

## Timely insights from portfolio managers and industry experts on key financial, economic and political issues.

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### International Small Caps - Challenge and Opportunity

**London** - Since early May, international small-cap stocks, as measured by the MSCI EAFE Small/Mid Cap Index, have risen by over 2%, and are now trading at all-time highs. Having risen by 14% so far this year (as of September 13), international small caps are outpacing their international large-cap counterparts in 2021.

In late 2020 and into the first quarter of 2021, the cocktail of the post-vaccine COVID recovery trade — combined with massive monetary and fiscal stimulus measures — led parts of the equity market sharply higher. Since April, in our view, a very exuberant and macro-oriented global stock market has moderated in sentiment and stock picking has once again come to the fore.

Although global stock markets overall have moved significantly higher this year, the volatility of late is highlighting the list of challenges to stocks' seemingly relentless advance:

- Valuations look stretched at a time when we are moving from an early-stage COVID-related economic recovery to a more midcycle phase.
- We are seeing increasing talk of tapering by the U.S. Federal Reserve.
- Supply chain bottlenecks around the globe are stalling product deliveries, contributing to inflationary pressures.
- Growth expectations are slowing.
- The constant threat of new COVID variants is upsetting the pace of recovery, as is uncertainty in relation to how long vaccines will remain effective until boosters are potentially required.
- Harsher regulatory narrative from government leadership in China has investors and markets on edge.

Although such a list of challenges naturally leads to a degree of caution, we believe any resultant volatility plays into the hands of stock pickers, especially favoring those with strategies that focus as much on capital preservation as on capital appreciation.

#### Structural change afoot

While only time will tell what the long-term implications of the pandemic will be, we think it already seems clear that certain sectors will be challenged in terms of their future business models. A classic case appears to be the airline industry, where COVID-19 has shone a bright light on the amount of money and time spent on business travel prepandemic — at least some of which now appears to have been unnecessary, if not wasteful. Moreover, climate change is likely to impact the airline sector longer term as well as the broader transportation industry, among others.



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Business models will need to change, hopefully for good reasons, as they focus more on the environmental, social and governance (ESG) challenges facing their companies or industries. Nevertheless, from an investment perspective, with structural change comes heightened uncertainty.

With an eye toward avoiding underperformance, we think it wise to look for areas where greater certainty and long-term structural growth tend to exist. Some places where we see these opportunities include:

**Translation services** are increasingly outsourced. By this we do not mean simple translation for corporate holiday events or friends and family. But rather we consider the pinpoint accuracy required when translating details of drugs being developed, approved and marketed across multiple jurisdictions and regulatory authorities, where there is zero room for error. Or think about *transcreation*, where, for example, a major international consumer goods or technology company wants to launch a new product in Japan, Germany, France, the U.S. and the U.K. at the same time. The messaging needs to suit different markets and different cultures — not simply a case of translating each word in the boilerplate text.

**Luxury goods** have a well-trodden and very profitable path historically. Currently, our research shows that U.S. consumers' per-capita spending on luxury watches has fallen well below that of other developed countries such as the U.K., when it used to be on an equal footing. We believe this spending gap reflects a less-than-ideal market structure and marketing approach in the U.S., which is starting to change.

The point with these examples is that if you look beyond the near term, we believe there are many structural and scalable growth opportunities available — especially for international small-cap investors who have a broad investment universe.

**Bottom line:** Although small-cap international stocks face a number of challenges exist in the current market, we believe that we can still find attractive areas for potential investment. Our approach is to look for those areas where we may be able to take advantage of near-term risks, while we continue to focus on the long-term opportunities.

MSCI EAFE Small/Mid Cap Index is an unmanaged index of small and mid-capitalization equities in the developed markets, excluding the U.S. and Canada.

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