For Professional Investors

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# Global Emerging Markets Small Caps: Benefits to going off the beaten path

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## OVERVIEW

*Despite headlines of slowing growth in emerging markets, global emerging markets small-caps have outperformed most major equity indexes year-to-date. In this piece, Rick Wetmore, CFA Deputy Chief Investment Officer from our Global Emerging Market (GEM) Equities team examines the current state of GEM small-cap equities. The team presently manages our GEM equity all-cap growth capability, a frontier strategy, and has recently launched our GEM small-cap equity strategy.*

## THANK YOU, RICK, FOR BEING WITH US TODAY. IF YOU WOULD, PLEASE TELL US ABOUT THE SMALL CAPS YOU MANAGE AND HOW YOU DEFINE THEM.

We manage a GEM small-cap strategy benchmarked to the MSCI EM Small Cap Index. In our view, small cap companies generally have a market capitalization of less than $2.5 billion at time of purchase. We believe that an active approach in emerging market (EM) small-caps offers investors numerous potential benefits.

## WHAT ARE SOME WAYS THAT GLOBAL EMERGING MARKET SMALL-CAPS DIFFER FROM LARGE CAPS AND WHAT ADVANTAGES DO THEY OFFER?

EM small-caps offer investors greater opportunity for outsized returns due to a broader, more inefficient universe, attractive risk reward characteristics and diversification through more exposure to domestically-oriented companies.

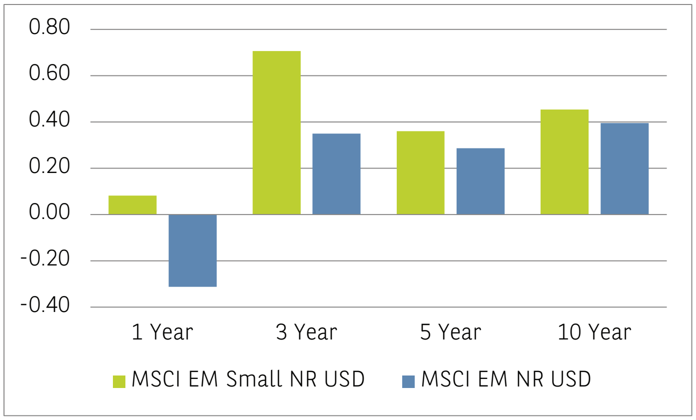
The EM small-cap space has a greater number and diversity of companies than the EM index. The MSCI Emerging Market Small Cap Index, for example, includes close to 1,800 stocks, while the standard MSCI Emerging Market Index includes a more concentrated 833 stocks.

Information on EM small-cap stocks is much less readily available than for their EM large-cap counterparts. Analyst coverage of small-cap stocks is significantly lower than that of developed-market or larger EM companies. As of May 29, 2015, the median number of analysts covering a stock in the EM small cap universe was three. This compares with 14 for the MSCI Emerging Markets Index and 18 for the S&P 500.

This inefficient universe provides opportunities to achieve strong, uncorrelated performance from the EM small-cap asset class. Returns from EM small-cap stocks have outpaced the average returns from the broader EM universe, over the last 1, 3, 5 and 10 year periods as of the end of June 2015, as well as for 7 of the last 10 calendar years.

Over the past decade, EM small-cap equities have not only delivered better absolute returns but have also provided higher risk-adjusted returns than the broader EM universe (see Chart 1)

**Chart 1: Sharpe Ratios**




*Source: Morningstar Direct, as of June 30, 2015*

The EM small-cap asset class provides a significant opportunity for geographic diversification. By comparison with larger-cap stocks, EM small-cap stocks are less exposed to the BRIC countries (Brazil, Russia, India and China), as the weightings to Brazil and Russia are meaningfully lower. Although the country-specific contribution to returns in emerging markets has diminished, there remain a number of thematic exposures for EM small-cap stocks, as follows:

- less exposure to global cyclicals (Brazil and Russia);
- greater exposure to information technology (Taiwan); and
- greater exposure to countries with current-account surpluses.

EM small-cap stocks enjoy the benefits of a more local orientation and greater independence from government intervention. For example, emerging markets are growing faster than developed markets and small-cap companies' relative independence from government involvement allows them to focus on delivering shareholder returns rather than fulfilling the strategic agenda of government. Additionally, small, independent companies by nature tend to be more entrepreneurial, as their managements cannot rely on government backing or the diversity of their businesses for success.

State-owned companies, otherwise known as State-Owned Enterprises (SOE), are a large component of the MSCI Emerging Market Index, particularly in countries such as China and India. Often, these companies do not act in the best interests of their minority shareholders and may destroy shareholder value for strategic reasons or in national interest.

Data from the International Monetary Fund shows that return on assets from non-state oriented companies has been consistently and significantly higher than from SOEs. The EM small-cap benchmark contains much less exposure to SOEs.

Given alpha-generation opportunities in EM small-cap stocks, investors who neglect them may bear a meaningful opportunity cost.

## WHAT FOCAL POINTS HAVE YOU FOUND TO BE MOST IMPORTANT IN YOUR IDENTIFICATION AND EVALUATION OF EM SMALL-CAP OPPORTUNITIES?

Since information on EM small-cap stocks is much less readily available than for large-cap equities, gaining knowledge in small-caps requires more effort. This means more travel to local markets and greater interaction with management to understand company strategy and challenges, along with local accounting nuances.

Our fundamental, research driven investment process is focused on finding quality companies with resilient business models that can grow shareholder value over the long-run and sustain this growth through differentiation or competitive edge. This approach is particularly powerful in the EM small-cap space.

In addition to travel to local markets and meetings with company management conducted by our team in Boston, we can also leverage the expertise of an on-the-ground network of over 200 investment professionals located in many important emerging market countries including China, India, Brazil, Korea and Turkey. Our local partners provide unique insights into management practices, corporate governance and industry dynamics.

The Boston-based portfolio management team's strength in finding undiscovered EM small-cap growth companies, combined with the local flavor provided by our on-the ground colleagues, gives us an ideal combination for investing in EM small-cap companies.

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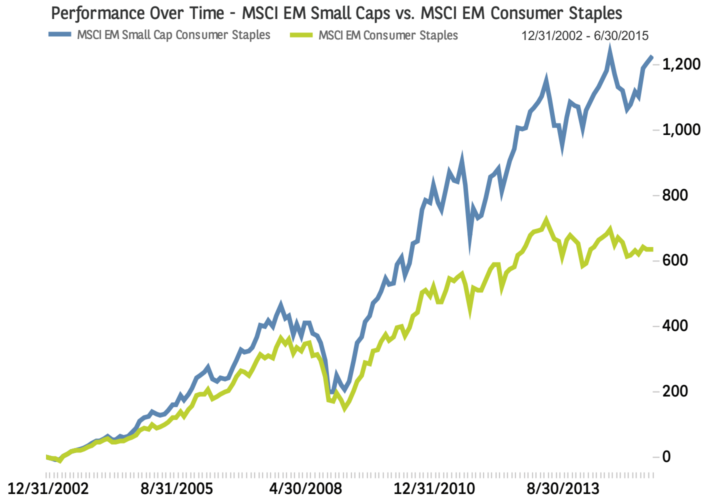
## HOW HAVE EM SMALL-CAP VALUATIONS FARED IN 2015 AND WHAT DO YOU BELIEVE ARE THE KEY DRIVERS?

EM small-cap valuations have increased modestly year-to-date through June 30, 2015. The rise in Next-Twelve-Month (NTM) P/E was driven in part by rallies in Korean and Chinese markets. In Korea, health care and consumer staples companies performed well, while in China, financials and consumer discretionary stocks outperformed.

## FOR SMALL-CAPS, WHICH SECTORS DO YOU FIND PARTICULARLY ATTRACTIVE AND WHAT ARE THE KEY DRIVERS?

The sector that best demonstrates the efficacy of a local orientation is consumer staples, with its stable earnings power and generally high return on invested capital (ROIC). Emerging market consumer companies with strong brands have experienced generous levels of growth in demand over the last 15 years. This has come as consumer incomes have risen, creating an expanding middle class. The best managed of these companies have been able to generate strong and often improving ROIC. As these firms are more likely to operate in industries that are well-structured for profit generation, the potential exists for continued long-term value creation, as resilient market growth and high returns drive strong reinvestment opportunities. This value creation is exhibited through an enhanced return profile for a number of EM small-cap sectors relative to their corresponding larger-stock EM sectors over the past 15 years (see Chart 2).

**Chart 2: Small-cap vs. large-cap stock performance in the EM consumer-staples sector**




*Source: MSCI, June 2015*

This performance improvement is evident beyond the consumer staples sector. Other, more cyclical sectors, such as materials and financials, also show similar historical return comparison patterns. The better performance of smaller-cap stocks represents the improved opportunity set for more nimble and market-driven companies, along with the reduced presence of SOEs in this segment of the market.

## WHAT DO YOU FORESEE AS ONE OF THE BIGGEST RISKS TO SMALL-CAP STOCKS OVER THE NEXT 12 MONTHS AND HOW CAN INVESTORS MANAGE THAT RISK?

One of the most significant risks to EM small-cap stocks over the next 12 months is the potential reallocation of capital to the U.S. as the U.S. Federal Reserve begins to raise rates. The best way for investors to manage this risk is to invest in a diversified portfolio of stocks selected for their individual stock specific drivers, such as distribution power, growing end markets, unique intellectual property, or strong brands.

We find that financially productive and economically resilient businesses tend to strengthen difficult economic conditions. These companies make the most of challenging periods by taking market share from weakened competitors. Additionally, businesses we look to invest in are relatively capital light or are using capital very efficiently, therefore they are not necessarily reliant upon outside financing.

There will most likely be volatility surrounding the timing and magnitude of the end of the zero interest rate policy in the U.S. Periods of uncertainty and volatility present some of the greatest opportunities in emerging markets allowing us to add value over the long-term by investing in well-run, quality growth companies at attractive valuations.

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## BIOGRAPHY

**Rick Wetmore, CFA**
**Deputy Chief Investment Officer & Senior Portfolio Manager**
**Global Emerging Market Equities Team**

Rick is the Deputy Chief Investment Officer and Senior Portfolio Manager for the Global Emerging Markets Equities team. He joined BNP Paribas Investment Partners in May 2014 from Turner Investment Partners. During his tenure at Turner Investments, Rick was co-head of Global Emerging Markets Equities and a portfolio manager for US Small Cap Equities, International Equities and an equity long/short strategy.

Rick has a BS from the Wharton School of the University of Pennsylvania. He holds the Chartered Financial Analyst designation.

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