

RETHINKING EMERGING MARKETS

Diversify risks and improve outcomes with emerging markets small cap

Emerging markets have significantly lagged among global equities in the last several years. The headline MSCI EM Index has returned 8.7% annualized since the start of the recovery post-COVID (April 2020 – June 2024), while its developed markets counterpart, the MSCI World Index, is up an impressive 18.1% annualized. That's more than a nine-percentage point annualized differential. The relentless underperformance of Chinese equities coupled with widespread geopolitical tensions and a rising interest rate environment are a few of the reasons emerging markets have failed to keep pace. This stretch of underperformance has prompted many investors to take a deeper look at the asset class.

However, if we view emerging markets through a wider lens, we see a very different picture. Broadening exposure to include a small cap allocation over these last few years would have yielded significantly different results. EM small cap outperformed not only the MSCI EM Index (large/mid cap), but also developed markets large and small. And it did so with comparable volatility to developed markets. Despite its diversification potential, differentiated risk/return profile, and active management success, emerging markets small cap is often an overlooked corner of the market.

In this paper, we shine light on three key reasons to consider an allocation to emerging markets small cap to offset unintended risks and improve outcomes in a global portfolio.

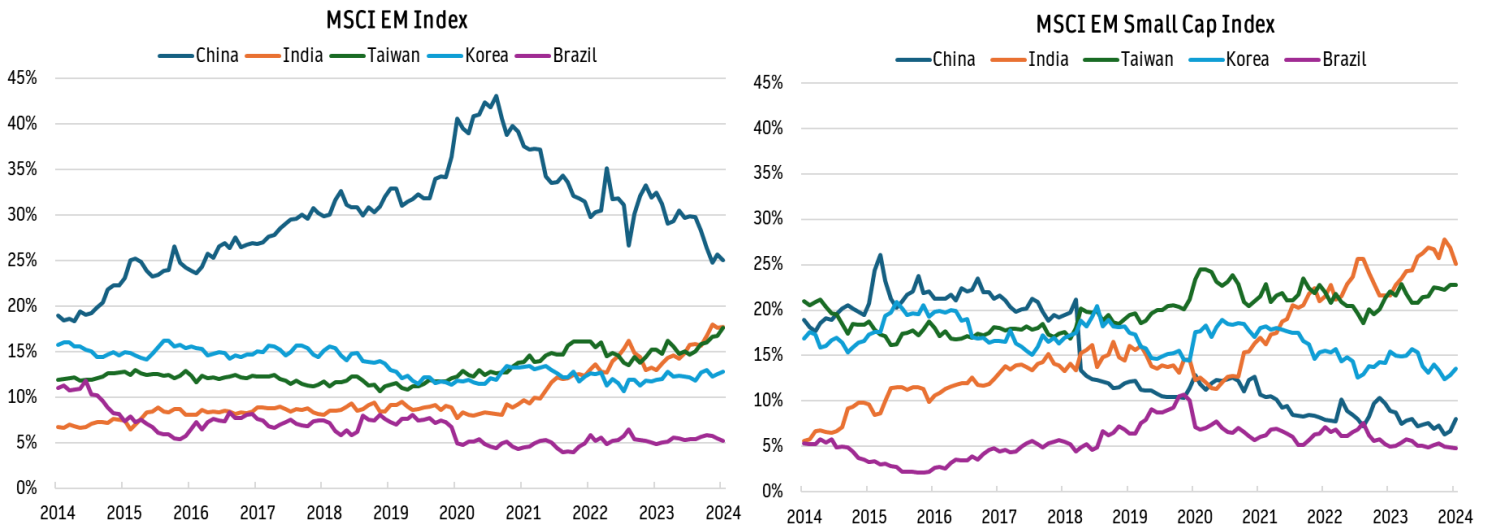
- 1. Diversification | A more balanced view of emerging markets**
- 2. Risk/Return Profile | Potential for outperformance with less risk than perceived**
- 3. Active Management Approach | Factor tilts can increase the likelihood of success**

A More Balanced View of Emerging Markets

It is common for institutional investors to own a dedicated allocation to small cap stocks alongside existing large cap allocations in developed markets. Combining the two asset classes can potentially achieve beneficial and differentiated returns and exposures when compared to a standalone large cap allocation. The same principles hold true in emerging markets given the country concentration risk and the prominence of mega cap stocks.

The MSCI Emerging Markets Index is the most common benchmark for emerging markets investors. China has consistently been the largest country represented in the index for the last decade with exposure reaching as high as 43% in 2020. China’s underperformance since this peak has been a significant drag on the index in recent years. As a result, the index’s exposure to China has declined and now lies at a quarter of the portfolio; still more than 7 percentage points greater than the next largest country in the index. At the same time, the largest country exposures in EM small cap have maintained more balanced weights.

China has dominated the MSCI EM index, while small cap has had more diversified country exposures



Source: Factset, MSCI. Top five country exposures in each respective index.

Similarly, the top five largest stocks in the MSCI EM Index made up 21% of the index as of June 30, 2024, while the largest weights in small cap made up less than 2% of the index. Also worth noting, heavyweights Taiwan Semiconductor and Samsung are multinational corporations whose revenues are more influenced by the global economy. Smaller companies are more likely to have business models tied to local markets thus contributing to their diversification benefits within a global portfolio.

Large cap index concentration is a risk

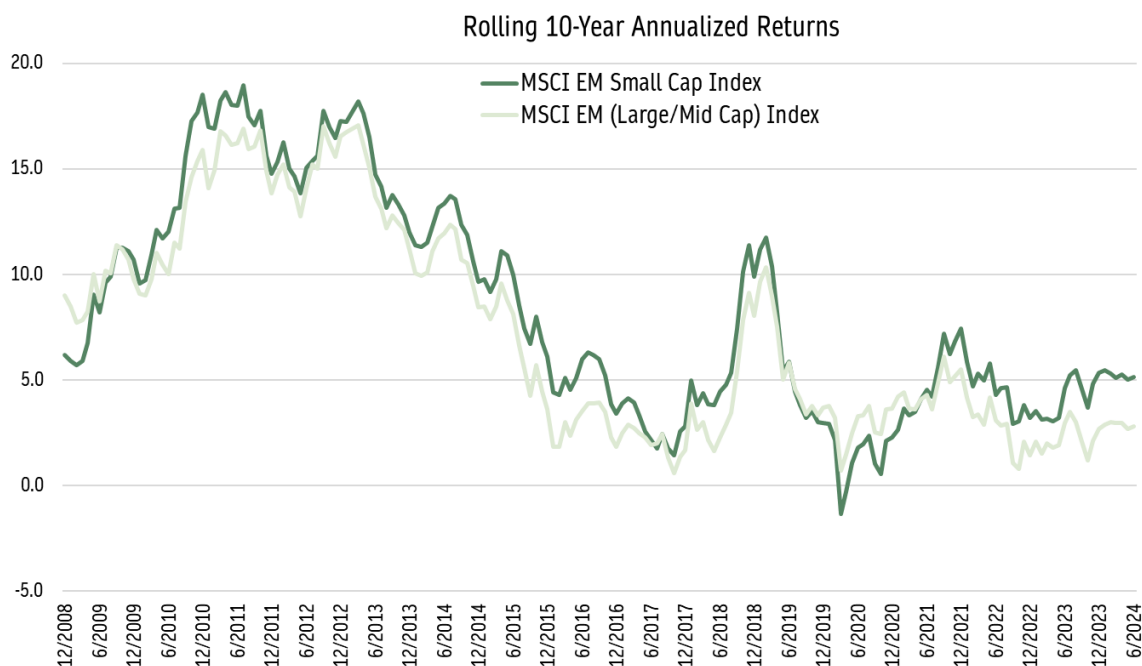
	Weight
Taiwan Semiconductor	9.7%
Tencent Holdings	4.2%
Samsung Electronics	3.7%
Alibaba Group Holding	1.9%
Reliance Industries	1.5%
Top 5 Stocks in EM Index	21.0%
Top 5 Stocks in EM Small Cap Index	1.7%

Potential For Outperformance

Recent performance of small cap in emerging markets has drawn attention. In 2023, the MSCI EM Small Cap Index gained 23.9% while the MSCI EM Index (large/mid cap stocks) returned 9.8%. At the same time, small cap in developed markets significantly lagged large cap peers. This shined light on the potential for emerging markets small cap to deliver differentiated returns, and this trend has continued so far in 2024.

With small cap, the expectation is often that the potential for outperformance is compensated with higher volatility. While this may be true at times, it is not to the degree that some may think. EM small cap has outperformed with comparable or lower volatility than realized in large cap in recent periods. As such, higher Sharpe ratios indicate short periods of increased volatility have been well compensated over time.

Small cap has outperformed over longer time periods in emerging markets; 82% of rolling 10-year periods



Source: MSCI monthly returns for the common index return period historically through June 30, 2024.

Outperformed on both an absolute and risk-adjusted basis, and with lower volatility than large cap

	1 Year			3 Year			5 Year			10 Year		
	Return	Std. Dev. (%)	Sharpe Ratio	Return	Std. Dev. (%)	Sharpe Ratio	Return	Std. Dev. (%)	Sharpe Ratio	Return	Std. Dev. (%)	Sharpe Ratio
Median EM Small Cap Manager	21.34%	14.48	1.11	5.22%	16.13	0.15	9.45%	19.94	0.39	6.99%	17.05	0.32
MSCI EM Small Cap Index	20.56%	14.19	1.06	4.23%	15.62	0.10	8.51%	20.56	0.31	5.09%	17.59	0.21
MSCI EM Index	8.15%	16.18	0.17	-5.05%	17.76	-0.44	2.22%	19.05	0.01	2.95%	17.18	0.09

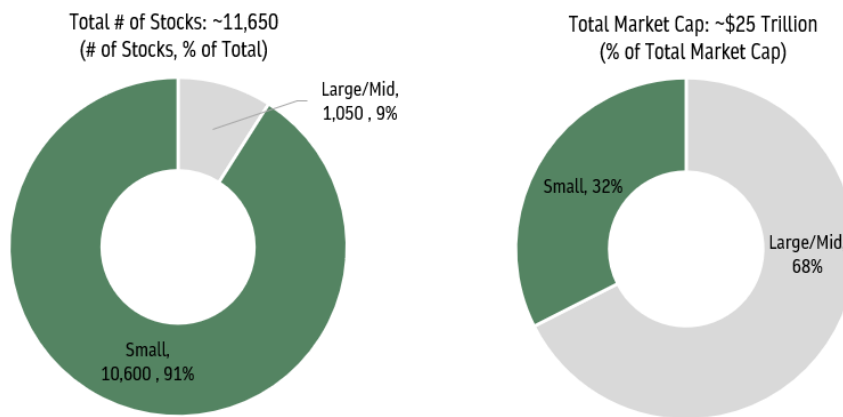
Source: MSCI monthly returns data, as of June 30, 2024. Evestment median manager annualized returns and risk are calculated gross of fees as of March 31, 2024. Please see important disclosures at the end of this document

Fertile Ground for Active Management

While the EM small cap index has produced compelling results, active managers have further benefitted from the dynamic universe of emerging markets small cap companies.

Small cap offers a vast opportunity set where the potential for overlooked and mispriced stocks is far greater than in large cap. There are ~10,000 emerging markets stocks with a market cap between \$100 Million and \$4 Billion— or roughly ten times the number of stocks in large and mid cap companies. These small cap companies are covered by two analysts on average with more than half having no analyst coverage at all. Additionally, the dispersion of returns among names in the emerging markets small cap universe is wide. Cross-sectional volatility – a metric used to measure the opportunity for stock selection – is greater in the MSCI EM Small Cap Index than in more popular international markets indices.

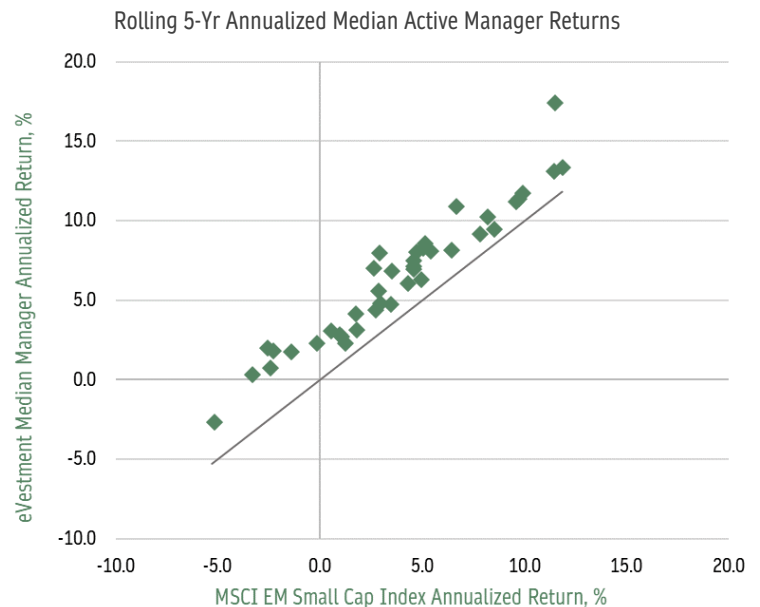
Broad, under-followed universe with high cross-sectional volatility indicates alpha opportunity



These characteristics have enabled active managers to consistently generate excess returns beyond the MSCI EM Small Cap Index. Over the last decade, the median strategy return in the eVestment Global Emerging Markets Small Cap universe has outperformed the benchmark 100% of the time on a rolling 5-year basis, and by an average of 256 basis points annualized.

Skilled active managers have been able to thrive in the small cap landscape, consistently adding value above the index. Bottom-up stock selection will continue to be a key source of value-add as the expansive universe and high level of informational efficiencies enable strategies designed to exploit these opportunities.

Active managers have consistently added value



Source: MSCI, eVestment. EVestment median manager returns for monthly rolling periods ending 3/31/2024, calculated using the Emerging Markets Small Cap universe and relative to the MSCI EM Small Cap Index, gross of fees. Please see important disclosures at the end of this document.

Manager Selection, Factor Exposures May Provide a Tailwind

As in any asset class, the investment approach matters, as style/factor biases can significantly impact results. Particularly in emerging markets, there is a significant dispersion in returns among popular factors. We conducted a study using Fama-French historical data to look at performance and risk of Momentum, Value, Growth and Quality within 32 distinct global equity markets. Our findings show momentum to be the best performing factor in emerging markets on both an absolute and risk-adjusted basis, with results being strongest in small cap. This suggests that selecting a manager with the added tailwind of momentum exposure may prove beneficial over time.

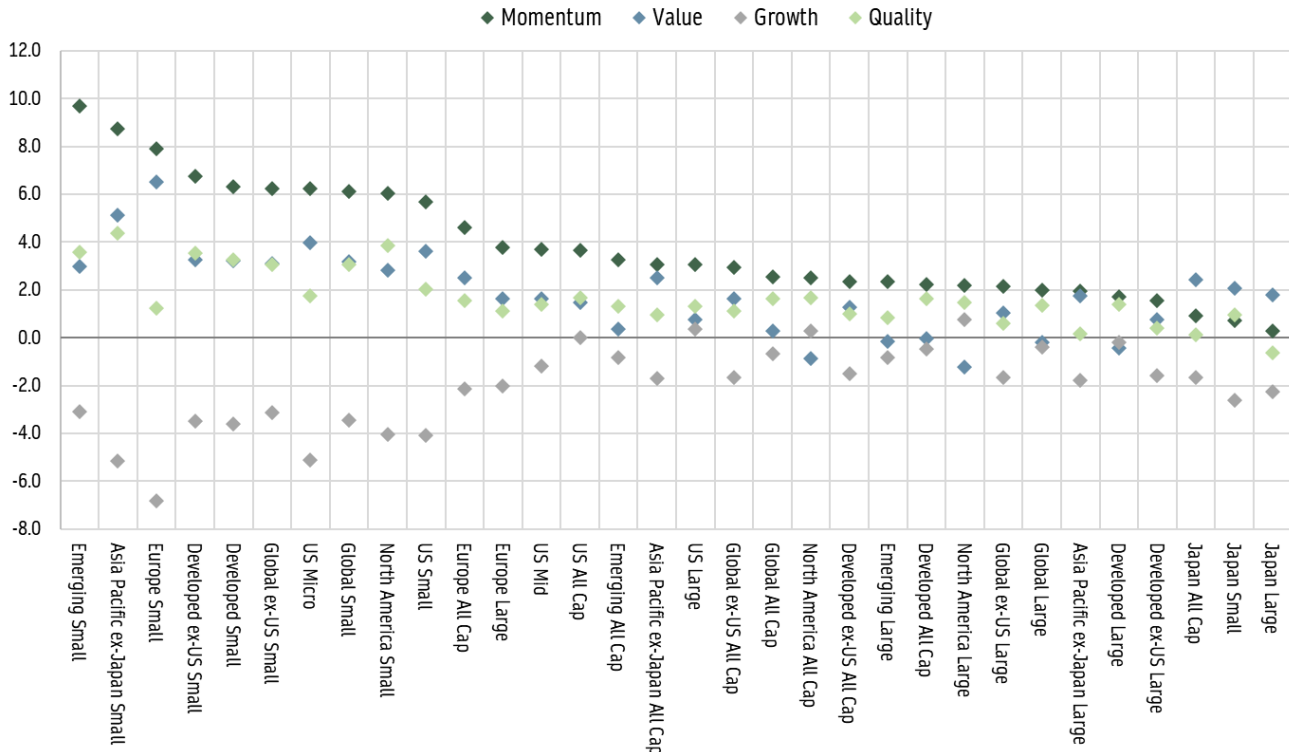
Momentum has superior absolute and risk-adjusted returns among popular factors

Emerging Markets Small Cap

	Momentum	Value	Growth	Quality	Market
Return (Annualized)	15.32%	13.94%	0.59%	8.66%	7.42%
Volatility (Annualized)	20.92%	20.80%	21.45%	20.80%	20.44%
Tracking Error (to Market)	6.35%	5.21%	5.18%	7.12%	--
Sharpe Ratio	0.62	0.56	-0.08	0.30	0.25
Information Ratio (to Market)	1.24	1.25	-1.32	0.17	--
T-Stat (Excess Returns)	6.47	6.52	-6.96	0.98	--
Batting Average (Excess Returns)	71%	69%	31%	56%	--

Momentum is strongest in EM Small Cap

Excess Return



Source: Fama-French historical returns are calculated using data from Ken French's website. The time period covered is July 1963 through August 2023 for US markets and July 1991 through August 2023 for Non-US and Global markets. The factors displayed are referenced by Ken French as follows: Value (High Book/Market), Low Size (Small Cap.), Momentum (High Prior Return), Growth (Low Book/Market), and Quality (High Operating Profitability). Please see Important Disclosures at the end of this document.

Summary | Offset Risks and Improve Outcomes with EM Small Cap

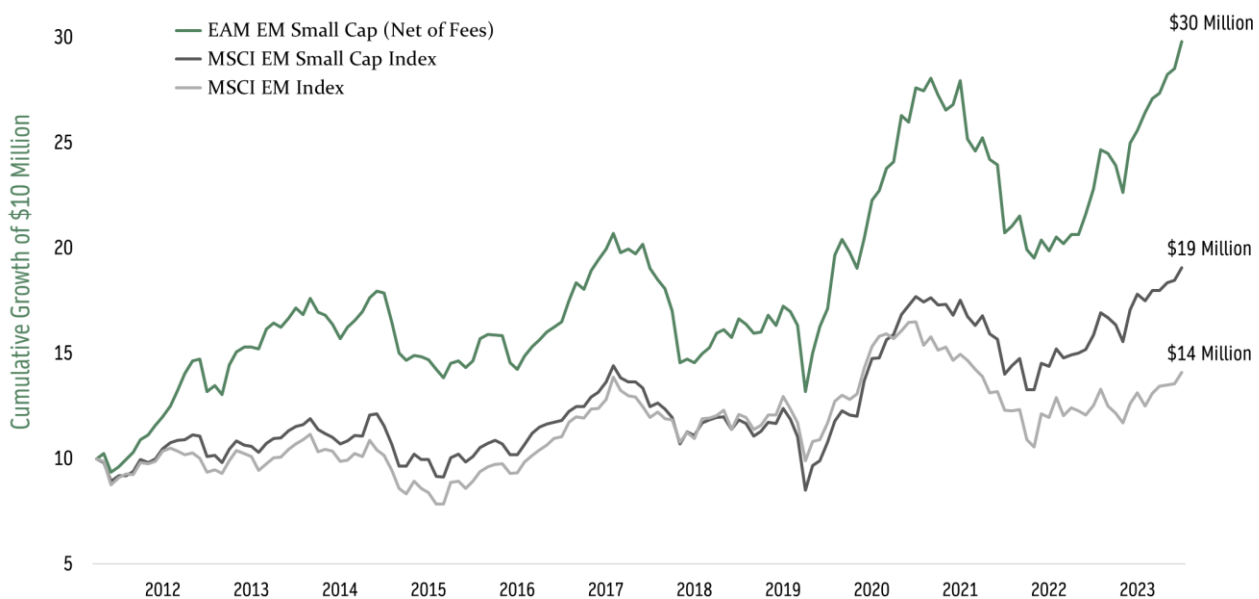
We have demonstrated that an allocation to EM small cap can be a worthy addition to a global portfolio. Within emerging markets, small cap offers a differentiated source of exposures than large/mid cap and has outperformed on both an absolute and risk-adjusted basis. Additionally, its vast universe and information inefficiencies have enabled active managers to consistently generate excess returns beyond an EM small cap benchmark. Historically, momentum has proven to be a beneficial strategy to take advantage of the dynamic emerging markets small cap opportunity set.

EAM’s Approach in EM Small Cap

EAM Investors has been able to navigate the large selection universe of emerging markets small cap stocks by utilizing a systematic approach to deliver more consistent and predictable return streams. This Informed Momentum® approach combines momentum with stock selection, tailored risk management, and efficient implementation to deliver alpha for clients. This approach is the foundation of the firm and has been applied consistently across all EAM’s strategies since inception in 2007.

Strong inception-to-date alpha	Benchmark-like volatility with beta at or below 1.0	Favorable upside and downside capture ratios	Excess return correlations complement traditional styles	Consistent exposure to stock-specific risk and momentum
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EAM Emerging Markets Small Cap Composite Performance Since Inception



Data presented is for the period since inception April 1, 2012 – June 30, 2024. Please see Important Disclosures at the end of this document.

Performance as of June 30, 2024

	Q2	YTD	1 Year	3 Year	5 Year	7 Year	10 Year	ITD*
EAM Emerging Markets Small Cap (Gross)	9.11%	16.89%	31.27%	3.10%	12.91%	9.36%	6.21%	9.88%
EAM Emerging Markets Small Cap (Net)	8.97%	16.60%	30.61%	2.59%	12.35%	8.82%	5.68%	9.33%
MSCI Emerging Markets Small Cap Index	5.93%	7.04%	20.04%	2.54%	9.99%	7.07%	5.15%	5.41%
MSCI EM Small Cap Growth Index	5.39%	6.25%	16.82%	0.42%	10.07%	6.72%	4.22%	4.89%
MSCI EM Small Cap Value Index	6.48%	7.85%	23.38%	4.70%	9.78%	7.33%	6.00%	5.85%

Risk Statistics Since Inception

	EAM Emerging Markets Small Cap	MSCI EM Small Cap Index
Annualized Return (Gross)	9.88%	5.41%
Annualized Return (Net)	9.33%	5.41%
Alpha	4.94%	-
Tracking Error	8.50%	-
Standard Deviation	17.0%	16.7%
Information Ratio	0.53	-
Sharpe Ratio	0.51	0.25
Beta	0.89	1.00
R-Squared	0.76	1.00
Up Market Capture	106.0%	-
Down Market Capture	86.8%	-

Data presented is for the period since inception April 1, 2012 – June 30, 2024, relative to the MSCI EM Small Cap Index. Risk statistics are calculated gross of fees. Please see Important Disclosures at the end of this document.

Important Disclosures

Past performance does not ensure future results, and there is no assurance that the portfolios will achieve their investment objectives.

The inception date for the EAM Emerging Markets Small Cap composite is April 1, 2012. Net returns are net of the maximum annual management fee of 0.50%. The MSCI Emerging Markets Small Cap Index includes small cap representation across 25 Emerging Markets countries (EM) and is designed to measure small cap equity market performance in the global emerging markets. The MSCI Emerging Markets Small Cap Index has been chosen as a benchmark to the EAM Emerging Markets Small Cap strategy because the Advisor believes that it is the most appropriate broad-based securities index available to be used for comparative purposes given the investment strategy of the portfolios. The MSCI Emerging Markets Small Cap Growth Index captures small cap securities exhibiting overall growth style characteristics across 25 EM countries. The MSCI Emerging Markets Value Index captures small cap securities exhibiting value style characteristics across 25 EM countries. The MSCI Emerging Markets Small Cap Growth Index and the MSCI Emerging Markets Small Cap Value Index are being presented for informational purposes only.

Gross and net composite returns are presented net of brokerage commissions and include income from interest and dividends as well as capital gains less applicable withholdings. The returns do not reflect the deduction of other taxes a typical investor may accrue or custodial fees. The U.S Dollar is the currency used to express performance. All periods greater than one year are annualized.

Risk stats are calculated based upon the inception date of the composite strategy through June 30, 2024.

The portfolio(s) are actively managed and holdings are subject to change. We believe the information presented is reliable, but we do not guarantee its accuracy. The opinions expressed will evolve as future events unfold. The investment risk of the portfolio(s) may be increased by the portfolios' ability to invest in smaller company stocks, and IPOs. Investing in growth stocks involves certain risks, in part, because the value of securities is based upon future expectations that may or may not be met. Small company stocks are generally riskier than large company stocks due to greater volatility and less liquidity.

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