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INTERNATIONAL SMALL-CAP EQUITIES

Improving portfolio risk and return.

Small-cap stocks are typically used to add return or diversify risk. But Canadian institutional investors have traditionally limited their small-cap exposure to Canadian or U.S. small-caps. International small-cap stocks are often overlooked, despite some of the advantages they carry.

Large-cap stocks, both domestic and foreign, are exposed to similar global influences (e.g., is Deutsche Bank really that different from Goldman Sachs?). International small-cap stocks are better diversifiers because smaller stocks are more connected to local factors in their respective geographic regions. It could also be argued that adding international small-cap exposure to an equity portfolio brings added value without introducing additional risk factors such as political risk, currency risk or liquidity risk that can be associated with emerging markets. And, it has no more risk than what plan sponsors are typically exposed to with international investing (e.g. EAFE) or U.S. and Canadian small-cap investing.

One objective shared by many investors is to build portfolios that provide the most opportunities for adding value. An effective way of achieving this objective is by adding small-cap exposure to an equity portfolio in order to expand its active management universe. But how do you determine which small-cap market to choose?

The existing breadth of the investor's equity portfolio should drive the answer to this question. Using market cap coverage as a proxy for breadth and looking at the benchmarks commonly used by institutional investors for exposure to the Canadian, U.S. and international equity markets, the argument for international small-cap investing is strong. For example, the MSCI EAFE Index provides about 79% market coverage, leaving more than 20% of potential market opportunities uncovered. The U.S. market in comparison, as represented by the S&P 500 and Russell 1000 indices, covers a healthy 90% of the overall

market. The Canadian market, represented by the S&P/TSX Composite Index, manages to cover 71%, leaving room for small-cap exposure as well.

On the sole basis of market coverage, adding exposure to international small-cap is a compelling argument for a completely well-rounded equity portfolio, thereby enhancing the opportunity for adding value.

Now the question is: what's the best way to gain exposure to international small caps?

While the potential benefits of international small-cap exposure are clear to investors, it's less clear what the best way is to add this exposure to an equity portfolio. International small-cap portfolio management is a specialty. Investing in a dedicated small-cap mandate with a dedicated small-cap portfolio management team is the recommended approach. We can point to at least three key reasons why:

1. Greater diversification—A dedicated mandate will consider hundreds of small-cap stocks, whereas small-cap exposure as part of a broader EAFE strategy might only result in investment in a handful of stocks.

2. Reduced liquidity risk—The dedicated small-cap mandate not only offers greater diversification through its larger stock holdings, it also lowers your portfolio's liquidity risk by reducing the amount invested in any one small-cap stock.

3. Higher potential for alpha—An additional benefit of a small-cap mandate is that it provides far more active money for your dollar than a large-cap portfolio. With large-cap investing, the restrictions on individual stock weightings, combined with a much smaller universe of stocks to choose from, results in a greater percentage of "deadweight loss" in the portfolio. On the contrary, the much larger selection of small-cap stocks results in a high percentage of active money invested, with the potential for higher returns that this active management provides.

With the proper elements in place, the benefits of an international small-cap mandate can be significant. ■