T. Rowe Price

International small-caps: Unlocking the value in this unloved asset class

From the Field
November 2024

Key Insights

- International (ex-U.S.) small-cap stocks are trading at their cheapest valuations versus large-cap stocks in 15 years.
- While recent conditions have been unfavorable for small caps, historically, the asset class has been additive.
- International small-cap stocks have stronger earnings growth prospects than large-cap stocks as the economic environment improves.

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Small-cap stocks have lagged their large-cap peers across developed markets for several years, having been hit harder by COVID pandemic disruptions and supply chain challenges and, subsequently, by inflation and rapidly rising interest rates. All cycles must come to an end, however, and we believe international small-caps are well positioned for a return to historical outperformance versus their large-cap peers.

The impact of the COVID pandemic on small-cap stocks should not be understated. From February 2001 to December 2019 (just prior to the pandemic), the MSCI ACWI ex-U.S. Small and Mid-Cap Index outperformed the MSCI ACWI ex-U.S. Large-Cap Index in 98% of monthly rolling five-year periods; however, that figure falls to 81% when the period is extended to September 2024—providing a stark indication of the impact that the pandemic had on small- and mid-cap returns.

So while recent conditions have been unfavorable for small-caps, historically, the asset class has been additive. And we see a potential to return to the historic norm.

It is also worth highlighting that not only have small-cap stocks historically generated strong returns, but—despite what many investors may think—international small-cap quality (as measured by debt-to-asset ratios) and profitability (measured by return on equity) metrics do not differ markedly from their international large-cap or U.S. small-cap

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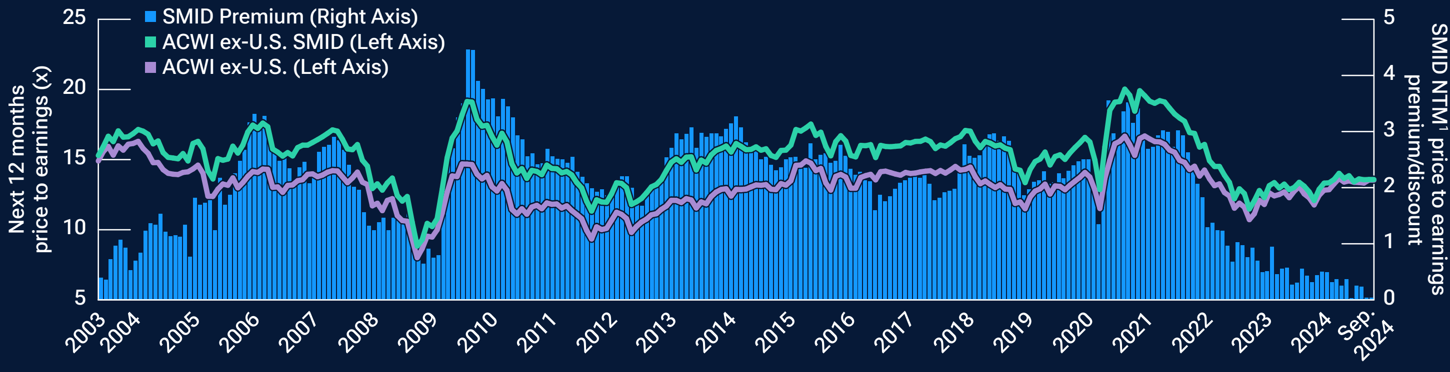
The small-cap premium over large-caps has disappeared

(Fig. 1) Valuations are virtually identical for the first time in 15 years



As of September 30, 2024.
[1] Next twelve months.
ACWI ex-U.S. SMID = MSCI ACWI ex-U.S. Small and Mid-Cap Index; ACWI ex-U.S. = MSCI All Country World ex USA Index. See Additional Disclosure.

peers over the long term (although we acknowledge these metrics can vary at any given point in time).

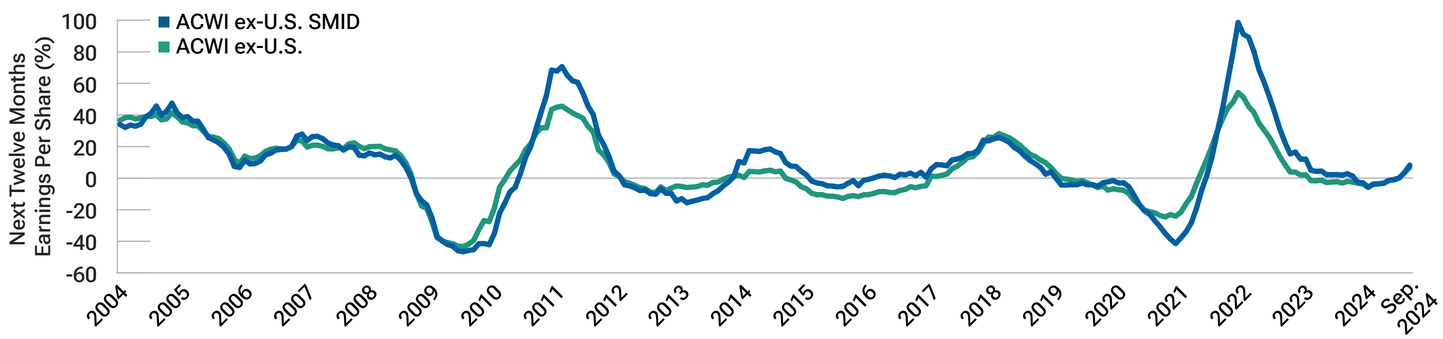
Valuations underestimate improving EPS growth outlook

Prior to the COVID pandemic, international small-caps were trading at a clear premium to large-caps; as of September 30 this year, this premium had been reduced to zero (Figure 1). We believe this valuation discount presents a strong opportunity for long-term investors.

Equally importantly, we believe that international small-caps have the potential to deliver stronger earnings per share (EPS) growth than their large-cap peers as the economic environment rebounds. (It is important to note that, unlike the U.S., Europe has already experienced a meaningful slowdown.) History shows that following periods of earnings decline, earnings growth for small-caps have typically exceeded large-caps. This occurred following the global financial crisis (GFC), the eurozone debt crisis, and the COVID pandemic (Figure 2). We anticipate this will also occur on this occasion and that small-caps will outperform large-caps in the period ahead—but, as illustrated, this time coming from a point of extreme valuation support that should further compound an earnings rebound.

Small-caps historically outperformed large-caps after earnings slumps

(Fig. 2) Rebounds occurred after the GFC, eurozone debt crisis, and COVID pandemic



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Finally, while the outlook for global rates is uncertain, it is likely that most central banks will begin to lower borrowing costs over the next 18 months. This should help the global economy to deliver solid, if unspectacular, growth over the next few years. Small-cap stocks have typically benefited from declining rates and solid economic growth more than their large-cap peers. As such, we believe the current outlook of improving growth and declining interest rates should provide the catalyst for improved earnings and thus favor international small-caps.

UK and Japan among the picks of international markets

In a generally unloved asset class, UK small-cap stocks are regarded with a particular lack of affection. Stocks listed in London have lagged their peers in the U.S. and Europe as sectors such as banking and energy have struggled to keep pace with technology stocks, and political uncertainty following Brexit has weighed on the UK economy.

Yet despite its unpopularity, the UK stock market remains a large one in which many international firms are listed. And there are reasons to believe that the prospects for UK-listed small-cap stocks are much more positive than implied by current valuations. This is especially true for many UK small-cap stocks that, despite their size, are multinational and thus not tied to the UK economy alone. In addition, the political turbulence of the past few years has subsided, and the large majority won by the Labor Party in June's general election should provide further stability if the party delivers on its promise to bring stable governance, fiscal responsibility, and the removal of regulations to boost growth. The UK's economy is improving and may even outperform the eurozone in 2024.

Japan also looks attractive. Improved corporate governance standards continue to have a tangible—and considerable—impact on company performance. While the Bank of Japan's (BoJ's) recent decision to hike rates prompted a surge in the yen against the U.S. dollar, the currency has settled at a level that remains relatively weak by the standards of the past few decades—and the BoJ is not expected to embark on a hiking cycle that brings Japanese rates in line with those of other developed markets. The long-term Japan recovery story remains, in our view, a strong one: As the economy continues to reflate and wages increase, consumption and investment should strengthen. Valuations are reasonably attractive, too—although the Nikkei 225 hit its record high in February (in yen terms), Japanese stocks continue to trade at a low price to book value, especially small-cap stocks.

Emerging markets small-caps—the hidden outperformer

Although developed markets have been dominated by large caps in recent years, the same cannot be said for emerging markets (EM). Over the three and five year periods ended September 30, the MSCI Emerging Markets Small and Mid Cap (EM SMID Cap) Index outperformed the MSCI EM Large-Cap Index. Even relative to other regional SMID indices, EM SMID has performed well over the same 3 and 5 year periods, outpacing both US SMID (Russell 2500) and developed market SMID (MSCI EAFE SMID).

Part of the outperformance of EM small- and mid-caps versus their large-cap peers can be attributed to weakness in Chinese large-caps, where many of the most widely held names suffered from regulatory pressure, geopolitical turmoil, and foreign selling (also of note, China is less than half the size in the EM SMID Cap Index, comprising just 14.1% versus 29.7% in the large-cap index as of September 30). But that is not the full story: Many emerging markets also did a good job of combating inflation, raising rates ahead of developed markets while also keeping account balances in check. Having raised rates early, many emerging market economies are expected to benefit from Fed rate cuts.

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In addition, supply chain diversification has resulted in increased economic activity in areas such as Mexico and ASEAN[1] countries. India, one of the best-performing SMID-cap countries in recent years, is another beneficiary of supply chain diversification, but it is also experiencing significant economic growth, political stability, and foreign investment. Finally, while Taiwan is largely known for the Taiwan Semiconductor Manufacturing Company, many other tech and artificial intelligence (AI) beneficiary names—many down the market cap spectrum—have also driven performance. The AI capex cycle is one we expect to continue, and it should therefore continue to benefit Taiwan's robust semiconductor ecosystem.

With relatively cheap valuations—outside of India, which we acknowledge has become very expensive—cheap currencies, Fed rate cuts on the horizon, demonstrated economic resilience, and, most recently, stimulus efforts from China, emerging market small-caps could continue to perform well.

Fertile ground for stock pickers

The international small-cap universe is a large investable market with significant breadth. As many international markets look set for a period of steady growth and lower interest rates, conditions appear ideal for small-cap firms to start delivering solid earnings growth. Moreover, the conditions that have in the past made international small-caps fertile ground for stock picking remain present. There has been greater dispersion in performance within small-caps than within large-caps, presenting opportunities for investment managers with deep research platforms. Analyst coverage of international small-caps can be patchy, leading to greater inefficiencies from which to profit.

As such, we believe that active management is crucial when investing in small-caps. Many small-cap companies lose money over the long term, placing great emphasis on the ability to differentiate winners from losers. History shows that the top-performing active managers have typically performed well coming out of concentrated markets, for example following the Japan asset price bubble of the 1980s, the dot-com bubble of the 1990s and the emerging markets rally of the 2000s.[2] While it is difficult to predict exactly when the current period of index concentration will recede meaningfully, there are signs that the dominance of mega-cap U.S. technology stocks is beginning to fade.

This process may take a while. However, we believe that the current opportunity set in international small-caps is a favorable one—and, at current valuations, probably too favorable to ignore.

[1] Association of Southeast Asian Nations.
[2] Rob Sharps, Active Investing is Suited to the Uncertain Environment Ahead. July 2024.

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