International Small-Cap – A Growing Opportunity in Portfolio Diversification

Investing in U.S. small-cap equity has become a widely followed strategy for building diversified portfolios. Over time, small-capitalization stocks have provided exposure to a segment of the equity market that historically has offered faster growth, strong risk-adjusted returns and lower correlation with larger-cap stocks. Yet when investors consider making an allocation to international markets, they tend to overlook the substantial universe of small-cap stocks available internationally. As a result, they may miss the potential opportunity to further add value and increase portfolio diversification. The following analysis illustrates the potential advantages that international small-cap stocks may offer including *diversification, risk-adjusted returns, inefficiencies, and growing investor adoption*.

**Diversification**

Large-cap stocks, both domestic and international, have become more highly correlated over time while international small-cap stocks have offered lower correlations. In addition, the performance pattern of international small-cap stocks (as defined by R-squared) indicates that, over time, these stocks do not move in a significantly similar manner to domestic large-cap stocks (as defined by the S&P 500 Index). Lastly, investors seeking to diversify internationally tend to view the equity asset allocation decision within a framework of large-cap equity (growth and value) versus emerging markets equity. We believe the future asset allocation framework will include a separate allocation to international small-cap, reflecting the potential benefits of this asset class.

**Correlation Matrix**

10 Years Ending 9/30/12

<table>
<thead>
<tr>
<th></th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Russell 2000</td>
<td>0.95</td>
<td>1.00</td>
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<tr>
<td>MSCI EAFE - ND</td>
<td>0.92</td>
<td>0.88</td>
<td>1.00</td>
<td></td>
</tr>
<tr>
<td>MSCI EAFE Small Cap - ND</td>
<td>0.85</td>
<td>0.85</td>
<td>0.95</td>
<td>1.00</td>
</tr>
</tbody>
</table>

**R– Squared vs. S&P 500**

Periods Ending 9/30/12

<table>
<thead>
<tr>
<th></th>
<th>3 Years</th>
<th>5 Years</th>
<th>10 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>MSCI EAFE-ND</td>
<td>0.95</td>
<td>0.88</td>
<td>1.00</td>
</tr>
<tr>
<td>MSCI EAFE Small Cap-ND</td>
<td>0.95</td>
<td>0.85</td>
<td>0.95</td>
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</tbody>
</table>

Data source: Evestment. A fee was paid to eVestment Alliance, an outside vendor whose software was used to create these statistics and comparisons. Charts are provided for illustrative purposes. Past performance is not a guarantee of future results.

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International Small-Cap
A Growing Opportunity in Portfolio Diversification (cont’d)

Risk-Adjusted Returns
International small-cap stocks have outperformed their large-cap peers over the past ten years. Similar patterns exist in the U.S. equity market. Importantly, international small-cap portfolios have been able to produce stronger risk-adjusted returns relative to their large-cap peers over time as evidenced by their higher Sharpe ratios and alpha. Consequently, international small-cap stocks have the potential to enhance overall portfolio returns while reducing risk.

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Inefficient Marketplace
While the international small-cap universe is large with approximately 13,000 stocks in the index, there are fewer sell side research analysts following these stocks than the stocks in the MSCI EAFE Index (approximately 3-5 times less according to Bloomberg). We believe this creates inefficiencies that may create greater growth opportunities that can be exploited over time using active management.

Source: Bloomberg. When screening in Bloomberg, the international equity markets results in 13,191 companies after an initial screen of market cap between $100 million and $3.5 billion outside of the U.S.
International Small-Cap
A Growing Opportunity in Portfolio Diversification (cont’d)

Growing Investor Adoption

As investors face fee pressures and perceived decreased investing opportunities globally, investor behavior and appetite for international versus U.S., and large-cap versus small-cap equities have changed. We have seen a substantial increase in international equity investing and a move towards a combination of large-cap and small-cap instead of predominantly large-cap growth and large-cap value. Except for 2008, when both international and U.S. small-cap investing saw a year of greater outflows, the style has been trending positively.

Source: Morningstar. For periods ending December 31, 2011. Data for 2012 is through 9/30. Charts are provided for illustrative purposes.

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