Investment Update

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Another Arrow in our Quiver

A quiver full of arrows is an archer's best friend. If you have a teenager like I do, you are probably familiar with Katniss Everdeen, the heroine in the now famous book series and movie trilogy, *The Hunger Games*. Katniss relies on her bow and arrow skills to defend herself in treacherous environments. Her quiver full of arrows allows her the opportunity to win, and without it, the odds would not be in her favor!

In the investment world, we recognize that it takes a full quiver of strategies to navigate today's complex markets. No one strategy can consistently hit the bullseye. Thus, it is important to select the right combination of arrows that will hit the target over time and to also recognize that new arrows may be needed as market conditions change. But how do we know which combination of arrows will hit the target?

Here at BNY Mellon Wealth Management, I lead a team of experts in making strategic asset allocation recommendations designed to help clients reach their long-term objectives. Typically we discuss the relationships between our existing asset classes: Do we overweight equities versus bonds? Should we allocate more to large cap stocks and take from small cap stocks? How much should we allocate to alternative investments?

There are also times when we may want to take advantage of a new investment opportunity. Typically, these situations arise when there are dislocations, or mispricings, in the market that enable us to add an additional source of diversification, protect against risks, or add an additional source of return. We have been monitoring developments in international developed markets and have been researching the viability of adding international small capitalization equities to our asset allocation for some time. We believe markets are now presenting us with the opportunity to add this asset class to client portfolios. Our friends at The Boston Company share our favorable views of the asset class, and recently produced a white paper on the subject: "Making the Case for International Small-Cap Stocks." As a companion to their work, I'd like to highlight some of the reasons why we have decided to recommend exposure to this asset class and the role it can play in client portfolios.

Why invest in international small cap now?

Although the U.S. economy continues to lead many other developed markets, Europe and Japan are regaining their footing in part due to stimulative policy actions. Recently, the European Central Bank (ECB) launched its massive bond-buying program, which will pump €60 billion a month ($66.3 billion) into the Eurozone economy in an effort to help stimulate growth in the region, drive down interest rates, and restore the inflation rate back to targeted levels. Likewise, Japan's economy is rebounding and has recently expanded its quantitative easing program aimed at achieving a 2% inflation target. These policy actions have also weakened both the yen and euro versus the dollar, which will decrease the cost of exports, making local companies more competitive.

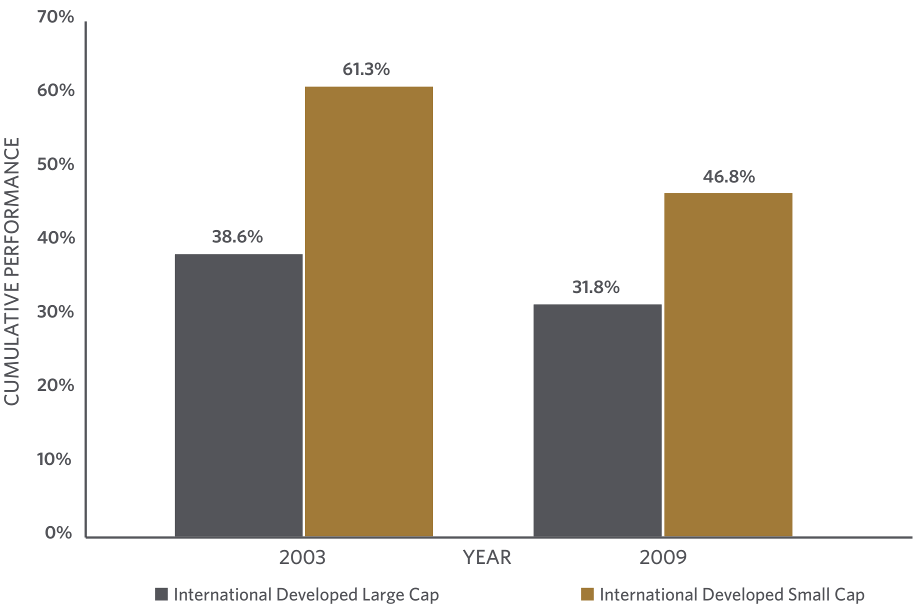
Although small cap stocks don't have the direct exporting tailwinds of their large cap counterparts, they do tend to perform better early in a recovery as smaller companies have leaner operations and can more quickly respond to changing market dynamics. This trend was evident in 2003 and 2009 with international small cap outperforming international large cap (Figure 1).

Compelling returns and an opportunity for active management

For the 10-year trailing period ending 3/31/15, international small cap equities produced higher returns than international large caps by 1.22%. However, compelling long-term returns of international small cap stocks also come with some drawbacks—notably higher volatility with a 10-year standard deviation of 19.7 versus 18.2 for international large cap.

The international small cap equity space is less researched than other asset classes with greater disparity between constituent stocks' performance. Both of these factors create a significant opportunity for investment managers who have the commitment and skill to capitalize on the resulting market inefficiencies. Thus, a clear potential exists for good managers to outperform the index and add value to client portfolios.

Figure 1 – International Small Cap v. International Large Cap



Source: Morningstar Direct. Data represents the MSCI EAFE Index and the MSCI EAFE Small Cap Index

Attractive Valuations

We are taught to always buy low and sell high, but often this lesson is overlooked amidst increased optimism and confidence in late-stage bull markets. While we have recommended and continue to recommend an overweight to large cap equities investors should not overlook those "buy low" opportunities that will pay off once market leadership inevitably shifts.

International small cap equities are attractively valued versus domestic large cap stocks. As of March 31, 2015, we deem U.S. large caps and small caps to be more fairly valued with their price-to-earnings ratios trading near their historical averages. International large cap and international small cap equities, on the other hand, are trading at much lower P/E ratios compared to their longer term averages, with current P/E ratios of 17 and 22 versus averages of 24 and 33, respectively.

Furthermore, as highlighted in TBC's article, "both Japanese and European corporate earnings trends should benefit from currency weakness versus the U.S. dollar as forward earning expectations maintain a strong, positive correlation with a weakening of their respective currencies on a trade-weighted basis." Thus, investing in international developed small cap offers opportunities to find attractively priced companies that can benefit from the recovery in both Europe and Japan.

Conclusion

Just as Katniss relied on her bow and arrow skills to succeed, we too rely on discipline and skill to add value to client portfolios. Adding another arrow to our quiver, such as international small cap equities provides another source of diversification and potential capital appreciation to a well-diversified portfolio. In today's changing market, access to new investment strategies provides the kind of flexibility needed to reap the benefits from evolving market conditions while staying true to long-term wealth objectives.

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