



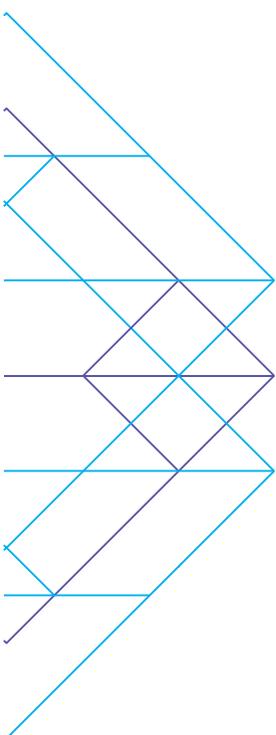
Q2 2025

Go Small or Go Home

The Case for International and Emerging Small Cap Stocks

Executive Summary

Amid a market environment marked by significant concentration and elevated valuations within the major U.S. large cap indices, many investors are seeking to diversify their exposures. This article explores why small caps, especially in the international and emerging regions, present a compelling investment opportunity driven by the potential for higher expected market returns, attractive earnings growth, strong diversification benefits, and rich alpha opportunities.



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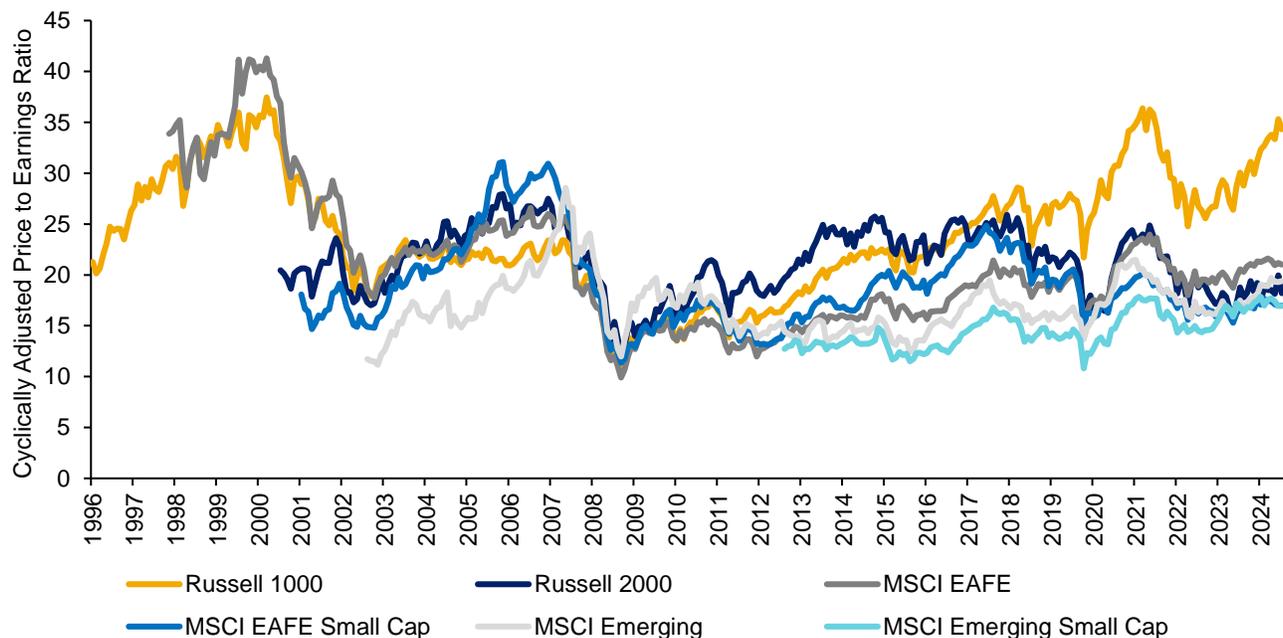
Introduction

Amid a market environment characterized by significant concentration and elevated valuations within the U.S. large cap universe (**Exhibit 1**), many investors are seeking to diversify their exposures. Questions around continued U.S. exceptionalism, driven by recent policy changes, further underscore the need for diversification. While we are big believers in allocating to alternatives to diversify overall equity exposure, it is equally important to consider diversification within an equity allocation. There are two

primary ways to achieve this: across geographies and across market cap segments. While international diversification is sensible and 2025 appears to indicate a shift away from the U.S. market¹, we believe there is an overlooked opportunity in diversifying across the market cap spectrum as well. Specifically, we see the international and emerging small cap segments as offering both diversification benefits and a fertile ground for delivering active excess returns.

Exhibit 1: Large Cap versus Small Cap Historical Regional Valuations

June 1, 1996 - December 31, 2024



Source: AQR, Bloomberg. Chart shows historical cyclically-adjusted price-to-earnings (CAPE) ratios. Valuations are subject to change at any time without notice. Data for the Russell 1000 Index became available in June 1996, for the Russell 2000 Index in December 2000, for the MSCI EAFE Index in April 1998, for the MSCI EAFE Small Cap Index in June 2001, for the MSCI Emerging Index in January 2003, and for the MSCI Emerging Small Cap Index in January 2013.

¹ Reuters: "Investors spy the dawn of a tectonic shift away from US markets," 3/6/2025

Diversification does not eliminate the risk of experiencing investment losses.

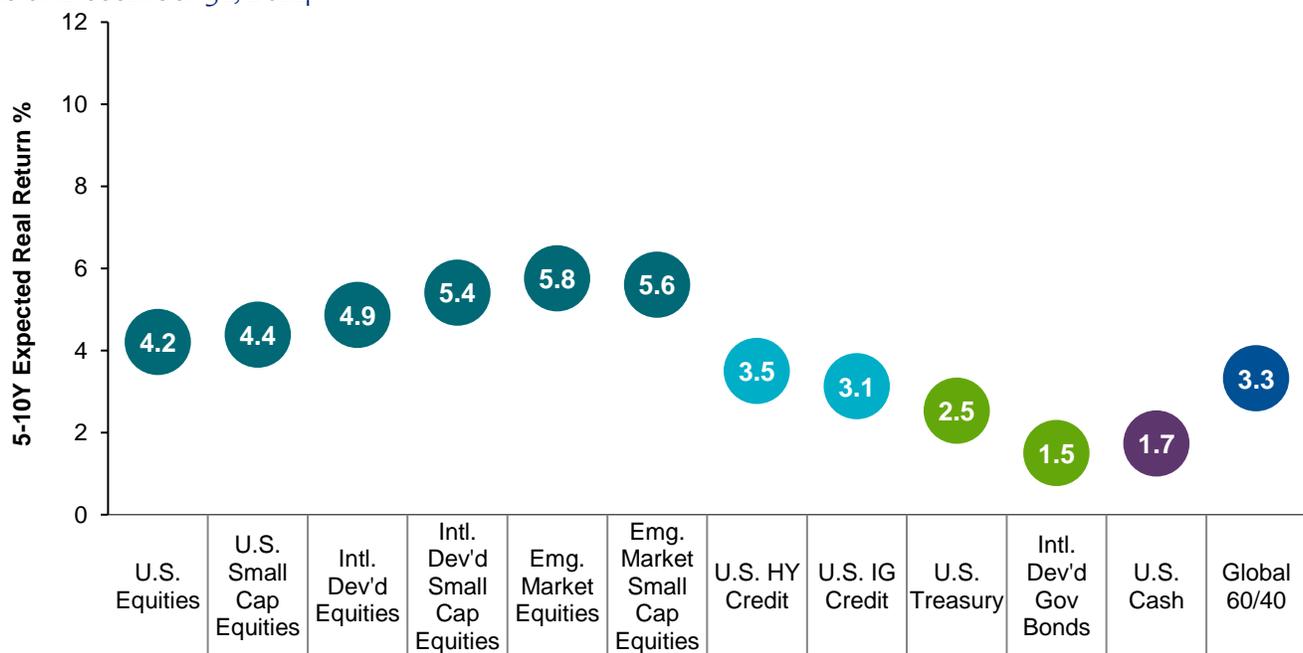
The Beta Opportunity

After about 15 years of U.S. exceptionalism, with the U.S. market outperforming international and emerging markets, it is easy to forget that market leadership is usually cyclical, not a permanent feature. Our latest Capital Market Assumptions (**Exhibit 2**) suggest that local real (inflation-adjusted) annual compound rates of return for a horizon of 5 to 10 years are fairly compressed for public equities, especially for U.S. equities. In

contrast, international and emerging markets, particularly in the small cap space, are projected to offer more attractive returns over the medium to long-term horizon. While forming these return forecasts over such horizons comes with a high margin of error, they are intended to assist investors in setting medium-term expectations and can help provide a structured framework for strategic asset allocation.

Exhibit 2: Medium-Term Expected Real Returns for Liquid Asset Classes

As of December 31, 2024



Source: AQR; see Alternative Thinking 2025 Issue 1 'Capital Market Assumptions for Major Asset Classes' for further details. Estimates as of December 31, 2024 are local real annual compound rates of return for a horizon of 5 to 10 years. "International developed equities" is cap-weighted average of Euro-5, Japan, U.K., Australia, Canada. "International 10Y govt. bonds" is GDP-weighted average of Germany, Japan, U.K., Australia, Canada. Global 60/40 is 60% Global Equities and 40% Global Bonds. These are intended to emphasize the uncertainty around any point estimates. Not only are the return forecasts uncertain, but also any measures of forecast uncertainty are debatable. Estimates are for illustrative purposes only, are not a guarantee of performance and are subject to change. Not representative of any portfolio that AQR currently manages.

While capital market assumptions typically focus on medium-term (5- to 10-year) expected returns, earnings growth remains a crucial driver of stock performance. Notably, small cap stocks in both emerging and international markets have a forecasted EPS growth that is higher compared to their large cap counterparts. In particular, small

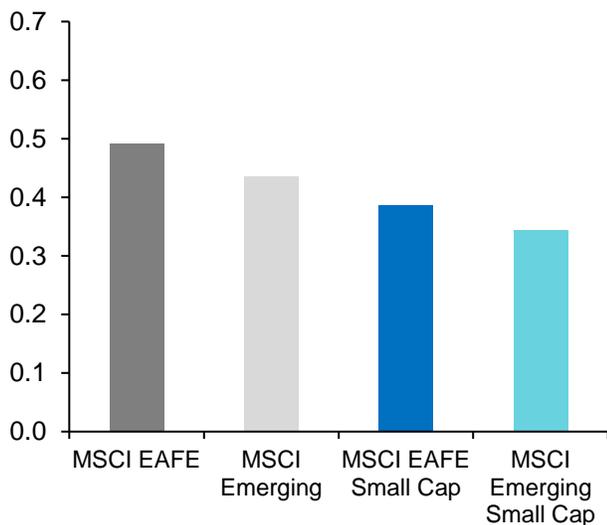
cap stocks in emerging markets may be poised for faster growth, making them attractive opportunities for investors seeking higher returns in exchange for the additional risk typically associated with smaller companies.

Although returns are important, diversification is equally crucial². Global markets, such as the MSCI World Index, have always been highly correlated to U.S. markets, but this relationship has only strengthened over the past decade as U.S. exposure within global indices has increased to more than 70%. As shown in **Exhibit 3**, international and emerging markets offer diversifying exposures, and this is especially true for the small cap universes, which have historically shown a lower correlation to U.S. large cap stocks compared to their large cap counterparts³.

One reason for this increased diversification could be attributed to the source of revenue. Small cap stocks outside the U.S. often derive a larger portion of their revenue from domestic customers, making them less vulnerable to disruptions from recent tariff policies. **Exhibit 4** illustrates the benchmark-weighted percentage of revenue from domestic sales in broad market indices, showing that international small cap and emerging small cap stocks provide greater exposure to domestic demand.

Exhibit 3: Full Period Correlation of Russell 1000 with other Indices

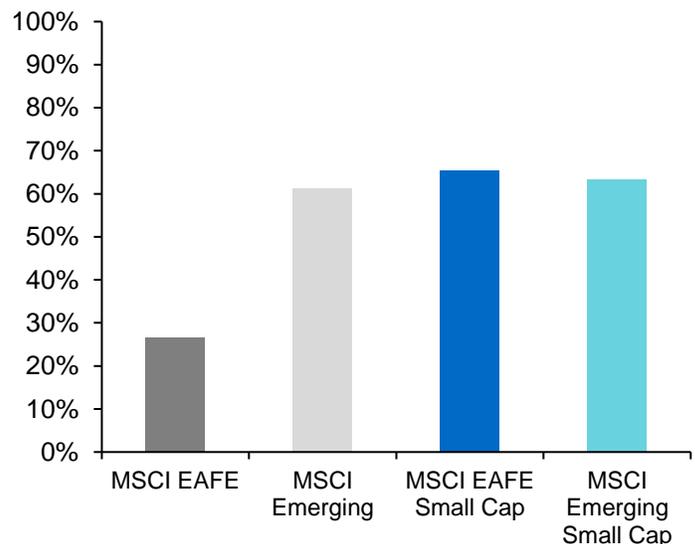
January 1, 1999 - December 31, 2024



Source: AQR, Bloomberg. Full period correlation computed using daily returns. Diversification does not eliminate the risk of experiencing investment losses. Past performance is not a reliable indicator of future performance.

Exhibit 4: Percentage of Revenue from Domestic Sales

As of December 31, 2024



Source: AQR, CapIQ. The chart illustrates benchmark weighted percent of revenue from domestic sales in broad market indices.

² See '[International Diversification Works \(Eventually\)](#)' and '[International Diversification - Still Not Crazy after All These Years](#)'

Diversification does not eliminate the risk of experiencing investment losses.

³ Recent observations show that rolling 6-month correlations have continued to decline, further reinforcing the diversifying potential of international and emerging small cap equities.

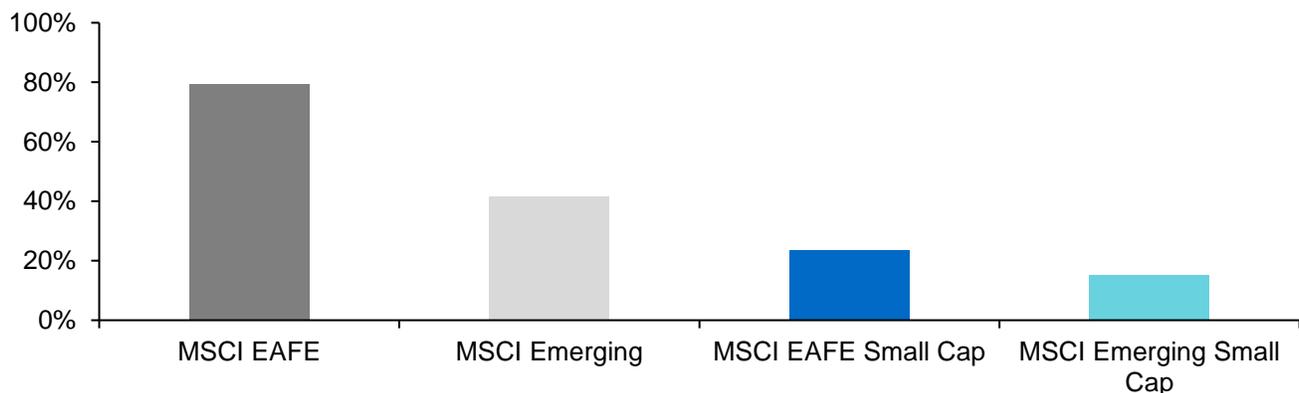
The Alpha Opportunity

When it comes to alpha opportunities, international small cap and emerging small cap may offer added value that is highly competitive and promising. The extensive scope and large number of companies within the small cap universe present a notable advantage for investment managers who have the resources and expertise to effectively explore these segments. The sheer volume of small cap stocks often exceeds the analytical

capabilities of sell-side analysts. **Exhibit 5** highlights this discrepancy, showing that international and emerging large cap stocks receive higher coverage than their small cap counterparts. As a result, many small cap stocks remain under-analyzed or overlooked, leading to slower incorporation of fundamental changes into their stock prices. This gap may offer investors opportunities to identify and benefit from relatively untapped alpha.

Exhibit 5: Broker Report Coverage for Int'l and Emerging Large and Small Cap

As of December 31, 2024



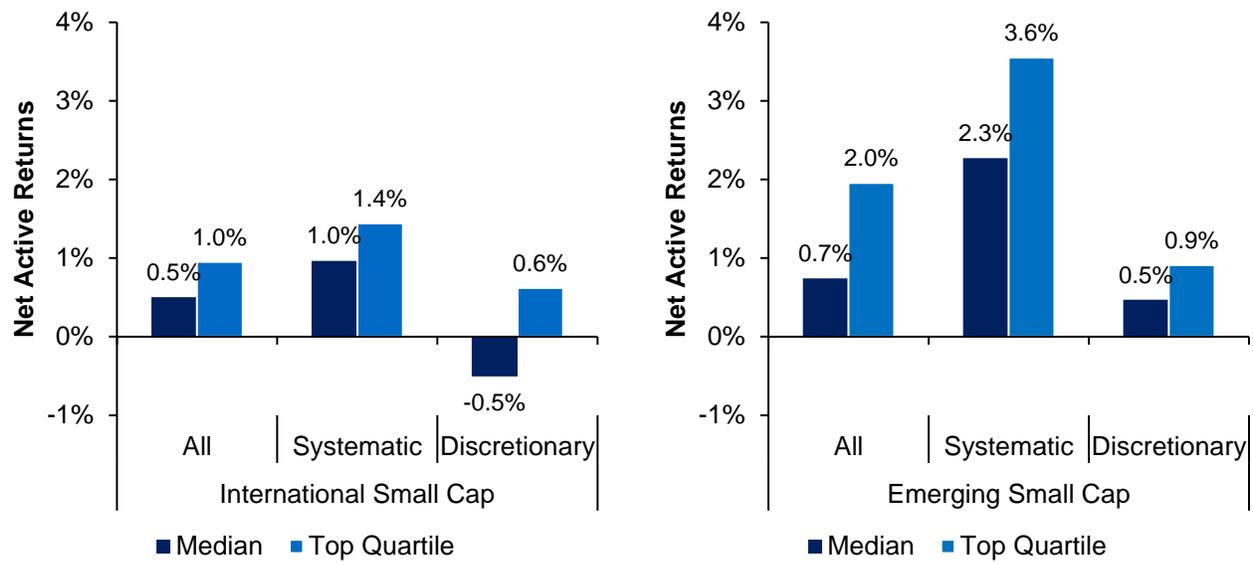
Source: AQR. Based on AQR's proprietary signal and illustrates broker report coverage for constituents in broad market indices. Please read important disclosures in the Disclosures section.

While these inefficiencies may offer skilled investors meaningful opportunities to uncover mispricing and generate alpha, they also tend to be accompanied by higher transaction costs, which can erode returns and contribute to the persistence of inefficiencies by discouraging broader market participation. As a result, the small cap universe is particularly well-suited for a systematic investment approach. **Exhibit 6**

demonstrates that systematic managers, in particular, have shown an ability to add consistent alpha over their benchmarks in these regions. By identifying and capitalizing on market opportunities that may be overlooked by discretionary managers and maintaining more diversified portfolios that help reduce idiosyncratic risk, they have the ability to achieve higher active returns.

Exhibit 6: International and Emerging Small Cap Active Returns

January 1, 2015 - December 31, 2024



Source: AQR, eVestment. Regional equity universes shown are categories within the eVestment database which are described in the Disclosures. The International Small Cap sample includes 52 managers, 12 of which are Systematic and 31 of which are Discretionary. The Emerging Small Cap sample includes 31 managers, 7 of which are Systematic and 18 of which are Discretionary. Discretionary and Systematic refer to investors in the International and Emerging Small Cap eVestment universes who have reported their primary investment approach as fundamental and quantitative. We remove all managers who do not have complete return series over the trailing 10-year period. Manager active returns are calculated by eVestment relative to manager preferred benchmarks and are reported gross of fees. Gross performance results do not reflect the deduction of investment advisory fees and other expenses, which would reduce an investor's actual return.

Concluding Thoughts

Despite recent market correction, the strong performance of U.S. large cap equities over the past several years has led to lower expected future returns, posing a potential risk to global equity portfolios. Ongoing volatility - including uncertainty stemming from shifting tariff policies - adds another layer of risk for investors. While international and emerging large cap stocks also currently present an attractive option for equity

diversification and may be more familiar to investors, we would encourage investors not to overlook even greater potential opportunities in international and emerging small cap stocks. These smaller market segments may not only offer higher expected market returns but also have the ability to provide significant diversification benefits and potentially rich alpha opportunities.

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The Russell 1000 Index is a market capitalization-weighted index that represents the highest-ranking 1000 stocks in the Russell 3000 Index.

The Russell 2000 Index is a subset of the Russell 3000® Index which is designed to represent approximately 98% of the investable US equity market. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership.

The MSCI Emerging Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

The MSCI Emerging Small Cap Index is a free float-adjusted market capitalization weighted index that includes small cap representation across 24 Emerging Markets countries.

The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada.

The MSCI EAFE Small Cap Index is designed to measure the equity market performance of small cap indices across the world, excluding the U.S. and Canada.

eVestment manager universe descriptions: EAFE Small Cap Equity: EAFE Equity products that primarily invest in small capitalization stocks regardless of the style (growth, value, or core) focus. Universe ID: 1152. Date Added: 10/2/2009. Global Emerging Mkts Small Cap Equity: Global Emerging Markets equity products that primarily invest in small capitalization stocks regardless of the style (growth, value, or core) focus. Universe ID: 211174. Date Added: 8/25/2011.

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