

This document is intended exclusively for institutional investors only

WHITE PAPER

from AXA Rosenberg

Actively Managed Emerging
Markets Small Cap Equity:
Capturing Current Opportunity
and Long-Run Potential

WHITE PAPER

Capturing Current Opportunity and Long-Run Potential

by

KATHRYN MOHAN McDONALD

Director of Investment Strategy
AXA Rosenberg

Emerging Small Cap stocks have an impressive history of outperformance and a well-earned reputation for elevated risk. They represent one of the most inefficient parts of the global equity market due to the sheer number of available stocks and limited analyst coverage. While distinct challenges like illiquidity and trading costs await active managers who choose to invest in this asset class, there exists significant alpha potential for those who possess fundamentally sound and implementable investment ideas.

The recent sell-off in all emerging markets stocks – large and small alike – presents an attractive opportunity to buy into Emerging Small Caps for investors who seek long-run exposure to this asset class. The category appears to be trading close to (or even below) its historical discount relative to Developed markets, when viewed along both Price/Book and Price/IBES 12-Month Forecast Earnings dimensions¹. When viewed from this vantage, it is natural to wonder whether the sell-off in Emerging Small Cap over the last year was, perhaps, an over-reaction to macroeconomic news (e.g. the announcement of the Fed’s “taper”) or simply a manifestation of an overly-pessimistic world view. Regardless, for an investor interested in the long run, current prices may represent an attractive entry point.

A History of Outperformance

Emerging Small Cap stocks have a history of strong performance. Over the trailing 10 years – a period in equity market history marked by significant boom and bust periods –the category has outperformed developed Large Caps by more than 5% on an annualized basis. While Emerging Small Caps’ reaction to the recent, varied market environments can euphemistically be described as “exciting”, they have undeniably produced better returns over the full period. Perhaps surprisingly, investors in Emerging Small Cap stocks have enjoyed superior returns even when the asset classes’ additional risk is considered. As shown in Exhibit 1, the total return/risk ratio for Emerging Small Caps is superior to that of other equity options.

<i>Annualized Return and Risk Summary Developed and Emerging Market Equity Indices</i>				
<i>Jul 2004 - Jun 2014</i>				
	<u>MSCI World Index</u>	<u>MSCI World Small Cap Index</u>	<u>MSCI EM Index</u>	<u>MSCI EM Small Cap Index</u>
Annualized Total Return	7.84%	9.87%	12.30%	13.67%
Total Volatility	16.07%	18.87%	23.768%	25.56%
Return / Risk	0.487	0.523	0.517	0.535

Exhibit 1 Source: AXA Rosenberg, MSCI. All figures presented in USD, gross. Historical performance is not a guarantee of future results.

Another meaningful benefit to investors in Emerging Small Cap stocks has been their pattern of returns. Beginning in mid-2008, we see an increase in the correlations of all equity indices. Given the dramatic changes to technology and global trade, in addition to several significant market shocks, it is not surprising that the behavior of all stocks has become increasingly similar, thus lessening the diversification impact of different segments of the equity market. Emerging Small Caps have, to a certain extent, bucked this trend as can be seen in Exhibit 2. As Emerging Small Cap stocks have proportionally greater exposure to local cash flow (in local currency) they appear to be driven less by global sector trends, and more by local or regional conditions, resulting in lower correlation with developed world equities. The asset class thus has exhibited greater potential to act as an agent of diversification within a broader portfolio context.

¹Emerging Small stocks, as proxied by the MSCI EM Small Cap Index, historically have traded at a discount relative to developed broad market and developed small cap stocks (represented by MSCI World Index and MSCI World Small Cap Index, respectively) along Price/Book and Price/IBES Forecast Earnings dimensions, measured over the period 31 Dec 2004 – 30 Jun 2014. The historical average discount of P/B for Emerging Small stocks relative to Developed Broad and Developed Small stocks is 28% and 15%, respectively; the discount on 30 June 2014 was 38% and 32%, respectively. With respect to P/IBES, the historical discount is 18% relative to Developed Broad and 35% relative to Developed Small, with 30 June 2014 discount being 18% and 33%, respectively.

WHITE PAPER

Capturing Current Opportunity and Long-Run Potential

**Correlation of Rolling 36 Month Returns
June 2007- June 2014**

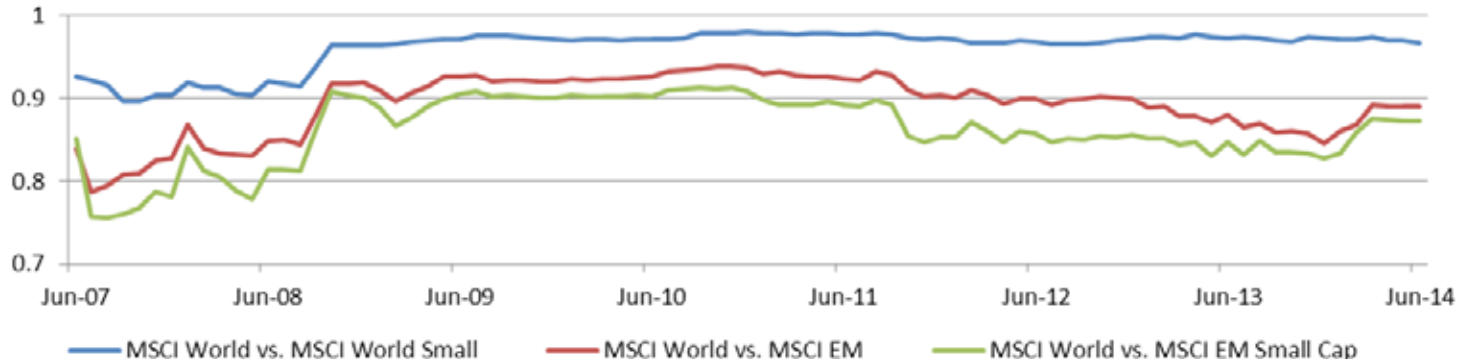


Exhibit 2 Source: AXA Rosenberg, MSCI

Paired with an exceptional magnitude of return, the historically less-correlated pattern of return has made Emerging Small Caps a very attractive choice for investors committed to diverse global equity exposure.

Benefitting from Demographic Trends

Looking in the rear-view mirror, it is easy to make a compelling case for Emerging Small Caps, but the question that investors face is one that is forward looking – what may the future hold for this asset class? Will strong returns continue? Will the additional diversification benefit remain? A changing demographic landscape will undoubtedly help dictate future winners and losers within the equity world. As the current “emerging” economies grow in terms of population and purchasing power, they are predicted to account for a larger and larger share of the world’s middle class². This demographic evolution bodes well for companies that can harness local consumer demand and the growing wealth creation of an expanding middle class. As incomes grow and populations move from lower to middle class, their proportional spending on discretionary items naturally increases. Companies exposed to these more cyclical parts of the economy are well positioned to benefit from the evolution in consumer spending.

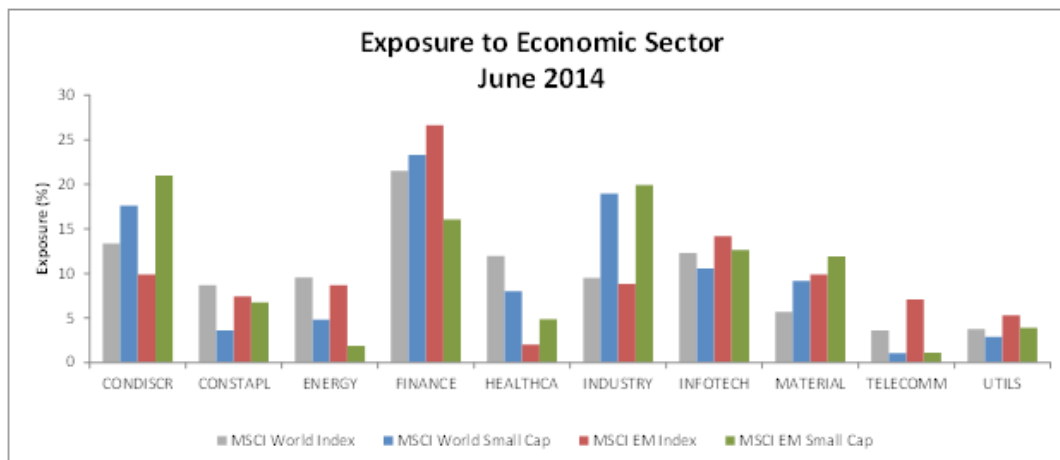


Exhibit 3 Source: AXA Rosenberg, MSCI. Exposures based on AXA Rosenberg’s sector definitions.

²The Emerging Middle Class in Developing Countries, The Brookings Institution, Homi Kharas, 2010

Relative to Developed Markets equities, or even Emerging Large Caps, Emerging Small Cap stocks, as a group, have greater exposure to Consumer Discretionary, Industrials, Technology, and Materials all cyclical areas of the economy that should benefit from an increase in non-essential spending (Exhibit 3). Moreover, they are less exposed to some sectors that are the most highly regulated (e.g. Financials) or likely to be state owned (e.g. Energy, Utilities). The cyclical, and arguably nimble, nature of Emerging Small Cap companies positions them to respond to local market demand in the face of evolving global demographics.

A Robust Opportunity for Active Management

Emerging Markets Small Cap is an asset class in which active management should thrive as it is arguably one of the least efficient segments of the global equity market. In theory, then, the ability of an Emerging Small Cap manager to generate alpha is high in the presence of a sound, implementable investment thesis. Implementation considerations are especially critical within this category, as the universe of opportunities is expansive, comparability across companies is difficult, liquidity can be spotty, and transaction costs can be steep.

AXA Rosenberg's Approach to Active Management

First and foremost, we believe in a bottom-up, fundamentals-based approach to active investing within the Emerging Small Cap segment. Our research indicates a strong relationship between attractive valuations and earnings growth, and price performance within the category. We believe that part of our ability to add value is attributable to our coverage of companies that are simply out of scope for most other managers³. This exceptional breadth does present a challenge: in order to perform meaningful, granular comparisons of companies along fundamental dimensions, we must work to ensure comparability. AXA Rosenberg has built a proprietary system designed to convert financial statements originating in disparate accounting regimes to a single, pro forma basis, thereby better enabling an “apples to apples” comparisons of income statement and balance sheet items, critical for meaningful cross-border company comparisons. Liquidity and transaction costs require special focus in areas like Emerging Markets Small Caps. By taking informed liquidity risk we believe we are better able to capture the known “illiquidity premium” while ensuring that the ability to trade individual positions and the portfolio as a whole remains within tolerance levels. With respect to transaction costs, we recognize that market impact – a cost that directly erodes alpha – can be minimized by holding smaller positions across a larger number of stocks. In sum, by virtue of our extremely broad selection universe, our proprietary accounting approach, and the care and consideration put into our implementation strategy, we believe that we are well positioned to add alpha by focusing on bottom-up, fundamentals-based stock picking.

³AXA Rosenberg's EM Small Cap universe membership numbered approximately 5,900 on 31 July 2014. By comparison, the MSCI EM Small Cap Index contained 1,814 stocks on the same date. Note that AXA Rosenberg's coverage will vary depending on the overall number of companies that are in existence and listed at any point in time. The concept of 'breadth' is key to any active manager's ability to add value on a risk adjusted basis (information ratio), as shown in *Active Portfolio Management* (2nd Edition) by Richard C. Grinold and Ronald N. Kahn, New York: McGraw-Hill, 2000.

This communication is for institutional investors only and must not be relied upon by retail clients. Circulation must be restricted accordingly.

This material is published for informational purposes only and is neither an offer, recommendation or solicitation for any services, securities, or investment funds described herein, nor is it intended to provide investment, tax, or legal advice. If this material refers to funds, any investments made in such funds are subject to the relevant offering documents. This material is not intended for distribution to any persons or in any jurisdictions for which it is prohibited. No representation is made that any of the services, securities, or investment funds referred to herein are suitable for any particular investor. No guarantee, warranty, or representation, express or implied, is given as to the accuracy or completeness of this material. Investors should be aware that investments may increase or decrease in value and that past performance is no guide to future performance. Any forward-looking or simulated data or information contained herein is subject to certain inherent limitations and are based upon assumptions that may not materialize or may vary significantly from actual events and conditions. Accordingly, actual results may vary and such variations may be material. Prospective investors should understand and evaluate such assumptions to determine whether they are appropriate for their purposes. The investment models, research, and risk controls referred to herein do not guarantee against any loss of principal, nor do they guarantee that any investment objectives, targets or expectations described herein will be achieved. Investors should understand that any and all of the information presented herein is always subject to change and all rights are reserved in respect thereof. Performance information shown, unless otherwise stated, is gross of management fees.

AXA IM/AXA Rosenberg seeks to achieve its clients' investment objectives in reliance on signals generated by analytical models. The accuracy of the signals produced by the models is dependent on a number of factors including, without limitation, the analytical and mathematical underpinning of the models, the accurate encapsulation of those principles in a complex computational (including software code) environment, the quality of the data put into the models, changes in market conditions, and the successful deployment of the models' output into the investment portfolio construction process. Each factor may have subjective elements that present the possibility of human error. While controls are employed that are designed to assure that models are sound in their development and appropriately adapted, calibrated and configured, analytical errors, software development errors, and implementation errors are an inherent risk of complex analytical models and the quantitative investment management processes. These errors may be extremely hard to detect in some cases, and some errors may go undetected for long periods of time, or not be detected at all. Because of the complexity involved and indeterminate nature of the undertaking, AXA IM/AXA Rosenberg may in good faith and in accordance with its obligations decide not to correct or to delay the correction of an error, not to undertake an in-depth analysis of the effect of an error on performance and not to disclose an error to its clients. Even if the signals produced by the models are accurate, the ultimate investment performance still depends on AXA IM/AXA Rosenberg's ability to interpret the buy and sell signals generated by the models and to then implement these signals through the purchase and sale of securities and other investments.

If MSCI information appears herein, it may only be used for your internal use, it may not be reproduced or disseminated in any form, and it may not be used as a basis for or a component of any financial instruments or products or indices. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each other person involved in or related to compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties (including, without limitation, any warranties of originality, accuracy, completeness, timeliness, non-infringement, merchantability and fitness for a particular purpose) with respect to this information. Without limiting any of the foregoing, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including, without limitation, lost profits) or any other damages. (www.mscibarra.com).

© 2014 AXA Rosenberg and/or AXA Investment Managers. All rights reserved.

These materials are issued by the relevant AXA Investment Managers or AXA Rosenberg entity (hereinafter "AXA IM or AXA Rosenberg") located in the recipient's respective jurisdiction or region, which could include but not are not limited to the following entities: AXA Rosenberg Investment Management LLC, AXA Rosenberg Investment Management Ltd. (UK), AXA Investment Managers UK Ltd., AXA Investment Managers Asia (Singapore) Ltd, AXA Investment Managers Asia Ltd, AXA Rosenberg Investment Management Asia Pacific Ltd (HK), AXA Investment Managers Japan Ltd. Depending on the relevant issuing entity, the following additional disclosures may apply:

For European investors: AXA Rosenberg Investment Management Ltd (UK) and AXA Investment Managers UK Ltd are authorised and regulated by the Financial Conduct Authority (25 The North Colonnade, Canary Wharf, London, E14 5HS) ("FCA"). In the United Kingdom, this material is intended for the use of persons meeting the MiFID client classification of Professional Clients or Eligible Counterparties and is not approved for communication to retail customers in any territory. The financial instruments used carry inherent risks which are unavoidable such as Market Risk, Credit Risk, Liquidity Risk and other risks. These risks are described in detail in our Risk Warnings document which is available upon request.

For Australian investors: AXA Investment Managers Asia (Singapore) Ltd (ARBN 115203622) is exempt from the requirement to hold an Australian Financial Services License and is regulated by the Monetary Authority of Singapore under Singaporean laws, which differ from Australian laws. AXA IM offers financial services in Australia only to residents who are "wholesale investors" within the meaning of Corporations Act 2001 (Cth).

For Korean investors: AXA Investment Managers Asia (Singapore) Ltd is a registered Cross Border Investment Advisor/Discretionary Investment Management Company under the Financial Investment Services and Capital Markets Act (the "Act"). The activities referenced under the Act are 5-0-2 Investment Advisory Business and 6-0-2 Discretionary Investment Management Business, respectively. AXA IM's financial services are available in Korea only to Professional Investors within the meaning of Article 10 of Enforcement Decree of the Financial Investment Services and Capital Markets Act.

For Hong Kong investors: The authorisation of any fund by the Securities and Futures Commission in Hong Kong ("SFC") does not imply official approval or recommendation. SFC authorization of a fund is not a recommendation or endorsement of a fund nor does it guarantee the commercial merits of a fund or its performance. It does not mean the fund is suitable for all investors nor is it an endorsement of its suitability for any particular investor or class of investors. Where a fund is not authorized by the SFC, any information relating to it is solely for the use of professional investors in Hong Kong. Materials exempted from authorization by the SFC have not been reviewed by the SFC.

For Singapore investors: In Singapore, this document is for use by Institutional Investors only, as defined in Section 4A of the Securities and Futures Act (Cap. 289) and must not be relied upon by retail clients. Circulation must be restricted accordingly.

U201408-833
20140827_CB