	5.11
Telecommunications	4.01
Utilities	3.63
Consumer Services	1.39
Business Services	1.34
Cyclical (EAFE Large)	**28.93**

MSCI EAFE Small	
Finance	25.53
Industrials	15.79
Non-Energy Materials	11.15
Technology	10.92
Healthcare	8.72
Consumer Non-Cyclicals	8.24
Consumer Cyclicals	5.98
Consumer Services	4.61
Business Services	3.65
Utilities	2.00
Energy	1.80
Telecommunications	1.31
Cyclical (EAFE Small)	**34.73**

MSCI EM Large	
Finance	25.56
Technology	25.20
Consumer Non-Cyclicals	15.54
Non-Energy Materials	6.57
Energy	6.44
Telecommunications	4.73
Industrials	4.37
Consumer Cyclicals	3.65
Healthcare	2.49
Consumer Services	2.10
Utilities	1.74
Business Services	1.57
Cyclical (EM Large)	**21.03**

MSCI EM Small	
Technology	18.06
Finance	17.20
Non-Energy Materials	13.75
Industrials	11.71
Healthcare	10.08
Consumer Non-Cyclicals	9.50
Consumer Cyclicals	6.79
Utilities	4.13
Consumer Services	3.17
Energy	2.28
Telecommunications	1.65
Business Services	1.58
Cyclical (EM Small)	**34.54**

Source: Xponance professional estimates and FactSet