



# METIS INSIGHTS

SEPTEMBER 2018



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## INTERNATIONAL SMALL CAPS AND THE WINDS OF CHANGE: MACRO, MICRO, DEBT

### Executive Summary

International small cap value stocks now offer a rare opportunity in this uncertain investment world. Analysis of market and company fundamentals show that this segment of the world markets may now benefit from changes in underlying macro-economic conditions, historically cheap valuations, and defensive company attributes:

- **Macro:** Historic factor performance suggests that the potential for rising interest rates and inflation around the world may bode well for both small companies and a value approach.
- **Micro:** the growth stock trade-off between higher valuations and higher quality has collapsed within international small cap growth companies, creating a very attractive comparative profile for value small caps currently.
- **Debt:** Over the last decade of zero interest rate 'free money', international companies have greatly improved their debt structure when compared to their U.S. counterparts, positioning them well for macro changes.

### Macro: Changing Interest Rates and Inflation

Inflation has been subdued or non-existent in most of the developed world for decades, and bond yields have likewise declined to historically low levels. These long-term trends now appear to be reversing, and the current underlying trends in short and long bond rates, as well as inflation, suggest they may have nowhere to go but up. The initial impetus appears to be in the United States, but eventually these effects should spread to the rest of the world.

The macro drivers of interest rates and inflation have historically been important factors in the return expectations of global markets. But what do they have to say about international small cap, and more specifically small cap value?

Bernstein Research<sup>1</sup> looked at the impact of various factors affecting equity performance over a 25-year period (1990-2015), split between periods of rising, falling, and flat long bond rates and inflation. **Exhibit 1** shows the results of the various long bond interest rate environments for the two factors that are most relevant to international small cap value stocks: the value effect (Price to Book), and the size effect (small vs large). **Exhibit 2** shows the returns for the same factors in various inflationary periods.

#### Exhibit 1: Long Rates and Factor Returns

Style Factor	Avg return, all periods, %pa	Rising rates, return, %pa	Falling rates, return, %pa	Flat rates, return, %pa
Price to book (cheap/expensive)	3.19	9.21	0.80	2.93
Size (small/large)	6.36	35.29	-2.22	2.42

Source: Datastream, Bernstein analysis

Table shows the annualized return from factor portfolios in different rate environments from 1990-2015. Factor returns are defined as the long-short return of the top-bottom quintile from the 500 largest stocks in the MSCI World index. Portfolios have been rebalanced quarterly and returns are on equal-weighted total return basis. Long rates are 10 year sovereign yields. We take an equity market cap weighted average of national yields to form a global measure.

<sup>1</sup> Bernstein; Global Quantitative Strategy: Factors feeling the heat, July 13, 2018.

### Exhibit 2: Inflation Regimes and Factor Returns

Style Factor	Avg return, all periods, %pa	Rising inflation, return, %pa	Falling inflation, return, %pa	Flat inflation, return, %pa
Price to book (cheap/expensive)	3.19	11.78	6.62	-4.58
Size (small/large)	6.36	7.21	23.29	-8.39

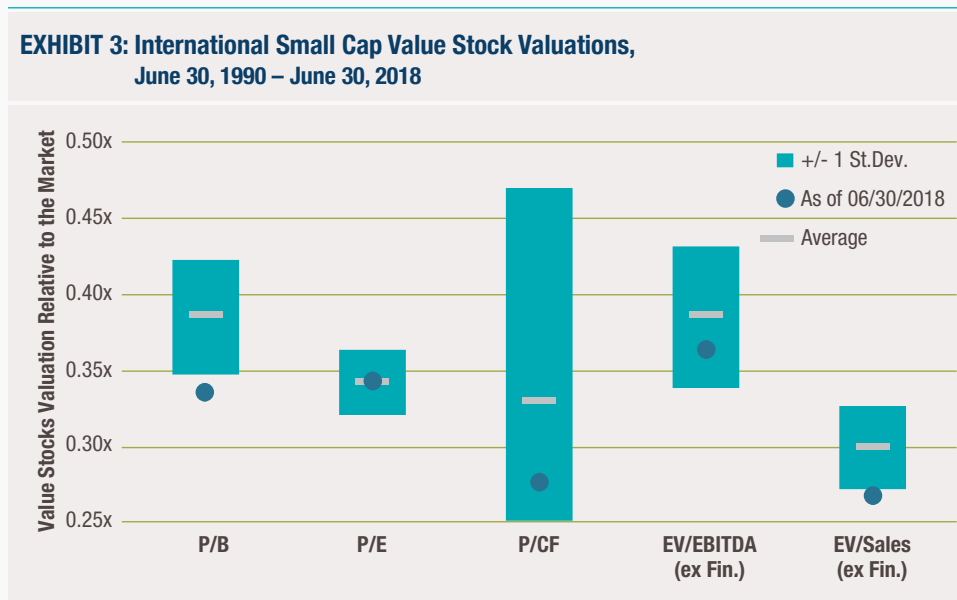
Source: Datastream, Bernstein analysis

Figures shows the annualized return from factor portfolios in different inflation environment from 1990-2015. Factor returns are defined as the long-short return of the top-bottom quintile from the 500 largest stocks in the MSCI World index. Portfolios have been rebalanced quarterly and returns are on equal-weighted total return basis. We take an equity market cap weighted average of inflation yields to form a global measure.

Their research suggests that periods of rising long-term bond rates create the strongest tailwinds for both the value and small size factors of any of the rate regimes. Similarly, rising inflation strongly supports the value factor performance and provides a positive environment for the small size factor as well.

### Micro: The Changing Valuation vs. Quality Relationship

The case for value vs. growth is often one of valuation versus perceived quality. If we look at international small cap value stocks today relative to the market, valuation metrics are generally below their near 30-year historical averages (Exhibit 3). Two of these measures (price to book and enterprise value to sales) are more than one standard deviation below the long-term averages, a mark of significant undervaluation.



Source: Worldscope via Clarifi, as of 6/30/2018. Value stocks are defined as the cheapest decile of companies by each respective metric in the market measured monthly. The market is defined as the 10th-25th percentile of stocks globally by market capitalization. Worldscope's coverage of financials for emerging and frontier markets is generally adequate by 1990, thus the starting point for valuations relative to the market.

“ rising long bond rates and rising inflation create the strongest tailwinds for both the value and small size factors ”

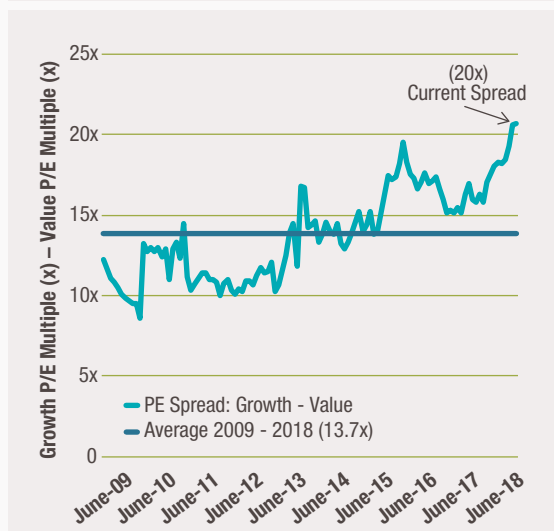
“the difference between growth and value P/Es is now higher than it has been since the tech bubble,”

But what about value vs. growth valuations? While international small cap value P/E ratios are not currently at extremes (as shown in Exhibit 3), the P/E multiple *spread* between small cap growth and value has changed significantly over the past decade. International small cap growth typically has a healthy P/E spread over value due to the market perception and expectation that growth companies should provide high quality investments, with quality being measured by metrics like return on equity (ROE). The difference between the average growth and value P/E is now higher than it has been since the tech bubble of the early 2000s.<sup>2</sup>

**Exhibit 4** shows that the average spread between small cap growth and value P/Es over the past decade was 13.7x. That same ratio is currently over 20x! This very large multiple premium should in turn suggest that these growth companies are delivering historically higher quality metrics as well. But this is not the case. Instead the quality spread between growth and value has *narrowed* materially over the last decade, as measured by ROE. As shown in **Exhibit 5**, the ROE spread between growth and value in international small cap was over 17% at times early in the past decade. The average spread for the period was 14.6%. But the gap has narrowed over the last five years and is now approaching 10%. Growth not only looks historically expensive from the P/E multiple perspective, but the quality benefit that an investor should reap by ‘paying-up’ for growth companies has collapsed relative to value. By these measures both valuation and quality currently appear to be favor value stylistically.

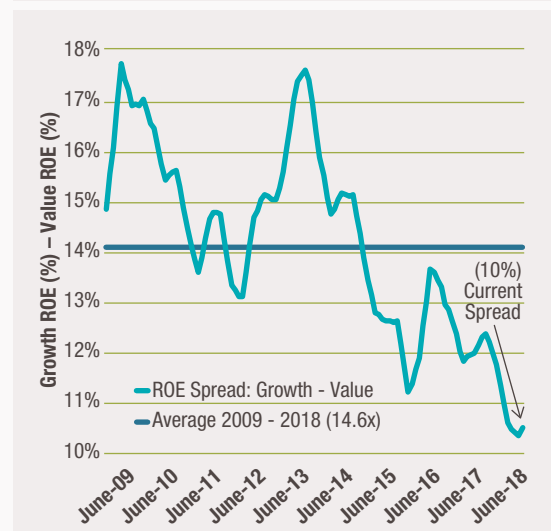
“the ROE quality benefit for growth companies has collapsed,”

**Exhibit 4: P/E Spread of Growth and Value Stocks Post Financial Crisis of 2008 (2009 – 2018)**



Source: Factset, S&P Global Ex US Small Cap Index. Price/Earnings (P/E) Spread is defined as the average P/E of the Growth stocks minus the average P/E of the Value stocks, rebalanced monthly from January 31, 2009-June 30, 2018. (Value stocks are defined as the cheapest Price/Book quintile (Q5) of companies while Growth stocks are defined as the most expensive Price/Book quintile (Q1)).

**Exhibit 5: Quality Gap (ROE) Between Growth and Value Stocks Post Financial Crisis of 2008 (2009 – 2018)**



Source: Factset, S&P Global Ex US Small Cap Index. Return on Equity (ROE) Spread is defined as the average ROE of the Growth stocks minus the average ROE of the Value stocks, rebalanced monthly from January 31, 2008-June 30, 2018. (Value stocks are defined as the cheapest Price/Book quintile (Q5) of companies while Growth stocks are defined as the most expensive Price/Book quintile (Q1)).

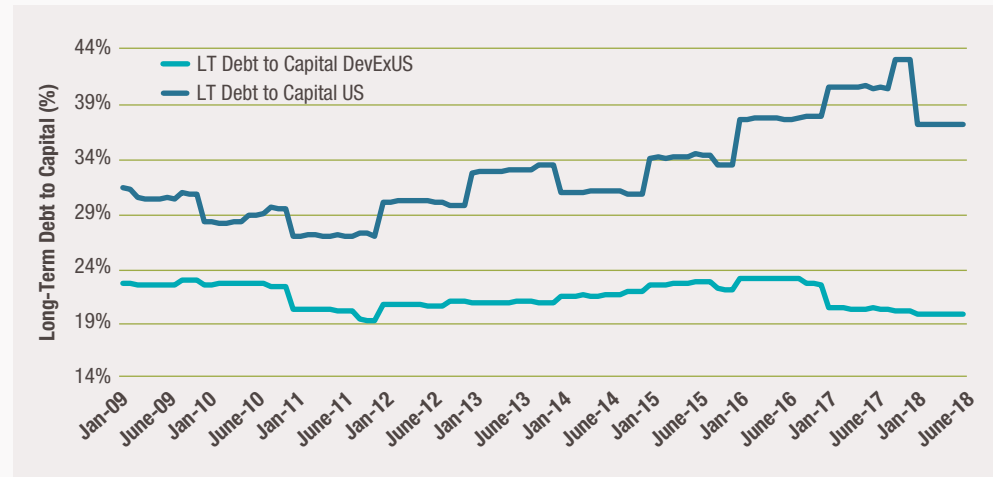
<sup>2</sup> Source: Metis Global Partners, S&P Global Small Cap ex.US Index, December 1999-June 2018. The P/E spread is calculated on a monthly basis and defined as the average P/E of the top quintile of P/B (Growth) index constituents minus the average of the P/E of the bottom quintile P/B (Value) index constituents.

## Debt: International Shifts From Variable to Fixed

If we are indeed at the threshold of an era of rising interest rates, it's worth examining the level and the type of debt for small cap companies worldwide. It is noteworthy that historically there has been a difference between the amount of corporate debt issued regionally. U.S. small cap companies have historically on average had moderately higher levels of long-term debt than their non-U.S. counterparts, with more of it structured as fixed debt. The lower debt utility seen in international small cap companies, has historically leaned toward variable debt structures.<sup>3</sup>

So how has the 'free money', low interest rate environment of the last decade affected debt usage? U.S. small cap companies since 2008 have built up debt and have also increased the proportion of it that is variable interest rate debt on average, exposing them to greater risk of rising interest rates. **Exhibits 6** and **7** show that international small companies have done just the opposite.

**Exhibit 6: Indebtedness of US and International Small Cap Post Financial Crisis of 2008**



Source: S&P Global BMI Indices, FactSet Fundamentals. Long Term Debt/Capital is calculated monthly between January 31, 2009-June 31, 2018 as the average of all stocks in the respective index: S&P Developed Ex US Small Caps Ex Financials and S&P US Small Caps Ex Financials.

“debt levels of U.S. small caps are now approximately double those of their international counterparts”

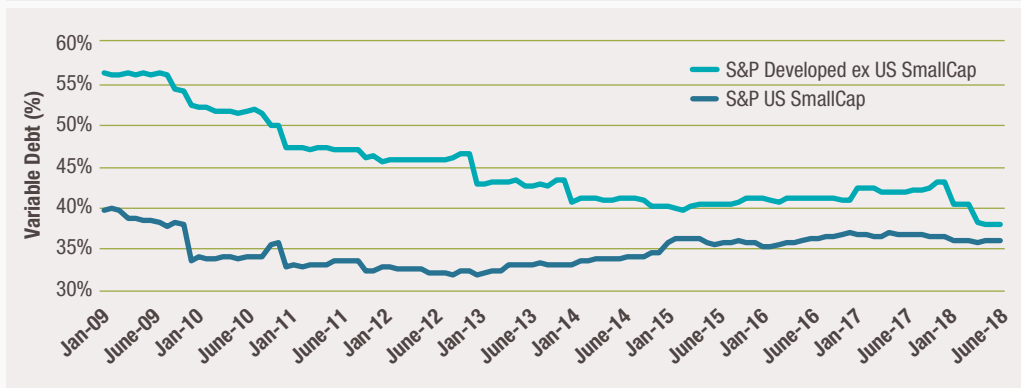
“International small cap companies have been aggressive in switching from variable to fixed rate debt”

Starting with Exhibit 6, we can observe the debt levels of U.S. small caps are now approximately double those of their Developed Ex-US counterparts. As previously mentioned, U.S. firms have generally carried a higher debt load, but a decade ago the U.S. small cap debt levels were only 40% higher than international small caps, not double as they are now.

Also true is that a decade ago, U.S. small caps had significantly less of their debt in variable rate borrowing than did their Developed Ex-US counterparts. As interest rates declined over that period, the international firms would therefore have seen more benefit from that variable rate exposure. However, these international small cap companies have been far more aggressive in switching from variable to fixed rate debt over the last decade, as shown in Exhibit 7. They now have brought their variable exposure down from 55% of total debt to levels comparable with their U.S. counterparts. This combination of lower overall debt and opportunistic restructuring to (presumably) low interest rate fixed debt, positions international small caps well for a move away from the ten year 'free money' environment global markets have experienced.

<sup>3</sup> Source: S&P BMI Global Indices, Factset 1990-2017.

**Exhibit 7: Variable Debt, US and International Small Cap Companies Post Financial Crisis of 2008**



Source: S&P Global BMI FactSet Fundamentals. Variable Debt/Total Debt is calculated monthly between January 31, 2009-June 30, 2018 as the average of all stocks in their respective index: S&P Developed Ex US Small Caps Ex Financials and S&P US Small Caps Ex Financials.

To sum up, it may now be a very appropriate time to visit (or re-visit) international small caps as a possible source of long-term returns with lower risk characteristics than their large cap or domestic counterparts, especially if we are poised for a new era of rising interest rates and higher inflation.

In this article, we have shown that

- Periods of rising bond yields and rising inflation may favor small, value stocks worldwide.
- International small cap value stock valuations are low compared to their own historical levels.
- They also have become steadily cheaper (as measured by P/E) than their growth counterparts over the past decade, at the same time as the quality gap between value and growth has narrowed.
- International small companies have reduced their debt as a proportion of capital and moved to more fixed debt while their U.S. counterparts have added debt.

-The Metis Team

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Please contact us at [info@metisgp.com](mailto:info@metisgp.com) or 858-436-3030 for questions or inquiries.

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#### INDEX DEFINITIONS

**S&P Global ex-US Small Cap Index:** The S&P Global ex-US Small Cap Index is a comprehensive, rules-based index measuring stock market performance of small capitalization companies from developed and emerging markets excluding the United States.

**S&P Developed ex-US Small Cap Index:** The S&P Developed ex-US Small Cap Index is a comprehensive, rules-based index measuring stock market performance of small capitalization companies from developed markets excluding the United States.

**S&P US Small Cap Index:** The S&P Developed US Small Cap Index is a comprehensive, rules-based index measuring stock market performance of small capitalization companies from the United States.

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