

# INTERNATIONAL SMALL CAP VALUE

PZENA Investment Management

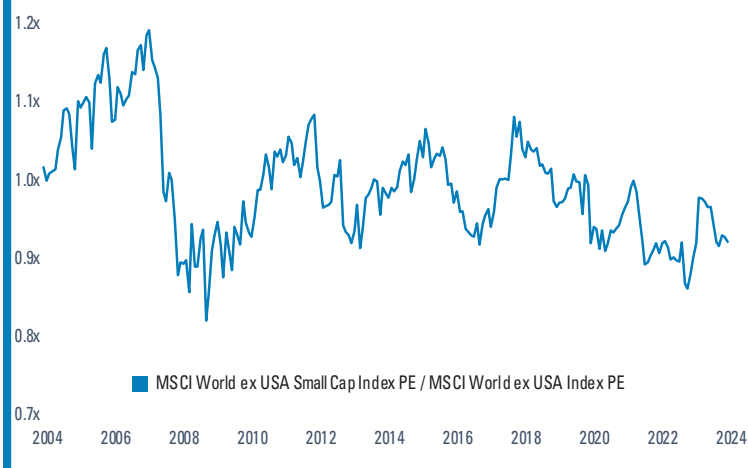
October 2024  
For Professional Investors Only

International small-cap stocks are attractively valued and have historically generated better returns than large caps. They offer a broader, more diverse, less correlated, and undiscovered universe of opportunities.

We believe today is a particularly attractive entry point for small-cap stocks internationally. Despite rising 85% since the depths of COVID, international small-cap stocks are trading at near-generational lows relative to international large-cap stocks (Exhibit 1).

## Exhibit 1 International Small Caps at Compelling Relative Valuations

Past 20 Years MSCI World ex USA Small & Large Cap Relative Price/Earnings Ratio



Source: FactSet, Pzena analysis  
Trailing price/earnings data from June 30, 2004 – June 30, 2024.

## WHY SMALL CAP?

Small-cap investing is a cousin of value investing. While small-cap investors search among undiscovered stocks, value investors search among unpopular stocks. As such, it should not be surprising that pairing small-cap with value investing has generated superior historical returns.

## THE SMALL-CAP ADVANTAGE

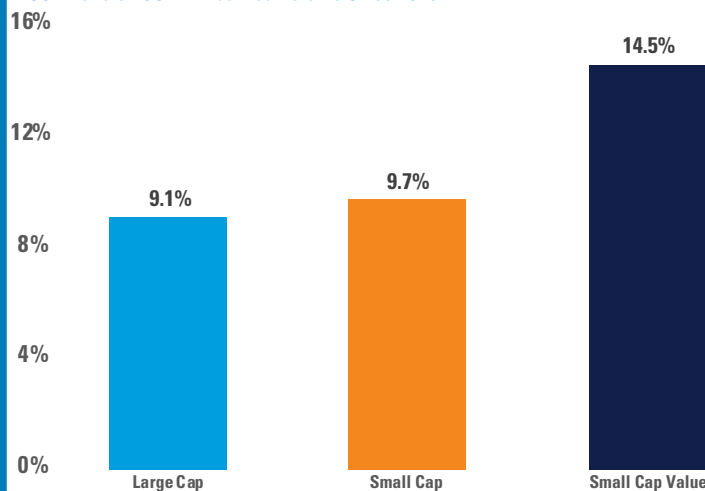
Small-cap stocks, especially those outside the US, provide access to a wide array of niche businesses, currencies, economies, regulatory regimes, languages, and market cycles. Understanding these nuances across different geographical areas can present lucrative opportunities; however, specific skills and judgment are required.

Historically, although small caps have exhibited higher short-term volatility than their large-cap counterparts, they have generated better risk-adjusted returns, while offering a broader, more diverse, and less correlated universe of stocks.

Performance: International small-cap stocks have beaten their large-cap equivalents by approximately 60 basis points per year since 1975, and small-cap value stocks have beaten the style-neutral broader small-cap index by approximately 480 basis points per year (Exhibit 2).

## Exhibit 2 The International Small Cap Advantage

MSCI World ex USA Annualized Returns Since 1975



Source: Sanford C. Bernstein & Co., MSCI, Pzena analysis  
Large Cap = MSCI World ex USA Index. Small Cap = Bernstein's MSCI World ex USA Small Cap universe (cap-weighted returns). Small Cap Value = Cheapest quintile price to book of the MSCI World ex USA Small Cap universe (equal-weighted returns). All total return data in US dollars from January 1, 1975 – June 30, 2024. Does not represent any specific Pzena product or service. Past performance is not indicative of future returns.

## THE VALUE OPPORTUNITY IN SMALL CAP

We believe it is a particularly attractive time for international small-cap value. The current fundamentals of the cheapest quintile of small-cap stocks are significantly better than those of the most expensive stocks. The cheapest stocks have also performed considerably better historically.

## Exhibit 3 Similar Fundamentals at Different Valuations in International Small Cap

Price/Normal Quintile <sup>1</sup>	Historical Return on Equity <sup>2</sup>	Historical Revenue Growth <sup>2</sup>	Forward P/E <sup>3</sup>
Q1 (cheapest)	11%	12%	9x
Q2	11%	11%	12x
Q3	10%	10%	14x
Q4	9%	12%	16x
Q5 (expensive)	4%	15%	24x

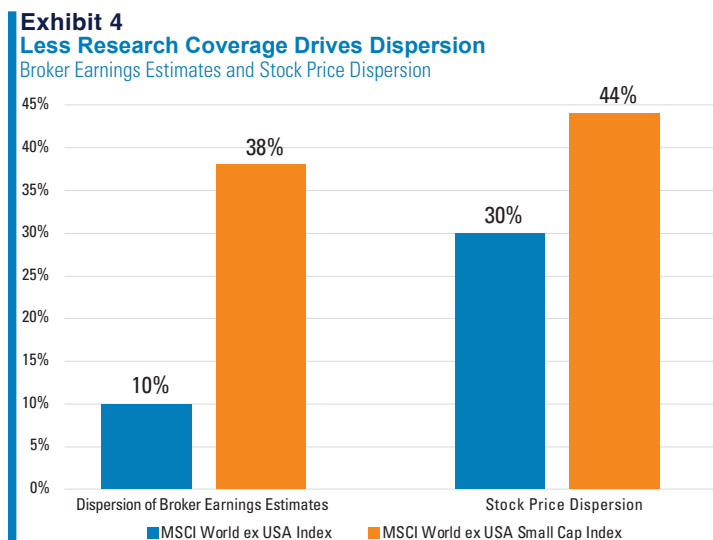
Ken French Price/Book Quintile <sup>4</sup>	Annualized Return Since 1990 <sup>5</sup>
Q1 (cheapest)	11.0%
Q2	8.0%
Q3	5.8%
Q4	3.9%
Q5 (expensive)	0.5%

Source: FactSet, Kenneth R. French, Pzena analysis  
1 Valuation quintile buckets based on Pzena's price-to-normalized earnings estimates. 2 Trailing 10-year period; median data for ROE. 3 Consensus FY1 estimates per FactSet. Universe used for top table is the MSCI World ex USA Small Cap; data as of June 30, 2024. 4 Quintiles based on price/book within the smallest 20% of stocks of Ken French's Developed Market ex US universe. 5 Total return annualized in US dollars from July 1, 1990 – May 31, 2024 (cap-weighted returns). Past performance is not indicative of future returns.

## ACTIVE ADVANTAGE IN SMALL CAP

As an underallocated, underfollowed asset class, small-cap investing is especially attractive for active management, because it is a less crowded corner of the equity universe.

**Undiscovered:** Small-cap value stocks – and small-cap stocks more generally – tend to attract less attention from equity research firms than large caps. Thirty-four percent of international small-cap stocks are followed by fewer than four analysts, compared with just three percent of international large-cap stocks<sup>1</sup>. The lack of analyst coverage is partly due to the large number of companies within the small-cap universe relative to the large-cap universe. Thin analyst coverage typically manifests in less company information available to the investment community, which may lead to investment controversy not being widely understood. With less Wall Street analyst coverage, earnings estimates and annual returns are also more dispersed (Exhibit 4).



Source: FactSet, Pzena analysis. The average standard deviation of all broker FY1 EPS estimates for each stock in the index as of June 30, 2024. The standard deviation of returns for all holdings in the index; calculated annually. Data from December 31, 2003 - December 31, 2023.

Uncertainty around cashflows and earnings creates opportunities for active managers to outperform through deep fundamental research. Successfully investing in a universe with a dearth of analyst coverage requires a dedicated research team with a disciplined process; our team canvasses the globe, sifting through the broad and diverse international small-cap universe in efforts to find truly outstanding potential investment opportunities.

## THE PZENA ADVANTAGE

As with all strategies at Pzena, we manage our International Small Cap Focused Value strategy with a focus on building concentrated portfolios of undervalued businesses, often experiencing temporary issues.

We utilize our proprietary screening tool StockAnalyzer to sift through the cheapest 20% of the vast small-cap investment universe for potential research candidates and assign research priority to the most interesting companies.

Our 30 research analysts cover companies according to global industry. When we research a small-cap company, our industry analysts often already have a deep knowledge of the competitive landscape, as well as the customer and supplier bases across the globe. The impact of this knowledge base is particularly crucial in the small cap universe, given the underfollowed nature and the unique dynamics of the companies in the universe, many of which operate in niche businesses.

The product of our process is an educated estimate of normalized earnings, as well as a thesis for how company management can turn around the business. Crucial to outperforming is focusing on purchasing good companies trading at steep discounts, due to temporary distress, which is often idiosyncratic and company-specific in nature.

Our rigorous fundamental research, paired with a structured process to uncover potential ideas across a broad, underfollowed, underallocated universe, gives us the opportunity to achieve meaningful outperformance over the long term.

<sup>1</sup> Source: FactSet

## FURTHER INFORMATION

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