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ASIAN SMALL CAPS: ASSESSING THE LANDSCAPE

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Asian Small Caps: Assessing the Landscape

Why Talk About Asian Small Caps?

Non-Asia-based investors seeking to capitalize on the Asian growth story have looked primarily at large-cap stocks, which include many names familiar to readers of the financial press. However, as investors become more familiar with the landscape, they are likely to broaden their focus. Already, on the private equity front, nary a day seems to pass without a story about a Western private equity firm doing a deal in Asia, planning to set up a local outpost, or hiring local talent.

Small caps will no doubt be part of this expanded investor focus. Emerging Asia companies now represent about 55% of the small caps covered by S&P/Citigroup.¹ Hong Kong and Singapore, meanwhile, have vibrant markets for such firms.² Indeed, both MSCI and Russell are in the process of enhancing their index coverage of Asian small caps as part of a plan to cover more firms outside of the United States.

Assuming the availability of good managers, small caps are an appealing strategy in Asia because, as in other markets, they may be less picked over and can be expected to outperform and underperform versus larger-cap stocks at different stages of the economic cycle, thereby providing diversification.³ While it is likely that most investors will want further mid- to large-cap exposure to the region before moving into the small-cap space—and there is no compelling reason from a valuation standpoint to invest in small caps right now—interest in the area will grow as markets broaden, costs decline, and investor understanding of Asia deepens.

A Closer Look

We examined information from three sources to gain a better understanding of Asian ex Japan small caps: the S&P/Citigroup Broad Market Index, which is composed of the small-cap Extended Market Index (EMI) and the large-cap Primary Market Index (PMI), the FTSE Small Cap Asia Pacific ex Japan Index (FTSE Small Cap), and the Nomura Asia Small Cap Index (Nomura Small Cap). In order to make apples to

¹ Although S&P began classifying South Korea as a developed rather than an emerging market index in 2002 we have included South Korea with the rest of emerging Asia in this paper to conform with the more common practice.

² For purposes of our discussion, Asia ex Japan is defined as China, Hong Kong, India, Indonesia, Malaysia, Pakistan, the Philippines, Singapore, South Korea, Taiwan, and Thailand. Since Japanese small-cap stocks make up a disproportionate amount of Asian small caps (well over half in market capitalization) and are relatively well known in comparison to other Asian small caps, we exclude them from this discussion. See Tables A through C for more detail.

³ For one thing, the economic sector weightings of countries in the small-cap indices can vary substantially from the weightings in the large-cap indices (Table A). For example, information technology stocks account for 27.7% and 21.7% of MSCI South Korea and MSCI India, respectively, but just 4.8% and 5.3% of the FTSE Small Cap indices for these two markets. By contrast, industrials make up only 9.3% and 3.6% of MSCI China and MSCI Taiwan, respectively, but 57.2% and 34.9% of the relevant FTSE Small Cap country indices. MSCI and FTSE are based on the GICS and ICB sector classifications, respectively. Although these sector classifications differ slightly, we believe they are comparable.

apples comparisons we subtracted data for Australia and New Zealand from the FTSE Index.⁴ As is the case with global ex U.S. small-cap indices generally, there are substantial differences among these three regional indices. The Nomura Small Cap includes all stocks with market capitalization of between \$100 million and \$1 billion that meet its selection criteria, while the EMI and the FTSE Small Cap constituents (which also must have at least \$100 million in market cap) are classified in the context of the total portfolio of stocks covered by S&P/Citigroup and FTSE, respectively: the EMI is the bottom 20% by market cap of the firms S&P/Citigroup covers and the FTSE Small Cap is the bottom 10% of FTSE's universe of companies. By way of comparison, at the end of 2006, the Nomura Small Cap represented 16.8% of the companies and 13.4% of the market cap of the firms listed on the region's major exchanges. As of the end of 2006 the Nomura Small Cap contained the largest number of companies (1,645), followed by the EMI (1,266) and the FTSE Small Cap (829) (Table A).

The number of Asian small-cap companies included in the indices is growing, whether due to the Asian growth story, broader analyst coverage or, more likely, some combination of the two. As of August 31, 2004, the Nomura Small Cap contained 1,248 companies with a combined market cap of \$399 billion. By the close of 2006, just 28 months later, there were 32% more companies, with a total market cap two-thirds higher. At the end of 2003, meanwhile, 502 companies worth \$83.0 billion (in investable capital) were in the FTSE Small Cap. Three years later there were 65% more companies, including three times as many Indian firms as before. Total available market cap had risen almost three-and-one-half times, with that of Indonesian companies nine times greater than in 2003. As of the end of 2006, the EMI includes \$497.4 billion, and the FTSE Small Cap, \$287.8 billion of investable capital. The Nomura Small Cap lists only the total capitalization of its constituents (\$660.9 billion) but their investable capital is likely within the EMI/FTSE small-cap range.⁵

The country weights among the small-cap indices are vastly different (Table A). For example, Indian companies make up just 10% of the EMI but 17.2% of the FTSE Small Cap and 22.7% (by total market cap) of the Nomura Small Cap. Firms listed in China account for 14.1% of the EMI, compared with 1.5% and 2.9% of the Nomura Asia Small Cap and the FTSE Small Cap, respectively.

Given these sharp discrepancies it is likely that economic sector weights differ substantially among the three indices. Returns certainly vary, highlighting the importance of understanding the various benchmarks and choosing the appropriate one. From 1997 to 2006 the FTSE Small Cap had an average annual compound return (AACR) of 0.4% compared to an AACR of -1.0% for the Nomura Small Cap. Although we do not have Asia ex Japan returns for the EMI, if we expand our focus to include Australia and New Zealand, we find a large discrepancy over the same period between the AACR for the S&P/Citigroup Pacific ex Japan EMI (10.2%) and that of the FTSE Asia Pacific ex Japan Small Cap Index (3.0%).

⁴ While the Nomura Index does not include Pakistani companies we did not eliminate such companies from either of the other two indices because Pakistan accounts for a miniscule share of index market cap.

⁵ This conclusion is based upon a review of total versus investable capital of the companies that make up the other two indices.

Valuations

With the caveat that one Asian small cap *index* may differ markedly, not only from another, but also relative to its own year-earlier incarnation, it remains worthwhile to examine the valuations of Asian small-cap *companies* versus their larger peers. The easiest way to do this is by comparing country valuations of the EMI (the bottom 20% of firms evaluated by S&P/Citigroup on a market capitalization basis) with their counterparts in the S&P/Citigroup PMI (the largest 80% of the firms on a market capitalization basis) (Table B). In the aggregate, Asia ex Japan small caps appear a touch less expensive than large caps. Small caps are cheaper based on price-earnings (P/E) and price-to-book (P/B) ratios, but slightly more expensive based on dividend yields (DYS) and price-to-cash flow (P/CF) measures. Small caps also have lower returns on equity (ROEs) than do large caps.

As for the individual Asia Pacific ex Japan markets, in each case the EMI firms have lower ROEs and trade at a P/B value discount to their large-cap counterparts. Small-cap yields are also predominantly lower. However, P/E and P/CF comparisons are mixed, although it is noteworthy that small caps from South Korea and Taiwan, the two largest markets in the EMI, trade at a premium to their larger cap counterparts. Similar conclusions hold when we compare data from the Nomura Small Cap and the relevant MSCI country indices⁶ although the small caps included in the former index tend to have higher DYS and P/CF ratios than their counterparts in the EMI⁷ (Table B).

While our data from S&P/Citigroup goes back no further than 1989 and in some cases only to 1999 (see note to Table C for more detail), it shows P/B and P/CF ratios for Asian small caps in the EMI to be generally above their historical means while P/E multiples are, except in the cases of India and Pakistan, below historical means (Table C). DYS in most markets are also below historical means, while ROEs are at above average levels in markets such as South Korea, Taiwan, and Singapore that collectively make up more than half the market capitalization.

Conclusion

Asian small caps are likely to be of greatest interest to investors already familiar with the Asian investment landscape. For those less involved in the region it is never too early to start keeping an eye out for what will clearly be a growth area. Asian small caps present another way to benefit from the Asian growth story and to diversify a portfolio. From a pricing standpoint, while no great bargains may be present at the moment, valuations appear reasonable on both a historical basis (based on our limited data) and relative to mid- and large-cap stocks in the region.

⁶ We lack valuation data for FTSE small caps.

⁷ According to GMO, data going back to 1980 show that non-U.S. small caps, in contrast to their U.S. counterparts, have historically traded at a discount to large caps. Please see April 2006 Global Market Commentary: *Non-U.S. Small Caps Look Rich?* However, since the GMO data covered small caps ex U.S. and were heavily influenced by Japanese and U.K. firms, which alone accounted for 44% to 51% of the total market capitalization, it does not allow us to draw any conclusions regarding Asian ex Japan small caps specifically.

Right now the benchmark indices differ substantially, underlining the importance of picking the appropriate one. More broadly, these differences at the index level reflect the substantial judgment required of active managers who must pick and choose small-cap stocks in markets that differ significantly by size, economic sector weighting, valuations, political and regulatory environment, economic outlook, etc. These factors in turn highlight the potential benefits of active management in the Asian small-cap space. Although the increasing coverage by global index providers may make investing in this asset class more uniform in the years ahead, the uneven landscape may provide opportunities (and pitfalls!) that are likely to persist for some time.

Table A
COMPARISON OF ASIA EX JAPAN INDICES
As of December 31, 2006

Country	Number of Companies			Market Capitalization (US\$ Mil)			Weighting by Market Cap (%)*			Average Market Cap per Company (US\$ Mil)						
	NASC	FTSE	S&P Citigroup EMI MSCI	NASC	FTSE	S&P Citigroup EMI MSCI	NASC	FTSE	S&P Citigroup EMI MSCI	NASC	FTSE	S&P Citigroup EMI MSCI				
China	31	65	145	83	10,065	8,288	70,241	282,823	1.5	2.9	14.1	17.5	325	128	484	3,408
Hong Kong	309	108	147	42	127,836	38,325	70,937	227,838	19.3	13.3	14.3	14.1	414	355	483	5,425
India	348	114	143	68	149,822	49,611	49,687	156,982	22.7	17.2	10.0	9.7	431	435	347	2,309
Indonesia	43	19	29	24	21,167	10,280	8,631	39,340	3.2	3.6	1.7	2.4	492	541	298	1,639
Malaysia	128	50	65	59	55,569	14,861	15,606	62,936	8.4	5.2	3.1	3.9	434	297	240	1,067
Pakistan	10	13	15	15	---	2,054	2,282	4,915	---	0.7	0.5	0.3	---	205	176	328
The Philippines	24	6	15	16	15,701	1,665	4,748	12,166	2.4	0.6	1.0	0.8	654	278	317	760
Singapore	132	54	99	39	52,396	20,798	39,005	122,236	7.9	7.2	7.8	7.6	397	385	394	3,134
South Korea	222	140	237	93	78,705	65,680	124,879	371,451	11.9	22.8	25.1	23.0	355	469	527	3,994
Taiwan	316	234	331	103	118,435	72,999	102,789	300,498	17.9	25.4	20.7	18.6	375	312	311	2,917
Thailand	92	29	42	42	31,187	3,190	8,625	34,574	4.7	1.1	1.7	2.1	339	110	205	823
Total	1,645	829	1,266	584	660,883	287,751	497,430	1,615,761	100.0	100.0	100.0	100.0	402	347	393	2,767

Sources: The Bloomberg, FTSE International Limited, Morgan Stanley Capital International, Nomura Securities Company Limited, S&P/Citigroup Global Markets, and Thomson Datastream. MSCI data provided "as is" without any expressed or implied warranties.

Notes: Market capitalization data refer to available or investable market capitalization, except in the case of the Nomura Asia Small Cap Index, which uses total market capitalization of index constituents. EMI refers to Extended Market Index. NASC refers to the Nomura Asia Small Cap Index. MSCI indices only represent large- and mid-cap coverage.

* Percentages may not total due to rounding.

Table B
ASIA EX JAPAN VALUATIONS
As of December 31, 2006

Region	Price-Earnings			Dividend Yield (%)			Price-to-Book Value			Price-to-Cash Earnings			ROE (%)			
	S&P/Citigroup EMI	PMI	MSCI	NASC	EMI	PMI	MSCI	NASC	EMI	PMI	MSCI	EMI	PMI	EMI	PMI	
China	10.0	20.4	21.0	1.4	1.3	1.5	1.5	3.4	1.6	3.0	3.2	11.3	11.7	10.3	7.3	13.8
Hong Kong	10.1	11.2	19.1	2.5	2.4	2.6	2.6	1.8	0.6	1.5	2.0	12.2	12.1	13.7	5.2	8.1
India	20.7	22.5	22.9	1.4	1.0	1.0	1.0	2.9	3.9	5.1	5.2	13.7	16.7	17.4	17.3	23.3
Indonesia	19.5	18.5	19.5	1.6	1.5	2.4	2.3	2.2	2.1	4.2	4.4	15.7	12.2	11.7	8.2	21.5
Malaysia	17.6	14.2	18.4	3.4	2.7	3.5	2.6	1.5	1.6	2.3	2.2	12.1	9.2	11.7	8.6	12.5
Pakistan	9.4	10.3	10.0	---	2.8	5.6	5.8	---	1.7	3.4	2.9	6.8	7.4	7.7	18.4	32.0
The Philippines	13.1	17.6	17.7	1.4	1.6	2.2	2.2	1.9	1.7	3.1	2.8	7.2	9.6	9.4	12.7	16.3
Singapore	19.4	16.0	18.5	2.9	2.9	3.2	2.3	1.9	1.7	2.1	2.2	14.3	11.7	12.3	10.4	10.9
South Korea	13.6	11.6	11.6	2.0	1.6	1.5	1.6	1.2	1.5	1.7	1.7	4.8	4.7	7.3	11.7	16.4
Taiwan	26.2	19.1	18.1	5.5	3.2	3.5	3.5	1.7	1.8	2.3	2.2	8.3	7.5	10.0	9.5	9.6
Thailand	16.2	7.1	9.1	4.1	4.2	3.4	3.9	1.5	1.4	1.8	1.9	6.4	5.6	5.9	12.0	24.4
Asia Emg + HK +SI	15.0	16.3	---	---	2.3	2.5	---	---	1.4	2.3	---	10.7	10.1	---	7.9	11.6
Asia Pacific Emerging	16.6	18.4	---	---	2.2	2.4	---	---	1.9	2.8	---	9.9	9.5	---	9.7	13.4

Sources: The Bloomberg, FTSE International Limited, Morgan Stanley Capital International, Nomura Securities Company Limited, S&P/Citigroup Global Markets, and Thomson Datastream. MSCI data provided "as is" without any expressed or implied warranties.

Notes: "Asia Emerging + Hong Kong + Singapore" and "Asia Pacific Emerging" are measures reported by S&P/Citigroup. Neither includes South Korea, which S&P/Citigroup defines as a developed rather than an emerging market. EMI refers to Extended Market Index and PMI refers to Primary Market Index. NASC refers to the Nomura Asia Small Cap Index. MSCI indices only represent large- and mid-cap coverage.

Table C
VALUATIONS FOR ASIA SMALL CAPS

Market	Price-Earnings		Price-to-Book Value		Price-to-Cash Flows		Dividend Yield (%)	
	<u>Current</u>	<u>Historical Average</u>	<u>Current</u>	<u>Historical Average</u>	<u>Current</u>	<u>Historical Average</u>	<u>Current</u>	<u>Historical Average</u>
China	10.0	17.0	1.6	1.3	11.3	9.0	1.3	2.9
Hong Kong	10.1	18.4	0.6	1.1	12.2	10.6	2.4	3.5
India	20.7	14.2	3.9	2.4	13.7	10.4	1.0	2.0
Indonesia	19.5	34.6	2.1	2.8	15.7	9.1	1.5	2.1
Malaysia	17.6	33.9	1.6	1.5	12.1	17.4	2.7	2.5
Pakistan	9.4	8.6	1.7	2.5	6.8	7.0	2.8	5.7
The Philippines	13.1	16.0	1.7	1.2	7.2	9.3	1.6	1.9
Singapore	19.4	20.0	1.7	1.2	14.3	11.9	2.9	2.5
South Korea	13.6	21.8	1.5	0.8	4.8	4.5	1.6	2.1
Taiwan	26.2	66.1	1.8	1.6	8.3	12.3	3.2	2.6
Thailand	16.2	19.9	1.4	1.7	6.4	14.0	4.2	4.1
Asia Pacific Emerging	16.6	27.0	1.9	1.3	9.9	11.9	2.2	2.5

Source: S&P/Citigroup Global Markets.

Notes: "Asia Pacific Emerging" does not include Hong Kong, Singapore, and South Korea, which S&P/Citigroup defines as a developed rather than an emerging market. Historical average data are based on monthly valuations, excluding negative values. Price-to-earnings data are based on 12-month trailing earnings per share and data begin on November 30, 1999 for all markets. Data for Hong Kong, Singapore, and Malaysia start on June 30, 1989. Data for South Korea, the Philippines, Taiwan, and Thailand start on October 31, 1994. Data for Asia Pacific Emerging and Indonesia start on December 31, 1994 and on January 31, 1995 for India. Data for China start on December 31, 1995. Data for Pakistan starts on January 31, 1997. All indices represent the S&P/Citigroup EMI, or Extended Market Index, series.