Opportunities in 2012: The Case for International Small-Cap Equities

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While US-based investors have often embraced the return potential and diversification benefits of international large-cap equities, US small-cap equities and Growth and Emerging Markets, there is one area within the global equity universe that is frequently underrepresented or entirely absent all together—international small-cap equities.

International equities (inclusive of all capitalization ranges) already comprise over half of the total equity global market capitalization, a figure projected to grow to 62% by 2030. Although the majority of investors have exposure to international large-cap equities, many fail to realize that international small-cap equities have unique characteristics and can act as both a diversifier and complement to an international large-cap allocation. For example, the international small-cap universe is comprised of nearly 4,000 stocks, where a higher degree of dispersion in valuations and returns, particularly relative to the large-cap universe, allows for a greater degree of active management and stock selection. Historically, international small-cap equities have provided stronger risk-adjusted results relative to both US and international large-cap stocks, as well as offered additional diversification benefits relative to US small-caps. As investors consider future equity allocation decisions, we believe the international small-cap universe can offer attractive access to global growth through a differentiated opportunity set.

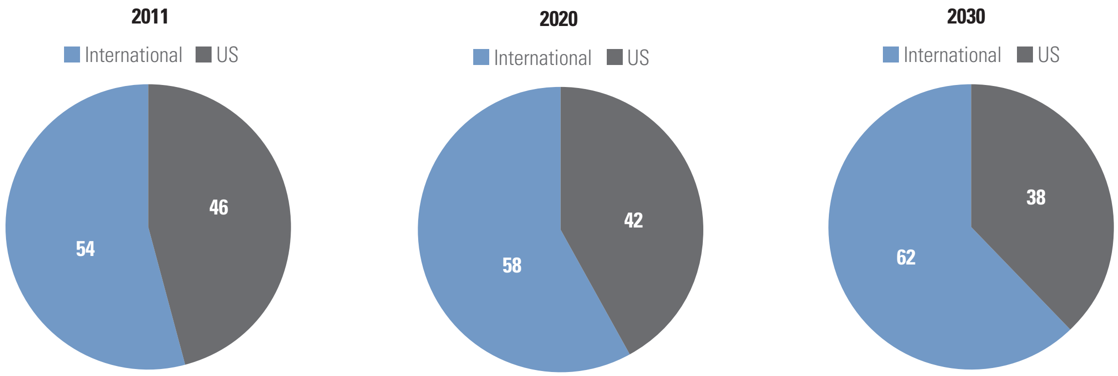
Why International Equity?

Growing share of global market capitalization

The US accounts for approximately 46% of the global equity universe,[1] yet for most US investors, domestic equities comprise a disproportionately larger percentage of their equity portfolios. Having a strong home bias can prevent US investors from achieving the risk and return benefits of a more diversified, global portfolio. Moreover, US equity markets are projected to represent an increasingly smaller share of the total world market cap over the next few decades as global and Growth and Emerging Markets deepen. When considering future equity allocations, we believe investors should increase the degree of globalization in their portfolios to better position themselves to capture this compelling opportunity.

[1]Source: MSCI All Country World Index, by Weight %. As of December 31, 2011.

Exhibit 1: International equities are gaining share of the global market capitalization



Sources: MSCI All Country World Index, by Weight %. As of December 31, 2011; "Global Economics Paper No: 204", GS Global ECS Research. September 8, 2010.

Understanding the international small-cap opportunity

This trend also holds true within the small-cap segment of the developed equity universe. For investors who already access small-caps through the US market, consider the broader picture: small-cap equities comprise 14% of today's total global market cap. Within small-cap equities, international small-caps represent 55% of the total universe,[2] yet the average US investor allocates approximately 15% of their small-cap exposure to these stocks.[3] We believe that small-cap investors should more broadly diversify and complement their US small-cap market exposure with international small-cap equities in an effort to better reflect globalization and the future growth of non-US equity markets.

Increasing investor focus

Recent search activity substantiates the notion that investors are already increasing their focus on international markets. Over the last five years, while international equity searches have accounted for 38% of the total number of equity searches, the total assets associated with these searches represented 56%. In 2011, international equity search activity surpassed US equity searches in both number of searches and dollars allocated, as indicated in *Exhibit 2*. We believe this trend will continue as investors continue to allocate their portfolios toward non-US markets.

Exhibit 2a: In equity searches, international equities are surpassing the US

	5-Year Search Activity 2006-2010		2011 Year-to-Date Search Activity	
	Number of Searches	Amount Allocated ($B)	Number of Searches	Amount Allocated ($B)
Domestic Equity	253	$42.1	25	$1.6
International/Global Equity	156	$54.5	30	$3.7

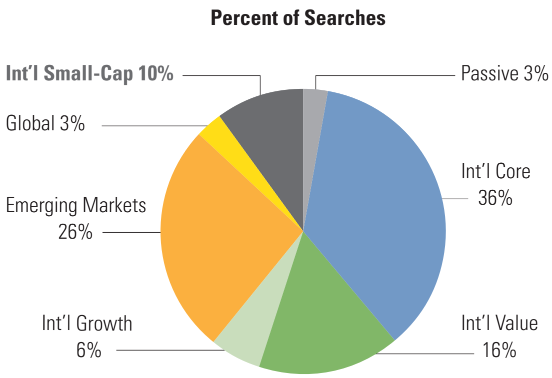
Source: Callan Associates, Manager Research Trends. As of August 31, 2011.

At the same time, the international small-cap asset class has also attracted a significant amount of attention during the recent uptick in international equity searches. International small-cap already accounts for 10% of all global equity searches and has been one of the largest share gainers of search activity over the last two years.

[2]FactSet as of December 31, 2011.

[3]US Based on Morningstar Categories: Small Cap Growth, Small Cap Value, and Small Cap Blend; Non US Based on Morningstar Categories: Foreign Small/SMID Growth and Foreign Small/Mid Blend.

Exhibit 2b: Within international equity searches, international small-cap is an increasingly large component



Source: Callan Associates, Manager Research Trends. As of August 31, 2011.

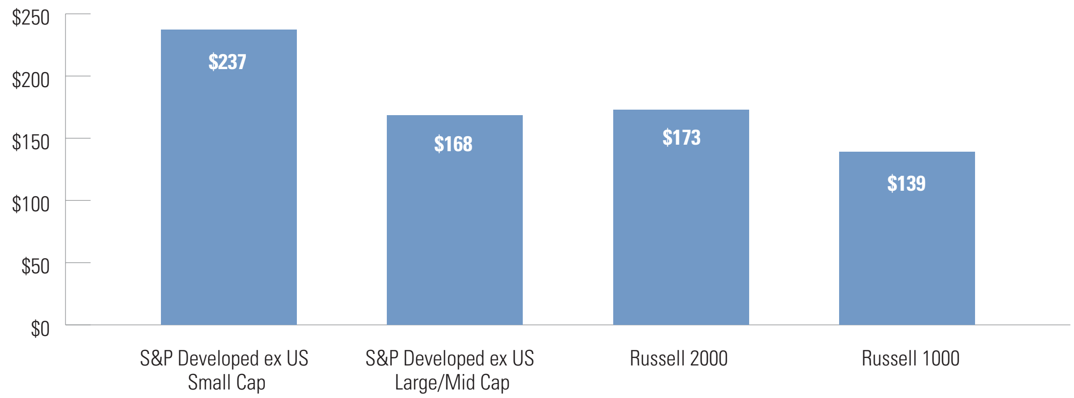
Investors are increasingly focused on non-US equity, a trend we expect to continue as global markets evolve and home country biases moderate. Importantly, the international equity asset class is a collection of diverse opportunity sets; the small-cap segment of this universe can offer a differentiated, compelling solution that we believe warrants more consideration.

Why International Small-Cap Equity?

Strong relative performance history

We believe that international small-cap equities can both complement and provide diversification benefits to an investor's equity allocation. International and US small-caps have historically provided strong returns relative to their large-cap counterparts. Over the last decade, international small-cap equity has outperformed US large-cap equity by almost 100% and international large-cap equity by almost 70% on a cumulative basis.

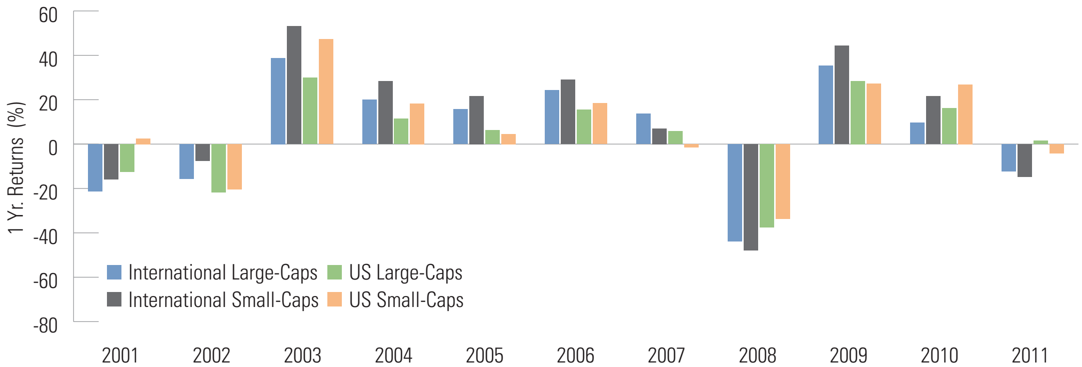
Exhibit 3: International small-cap equities have grown 137% over the last ten years
Growth of $100 investment over the last ten years as of December 31, 2011



Source: GSAM. January 1, 2002 - December 31, 2011. Based on $100 initial investment.
A graphical measurement of a portfolio's gross return that simulates the performance of an initial investment of $100 over the given time period. The example provided does not reflect the deduction of investment advisory fees which would reduce an investor's return. Please be advised that since this example is calculated gross of fees the compounding effect of an investment manager's fees are not taken into consideration and the deduction of such fees would have a significant impact on the returns the greater the time period and as such the value of the $100, if calculated on a net basis, would be significantly lower than shown in this example.
In Exhibit 3, Exhibit 4 and Exhibit 5: International Small-Caps are represented by the S&P Developed ex US Small Cap Index (total return net of dividend withholding taxes, unhedged, measured in USD); International Large-Caps are represented by the S&P Developed ex US Large/Mid Cap Index (total return net of dividend withholding taxes, unhedged, measured in USD); US Large-Caps are represented by the Russell 1000 Index (total return); US Small-Caps are represented by the Russell 2000 Index (total return).

Importantly, this outperformance has been consistent, with the international small-cap universe outpacing international large-cap equities in eight out of the last eleven calendar years, and US small-caps outpacing US large-caps in seven out of the last eleven years. Diversification of international small-caps has also added value relative to US small-caps over the long term.

Exhibit 4: International small-cap equities have been outpacing other domestic and international equities



Source: FactSet. Past performance is no guarantee of future results.

On a risk-adjusted basis, international small-cap performance has also been compelling, with a Sharpe ratio double that of US small-cap and international large-cap, and nearly 4X that of the US large-cap universe.

Exhibit 5: International small-cap equities provide compelling risk-adjusted returns

Index	Compounded Annualized Return (%)	Annualized Standard Deviation (%)	Sharpe Ratio
S&P Developed ex US Small Cap	9.03	20.21	0.35
S&P Developed ex US Large/Mid Cap	5.34	18.78	0.18
Russell 2000	5.62	21.00	0.17
Russell 1000	3.34	16.07	0.09

Source: GSAM. January 1, 2002 - December 31, 2011. Risk-free rate is Bank of America Merrill Lynch US T-bill: 3 month index.

Why Active Management?

Broad and inefficient universe presents opportunities

We think small-caps represent an exciting investment opportunity based on the distinct attributes of the asset class and its constituents. The characteristics of the universe are attractive: it is both large and inefficient. The international small-cap universe is comprised of nearly 4,000 stocks, while the large-/mid-cap segment includes approximately 1,200 stocks.[4] Given the larger scope of the universe and the smaller size of the individual companies, international small-caps also tend to have less research coverage relative to their large-cap counterparts.

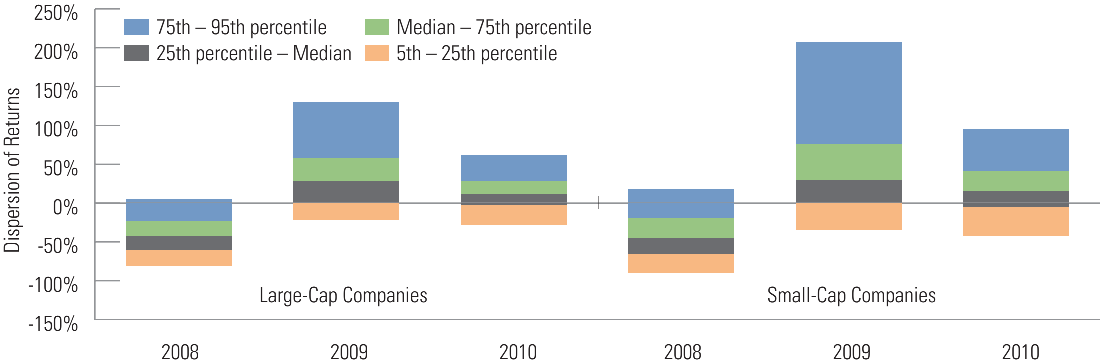
[4]International Small-Caps are represented by the S&P Developed ex US Small Cap Index; International Large-Caps are represented by the S&P Developed ex US Large/Mid Cap Index; US Large-Caps are represented by the Russell 1000 Index; US Small-Caps are represented by the Russell 2000 Index. As of December 31, 2011.

On average, large-cap companies are covered by seven research firms, while small-cap companies are covered by only three.[5] Within the international small-cap equity universe, less research coverage and a greater number of securities offers active managers a wider opportunity set, relative to large-cap equities, from which to exploit market inefficiencies and source investment ideas.

These thousands of diverse companies with varying valuations create a higher dispersion of returns among individual stocks compared to the large-cap universe, as seen in *Exhibit 6*. This dispersion presents many winners and losers, and thus fertile ground for alpha generation. Skilled active managers can identify true candidates for growth and capitalize on the large dispersion of returns within the small-cap equity universe. With robust research, active managers can uncover early stage opportunities such as small businesses in growing economic segments, players in niche markets with ample room for growth and takeout candidates in consolidating markets, a particularly timely theme with record levels of cash on corporate balance sheets. Additionally, well-managed small-cap companies with exposure to growth markets may also provide compelling upside potential. At the same time, greater variance of returns can pose greater volatility. We believe strong active managers can mitigate the risks of higher stock level dispersion through in-depth analysis and portfolio risk metrics.

Exhibit 6: Small-cap companies offer more differentiated returns

Dispersion of calendar year returns, large-cap vs small-cap companies



Source: Thomson Reuters, GSAM. Large-cap companies represented by the MSCI World Standard (Large+Mid Cap) Index. Small-cap companies represented by the MSCI World Small-Cap Index. As of December 31, 2010. **Past performance is not indicative of future results, which may vary.**

[5]Source: Thomson Reuters, GSAM. Large-cap companies represented by the MSCI World Standard (Large+Mid Cap) Index. Small-cap companies represented by the MSCI World Small Cap Index. As of December 31, 2010. **Past performance is not indicative of future results, which may vary.**

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Conclusion

As investors consider their equity allocations, we believe they should expand their approach to more international opportunities to capture the growth of non-US markets over the next two decades. Taking this a step further, international small-cap equities have historically offered greater risk/return potential relative to their large-cap counterparts. In addition, the international small-cap universe is large, with higher dispersion and less research coverage. We believe that these unique characteristics, among others, provide active managers with ample opportunity to exploit inefficiencies and generate alpha across international small-cap equities.

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