

Small-Caps Move to the International Forefront

■ Small, and Underappreciated

Historically, U.S. investors who craved exposure to international economic markets usually focused on large public companies. It was generally believed that large companies, with vast resources, were best equipped for navigating the business environment in foreign economies. It was assumed that small-cap firms did not offer material international revenue generation. Perhaps this reasoning was based on the perception that smaller firms lacked the resources and maybe even the wherewithal to operate internationally. While this may have been true years ago, many domestically domiciled small-cap stocks now derive a material amount of revenue from international operations. Accordingly, this international exposure enables the companies to access incremental revenue and profit, which allows firms to grow at a significantly faster pace than if they had concentrated solely on domestic operations.

Since the early 1990s, investors have warmed to small-cap firms with international exposure. Whether these firms were domiciled domestically or abroad, as long as their revenues were significantly international, investors were interested. What initiated the shift in interest at that particular point in time? And, how can investment managers harness small-caps with international exposure without compromising their portfolios?

■ A Sleeping Giant

Investors often talk about unlocking value when identifying mis-priced securities in the market. The idea is that an event will act as a catalyst to awaken the market to the virtues of a security. Once awake and aware, the market, spurred on by the *caffeinated* catalyst, will find the security more appealing than it did before, and the stock will flourish.

The same theory can be applied to regional economies. In the late 1980s, a famous political event and a textbook catalyst unlocked the economic value for a fair portion of the more developed world. The fall of the Berlin Wall was the iconic event that transformed economies in many countries. The examples are too numerous to recount here, but it is sufficient to say that “after the fall” international opportunities began to pique the interest of U.S. investors.

The collapse of the Wall and the ensuing fundamental changes in the global economy helped carry the popularity of small-cap international stocks forward. In the late 1990s the movement picked up even more steam with the coming of age of the emerging markets famously represented by, but certainly not limited to, India, China, and Brazil. The continent of Africa is sure to offer still more opportunities for small-caps to grow internationally.

For many years, U.S. small-cap companies did not expand significantly internationally. Many felt that this was because the U.S. market was the largest, most appealing market in the world and that smaller U.S. firms did not need to augment their domestic revenue with international sales. Profits were churning along at such an attractive pace that the smaller players could afford to ignore international arenas. But economies eventually mature and growth becomes stagnant. This occurred in the U.S., and soon, foreign markets offered the opportunity for superior, cheaper growth.

Investors and executives began to take note of the global marketplace, and the money flows increased accordingly. In the early 1990s, U.S. investors sent 5% of their portfolios overseas into internationally focused funds. This percentage jumped to 50% in 1993; a significant turn of events to be sure (*A Zebra in Lion Country*, Ralph Wanger, 1997). Capital was seeking to migrate from mature to emerging economies with high growth opportunities. The fact that many international small-cap companies were uncorrelated with domestic options also charmed the Modern Portfolio Theory advocates seeking diversification, which no doubt increased capital allocation to the asset class.

Small firm executives also noticed the opportunity and realized that a global marketplace was emerging. They noted that incremental growth was easier to achieve abroad than it was domestically, leading many small-cap firms to begin seeking international business. This is reflected in the increase in revenue derived from international operations for companies listed on the Russell 2000[®] Index.

■ KING's Small-Cap Equity Holdings

Many positions within KING's small-cap portfolios as well as small-cap positions held in the multi-cap strategy have international exposure. The Hain Celestial Group, Inc. (HAIN), for example, derives a large portion of its revenues from Europe due to an increasing demand for organic foods. Wright Medical Group, Inc. (WMGI) obtains 40% of its revenues from Europe, and Superior Energy (SPN) generates a significant percentage of its revenues from international oil services activity. This is only a small sample of client holdings that not only help mitigate risk through global diversification, but also have made a positive impact on alpha.

■ Small-Cap Advantages

Small-cap international investing is an ever-evolving endeavor. There are many opportunities for investors, including buying U.S. domiciled small-caps that obtain a portion of revenue from international business, buying foreign small-cap firms, or resorting to larger entities. As daunting as it may be to choose from among these options, it is important in this global economy to gain exposure to international operations through ownership of small-cap equity.

Small-cap companies have low correlation with mainstream investments, offer growth at a reasonable price, are frequently mis-priced, and are abundant; all characteristics that lend themselves well to bottom-up, proactive investment management.