

The Time is Now

International small capitalization stocks – representing a relatively underappreciated and underexploited corner of the global equity market – warrant further attention from investors seeking a diversifying and distinctive asset class with superior return potential.





International, Small Cap, and Value – The Perfect Union

Successful active value investing is predicated on a manager's ability to identify and capitalize on significant price dislocations – namely, when stocks deviate substantially from their intrinsic values. In the international small capitalization (ISC) space, which is almost entirely composed of developed markets outside of the US, these mispricings can be more prevalent, as markets are inherently less transparent and consequently less efficient. For the active value manager, these price distortions, and the range of unique risks that ISC markets present, are exciting. ISC stocks provide access to a wide array of currencies, economies, regulatory regimes, languages, and market cycles. Understanding these nuances across geographies can present lucrative opportunities but requires specific skill and judgment.

International Small Cap: Where Value Packs a Punch

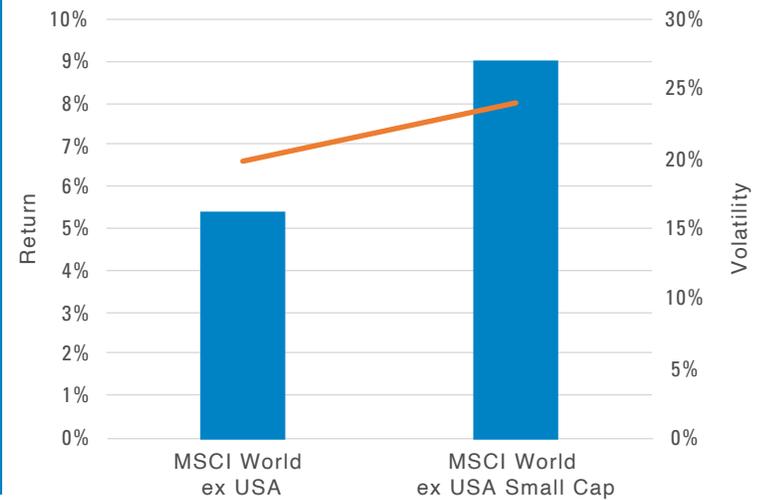
Small-cap stock returns have handily beaten those of large caps in international markets over the last 21 years. This shouldn't be too surprising to investors; it has been well-documented in academic literature (Fama & French '93), and a similar dynamic played out in the US over multiple decades. In general, and regardless of domicile, small-cap stocks offer higher rewards for those willing to exercise patience and look past short-term bouts of volatility, as shown in **Figure 1**¹. The data suggests a form of home-country bias exists, since US-based investors tend to focus on the domestic small-cap universe despite a broad and diverse set of companies existing overseas that effectively doubles the small-cap opportunity set. According to recent data from Morningstar, international small caps represent a minuscule 2% of US equity mutual fund assets (compared to nearly 6% for US small caps), with the value style accounting for a fractional 24 basis points².

Investors not exposed to ISC are forgoing access to approximately \$3.2 trillion in market value and 2,500 additional small-cap companies³ – a little more than half the global small-

cap stock investment universe (including the US). Further, the returns of those stocks are weakly correlated with global developed large-cap and US small-cap securities. The average rolling five-year correlations of monthly returns between the MSCI World ex USA Small Cap Index to the MSCI World and Russell 2000® indices are 0.79 and 0.74 respectively. The diversification benefit to a global equity portfolio is considerably better than the Russell 2000®'s 0.93 correlation to the MSCI World Index.

Part of the explanation for ISC's discernible outperformance can be chalked up to a lack of transparency. Valuation distortions can be more pronounced for smaller companies, which attract less attention from brokerage/equity research firms than large companies. In fact, the median number of analyst recommendations for a stock in the broad MSCI World ex USA Index is 17, versus just 6 for the small cap series⁴. Thin analyst coverage usually manifests in more frequent and measurable short-term pricing deviations, as traders naturally have less reliable, and less readily available information on which to base investment decisions.

Figure 1: Index Performance



1. Source: FactSet, MSCI, Pzena analysis (USD, gross)
Return: Annualized total return (CGR) since inception
Volatility: Standard deviation of annual returns since inception
Data from December 31, 2000 - December 31, 2021
Past performance is not indicative of future results.

■ Total Return Ann. (CGR)
— Volatility Ann.

2. Source: Morningstar, Pzena analysis of all US-domiciled open-end equity funds (USD)

3. Source: MSCI World ex USA Small Cap Index factsheet

4. Source: Bloomberg, Pzena analysis



In The End, Valuation Matters

Behavioral biases can cause stocks to be mispriced, creating compelling opportunities for investors who have the experience and discipline to follow an investment process that separates fact from sentiment. More specifically, we believe that overreactions to near-term events often cause investors to undervalue good companies that are experiencing some form of temporary distress. These are value stocks in the traditional sense of the word, evidenced by the data shown below.

As displayed in [Table 1](#), within the 5 quintiles of valuation on a price-to-normal earnings basis, the fundamental earnings power – either measured in returns or revenue growth – doesn't deviate all that much between groups.

Table 1: Small Cap Equities Outside the US
Key Financial Data by Valuation Quintile

Price/Normal Quintile	Total Quintile Earnings (bn)	Historical Return on Equity	Historical Revenue Growth	Price to		
				Earnings	Sales	Book Value
Q1 (cheapest)	\$95	10%	8%	9x	0.5x	0.8x
Q2	\$82	10%	9%	13x	0.7x	1.4x
Q3	\$55	10%	10%	19x	1.2x	2.0x
Q4	\$37	8%	12%	31x	1.9x	2.5x
Q5 (expensive)	-\$12	0%	17%	NM	3.1x	3.0x

Source: FactSet, Reuters, Pzena analysis. Valuation quintile buckets based on Pzena's price-to-normalized earnings estimate. P/E and P/S ratios are calculated using consensus FY1 estimates. Return on equity and revenue growth calculated over trailing 10-year period. Return on equity is calculated using median instead of average as many companies in this universe have a limited data history. Universe is the MSCI World ex USA Small Cap. Data as of December 31, 2021. Does not represent any specific Pzena product or service.

Despite trading at steep discounts regardless of the valuation metric, the companies in the first quintile have similar or better fundamentals as a group than the more expensive securities. As always, we believe that price matters, and, as [Figure 2](#)⁵ clearly shows, an investment strategy targeting this cheapest quintile has outperformed the market over time.

Figure 2: International Small Cap Annualized Returns



5. Source: Kenneth R. French data library, Pzena analysis; The full dataset was created using the 11/2021 Bloomberg database. It contains value-weighted returns for the intersections of 5 market equity portfolios and 5 book equity/market equity portfolios in Developed ex-US. Firms with negative book equity are not included in any portfolio. The universe consists of the smallest 20% of companies (market equity), segregated into valuation quintiles on a price-to-book basis. Performance encompasses the period from July 1990 – November 2021. Past performance is not indicative of future returns. Returns could be reduced, or losses incurred, due to currency fluctuations. Does not represent any specific Pzena product or service.



Uncovering Gems

ISC value has proven to be a historically profitable strategy, with the long-term performance of small caps improving markedly as valuations become more attractive. The caveat, of course, is the difficulty of uncovering fundamentally cheap stocks with strong balance sheets and solid business models poised for long-term share price appreciation. An active strategy is therefore critical, especially in the current investing environment where the valuation dispersion among stocks is at record levels.

The better part of the last decade has seen significant outperformance of US stocks over international, large cap over small, and growth over value, implying that each of these segments is worth watching. Within the ISC universe, the valuation dispersion has reached an extreme, at over three standard deviations above the mean. **Figure 3** shows the relative difference in price-to-book values between the cheapest and the most expensive stocks since the inception of the data. This differential has only surpassed today's level during one sustained period in the last ~50 years, creating uniquely compelling conditions to seek active exposure in this space.

Figure 3: World ex US Small Cap Valuation Dispersion Still at Extreme Level

World ex US Small Cap 1st Quintile vs. 5th Quintile Dispersion Expressed in Standard Deviations



Data through December 31, 2021. Source: Stanford C. Bernstein & Co., Pzena analysis
Dispersion between cheapest and most expensive quintiles based on price-to-book; equal-weighted data
Universe is the World ex US Small Cap (14% of free-float adjusted market capitalization in non-US developed market countries)

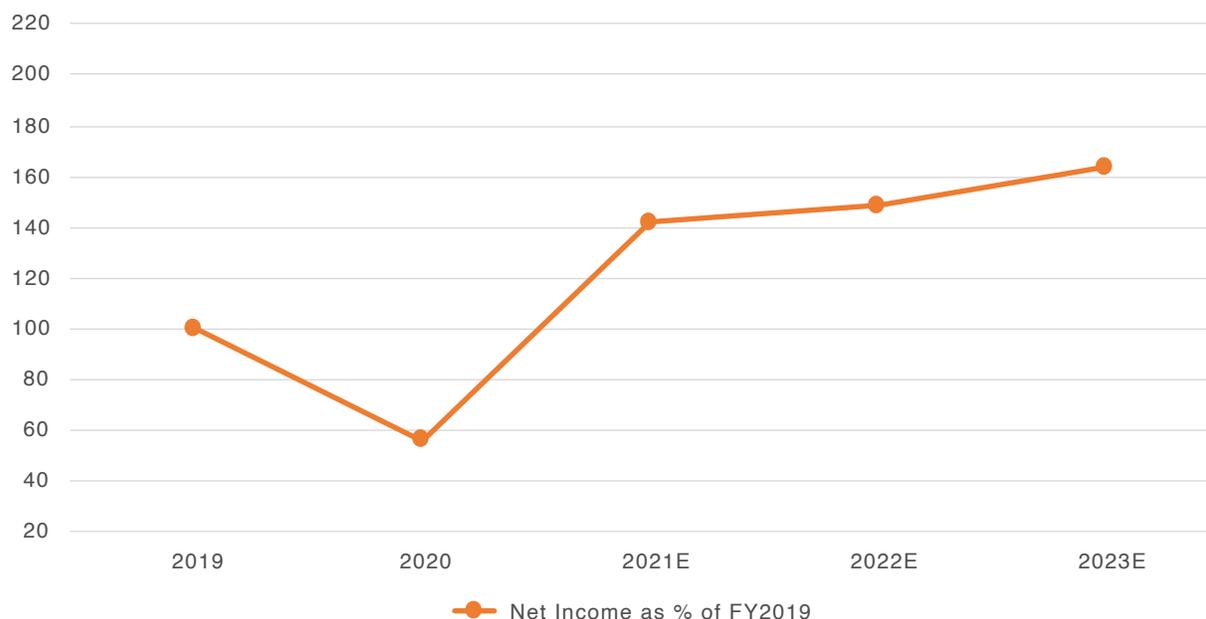


Pzena's Advantage for the Road Ahead

As with all strategies at Pzena, our International Small Cap Focused Value (ISCFV) product adheres to a deep value investing approach and leverages our entire global research team for investment insights. Our analysts cover companies according to global industry, not by product or market cap range; therefore, when we research an ISC company, our industry analysts already have a deep knowledge of the competitive landscape, as well as the customer and supplier bases across the globe. Through rigorous, fundamental research, we possess the tools necessary to create concentrated portfolios of our most attractive ideas, with the aim of achieving meaningful outperformance over the long run.

We seek stocks that, in our opinion, sell at substantial discounts to their intrinsic values for reasons we deem to be temporary. Companies included in the ISCFV portfolio are exclusively from the cheapest valuation quintile. The current picture for ISCFV is particularly compelling. During the pandemic downturn, the management teams of our portfolio companies did not sit still. Rather, many of them cut costs and restructured operations to an extent that may not have been possible absent such an acute crisis. These companies – many of which were significantly impacted by global lockdowns – should continue to realize strong earnings growth as revenues recover, operating margins expand, and expenses are held in check, potentially boosting profits above pre-pandemic levels ([Figure 4](#))⁶. We believe the share prices of these companies are poised for a re-rating as conditions normalize.

Figure 4: ISCFV Net Income Profile, Indexed to 2019



6. Source: S&P Capital IQ; Pzena analysis; portfolio holdings as of February 2022

Conclusion

We are currently in the midst of a pro-value cycle that's fully global in reach, providing investors ample opportunity to diversify their portfolios with attractively valued companies across geographies. Emotional investors tend to overreact to near-term events and misjudge the probabilities of what might happen in the future. As highly disciplined value investors, we are committed to intensive research to find good businesses going through periods of temporary distress. Pro-value periods, like the one we are currently experiencing, have historically begun with uncertainty and cynicism. While value stocks around the world have taken over leadership from their (still expensive) growth counterparts, the cycle has only just begun, and we see perhaps no better market segment to exploit the outperformance opportunity than international small cap.



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The MSCI World ex-USA Small-Cap Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of small cap developed markets excluding the US.

Russell 2000 Index

The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. It is a subset of the Russell 3000® Index and includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. Additional information is available at www.russell.com.

MSCI World Index

The MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. Additional information is available at www.msci.com.

MSCI World ex USA Index

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These indices cannot be invested in directly.

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