



C A M B R I D G E A S S O C I A T E S L L C

GLOBAL MARKET COMMENT

Asian Markets Primer Part V

Small-Cap Equity Indices

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Asian Markets Primer V

Small-Cap Equity Indices

This is the fifth in a series of six primers designed to introduce investors to Asian capital markets. This month we look at small-cap equity indices, and review their defining characteristics, historical returns, and current valuations.

There are three prominent small-cap indices in Japan and two in developed Asia. One additional regional index—Nomura Small Cap—includes those from both developed and emerging Asian markets, but there are no small-cap indices that focus solely on emerging Asian equities.

Japan's three small-cap indices—Topix Small, Topix Second Section (TSE2), and MSCI Japan Small Cap—are quite distinct in character.¹ Essentially, the Topix Small is a small-cap index, the TSE2 micro-cap, while the MSCI Japan Small Cap Index includes both small- and micro-cap shares (Table A).

The first section of the Topix (otherwise simply known as Topix) is divided into several subindices, including, *inter alia*, the Topix Small Index. This index is defined as including all but the largest 500 companies in the first section that meet certain liquidity requirements for inclusion. The Topix Small currently contains 1,072 constituent companies (compared with 1,645 for the first section), a total market cap of US\$433.3 billion, and a market-cap range of US\$29.6 million to US\$4.0 billion.

The TSE2 is made up of companies that have fewer listed shares (six million to 20 million) than those in the first section (at least 20 million). In terms of total market cap, it is only 17% the size of the Topix Small and half as large in terms of number of companies (515). Furthermore, the TSE2's market-cap range is much narrower than the Topix Small, US\$14.4 million to US\$1.96 billion.

MSCI Japan Small Cap is based on a different classification system and thus includes stocks in both of the other two small-cap indices on the Tokyo Stock Exchange. MSCI defines the small-cap universe as companies whose full market cap falls in the US\$200 million to US\$1.5 billion range. It also tries to capture 40% of the small-cap universe within each country by representing 40% of each industry. Currently, its market capitalization is about 40% of that of the Topix Small, though more than twice that of the TSE2, while the range of its market cap is US\$78.9 million to US\$2.08 billion (MSCI reconstitutes small-cap indices semiannually). The MSCI Japan Small Cap contains only 352 companies, roughly one-third of the size of the Topix Small and 70% of that of the TSE2. While the lower range of the MSCI index's market cap is nearly three times larger than that of the Topix Small, its upper range is about half the size (Tables B and C).

¹ For a discussion of Japanese indices across all capitalization sectors, please see our June 2004 Global Market Comment: *Japanese Equity Indices: A Look Under the Hood*. It reviews the Topix Small-Cap Index, which this Comment excludes because it is rarely used as a market or manager benchmark.

Though the regional Nomura Asia Small-Cap Index contains stocks from developed Asian countries, it is primarily an index of emerging equities; Hong Kong and Singapore account for 31.6% of its total market cap, while the remainder is developing Asia. The index's total market cap is larger than the Japanese small-cap indices, both in terms of total market cap and number of constituent companies.

The other two small-cap indices in Asia—MSCI Hong Kong Small Cap and MSCI Pacific ex Japan Small Cap—have a total market cap that is roughly 10% of the size of their “standard” MSCI indices.² The total market cap of MSCI Pacific ex Japan Small Cap Index is US\$89.6 billion, and MSCI Hong Kong Small Cap Index, US\$16.2 billion. The number of constituent companies totals 141 and 42, respectively.

Small caps have been on a tear relative to large caps in recent years, though investors should be careful not to extrapolate this outperformance into the future, for cap-sector leadership is highly cyclical (Tables D through F). Since February 2001 through April 2005, the Topix Small has posted an AACR of 8.6%, and TSE2, 14.1%, compared with -3.6% for the Topix, while the MSCI Pacific ex Japan Small Cap has registered a 14.2% AACR, compared with 4.2% for its “standard” cousin. (All returns are total returns in local currency except for Topix Small and TSE2, which are price returns.) Since 1993 MSCI Hong Kong outperformed its small-cap cousin, while since its 1997 inception, MSCI Pacific ex Japan Small Cap beat the “standard” index.

Concerning valuations, historical data are quite limited, but we can make the following observations based on their current levels (Table G). The Japanese small-cap indices appear comparably priced based on their dividend yields, though on a price-earnings (P/E) basis, the MSCI index, with a P/E of 48.7, appears quite overvalued. The TSE2 appears comparably priced relative to its historical averages; however, this may be a result of skewed historical data,³ rather than an indication that the index is currently fairly valued (Table H).

The MSCI Pacific ex Japan and Hong Kong Small Cap indices currently seem fairly valued, though they are modestly rich compared to their “standard” cousins. The Nomura Asia Small-Cap Index appears reasonably priced, which is consistent with the current attractive valuations of emerging Asian equities.

² Similarly, the current total market cap of the MSCI Japan Small Cap Index is 9.7% of that of the MSCI Japan Index.

³ For instance, from 1975-77, its P/E was zero, while it reached 300 to 400 during the last five months of 1978.

Table A

CHARACTERISTICS OF SMALL-CAP ASIAN EQUITY INDICES

As of April 30, 2005

U.S. Dollars

	<u>Market Cap (mm)</u>	<u>Market-Cap Range (mm)</u>	<u>Number of Companies</u>
TOPIX Small	433,310.4	29.6 - 4,013.7	1,072
TOPIX 2nd Market	73,464.5	14.4 - 1,960.2	515
MSCI Japan Small-Cap	180,028.5	78.9 - 2,079.9	352
MSCI Pacific ex Japan Small-Cap	89,596.9	54.8 - 2,492.6	141
MSCI Hong Kong Small-Cap	16,195.3	78.5 - 1,391.7	42
Nomura Asia Small-Cap	479,935.6	- -	1,236

Standard Asian Equity Indices

	<u>Market Cap (mm)</u>	<u>Market-Cap Range (mm)</u>	<u>Number of Companies</u>
TOPIX First Section	3,341,861.8	29.6 - 132,129.6	1,645
MSCI Japan	1,872,375.0	297.1 - 105,703.8	344
MSCI Pacific ex Japan	702,068.9	93.1 - 44,845.1	160
MSCI Hong Kong	150,841.2	319.6 - 19,004.1	38
MSCI Emerging Markets Asia	601,559.3	26.0 - 60,095.6	441

Sources: Factset, Morgan Stanley Capital International, Nomura Securities Co, Ltd., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Table B
MARKET-CAP QUINTILES

As of April 30, 2005

In U.S. Dollars

	% of Total Market Cap	Quintile Market Cap (mm)	Maket Cap Range (mm)			Number of Companies
Quintile 1						
MSCI Japan Small-Cap	42.1	75,766.3	760.2	-	2,079.9	70
MSCI Hong Kong Small-Cap	41.2	6,677.2	582.4	-	1,391.7	8
MSCI Pacific ex Japan Small-Cap	46.7	41,871.1	1,066.8	-	2,492.6	28
TOPIX Small	45.4	196,745.7	624.7	-	4,013.7	214
TOPIX 2nd Market	53.0	38,926.8	195.6	-	1,960.2	103
Quintile 2						
MSCI Japan Small-Cap	23.2	41,816.6	507.6	-	757.7	70
MSCI Hong Kong Small-Cap	23.4	3,783.6	400.8	-	530.9	8
MSCI Pacific ex Japan Small-Cap	25.3	22,624.0	587.3	-	1,063.9	28
TOPIX Small	24.5	106,204.0	392.1	-	624.3	214
TOPIX 2nd Market	21.1	15,507.1	118.8	-	194.6	103
Quintile 3						
MSCI Japan Small-Cap	16.8	30,248.1	349.3	-	501.8	71
MSCI Hong Kong Small-Cap	16.9	2,744.3	251.1	-	365.6	9
MSCI Pacific ex Japan Small-Cap	14.4	12,897.5	341.5	-	582.4	28
TOPIX Small	15.2	66,019.1	240.1	-	391.7	215
TOPIX 2nd Market	12.8	9,405.5	71.7	-	118.6	103
Quintile 4						
MSCI Japan Small-Cap	11.2	20,215.4	231.2	-	349.2	71
MSCI Hong Kong Small-Cap	10.9	1,772.8	194.0	-	238.3	8
MSCI Pacific ex Japan Small-Cap	8.9	7,951.5	230.0	-	335.9	28
TOPIX Small	9.6	41,798.4	150.5	-	239.4	214
TOPIX 2nd Market	8.3	6,069.6	47.0	-	71.7	103
Quintile 5						
MSCI Japan Small-Cap	6.7	11,982.1	78.9	-	229.3	70
MSCI Hong Kong Small-Cap	7.5	1,217.4	78.5	-	187.6	9
MSCI Pacific ex Japan Small-Cap	4.7	4,252.7	54.8	-	228.3	29
TOPIX Small	5.2	22,543.2	29.6	-	150.4	215
TOPIX 2nd Market	4.8	3,555.6	14.4	-	46.9	103

Sources: Factset, Morgan Stanley Capital International, and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Table C

SECTOR ALLOCATIONS FOR ASIAN EQUITY INDICES

As of April 30, 2005

	MSCI Japan <u>Small-Cap</u>	MSCI Hong Kong <u>Small-Cap</u>	MSCI Pacific ex Japan <u>Small-Cap</u>	MSCI Emerging <u>Asia</u>
Consumer Discretionary	25.06	26.23	17.40	8.81
Consumer Staples	10.52	11.34	10.77	5.24
Energy	1.16	1.20	2.18	8.12
Financials	8.30	31.34	23.23	18.49
Health Care	4.72	2.92	6.37	0.77
Industrials	24.68	4.64	15.95	8.99
Information Technology	15.05	14.72	6.54	27.89
Materials	10.00	2.89	13.07	9.48
Telecommunication Services	0.20	3.01	1.36	8.88
Utilities	0.30	1.71	3.13	3.34

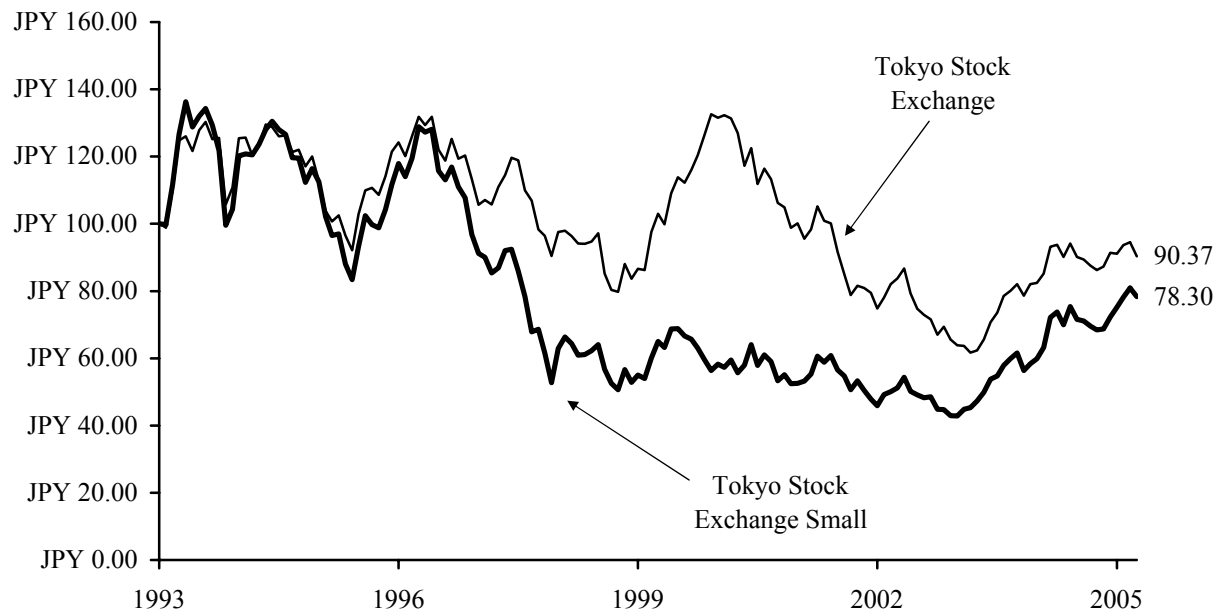
Sources: Factset and Morgan Stanley Capital International. MSCI data provided "as is" without any express or implied warranties.

Table D

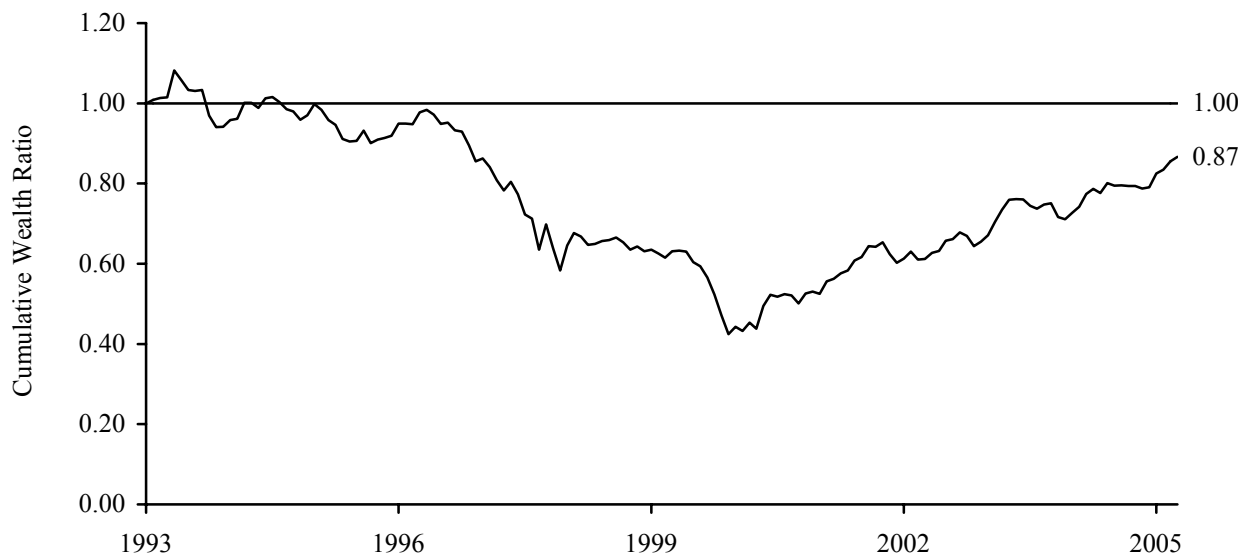
CUMULATIVE WEALTH OF THE TOKYO STOCK EXCHANGE AND THE TOKYO STOCK EXCHANGE SMALL

February 1, 1993 - April 30, 2005

Cumulative Wealth Index
(January 31, 1993 = ¥100)



Relative Cumulative Wealth Index
(Topix Small/Topix)



Source: Thomson Datastream.

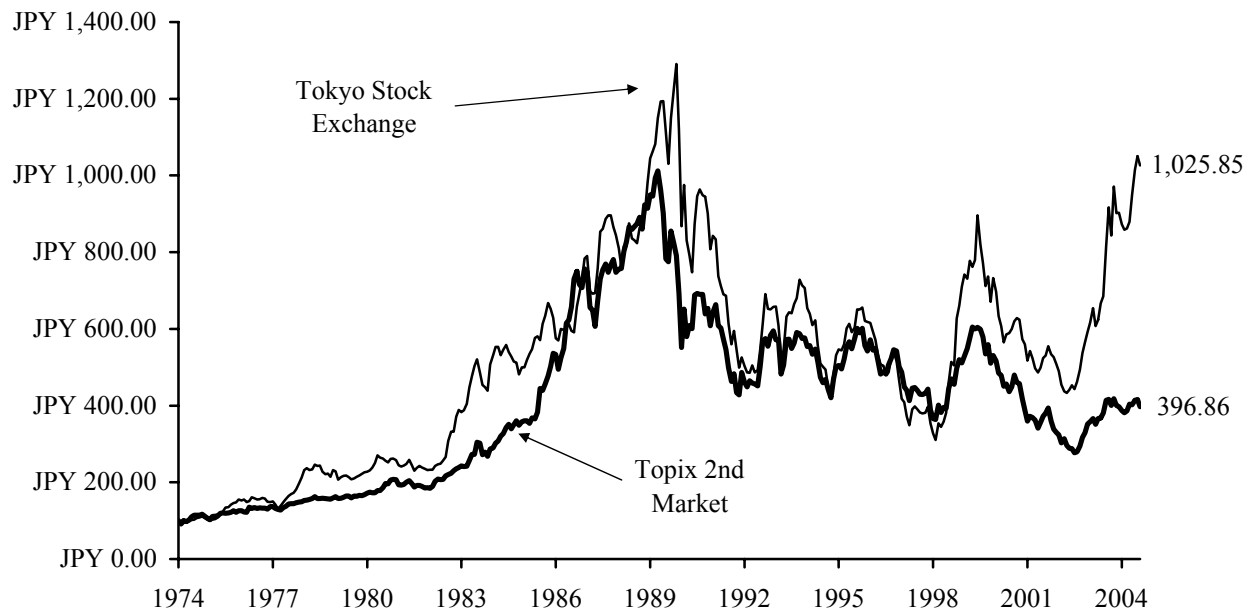
Note: Data from February 1, 1993 through October 31, 2001 represent price returns and data from November 1, 2001 through April 30, 2005 represent total returns.

Table E

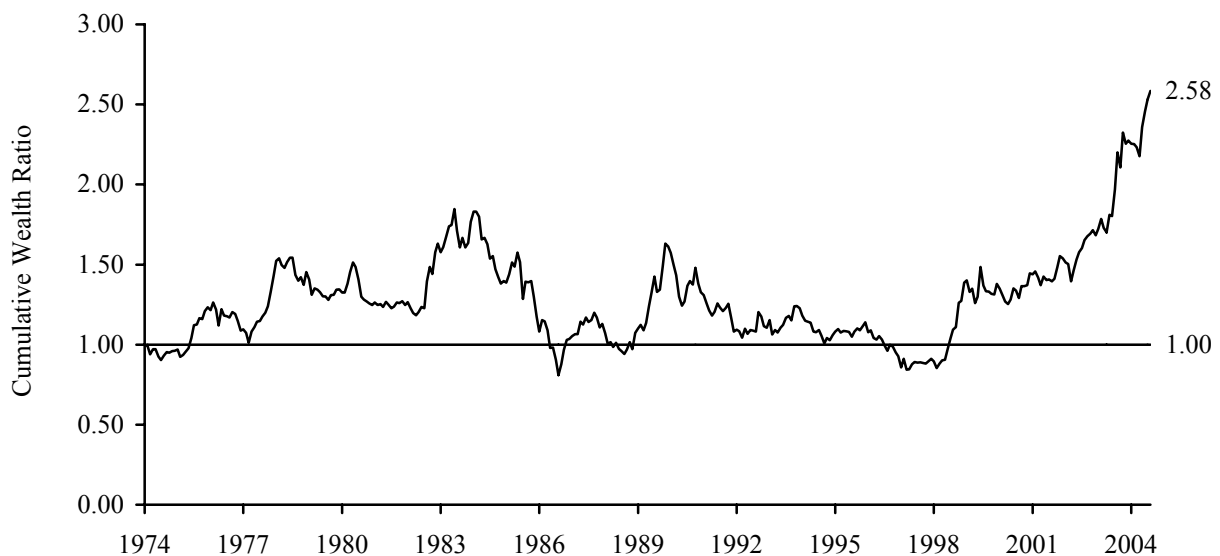
CUMULATIVE WEALTH OF THE TOKYO STOCK EXCHANGE AND THE TOKYO STOCK EXCHANGE 2ND MARKET

October 1, 1974 - April 30, 2005

Cumulative Wealth Index
(September 30, 1974 = ¥100)



Relative Cumulative Wealth Index
(Topix 2nd Market/Topix)



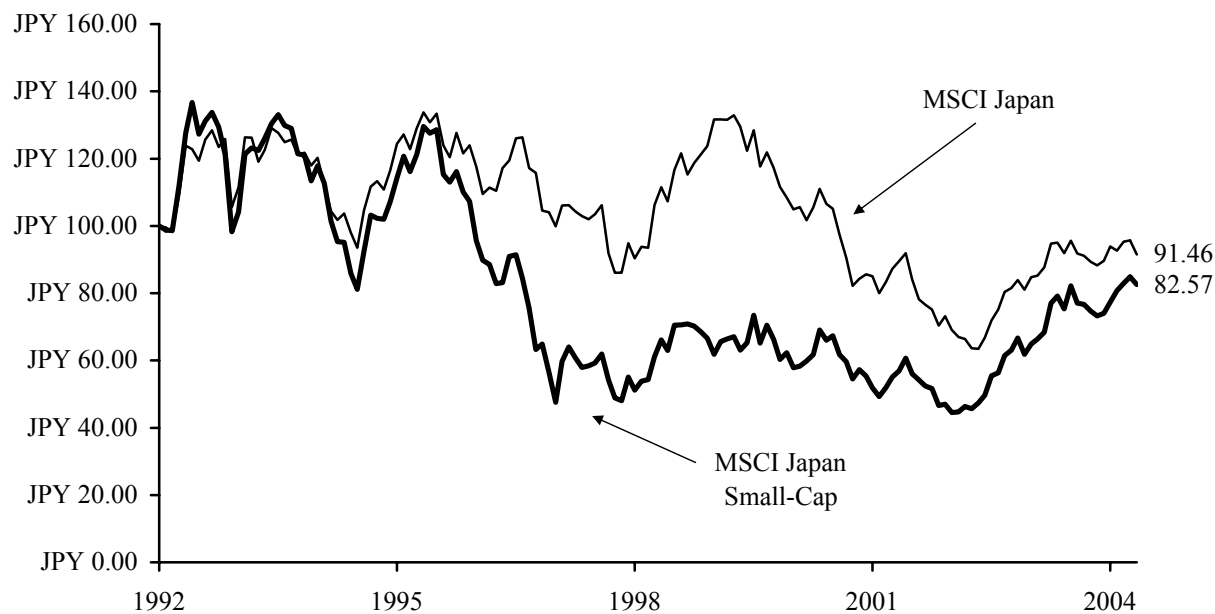
Source: Thomson Datastream.

Note: Graphs represent price returns.

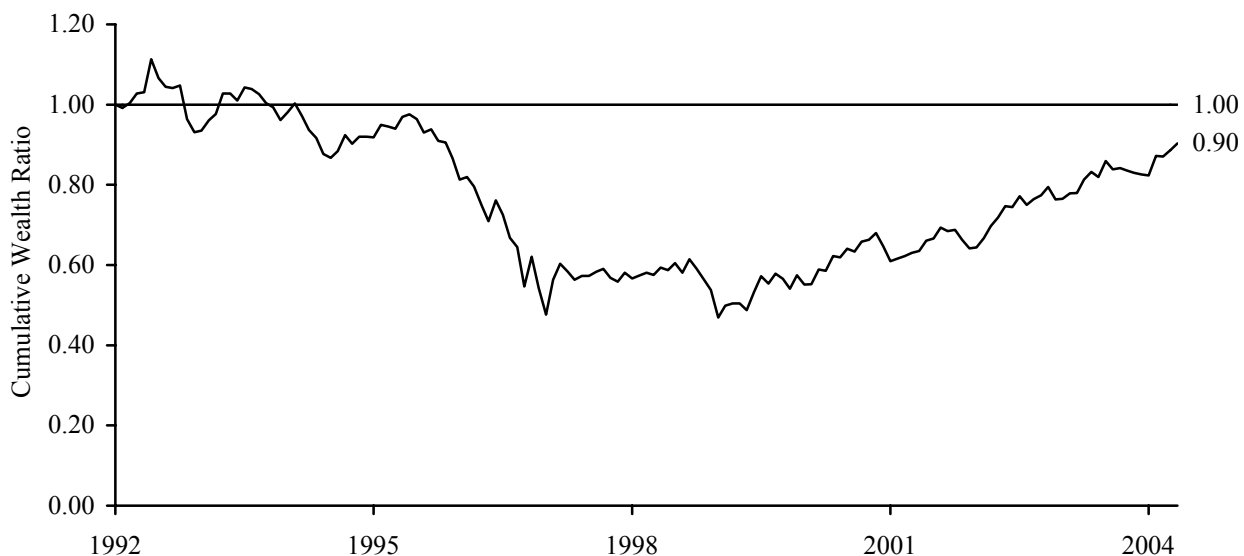
Table F
CUMULATIVE WEALTH OF MSCI JAPAN AND MSCI JAPAN SMALL-CAP

January 1, 1993 - April 30, 2005

Cumulative Wealth Index
(December 31, 1992 = ¥100)



Relative Cumulative Wealth Index
(MSCI Japan Small-Cap/MSCI Japan)



Source: Thomson Datastream.

Note: Data from January 1, 1993 through January 31, 2001 represent price returns and data from February 1, 2001 through April 30, 2005 represent total returns.

Table G

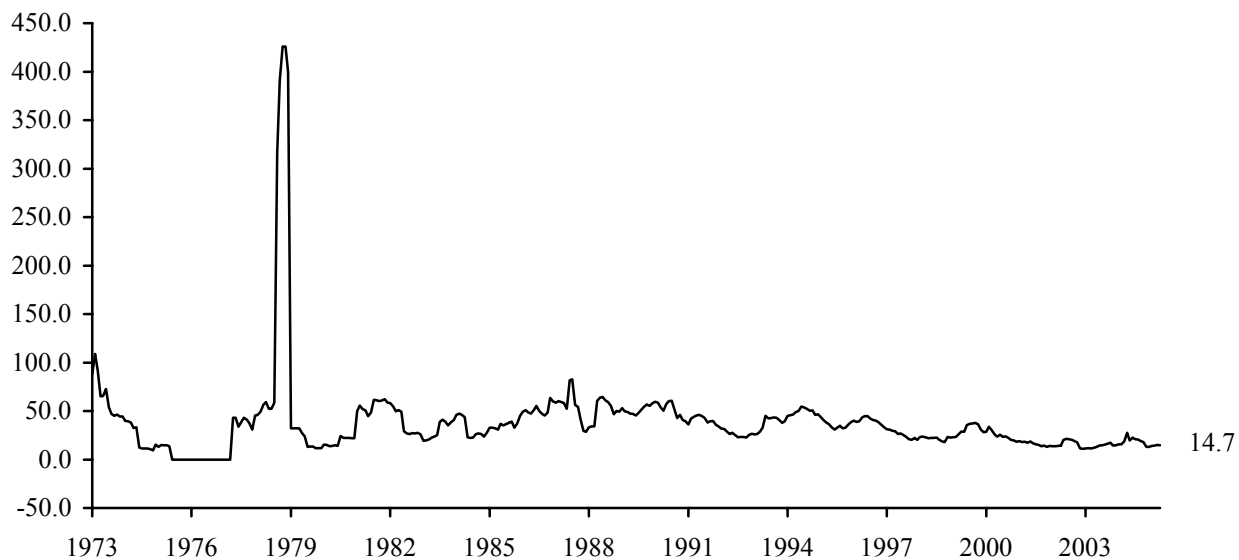
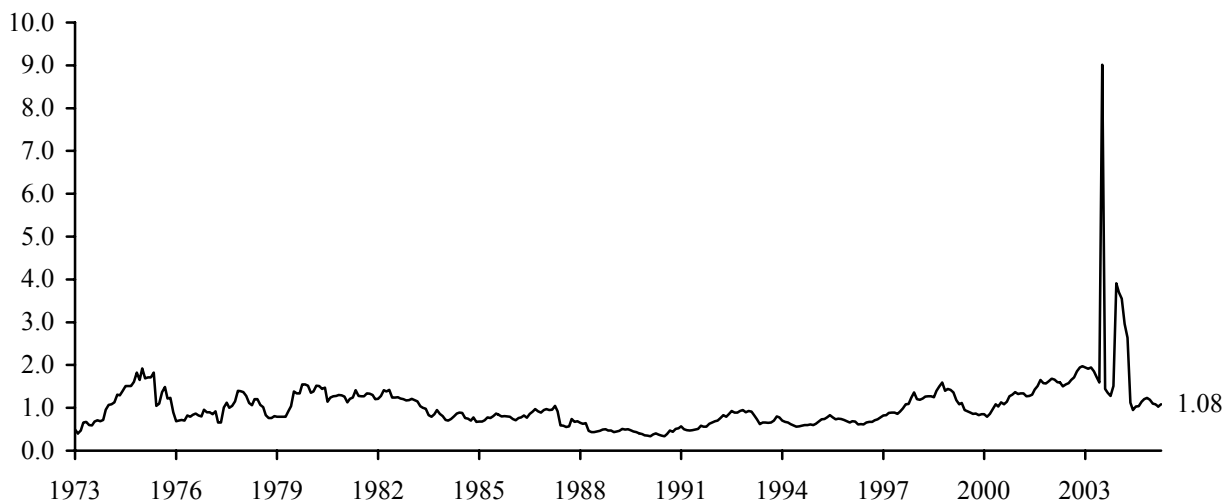
VALUATIONS

As of April 30, 2005

	<u>Price-to-Earnings</u>	<u>Dividend Yield (%)</u>	<u>Price-to-Book Value Ratio</u>	<u>Price-to-Cash Earnings</u>
Topix Small	24.4	1.2	---	---
Topix 2nd Market	14.7	1.1	---	---
MSCI Japan Small-Cap	48.7	1.1	1.4	6.4
MSCI Pacific ex Japan Small-Cap	19.4	3.7	2.1	12.6
MSCI Hong Kong Small-Cap	17.7	2.4	1.9	13.4
Nomura Asia Small-Cap	9.3	3.4	1.2	---

Sources: Morgan Stanley Capital International, Nomura Securities Co, Ltd., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Note: Valuation data for the Topix Small and Topix 2nd Market indices are calculated by Thomson Datastream.

Table H**VALUATIONS FOR THE TOKYO STOCK EXCHANGE 2ND MARKET****January 31, 1973 - April 30, 2005****Price-Earnings Ratio****Dividend Yield (%)**

Source: Thomson Datastream.

Notes: Graph represents monthly data. Data are calculated by Thomson Datastream.