

**FOCUS ON: VIRTUS KAR INTERNATIONAL SMALL-CAP FUND**

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The international equity marketplace is enormous. Approximately 56% of the total market capitalization is made up of foreign equities outside the U.S. with 44% based in the U.S.<sup>1</sup> Although many investors view international stocks as a diversifier and an independent return source, they may be overwhelmed by the sheer number of companies in their search for quality portfolio holdings. This contribution to our “Focus” series discusses the opportunities presented by investing in international small-cap equities.

**What is the rationale for investing in the international small-cap market?**

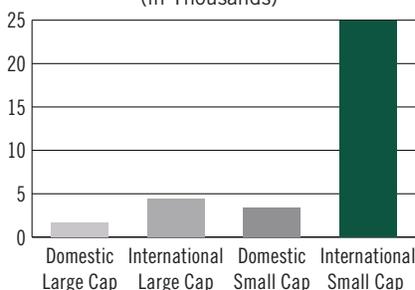
The international small-cap universe is approximately 2.9% of the global stock market, but represents about 1.8% of equity fund assets.<sup>2</sup> The total number of international small-cap companies exceeds 24,000, yet only 4,246 are included in the MSCI ACWI ex. USA Small Cap Index. Thus, most of these names have little to no institutional research coverage, which creates fertile ground for deep fundamental research to find under appreciated opportunities.



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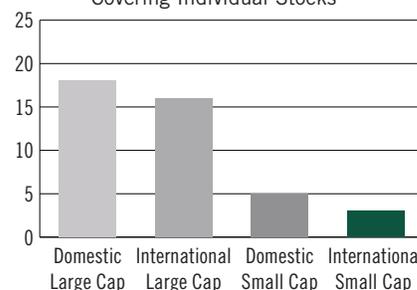
**Investable Universe**

Number of Companies (in Thousands)<sup>3</sup>



**Analyst Coverage**

Average Number of Analysts Covering Individual Stocks<sup>3</sup>



Shares of these undiscovered companies are frequently less expensive to own than comparable domestic small-cap companies. In fact, our view is that the international small-cap marketplace is comparable to the U.S. small-cap market 20 years ago.

**Past performance is no guarantee of future results.**

<sup>1</sup>As of 12/31/20. Source: FactSet Research.

<sup>2</sup>As of 12/31/20. Source: FactSet Research and Morningstar Direct.

<sup>3</sup>As of 1/18/21. Data is obtained from FactSet Research, compiled by Kayne Anderson Rudnick, and is assumed to be reliable.

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### What are the benefits of KAR's international small-cap research and investment expertise?

Kayne Anderson Rudnick (KAR) has been managing small-cap portfolios for more than 25 years, with a focus on identifying and investing in a select group of high-quality small-cap companies trading at attractive valuations. We believe that decades of specializing in this style of investing gives us an edge in identifying companies with truly long-term sustainable competitive advantages.

We believe we also have an advantage in avoiding companies that are earning high returns on capital now, but do not have the ability to maintain those results over time due to weak competitive protections. Our focus on the long-term strength of the businesses that we own allows us to ignore much of the “noise” that distracts many investors who attempt to outperform by trying to guess what is going to happen over the next one to four quarters. Historically, the strength of the businesses we own has also proven effective at helping to minimize the risk in our portfolios, as it is often most recognizable during difficult market and/or economic periods.

The following table provides a view into the portfolio we have assembled, versus what an investor may own through a “passive” offering. The Fund has produced more attractive quality, growth, and value statistics, historically:

#### Portfolio Characteristics<sup>1</sup> as of 12/31/20

		Virtus KAR International Small-Cap Fund	MSCI ACWI ex. USA Small Cap Index (net)
<b>Quality</b>	5 Year Return on Equity	26.7%	11.1%
	Total Debt/EBITDA	2.1x	9.6x
<b>Growth</b>	Earnings Per Share Growth – Past 10 Years	11.5%	9.0%
	Dividend Per Share Growth – Past 10 Years	12.3%	8.0%
<b>Value</b>	P/E Ratio – Trailing 12 Months	26.4x	32.9x
<b>Market Characteristics</b>	\$ Weighted Average Market Cap	\$3.4 B	\$2.7 B

To provide further insight into these statistics, let's consider our investment in AIT, a Japanese small-cap transportation company. We have been a long-term investor in the Seattle-based freight-forwarding logistics company Expeditors International in our domestic small-cap funds. While a solid investment for years, its valuations increased as it attracted greater analyst coverage. Our current view of AIT is similar to the way we have seen Expeditors International over the years: as a company with a good growth trajectory, pristine balance sheet, and little-to-no analyst coverage, but currently trading at very attractive multiples.

#### Past performance is no guarantee of future results.

<sup>1</sup>Data is obtained from the Frank Russell Company and FactSet and is assumed to be reliable. Other principal consultant firms may use different algorithms to calculate selected statistics. Estimates are based on certain assumptions and historical information.



## Where/how does the Fund fit into my portfolio?

Most investors understand the benefits of diversification and many have some allocation to international stocks. Unlike U.S.-centric investments, where investors tend to invest across all market capitalizations (small, medium, and large), international allocations have historically tended to focus on bigger developed and emerging market companies. These large, often multinational, corporations typically generate a good portion of their revenues from North America, thus mitigating the diversification benefits. Many investors have very little, if any, assets allocated to international small-cap stocks. The Fund invests in both developed and emerging markets, so our view is that it may be appropriate for investors to allocate a portion of their large-cap developed and emerging markets holdings into an international small-cap portfolio like ours.

The challenge in international small-cap investing is also the source of opportunity.

## How does currency hedging figure into the investment process?

Like the vast majority of our peers, we do not hedge currency. The primary reason is that we believe that hedging would lead to lower returns for the Fund, over time, due to hedging costs. In addition, most of the markets in which we invest offer a natural hedge. When the currency declines in these countries, it stimulates the local economy, often leading to higher stock prices (and vice versa). Currency moves are cyclical. The U.S. Dollar Index was launched in 1973 at a value of 100. Forty-five years later, the index is right around 100. We do not try to predict currency moves, but instead stick to what we believe is our strength—finding great companies at attractive valuations.

## What are the challenges to investing in the international small-cap market and where does risk management fit into the process?

The challenge with international small-cap investing is also the source of opportunity. As noted, the lack of coverage from sell-side research and little interaction with institutional investors impacts the information available about these companies. It takes more work to understand these businesses, the competitive landscape, and the management of each company. We believe this is where our expertise and our willingness to go where other managers do not can pay off.

Thus, our primary risk mitigation tool is the strength of the underlying businesses we own and a result of our rigorous bottom-up analysis. These companies have demonstrated a sustainable competitive advantage, high returns on invested capital, strong balance sheets, low capital intensity, and excellent free cash flow. We have found that these attributes may provide the best protection from permanent loss of capital, which is how we define risk. This is enhanced by our active monitoring of our geographic and sector exposure to ensure appropriate portfolio diversification.

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## About the Authors

**Craig Thrasher** is a portfolio manager and senior research analyst at Kayne Anderson Rudnick Investment Management. He is portfolio manager of the Virtus KAR International Small-Cap Fund and the Virtus KAR Emerging Markets Small-Cap Fund.

Before joining Kayne Anderson Rudnick in 2008, Mr. Thrasher worked at Kirr, Marbach & Company as an equity analyst, and at Wedbush Morgan Securities in correspondent credit.

Mr. Thrasher earned a B.S. in business and public administration, with a concentration in finance, from the University of Arizona, and an M.B.A. from the University of Chicago, Graduate School of Business. He is a Chartered Financial Analyst® (CFA®) charterholder. He began working in the investment industry in 2003.

**Hyung Kim** is a portfolio manager and senior research analyst at Kayne Anderson Rudnick (KAR) with primary responsibilities for the emerging markets small-cap and international small-cap strategies.

Prior to joining KAR in 2017, Mr. Kim served as an international equity analyst at Advisory Research Inc. for seven years, and as a portfolio manager on its global value strategy. Before joining Advisory Research, he worked as a research analyst at Coghill Capital Management and in corporate banking at HSBC and Woori Bank in Seoul, Korea. Mr. Kim also worked as an equity research intern at CLSA in Seoul.

Mr. Kim earned a B.A. in German with a minor in economics from Hankuk University of Foreign Studies in Seoul, Korea, and an M.B.A. in accounting and finance from the University of Chicago Booth School of Business. He is fluent in Korean and German. Mr. Kim began working in the investment industry in 2004.

## Top Ten Holdings as of 12/31/20

	% Fund
Headhunter Group PLC	5.05
VNV Global AB publ	4.87
Rightmove PLC	3.20
Auto Trader Group PLC	2.85
Marel Hf	2.83
Gruppo MutuiOnline S.p.A	2.81
Enento Group Oyj	2.80
CAE Inc.	2.79
Ascential PLC	2.78
Voltronic Power Technology Corp	2.76

Holdings are subject to change.

**Return on Equity** relates how well the company is using the money invested in it so that it can bring a return to its investors. A high portfolio ROE indicates that the portfolio is invested in historically profitable companies. **Total Debt/EBITDA** is calculated by dividing total debt by earnings before interest, taxes, depreciation, and amortization. It is a measure of a company's ability to pay off its incurred debt. **Earnings per Share Growth** indicates the earnings available to each common share. Earnings per share growth is the growth rate of these earnings per share. On a portfolio level, this statistic measures the trailing earnings per share growth of a portfolio's holdings. **Dividend per Share Growth** on a portfolio level measures the trailing dividends per share growth of a portfolio's holdings. The **P/E (price-earnings)** ratio is calculated by dividing the company's stock price divided by its earnings per share times 100. The higher the P/E ratio, the more an investor pays for the company's earnings. A low P/E generally indicates a better value, while a high P/E denotes an expensive stock with earnings that investors expect will grow rapidly. A negative P/E is generally indicative of companies with losses or negative earnings. **\$ Weighted Average Market Cap** is the average of the market capitalizations (price times the number of common shares outstanding) of the companies in the portfolio weighted by the size of each company's position within the portfolio. The **U.S. Dollar Index** is a measure of the value of the U.S. dollar relative to the value of a basket of currencies of the majority of the U.S.'s most significant trading partners. The **MSCI ACWI ex USA Small Cap Index (net)** is a free float-adjusted market capitalization-weighted index that measures small-cap equity performance of developed and emerging markets, excluding the U.S. The index is calculated on a total return basis with net dividends reinvested. The index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and is not available for direct investment.

## IMPORTANT RISK CONSIDERATIONS

**Equity Securities:** The market price of equity securities may be adversely affected by financial market, industry, or issuer-specific events. Focus on a particular style or on small or medium-sized companies may enhance that risk. **Foreign & Emerging Markets:** Investing in foreign securities, especially in emerging markets, subjects the fund to additional risks such as increased volatility, currency fluctuations, less liquidity, and political, regulatory, economic, and market risk. **Limited Number of Investments:** Because the fund has a limited number of securities, it may be more susceptible to factors adversely affecting its securities than a fund with a greater number of securities. **Non-Diversified:** The fund is non-diversified and may be more susceptible to factors negatively impacting its holdings to the extent that each security represents a larger portion of the fund's assets. **Market Volatility:** Local, regional, or global events such as war, acts of terrorism, the spread of infectious illness or other public health issues, recessions, or other events could have a significant impact on the portfolio and its investments, including hampering the ability of the portfolio manager(s) to invest the portfolio's assets as intended. **Prospectus:** For additional information on risks, please see the fund's prospectus.

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