



## INTERNATIONAL EQUITIES Seeking a More Complete Definition

May 2008

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### INTRODUCTION

As investors become more global in their orientation, they are also becoming more sophisticated in their search for additional sources of return and diversification. While most U.S. investors have long maintained core positions in international equities, this exposure has been heavily concentrated in the large-cap equities of developed countries, supplemented to some extent with emerging market equities. Meanwhile, smaller-cap international companies have been largely ignored, despite their strong performance in recent years and their potential diversification benefits. In this essay, we argue for the inclusion of these smaller-cap companies as part of a comprehensive international equity strategy.

One hurdle keeping investors out of this “sub-asset class” historically has been the complexity and unfamiliarity of available benchmarks.<sup>1</sup> This paper also assesses the international benchmark issue and how it has impacted the investment approach taken by most U.S. managers. We then discuss why the prevailing approaches are sub-optimal from the perspectives of both risk and return, and suggest ways to better integrate small-cap international equities into a global portfolio.

In today’s dynamic and expanding markets, accessing international markets in an appropriate manner is increasingly important. International stock markets represent more than half of the world’s total market capitalization, and U.S. investors have finally starting addressing their home country bias by adding significantly to their international exposure.<sup>2</sup> As this trend continues, investors need and deserve better and more transparent access to global small caps, in order to achieve comprehensive international equity exposure and improved asset allocations.

### IS EAFE OBSOLETE?

MSCI EAFE (Europe, Australasia and Far East) has been the dominant international equity benchmark for U.S. investors for over 30 years. Yet in an integrated global capital market, it is increasingly outdated as a measure of the opportunity set available outside our borders. Thus EAFE is obsolete for most investor applications.

Let us be clear: EAFE is not obsolete as a proxy for the large-cap equities of non-U.S. developed markets (except, of course, for its notable omission of Canada). But as a proxy for the true global ex-U.S. equity markets, it is most definitely outdated.

Unfortunately, it is in exactly this capacity that MSCI EAFE has served too many U.S. investors for far too long. As a result, there has been a tremendous flow of assets into strategies benchmarked to EAFE and, more recently, to the MSCI Emerging Markets Index. However, Canadian equities and the increasingly important small cap segment of the international market have been largely ignored.

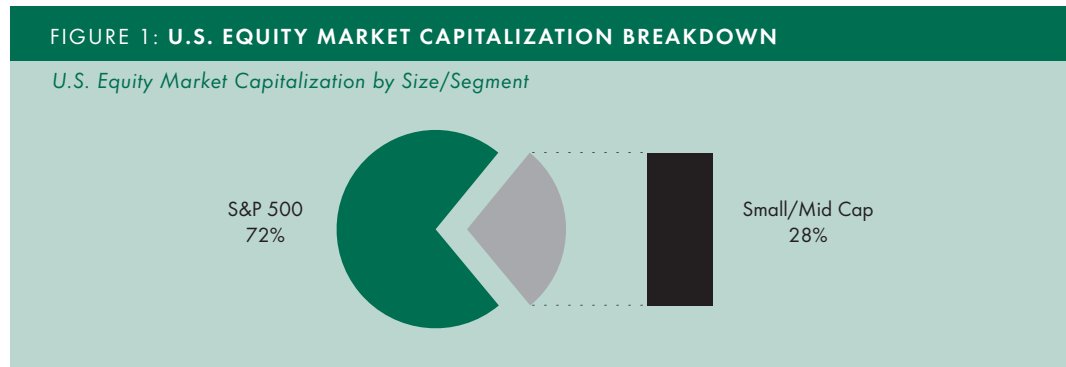
To fully understand this issue, one needs to grasp the major impact that a benchmark’s composition has on managed portfolios. With index funds, the linkage is direct and obvious. With

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active managers, the linkage is less direct, but nonetheless very important. Most active managers pay very close attention to the benchmark against which they are being measured. They will stray from a benchmark, but not too far, and tracking error versus the index is frequently cited as a measure of the “active risk” a manager incurs. Thus, a large-cap benchmark will generally translate into a large-cap portfolio, and that is exactly how EAFE has been used by asset owners and their consultants.

The MSCI EAFE index covers 21 developed countries with a total market capitalization of \$14 trillion. Weights within the index range from 22% for the U.K. to 0.4% for Portugal. Three countries — the U.K., Japan, and France — account for over 50% of the index weight. The index draws its constituents from the larger-cap companies within these countries. In total, EAFE captures approximately 69% of total non-U.S. equity market cap, about on par with the 72% market coverage offered by the S&P 500.



Source: NTGI Global Quantitative Management Group

While few sophisticated investors would argue that the S&P 500 is a comprehensive benchmark for U.S. equities, many take EAFE at face value as a proxy for “international equities.” In the U.S., investors supplement the S&P 500 benchmark with indexes such as the S&P SmallCap 600, Russell 2000 or the DJ Wilshire 4500, which include smaller-cap companies, to fill in the “benchmark gap” shown in Figure 1. Why restrict the portfolio choices of an active manager unnecessarily?

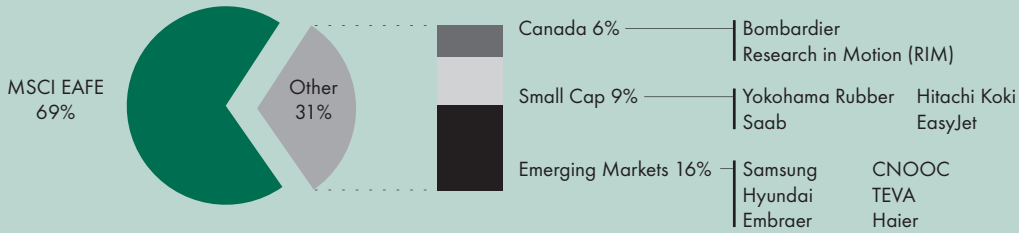
We hereby challenge American investors to perform the same exercise with their international allocations as they do with their U.S. allocations, with the objective of attaining complete coverage of the investment universe. Such an exercise is long overdue on the part of both asset owners and their consultants.

### WHAT ARE INVESTORS MISSING?

Because of the “benchmark gap” inherent in using MSCI EAFE as a primary measure of the international equity markets, investors tend to systematically underweight or overlook three important segments of the world outside the U.S.: Canada, developed international small caps and emerging markets. Collectively, these three markets account for more than \$4 trillion of market cap, almost one-third of the total \$12.5 trillion market cap for non-U.S. equity assets (see Figure 2)<sup>3</sup>. Furthermore, as shown in Figure 3, all three of these market segments have had periods of dramatic outperformance relative to EAFE and its equivalents. More importantly, they have delivered *substantially different* performance, and this diversification effect has not been captured by the EAFE benchmark.

**FIGURE 2: INTERNATIONAL EQUITY MARKET SUB-ASSET CLASSES**

*Non-U.S. Market Capitalization by Region*

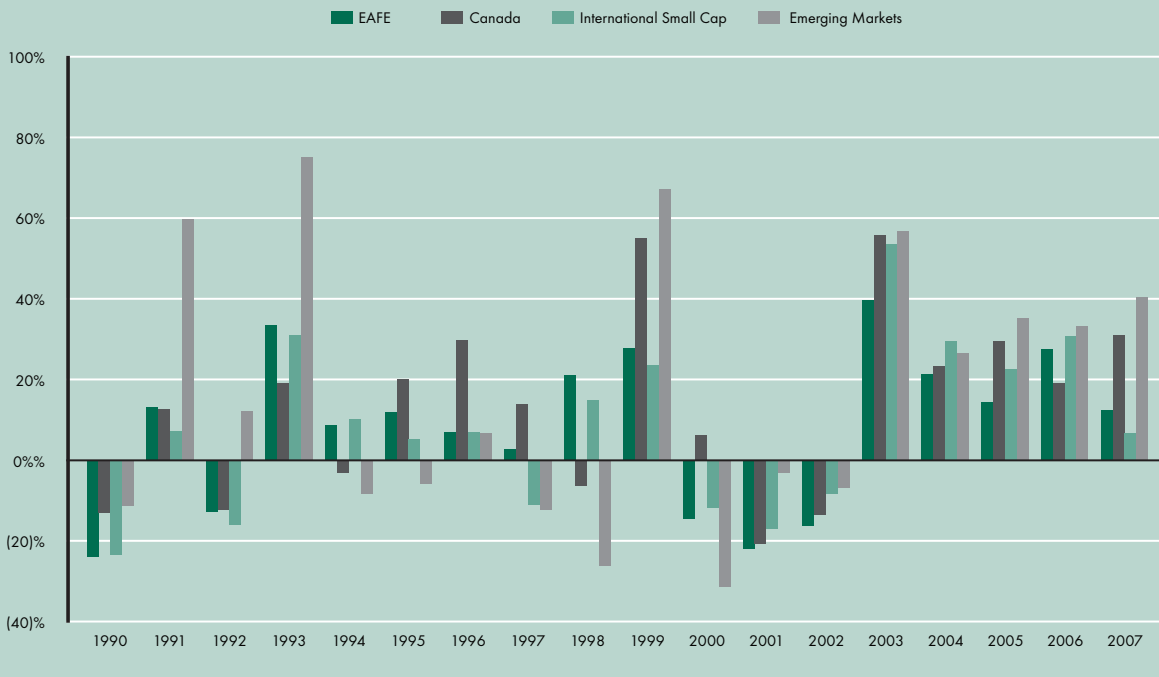


Source: NTGI, MSCI, S&P August 2007

Despite its incomplete representation of the international equity class, MSCI EAFE still prevails as the default benchmark. In the institutional investor space, it is used as a proxy for “international exposure” in asset allocation analyses and as a performance benchmark for both active and passive managers. In the individual investor arena, this “large and developed” bias is even more pronounced, and thus even more in need of evolution.

**FIGURE 3: POTENTIALLY MISSED PERFORMANCE OF INTERNATIONAL SUB-ASSET CLASSES**

*Differential Market Performance*



Source: NTGI, FactSet, MSCI, S&P

As American investors allocate a higher proportion of their equity portfolios to international stocks, it has become increasingly untenable to be imprecise in the measurement of, and allocation to, this opportunity set. By ignoring or underweighting three key market segments — Canada, developed international small cap and emerging markets — investors are leaving attractive investment opportunities on the table. They should consider shifting to more complete “total international equity” policy benchmarks, while also increasing their overall allocation to international equities. Filling this wide benchmark gap can increase portfolio returns while lowering risk due to improved diversification.

More and more investors are integrating emerging markets and Canada into their policy framework, as shown by the growing popularity of such “integrated international” benchmarks as the MSCI All Country World excluding U.S. (ACWI ex. U.S.) Index or FTSE All Country Index.<sup>4</sup> But even those benchmarks fall short. Inevitably we ask, shouldn’t international small-capitalization stocks be integrated as well?

### **BUT I’M EXPOSED TO INTERNATIONAL SMALL-CAP WITH MY EAFE MANDATE!**

Some managers with an MSCI EAFE benchmark have invested “opportunistically” in smaller-cap companies, seeing these as a source of potential alpha. In the same spirit, it is not at all uncommon for a manager to invest a (small) portion of an MSCI EAFE mandate in emerging market equities — “dabbling,” as it were. Many asset owners and their consultants explicitly allow or even encourage this approach (with maximum bands) as a way of getting exposure to both sub-asset categories.<sup>5</sup> While a case can be made for relying on a manager to make these sorts of active decisions, the benchmark will still have a significant influence on weightings. If the benchmark has no exposure to smaller-cap companies, a portfolio’s neutral position will also have no exposure. As a result, any exposure will be carefully monitored for its impact on overall risk. If, on the other hand, exposure to small-cap equities is included in the benchmark, the portfolio’s neutral position will reflect that.

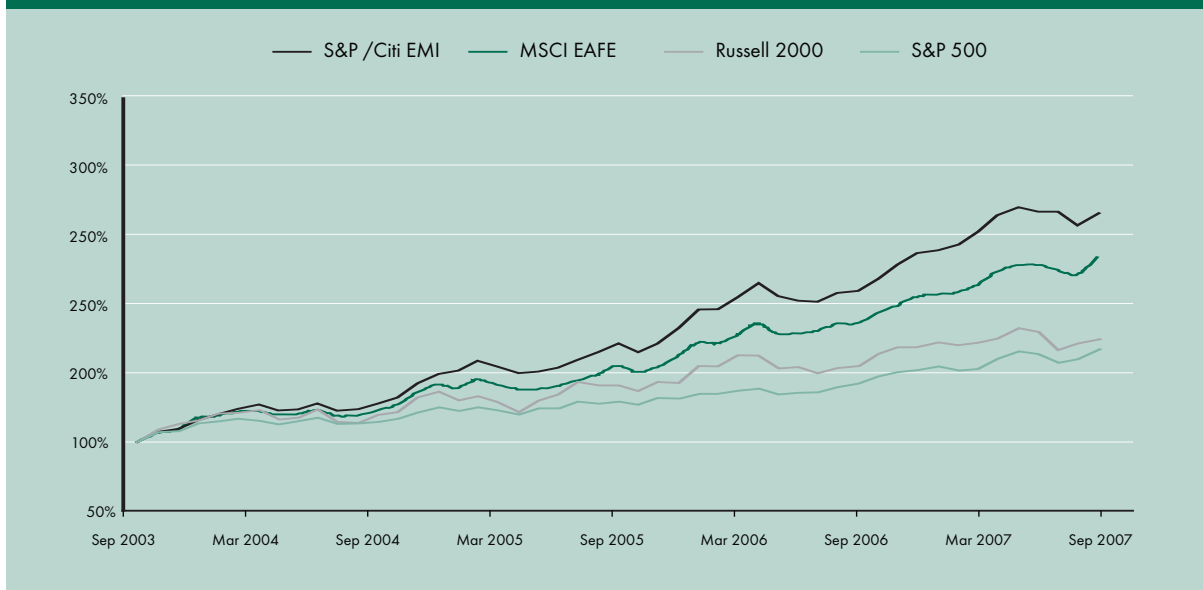
Furthermore, if a manager is holding small-cap issues as a core component of his/her strategy, one must question whether MSCI EAFE is the appropriate benchmark to use in measuring performance. As Figure 4 notes, over the last four years, developed-market international small-cap stocks have outperformed MSCI EAFE by 6.3% on an annualized basis. A manager making an allocation to this space will likely have outperformed the benchmark, but does this reflect skill in selecting these stocks or merely the beta of this sub-asset class? Will the opportunistic manager be able to time his/her moves in and out of this dynamic asset class effectively going forward?

We strongly believe that any attractive asset class or sub-asset class should be captured in the benchmark used to evaluate a manager. This holds as well for value- and growth-oriented managers within international equity.<sup>6</sup> The neutral position should represent the mix of assets with which the investor is genuinely comfortable, i.e. “the true opportunity set” for the investment manager.

## THE APPEAL OF DEVELOPED INTERNATIONAL SMALL-CAP STOCKS

Since this decade's stock market bottom in the spring of 2003, international small cap stocks (as represented by the S&P/Citi Extended Market Index [EMI]<sup>7</sup>) have significantly outperformed the MSCI EAFE, Russell 2000 and S&P 500 indexes, as shown in Figure 4. It should be noted that U.S. small-cap benchmarks such as the Russell 2000 and S&P SmallCap 600 also significantly outperformed their large-cap peers over this time period.

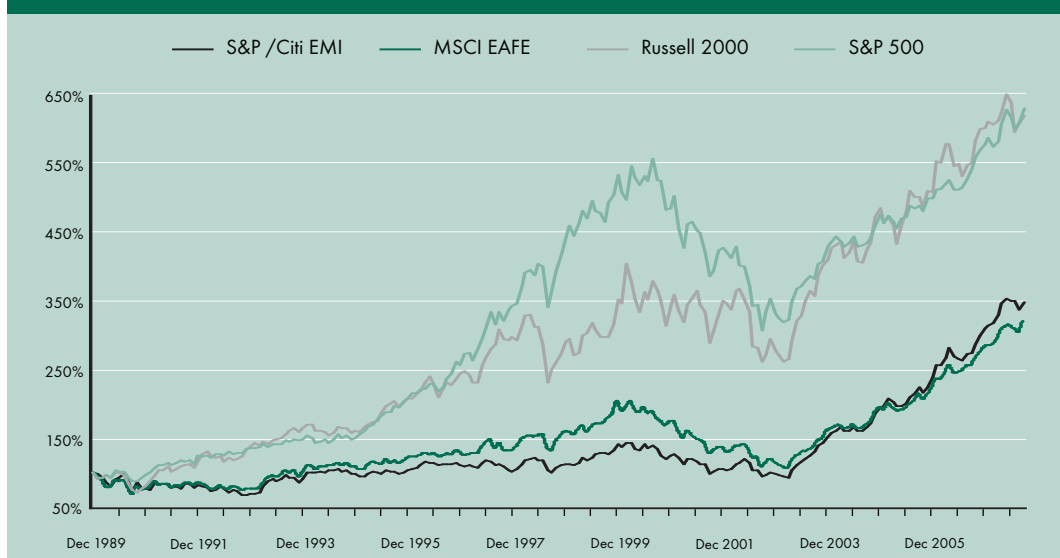
FIGURE 4: DEVELOPED INTERNATIONAL SMALL CAP SHORT-TERM PERFORMANCE COMPARISON



Source: NTGI, S&P, MSCI, Russell Indexes

This strong relative performance by small-cap stocks is a relatively recent phenomenon, as can be seen in Figure 5. Here, we look at returns over a 17.5-year time period, which includes general market cycles. International small-cap stocks may have been “unloved and underappreciated” by most American investors during the 1990s, but not without reason. As shown, U.S. equities significantly outperformed international equities, and neither large-cap nor small-cap international stocks made much comparative headway.

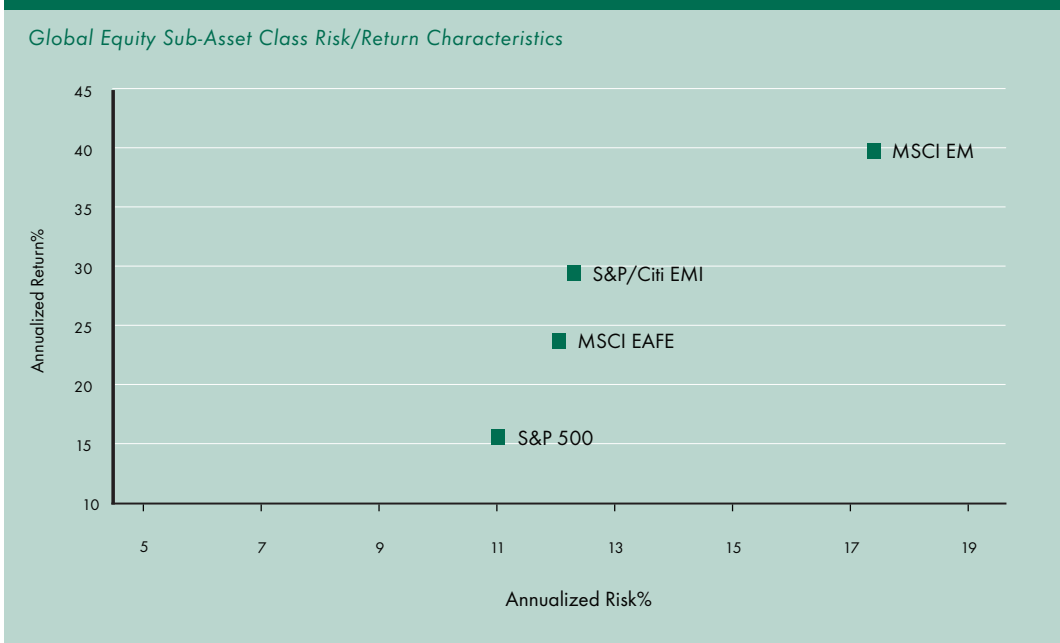
**FIGURE 5: SMALL CAP AND LARGE CAP LONG-TERM PERFORMANCE COMPARISON**



Source: NTGI, S&P, MSCI, Russell Indexes

It is critical for investors to balance short-term performance-oriented enthusiasm with the sobriety of a longer-term perspective. However, performance per se is only one of the factors that make this sub-asset class attractive. International small-cap equities have provided attractive risk-adjusted returns, as can be seen in Figure 6, which covers the five-year period ending September 2007.

**FIGURE 6: FIVE-YEAR RISK/RETURN OF U.S. AND INT'L EQUITY SUB-ASSET CLASSES**

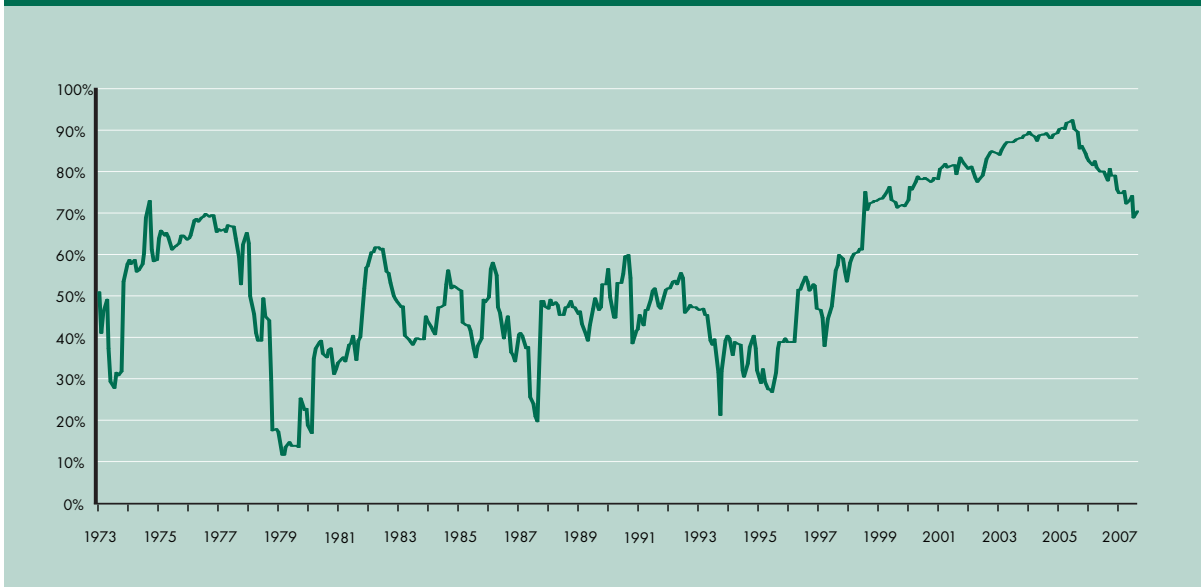


Source: NTGI, S&P, MSCI, Russell Indexes

## RELATIVELY LOW CORRELATIONS ACHIEVE IMPROVED DIVERSIFICATION

U.S. investors have long looked to international equities to provide diversification within a portfolio. In Figure 7, we show how the correlations between the S&P 500 and the MSCI EAFE have changed over time. The correlation is far higher today than it was a decade ago, which is not surprising when one thinks about the global nature of today's markets. International equities continue to provide some diversification; however, including international small-cap companies provides greater diversification than large cap alone (Figure 8). Clearly, international small cap adds diversification benefits, whether treated as a separate sub-asset class or integrated into the broader international equity asset class.

FIGURE 7: THREE-YEAR ROLLING CORRELATION OVER TIME S&P 500 VS. MSCI EAFE



Source: NTGI, S&P, MSCI, Russell Indexes

FIGURE 8: CORRELATION

	Long-Term Correlations '89-07				Short-Term Correlations Sept '04-Sept '07			
	S&P 500	MSCI EAFE	S&P/Citi EMI	MSCI EM	S&P 500	MSCI EAFE	S&P/Citi EMI	MSCI EM
S&P 500	1.00	0.65	0.53	0.62	1.00	0.71	0.63	0.62
MSCI EAFE	—	1.00	0.93	0.63	—	1.00	0.94	0.84
S&P/Citi EMI	—	—	1.00	0.61	—	—	—	0.82
MSCI EM	—	—	—	1.00	—	—	—	1.00

Source: NTGI, MSCI, FactSet, S&P

The goal of achieving this type of diversification is part of what has made foreign investing attractive to U.S. investors. With correlations rising among large-cap securities around the world (and especially among global “mega-cap” companies), developed international small-cap has a more important role to play than ever in helping build strong asset allocation models.

## A NOTE ON PERFORMANCE AND TIMING – CAVEAT EMPTOR

Adding developed international small-cap and emerging markets to a well-structured portfolio would have boosted returns over the past decade (Figure 9). Of course, a case can be made that these markets are no longer as compelling as they were in the early part of the decade, when valuations were significantly lower (the price-to-book value ratio of international small cap was just over 1.1). This should be a cautionary indicator for investors who may not have a longer-term perspective.

**FIGURE 9: COMPARATIVE RETURNS AND VALUATIONS FOR U.S. AND INTERNATIONAL EQUITIES, DATA AS OF SEPTEMBER 30, 2007**

	Annualized Total Return			Current Valuations	
	5 Years	10 Years	15 Years	PE	P/BV
S&P 500	15.46	6.57	11.11	17.10	2.80
S&P 600	18.74	9.41	–	22.60	2.30
MSCI EAFE	23.32	9.61	10.28	15.30	2.40
MSCI EM	39.79	15.48	12.81	18.50	3.00
S&P/Citi EMI World x U.S.	29.64	25.11	10.93	16.90	2.50

Source: NTGI, S&P, MSCI

## THE CHALLENGE OF DEFINING THE “SUB-ASSET CLASS”

Because international small-cap equities tend to “fall below” the standard developed international benchmarks, defining the sub-asset class has challenged and often confused many in the industry. Determining the correct benchmark for active managers and the best investment strategies to employ in this category has not been easy. Fortunately, this issue has recently been gaining long overdue attention. We believe that the industry is finally at the inflection point of shifting toward a more logical, holistic framework.

In November 2006, MSCI announced that it would be updating its methodology to correct an overlap that had long existed between its dominant large/mid-cap indexes (like the MSCI EAFE) and its small-cap index series. The new methodology will result in a series of indexes: the MSCI Global Investable Market Indexes (GIMI). Previously, the large/mid-cap indexes had a smattering of small cap exposure; in the new version, the indexes are discrete. The index series will now create a seamless series of benchmarks offering large/mid/small cap sub-sets for both the developed markets and emerging markets.

Since the previous methodology built in an overlap of the index series, it was unclear to many MSCI users how to successfully incorporate small-cap securities within their existing portfolios. Moreover, the new methodology still fell short of providing comprehensive representation of the sub-asset class.

Other global index providers also offer solutions in this space, including the S&P/Citigroup Global Indexes, FTSE Global Equity Index System, Dow Jones Wilshire Total Market Index and Russell Global indexes. These index families not only offer coherent solutions for the small-cap market segment, but also a series of clearly defined, non-overlapping indexes, providing broad exposure to international markets. Northern Trust can provide advice and analysis for our clients about the full range of total international equity benchmarks.

## **GAINING EFFICIENT EXPOSURE**

As the sub-asset class of international small-cap stocks has become more transparent, investors have gained better options for integrating it into their portfolios. Still, getting exposure with talented active managers, efficiently and at the necessary scale, can be a balancing act. Finding good international small-cap managers with sufficient capacity can be difficult. Though the number of strategies offered within this asset class has expanded, capacity constraints are a growing concern, (as they are among top-quartile emerging market managers).

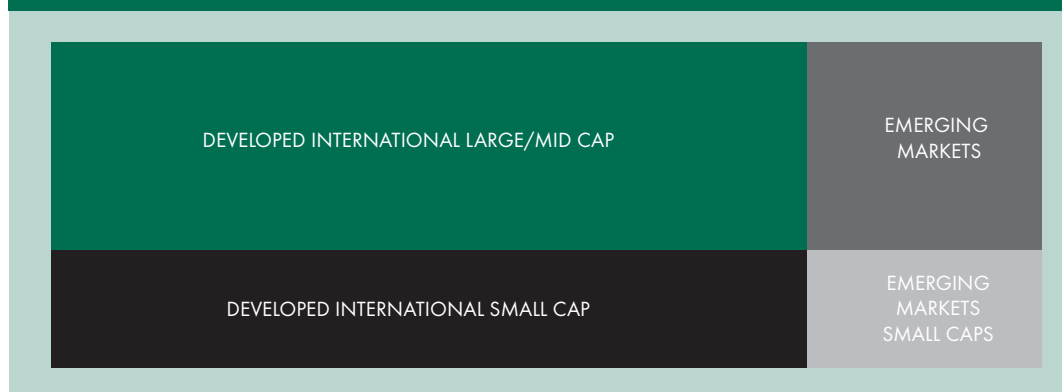
In a 2006 survey of the 42 managers that offered dedicated international small-cap portfolios, 14 of them, most with above-median performance — were closed to new investors. The 14 managers represented 48% of the market cap of assets managed in this space, highlighting the issue of limited capacity.<sup>8</sup> And while active management has delivered strong returns historically, capacity constraints are increasingly reducing the availability of alpha. Thus active management may not be the most effective and efficient way to acquire additional international small-cap exposure today.

One simple, cost-effective solution for investors is to utilize an index-based strategy in this space. Again, with the increased variety of comprehensive, investable indexes, index managers can now offer products to complement most investors' large-cap international equity strategies.

## **A COMPLETE SOLUTION – TOTAL INTERNATIONAL EQUITY STRATEGY (TIES)**

A dedicated international small-cap allocation is not the only approach, and may not be the best approach. Broad-based, all-inclusive benchmarks now exist that include small-cap stocks along with larger-cap issues and emerging markets. At Northern Trust, we call these complete strategies “Total International Equity Strategies,” or “TIES”, as illustrated in Figure 10. Choices of benchmarks include the MSCI Global Investable Market Index (GIMI), S&P/Citi Broad Market Index (BMI), FTSE All Cap Indexes, Russell Global Indexes and, most comprehensive of all, the Dow Jones Wilshire Global Total Market indexes. These benchmarks can be used to integrate each segment of the international market into one broad-based portfolio. Since each includes a broad array of issues across markets and market capitalizations, the adoption of any as a policy benchmark encourages managers to take positions in smaller-cap companies. Furthermore, adoption of “TIES” for the passive core of an international equity allocation enables investors to fill in gaps where

FIGURE 10: COMPONENTS OF A TOTAL INTERNATIONAL EQUITY STRATEGY (“TIES”)



they have not identified active managers. For example, by using an index-based developed international large-cap value strategy while conducting a search for an active manager in this category.

Many U.S. investors have implemented the comprehensive Russell 3000 or Dow Jones Wilshire 5000 as a policy benchmark for their U.S. equity allocations. We recommend that a similar approach be established for international allocations. As portrayed in Figure 10, the combination of the various sub-asset classes of International Equity into a single “total international” benchmark and allocation framework for policy purposes and investment mandates (both active and passive) has a similar logic and elegance. It is the view of the Global Quantitative Management Group that adoption of this framework is the inevitable next phase of sophisticated asset allocation for international equities.

Regardless of the benchmark or the investment approach (traditional active, structured or index), investors should not ignore any of the sub-components of the global markets. One can argue the merits of active versus passive, but as is often the case, simply “being there” is what matters the most, however the position is taken. We believe that overlooking international small-cap equities leaves the investor with an incomplete and inefficient global equity allocation. Relying on a developed international large-cap benchmark like MSCI EAFE as one’s sole index for the asset class is outdated and inappropriate.

The future of international equity investing is clearly moving toward a complete and seamless allocation and benchmark framework, one which parallels the approach already used for U.S. equity allocations. A total international equity strategy positions investors for this integrated future.

## ENDNOTES

1. We will emphasize throughout this article that international small cap, like emerging markets, should be considered a subcategory of international equity, just as U.S. small cap is a sub-asset class within U.S. equities.
2. According to *Pensions & Investments' 2007 Survey of the Top 1000 Defined Benefit Plans*, the average allocation to international equities was 16.8%.
3. It should be noted that the weights within the non-EAFE portion of the international equity asset class have shifted, with emerging markets growing dramatically in the past several years, but the overall percentage that has been "missing" (beyond EAFE) has been relatively stable this decade, ranging from 30 to 35 percent of the total universe of stock outside the U.S.
4. See pp. 38–39 of "Emerging Markets Investing, Efficiently Adding Emerging Market Equities to a Global Portfolio," by Steven A. Schoenfeld and Alain Cubeles, Northern Trust, March 2007 ([northerntrust.com](http://northerntrust.com)).
5. Some large pension funds even measure the extent of this "dabbling" as a way of both tracking and controlling their active managers' out-of-benchmark allocations to emerging markets and small cap.
6. For more background on the various style indexes for international equities, see Chapter 9 of *Active Index Investing: Maximizing Portfolio Performance and Minimizing Risk through Global Index Strategies*. (Wiley Finance, 2004), especially pp. 155–159.
7. We use the S&P/Citigroup EMI to represent the developed international small cap sub-asset class, as it has a longer history and a more stable composition than the MSCI's current international small cap indexes. The later has just undergone its phased transition to an improved construction methodology, which better reflects the international small-cap category. From its introduction in December 1998 (data back to December 1992) until November 2007, the MSCI's international small cap index series covered only about 40 percent of the universe, had overlap with its large-cap counterpart and exhibited very high turnover. This is discussed later in the paper.
8. InterSec Research, "Implementation Challenges in International Small Cap," February 2006.

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