TimesSquare Capital Management, LLC

Identifying the Global Best in Breed

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In the last decade, we have witnessed globalization and the growing interdependence among companies across the world. Globalization has broken down traditional competitive barriers, created integrated supply chains, and presented opportunities for small cap disruptors. It is difficult to assess the prospects of companies without taking into consideration the global landscape. On balance, home-country focused opportunities also remain ample as small capitalization companies can quickly adapt to and benefit from changing demographic trends.

The U.S. equity market remains attractive as the biggest individual market and continues to be an attractive place to mine companies with early cycle innovation. International small capitalization offers diversification benefits, relatively attractive valuations compared to U.S. peers, and may very well continue its growth in relevance when discussing a geographically unconstrained portfolio. A global small cap portfolio provides a unique manner to benefit from companies internationally and enables an investor to gain access to the world's best in breed.

Global Opportunities Come in Small Packages

The corporate and investment world has gotten smaller. Quicker adoption and leapfrogging of technological innovations have narrowed the "gap" between countries, regions, markets, and companies. Faster and more robust communications—from the spread of the Internet to wider access to broadband speeds—have significantly increased connectivity and thus lowered the costs of trade. Another contributing factor has been the move to lower-cost container shipping that allowed for trade in lower cost products around the world, which would have otherwise been difficult to achieve (Levinson 2006). The carrying capacity for container ships has increased by more than 1,200% since 1968 (World Shipping Council 2017). Meanwhile, domestic demand and demographic shifts create new or expanded markets within a company's home country. We have found small capitalization companies benefiting from these forces, and we have found them all over the globe.

Narrowing the Gap and Opportunities For New Disruptors

The continuous evolution of trade dynamics presents opportunities for small cap companies. Industry stalwarts constantly face increasing competition from new, nimble disruptors. Smaller firms have increased access to resources and have a more level playing field, which they were denied before. We have witnessed many examples of "the rise of the underdogs" play out in recent history. Traditional handset manufacturers such Motorola, Nokia and Blackberry have languished as a once smaller competitor called Apple adopted technological innovation and took market share. Another example is in the automotive sector. The Big Three (General Motors, Ford, Chrysler) historically dominated the global landscape, however, foreign car makers such as Toyota and Volkswagen began to gain market share in the 1980s. More recently, the rise of new disruptors such as Chinese car makers, India-based Tata Motors, and U.S.-based Tesla could lend to another structural shift for the car makers and their supply chains.

Rise of Globally Connected and Integrated Supply Chains

There has been a rise of global, connected supply chains and industry hubs which have evolved from each region playing to its individual strengths. New businesses have been created to capitalize on opportunities. India has a high population of English speakers, lower wages, and a well-educated labor force equipped with technical skills. These attributes have attracted international software companies to outsource information technology work to India. In China, the majority of the population was rural, lower-middle-class, or poor until the late 20th century when internal migration was allowed; immigrants moved to industrial cities where they were willing to work for low wages. The combination of ample labor supply and the government's investment in the business ecosystem lent to China's rise as the world's manufacturing hub. Japan's aging population and demographics have put that country at the forefront of the global automation, robotics, and industrial sectors.

In discussing the globally integrated supply chain, consider our prior example of the automotive sector. Whereas parts and services used in vehicle production historically came either from a captive production plant or a nearby supplier. Today, all automakers have the ability to source components from around the globe—the best hose clamps for high performance engines may come from Germany while the most advanced headlights may be found in Japan.

With faster communications (internet) and shipping (containers), a company can source components of the final product from anywhere. At the same time, smaller companies can sell its finished products in any market.

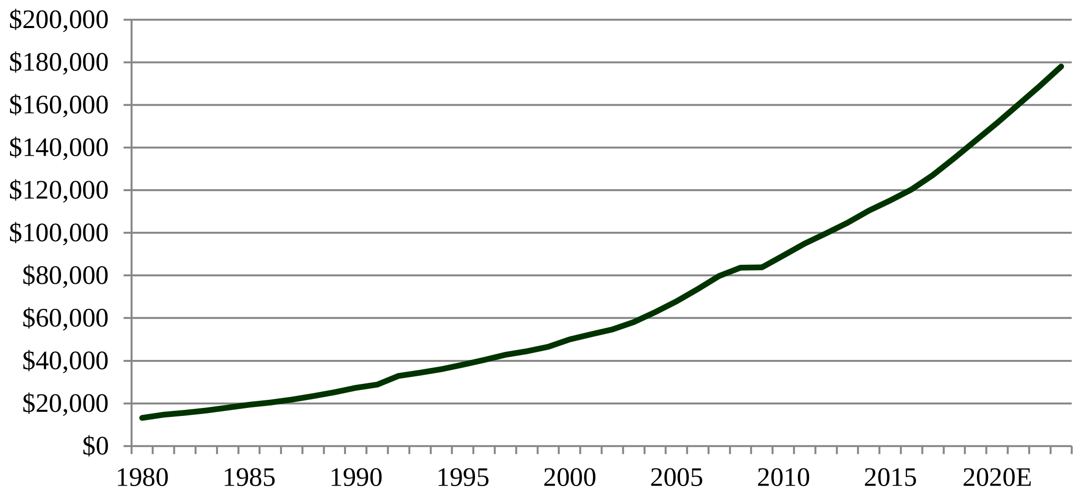
A Company's Domicile is Less Meaningful

Traditional geographic allocation tools have become less relevant compared to history, as a company's domicile is less meaningful. In light of how the world is constantly changing, investors may need to take an increasingly dynamic and holistic investment approach. As businesses globalize, it is important to understand where the companies operate and not just where they are domiciled. Japan-based Koito Manufacturing is the world market leader in the oligopolistic auto lighting industry. The company manufactures at production sites near its Original Equipment Manufacturing clients (e.g., Toyota, Honda, GM, Volvo). Over 60% of Koito's revenues are derived from outside of Japan (Koito Manufacturing Co., 2017 Annual Report). Koito has expanded overseas production capacity, not only to follow Japanese markers expanding overseas, but to better penetrate non-Japanese automakers around the world. While we can say that Koito is a global, leading automotive components supplier, it just happens to be headquartered in Japan. Another example is Italy-based Amplifon, the global leader in retailing of hearing aids. It distributes, adjusts and personalizes hearing aids operating through the Sonus, Miracle Ear, Beter Horen and Dialogue brands among others. The company has 3500 point of sales in 22 countries. The company's geographic revenue exposure is 60% from Europe, 18% from the Americas, and 14% from Asia Pacific; only 7% of sales are generated from Italy (Amplifon, 2017 Annual report).

Identifying Home-Country Focused Opportunities

Let's also not forget about home-country focused opportunities. Domestic small caps are generally better shielded from trade wars and geopolitical risks. Small capitalization companies also tend to be more locally focused than larger companies. They are more nimble to changes and would benefit more from positive trends in their local markets. In the emerging markets, one of those positive trends is the change in demographics resulting from the creation of economic value and wealth. The "consuming class" has become a major economic force in emerging markets and its influence should increase over time. Over the last 20 years, the consuming class in emerging markets doubled and by 2025, the population is expected to double again. By then, more than half of the world's population will be the consumer class in emerging markets (Mckinsey 2012). As an example, in the next 20 years the Asia-Pacific will reach nearly 40% of worldwide passenger traffic (IATA 2016) and will play a critically important role in the ongoing development of worldwide aviation, driven by the economic growth of China, India, and Southeast Asia markets.

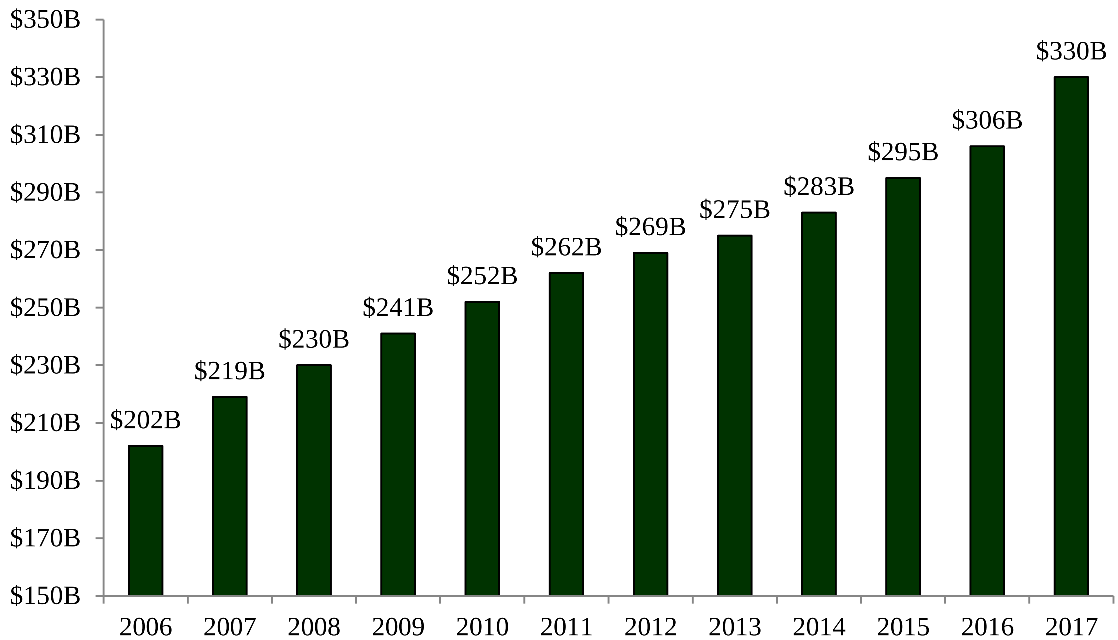
Chart 1: Current and Estimated Global GDP ($ in Billions USD)



Source: IMF 2018, GDP at Purchasing Price Parity

Local opportunities are also evident in the developed markets. As the world's largest economy, the U.S. also provides ample opportunities for domestically focused companies who benefit from the unique characteristics of the U.S. market. For example, post-acute care is a growing business opportunity in the U.S. (Chart 2). Patients who no longer need inpatient hospital care are often discharged to a post-acute care setting to ensure they receive appropriate transitional attention while they recover. Transitional care in these settings may include dressing changes, medication management, oxygen administration, physical therapy, restorative therapy, pain management, monitoring, and more. Aging demographics, burgeoning chronic disease, and the fact that Medicare patients are more likely to enter the post care continuum provides a tailwind for post-acute services. The large geographic area of the U.S. is also an important driver as many patients live far away from large hospitals and post-acute care centers provides a high level of convenience. Post-acute care also offers significant potential for savings and quality improvements for healthcare providers and is a unique domestic market opportunity.

Chart 2: National Health Expenditure on Post-Acute Care

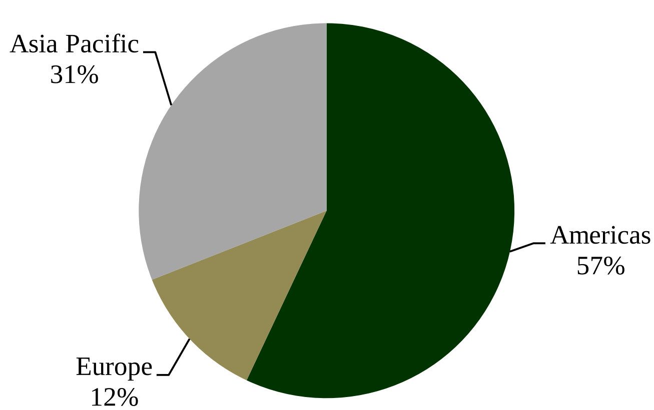


Source: Allied Health Research Institute 2017

U.S. Small Cap - At the Forefront of Innovation

The U.S. equity market is the biggest and most mature individual market globally. As such, the level of U.S. investor familiarity with small caps has been running ahead of the rest of the world. Small capitalization companies represent exciting opportunities to invest in early cycle companies. In the U.S. market, there is ample access to venture capital funding (Chart 3) and the cultural mindset to support companies as they attempt to disrupt industries. This has enabled U.S. companies to become some of the world leaders in the innovation-driven health care and technology sectors.

Chart 3: Venture Capital Deployment by Geography– (as of 12/31/2017)



Source: Venture Pulse, Q4'17, Global Analysis of Venture Funding, KPMG Enterprise

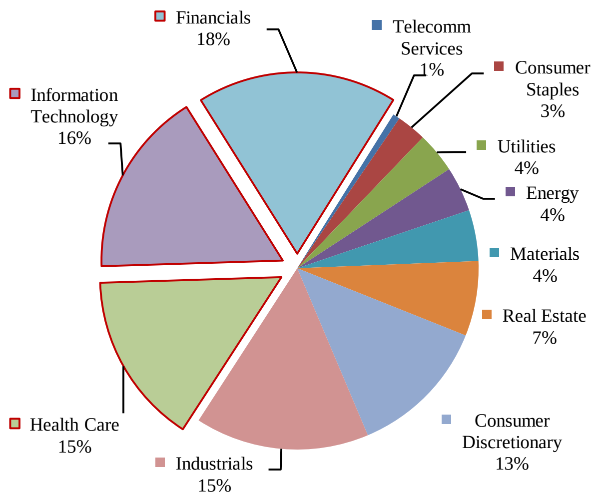
Moreover, the adoption of transformative solutions and technologies has spilled over into other sectors, thereby reshaping traditional sector classifications. For example, in the Fintech sector where companies utilize a variety of technological interventions into personal and commercial finance – are these companies considered financial or technology companies? Irrespective of the answer, U.S. small caps offer opportunities for investors to find businesses with enduring business models that allow their earnings to compound over time.

U.S. small caps continue to be viewed favorably due to the rise of thematic investing. Investor capital is increasingly focused on long-term innovation and tech disruption such as big data, artificial intelligence, and future mobility. The U.S. is at the forefront of these developments. Generally speaking, many companies within the thematic universe are in the information technology, health care, financial, and consumer discretionary sectors. As per Chart 4, healthcare and technology sector market cap weightings make-up 31% of the Russell 2000 Index versus an 18% weighting internationally as represented by the MSCI EAFE Small Cap Index. Disruption is emanating from the tech world, where generally newer and younger companies are challenging incumbents in nearly every sector.

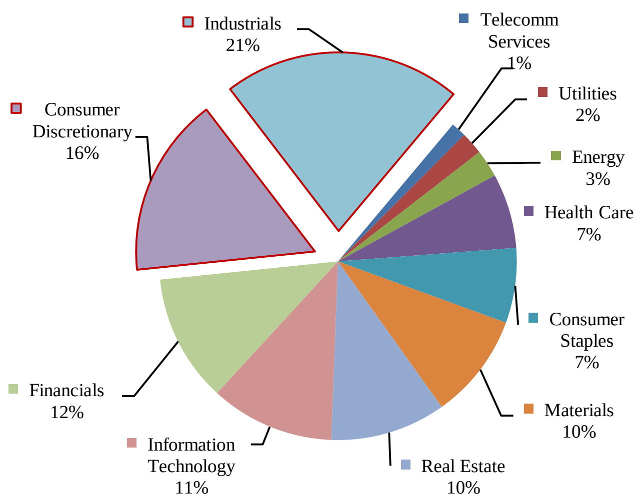
Investing in U.S. small caps has been a commonly accepted practice for years and continues to be a unique and beneficial strategy.

Chart 4: Global Small Cap Sector Weighting – (as of 12/31/2017)

Russell 2000



MSCI EAFE Small Cap



Source: FactSet – Portfolio Analytics

<u>International Small Cap – Attractive Valuations and Diversification</u>

Looking at high-level metrics, international small caps generally have more appealing valuations, higher dividends, and higher ROEs than their U.S. small cap counterparts. Factoring in globalization, we would expect non-U.S. smaller companies to continue to grow in relative importance with greater levels of investment allocations.

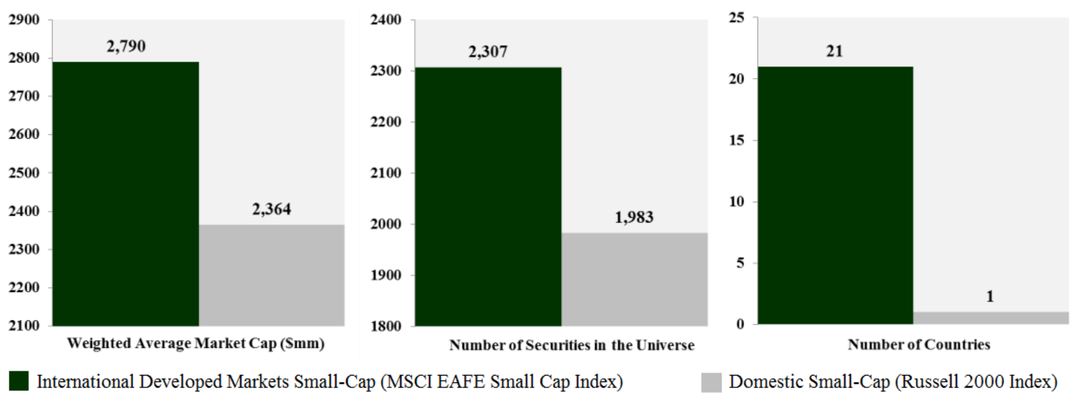
Table 1: Financial Metrics of International vs. U.S. Benchmarks

	Russell 2000	MSCI EAFE SC	MSCI World SC
ROE	7.88	12.21	10.16
ROA	1.10	6.25	3.71
LT Debt/Capital	33.91	24.67	38.07
P/E Ratio*	23.3x	17.9x	20.4x
Dividend Yield (%)	0.64	2.18	1.40

Source: FactSet – Portfolio Analytics
**Calculated using weighted harmonic average.*

According to Modern Portfolio Theory (Markowitz 1952), diverse and heterogeneous environments should be sought out by investors as they seek to construct a portfolio. These environments create more dissimilar companies which lead to more diversification benefits. Diversification decreases the idiosyncratic risk of the portfolio, decreasing overall portfolio risk for a similar level of return. A heterogeneous environment is also preferred because it leads to opportunities for potential investments in more sectors and a greater number of countries (Chart 5).

Chart 5: Breadth of Stock and Country Universe Offered by International – (as of 12/31/2017)

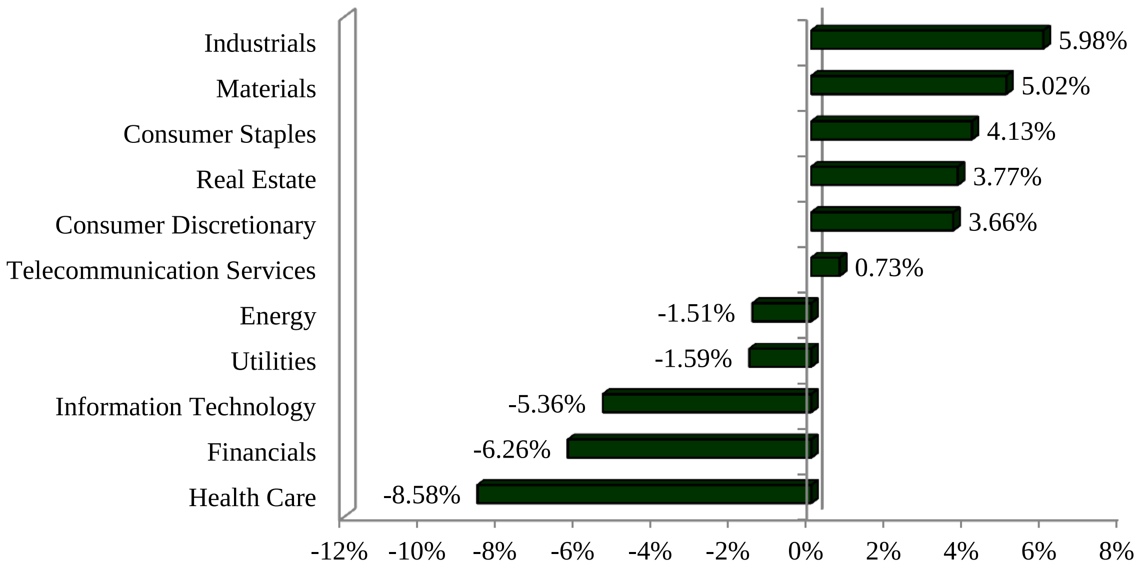


Source: FactSet – Portfolio Analytics

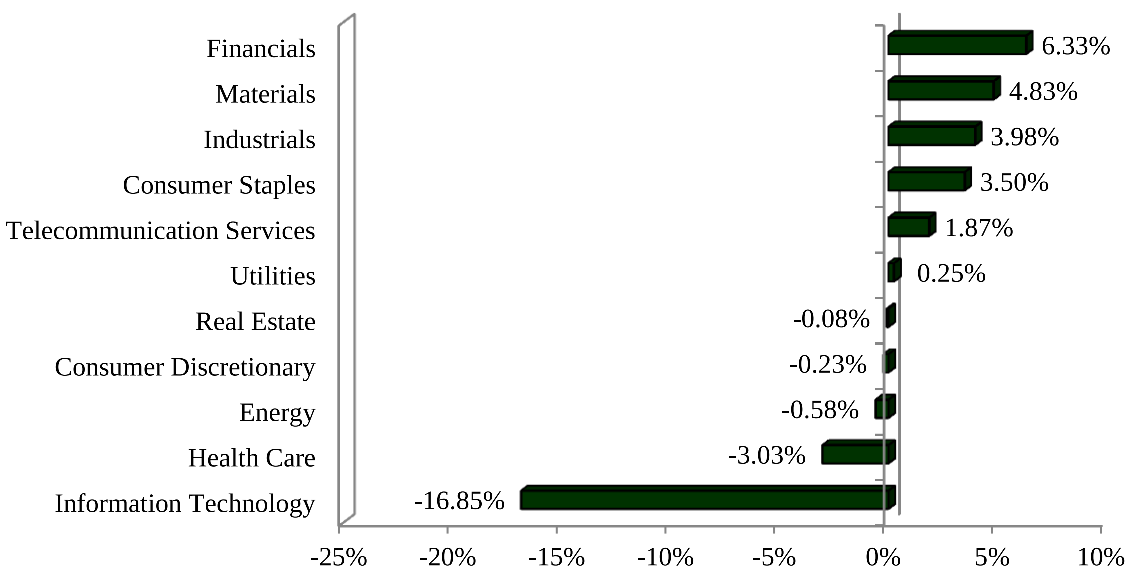
International small capitalization benchmarks offer a distinctly different economic composition when compared against larger capitalization indices for the U.S. or international markets as well as their U.S. small cap peers. The sector composition of benchmarks is a by-product of the secular trends and demographics of each country/region and each country's positioning in the global supply chain. For example, in Chart 6, the MSCI EAFE Small Cap Index has greater exposure than the Russell 2000 Index to certain economic segments, such as Industrials, Consumer Staples, and Materials while having lower exposure to Health Care and Information Technology. Perhaps, this is a reflection of a higher focus/priority on the buildout of infrastructure in the international markets.

Chart 6: GICS Sector (Weights %) Comparison

MSCI EAFE Small Cap vs. Russell 2000



MSCI EAFE vs. Russell 1000



Source: FactSet – Portfolio Analytics

The returns of an international component coupled with low correlation to the U.S. market warrant an international allocation. As per Table 2, the lower correlation (0.77) between Russell 2000 vs. MSCI SC EAFE is under the 0.95 threshold and considered desirable (Greer 1997). International small capitalization portfolios reside at the intersection of small capitalization stocks and non-domestic stocks, benefiting from the advantages of both.

Table 2: Correlation of Monthly Returns Over 10 Years Ending December 2017

	MSCI EAFE Small Cap	MSCI EAFE	MSCI World Small Cap	MSCI World	Russell 1000	Russell 2000
MSCI EAFE (Net) Small Cap	1.00	0.97	0.94	0.94	0.86	**0.77**
MSCI (Net) EAFE		1.00	0.93	0.97	0.90	0.79
MSCI World Small Cap (Net)			1.00	0.96	0.95	0.94
MSCI World (Net)				1.00	0.97	0.87
Russell 1000					1.00	0.92
Russell 2000						1.00

Source: eVestment

<u>Global Small Cap – The Best Opportunities No Matter the Domicile</u>

More than 30 years ago, the "size effect" was empirically documented (Banz 1981). That research found small capitalization companies on average achieved higher risk-adjusted returns than larger companies over the long-term (Table 3).

Table 3: Risk-Adjusted Returns Defined by Sharpe Ratios (as of 12/31/2017)

	3-Year	5-Year	10-Year	15-Year	20-Year
MSCI EAFE (Net) Index	0.61	0.65	0.09	0.42	0.20
MSCI World (Net) Index	0.85	1.15	0.29	0.53	0.27
MSCI EAFE Small Cap (Net) Index	1.17	1.09	0.28	0.62	N/A*
MSCI World Small Cap (Net) Index	0.98	1.17	0.40	0.65	N/A*

**MSCI EAFE Small Cap Index began on 01/01/2001*
Source: MercerInsight MPA, Monthly Returns

Another test on the benefits of smaller capitalization would be a comparison of large capitalization and small capitalization indices over time. Table 4 shows that small capitalization stocks have historically beat their large cap counterparts.

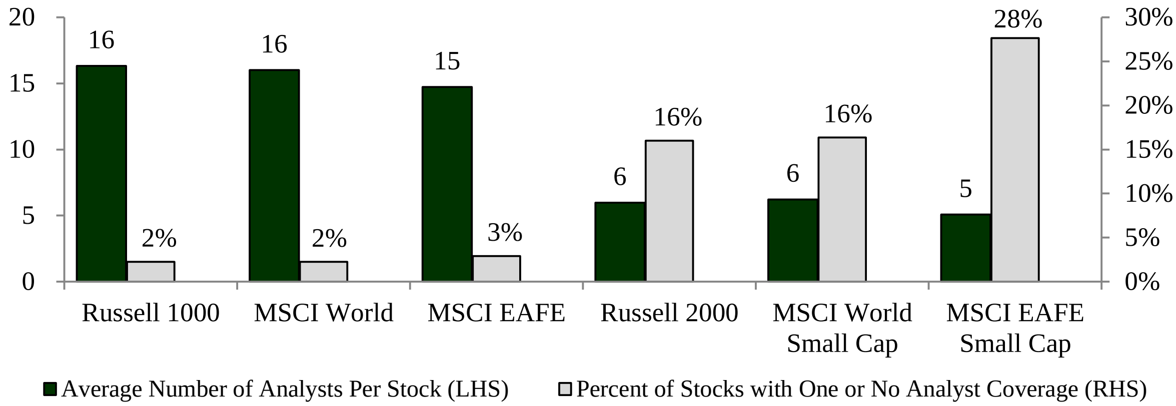
Table 4: Annualized Trailing Returns (through 12/31/2017)

	3-Year	5-Year	10-Year	15-Year	20-Year
MSCI EAFE (Net) Index	7.80%	7.90%	1.94%	8.11%	5.25%
MSCI World (Net) Index	9.26%	11.64%	5.03%	8.87%	6.01%
MSCI EAFE Small Cap (Net) Index	14.20%	12.85%	5.77%	12.24%	N/A*
MSCI World Small Cap (Net) Index	11.29%	13.20%	7.70%	12.21%	N/A*

**MSCI EAFE Small Cap Index began on 01/01/2001*
Source: MercerInsight MPA, Monthly Return

In understanding the reasoning, the neglected firm effect (Arbel & Strebel 1982) suggests that the lesser-known companies are able to generate higher returns in share price because they are less likely to be analyzed by market analysts. As indicated by Chart 7, small capitalization stocks have been underfollowed by sell-side analysts compared to larger cap stocks. A less efficient market could lend to opportunities for an active manager to uncover insights for that company.

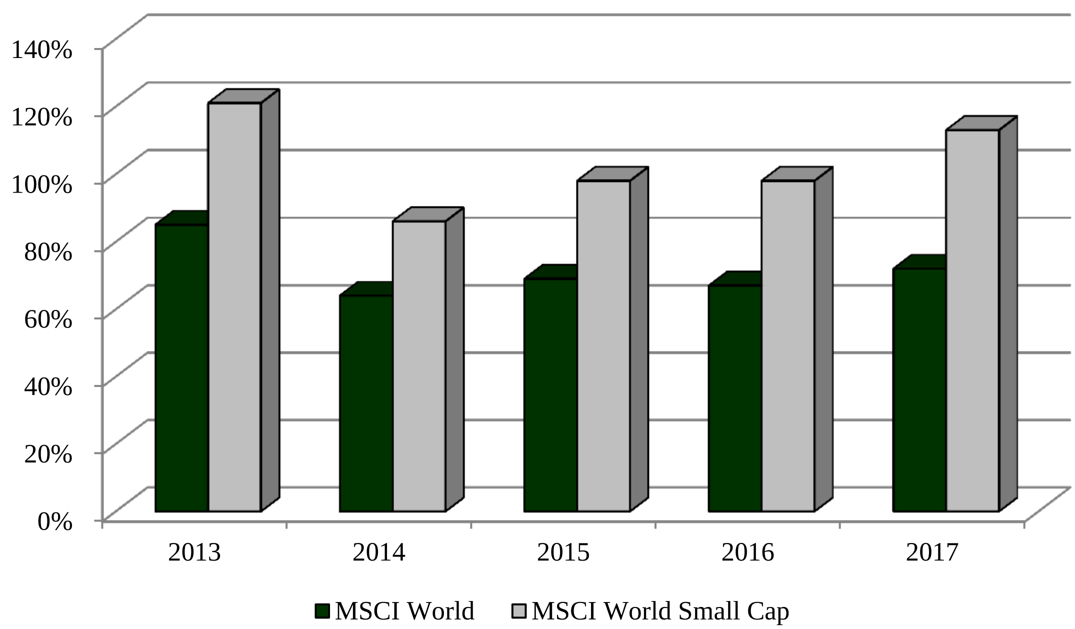
Chart 7: Analyst Coverage, per Benchmark Index



Source: FactSet – Portfolio Analytics

The MSCI World Small Cap Index consists of 4,300 stocks versus 1,600 stocks in the MSCI World Index. Investors who neglect small caps miss out on 70% of securities which are relevant to alpha generation. In analyzing the breadth of potential returns and the important role of active management, dispersion analysis – calculated as the difference between the average returns of the top 20% and bottom 20% of performance – indicates that active managers have a wider range of opportunities from which to choose (Chart 8).

Chart 8: Dispersion Between Top and Bottom Performance Quintiles



Source: FactSet – Portfolio Analytics

Conclusion

Adopting a global approach to small cap provides exposure to an unconstrained opportunity set and an expanding universe of small cap companies across both high growth and mature economies. After all, if a company believes it is better served by sourcing components and services from anywhere in the world, why should a small cap portfolio be constrained from doing so as well. For investors able to look beyond geographic borders, an actively managed global small cap portfolio can provide opportunities for attractive valuations and beneficial risk/return profiles.

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*At **TimesSquare Capital Management LLC**, we utilize a time-tested approach to evaluating and investing in growth stocks. We emphasize an assessment of management quality and an analysis of quality business models as key elements in our effort to produce positive risk-adjusted returns. Financial models and valuation techniques enable us to find attractive investment candidates with promising upside potential. We seek companies possessing distinct and sustainable competitive advantages. Our approach favors companies with a high proportion of recurring revenue, a diversified customer base and strong cash flow generation. Established price targets provide a framework for measuring our investment.*

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