

May 2022

Brian S. Freiwald, CFA
Portfolio ManagerCaroline L. Stone, CFA
Investment Director,
EquitiesDonald E. Perks
Quantitative Analyst,
Quantitative Equities

The case for emerging market small-cap equities

Key takeaways

In today's environment, small-capitalization stocks in emerging markets (EM) offer compelling reasons for consideration. We believe this universe has big potential, may deliver consistent returns, and can provide diversification in portfolios.

The case for active management in this space is equally persuasive, in our opinion. A gauge of EM small caps is composed of numerous companies with liquidity constraints. Many of these stocks are under-covered by analysts and typically misunderstood by the market.

Investors tend to focus elsewhere within the emerging market equity universe. As such, individual stock volatility can be high, and correlations among stocks are typically low. We believe this environment creates a fertile backdrop for active, fundamental investing.

In this paper, we explore the EM small-cap universe. We delve into why we believe these companies are likely to provide compelling long-term performance and how they offer investors exposure to non-U.S. markets.

Competitive historical performance

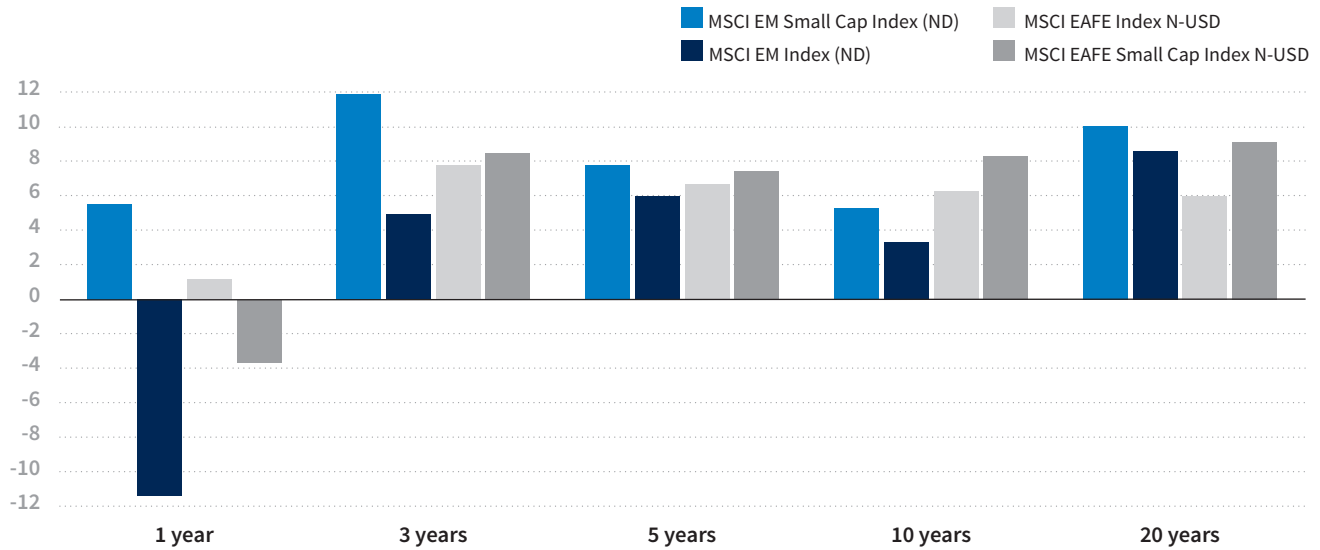
The MSCI Emerging Markets Small Cap Index, a benchmark that tracks the performance of small companies in developing countries, has generated attractive long-term gains. The index has returned 10.1% annualized over the trailing 20 years as of March 31, 2022. It has also added value relative to its all-cap counterpart, the MSCI Emerging Markets Index, as well as the MSCI EAFE Index, the MSCI EAFE Small Cap Index, and the S&P 500 Index over the same time period. We believe this relative outperformance should continue due to structural advantages in the EM small-cap space.

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Emerging market small-cap stocks have historically offered competitive short- and long-term returns

% annualized returns



Sources: Putnam Investments, MSCI Inc., as of 3/31/22.

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A case for active management

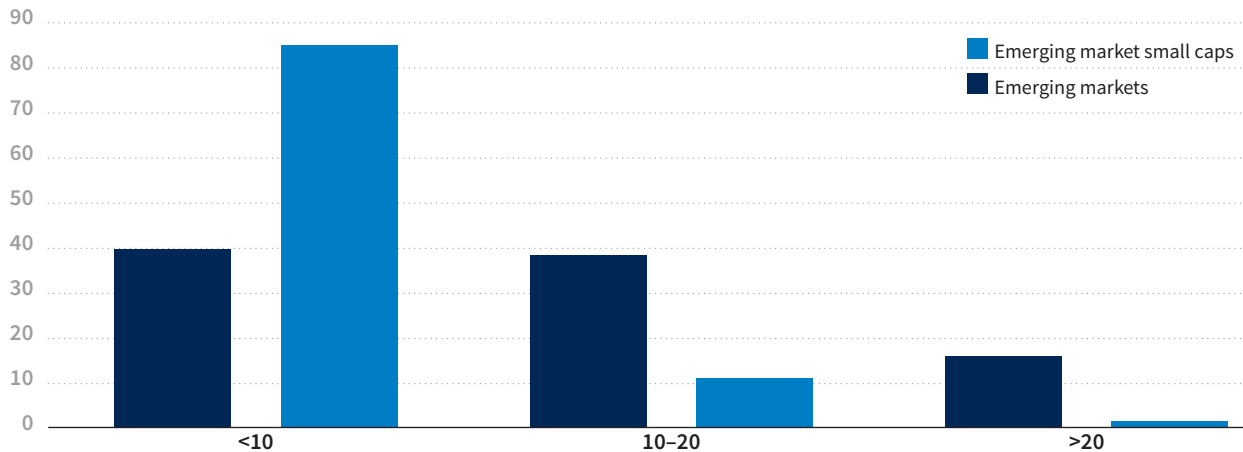
While small-cap EM stocks have attractive historical returns, this has not attracted significant research coverage by equity investors. The sector remains a highly inefficient area of the market, in our view. Given the large number of companies and liquidity constraints, research teams are often under-resourced, and as a result, stocks in this universe may be under-covered. For example, 43% of the MSCI EM Small Cap Index is covered by only two analysts or fewer, versus roughly 7% for the MSCI EM Index, according

to data from Bloomberg (as of 12/31/21). Many dedicated emerging market small-cap investment teams are typically composed of fewer than three analysts. As such, buy-side coverage is likely to be even lower.

We see opportunities within these constraints. We believe this can allow for the development of unique and differentiated insights and potential returns that are less correlated to global markets.

Low buy-side coverage offers high potential for opportunity in EM small caps

Sell-side coverage for EM and EM small-cap companies (# of analysts)



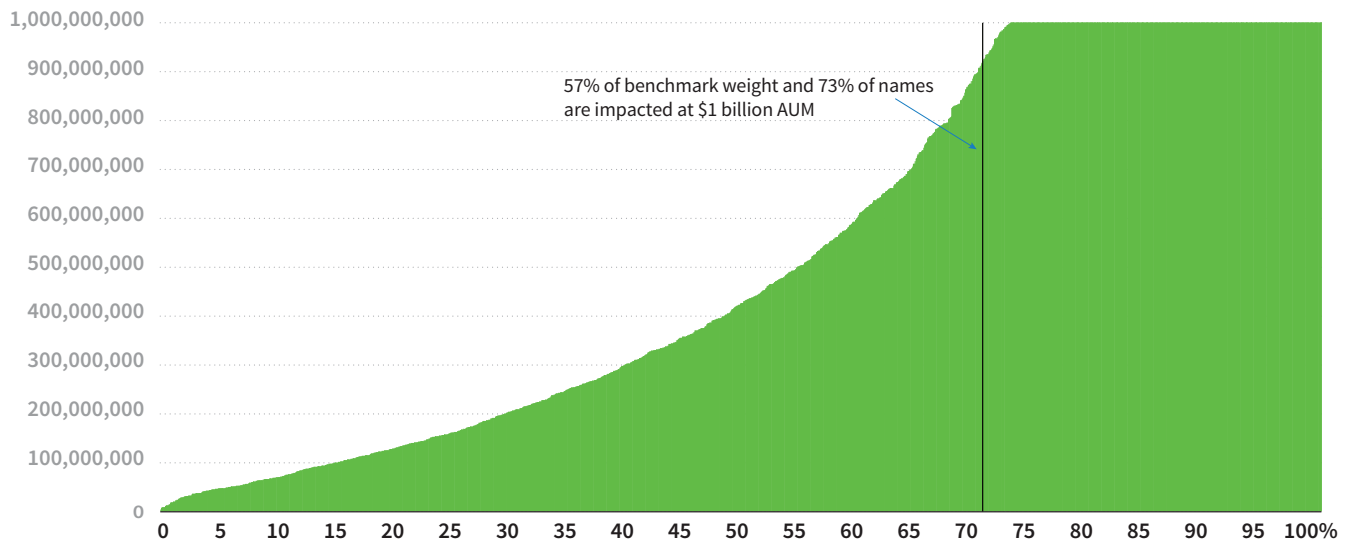
Sources: Putnam Investments, Bloomberg, as of 12/31/21. Counts include coverage for 1,352 stocks in the MSCI EM Index universe and 1,786 stocks in the MSCI EM Small Cap Index.

Furthermore, we believe the capacity-constrained nature of the market is another reason EM small caps remain under-covered and under-followed. That makes them inefficient and fundamentally compelling, in our opinion. Our research suggests an EM small-cap strategy starts to face liquidity challenges at around \$1 billion in assets

under management (AUM). Strategies with AUM levels above this breakpoint will face challenges in buying 57% of the MSCI EM Small Cap Index benchmark (by weight) in under two weeks at 2% for a hypothetical equal-weighted 50-company portfolio.

Capacity-constrained nature of universe contributes to opportunity set

Names in the MSCI EM Small Cap Index and the corresponding liquidity constraints by assets under management



Source: Putnam Investments, as of 12/31/21. For illustrative purposes only. Data reflect names in the MSCI EM Small Cap Index with 10 days, 1/3 trading-value liquidity with less than 5% ownership of outstanding shares for 50-name equal-weighted portfolio AUM. This corresponds to a 2% portfolio weight.

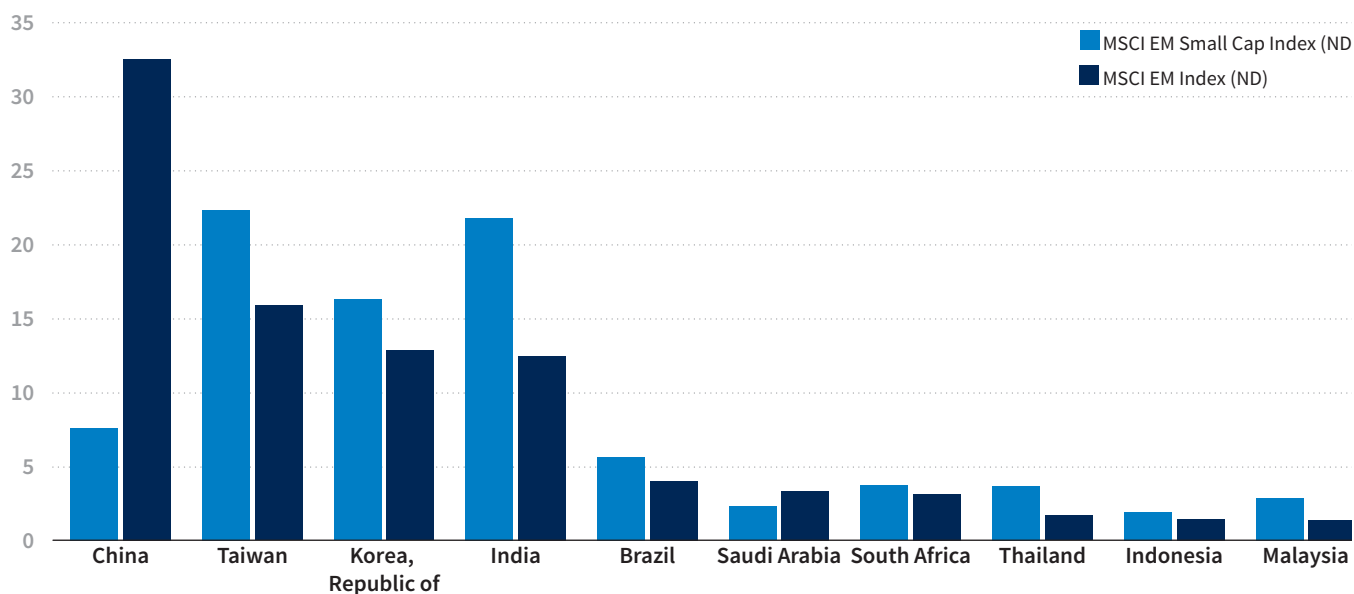
China's lower weight in small cap EM index

With this understanding of the historical performance and current low coverage and liquidity, we turn to an issue of index construction that differentiates the terrain for investing in EM small caps. China's market dominates the MSCI EM Index, but not the MSCI EM Small Cap Index. Chinese equities represented about 33% of the MSCI EM

Index and accounted for nearly 52% of the listed names as of December 31, 2021. That compares with just 9% for the MSCI EM Small Cap Index and roughly 14% of the listed companies. We believe this creates an attractive complementary case for the inclusion of emerging market small-cap exposure in a diversified portfolio.

Country exposures in EM small-cap stocks complement the larger EM country composition

Top 10 country sector weights (%) for the MSCI EM Index relative to the MSCI EM Small Cap Index



Sources: Putnam Investments, MSCI Inc., as of 12/31/21. Excludes exposure to Russia.

A smaller role for state-owned enterprises

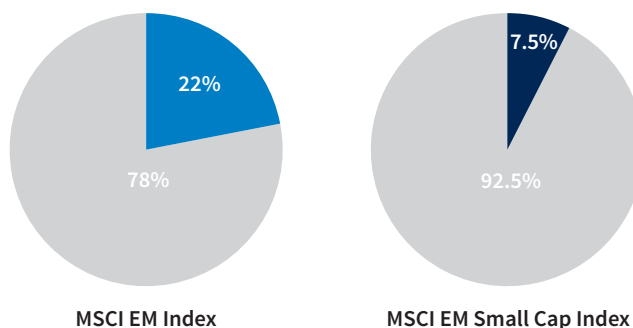
Aside from the China weighting, a second aspect of index construction for investors to note is the MSCI EM Small Cap Index’s low allocation to state-owned enterprises (SOEs). We believe SOEs do not typically provide attractive fundamental opportunities because of their poorly aligned incentives, below-average returns, and sector concentrations. SOEs account for just 7% of the benchmark.

We believe the index’s underweight to SOEs contributes to a more favorable index structure. In our opinion, SOEs are typically run for employment or other government objectives. They do not represent the best long-term opportunity for fundamental growth and maximizing shareholder value.

The MSCI EM Small Cap Index, in contrast, emphasizes sectors and industries that may benefit from innovation-driven growth, such as industrials, health care, and information technology. Such attributes are much more appealing to an active strategy with a growth or capital appreciation objective.

SOEs are less represented in the EM small-cap universe

Weighted sum of state-owned enterprises



Sources: Putnam Investments, MSCI Inc., as of 12/31/21.

The potential benefits of portfolio diversification

Reflecting the potential benefits offered by the sector and the characteristics of the benchmark index, EM small-cap shares offer broad diversification opportunities for investors. To this end, the MSCI EM Small Cap Index has a diversified list of countries and sectors. In addition,

exposure to this universe offers relatively lower correlations to other indexes across cap sizes and in developed markets. These include stocks listed on the S&P 500 Index (U.S. all-cap equities) and the Russell 2000 Index (small-cap stocks).

Small-cap stocks in developing markets offer attractive potential for returns and diversification

Return correlations across indexes

■ Lower correlation ■ Highest correlation

	MSCI EM Small Cap Index (ND)	MSCI EAFE Index (ND)	MSCI EM Index (ND)	MSCI World Small Cap Index (ND)	MSCI World Index (ND)	Russell 2000 Index	S&P 500 Index	MSCI EAFE Small Cap Index (ND)
MSCI EM Small Cap Index (ND)	100%							
MSCI EAFE Index (ND)	85%	100%						
MSCI EM Index (ND)	95%	86%	100%					
MSCI World Small Cap Index (ND)	84%	92%	83%	100%				
MSCI World Index (ND)	83%	96%	84%	94%	100%			
Russell 2000 Index	71%	80%	72%	95%	87%	100%		
S&P 500 Index	74%	87%	76%	91%	97%	89%	100%	
MSCI EAFE Small Cap Index (ND)	86%	95%	85%	94%	91%	79%	81%	100%

Sources: Putnam Investments, MSCI Inc., as of 12/31/21.

Diversification does not assure a profit or protect against loss. It is possible to lose money in a diversified portfolio. As with any investment, there is a potential for profit as well as the possibility of loss. Indexes are unmanaged and used as a broad measure of market performance. It is not possible to invest directly in an index. Past performance is not a guarantee of future results.

The opportunity for active management

Given this backdrop, small-cap strategies in the emerging markets space tend to have high active share, meaning portfolios can look very different than the benchmark. The median active share for the emerging market small-cap eVestment universe on a quarterly basis over the trailing 5-year period was roughly 90%, according to data from eVestment. Furthermore, over the trailing 3- and 5-year periods ending December 31, 2021, the top-decile performers had higher active share than their bottom-decile counterparts.

Additionally, over the same 3- and 5-year periods, the MSCI EM Small Cap Index ranked in the 61st and 69th percentiles, respectively, in the eVestment category. This reveals there is room for an active strategy to outperform the index, in our view. We believe investors will benefit from taking an active, best-ideas approach in this universe.

Conclusion

As investors mull their portfolio allocations in a changing market environment, they should consider emerging market small-cap equities. In our view, the investable universe offers attractive diversification and a modernized landscape, with the opportunity to gain exposure to a growing number of companies that could eventually become global leaders.

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