

Equity Diversification in Europe's DC Market

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Europe's defined contribution (DC) market grew at a rapid 12% pace in 2021, to 1.8 trillion euros. Over the next five years, it's expected to expand at a cumulative 6% average growth rate—compared with just a 3.6% rate for the rest of Europe's pensions industry.¹ Although DC assets represent just 17% of Europe's total pension assets today, that percentage is expected to climb to 20%—nearly 2.5 trillion euros—by 2026, according to Cerulli Associates.

Implementation of pension reforms in France and the Netherlands could lead to the Netherlands becoming the second-largest DC market in Europe by 2030, with an estimated 20% of the country's total pension assets in DC plans. Meanwhile, in the UK, Europe's largest DC market, the trend of consolidation within the DC market continues and the vast majority of DC members save into larger, more stable master trusts.

As the European pension market evolves towards greater member control of investment decisions, we believe fiduciaries should strive to provide investment options that are well diversified across asset classes (for example, as target retirement funds are) and provide choices that represent the broad market opportunity within each asset class. In this note, we explore possibilities for equity diversification within European DC plans.

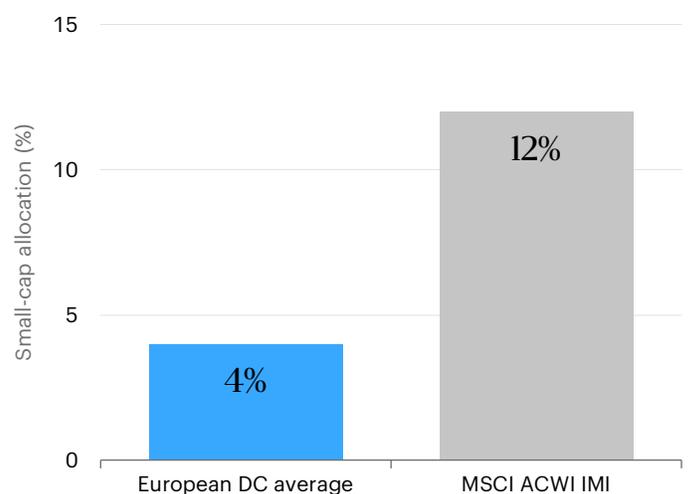
Equity diversification

Equities have the largest total allocation among European DC schemes, at 47% of aggregate plan assets.² The actual percentage varies by country, from 54% equities in the UK and the Netherlands to as low as 25% and 21% equities in France and Denmark, respectively.

Although equities represent the highest allocation in European DC portfolios, the equity choices available in these portfolios exhibit minimal diversification, particularly within small-cap equity. Mercer estimates that the aggregate allocation to small-cap equity in European DC equity portfolios is just 4%.² This is a substantial underweight to global small-cap companies that could serve as a diversifier to large-cap equity holdings. In comparison, the MSCI All Country World Index Investable Market Index (ACWI IMI) held a larger 12% small-cap allocation as of 31 December 2022 (Figure 1).³

FIGURE 1

European DC average small-cap % vs. market-cap %



Sources: Allspring and Cerulli Associates

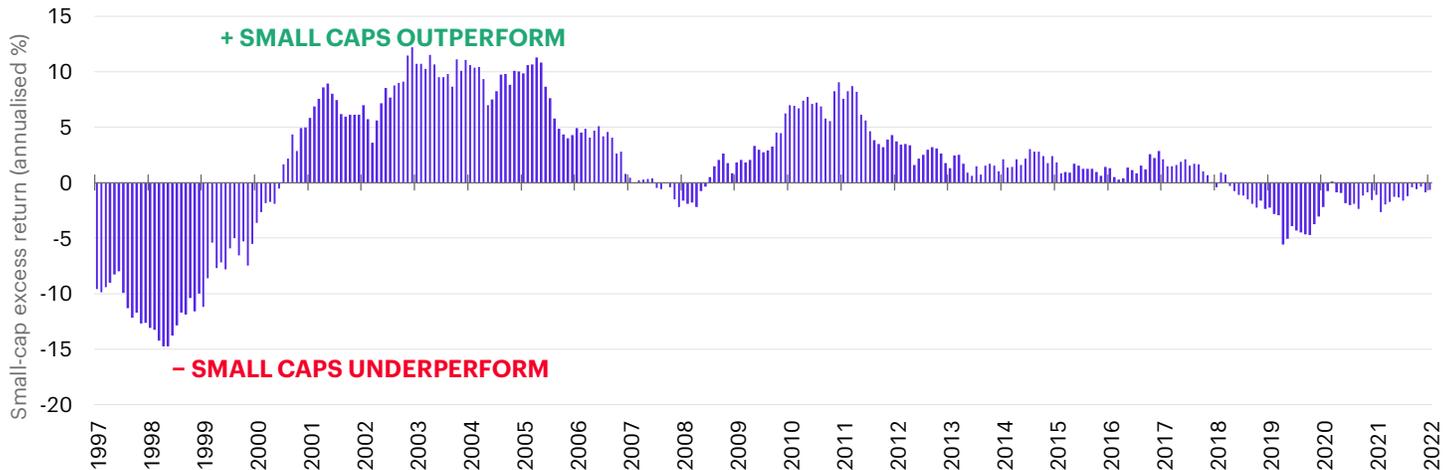


In recent rolling three-year periods (from 2018 through 2022), the performance of global small-cap equities trailed large-/mid-cap equities. However, over a longer span—from 1995 through 2022—global small caps outperformed large-/mid-cap stocks in 66% of rolling three-year periods. In fact, from 2000 through 2017, global small caps enjoyed a nearly uninterrupted 17-year stretch of outperformance over rolling three-year periods (Figure 2).

FIGURE 2

Global small-cap excess return over large-/mid-cap equities

(Rolling 3-year periods from 1995-2022)



Source: Morningstar Direct. Global small cap represented by MSCI ACWI Small PR and global large/mid cap by MSCI ACWI PR.

Despite the lengthy period of relative outperformance, global small caps and large/mid caps have tended to exhibit a cyclical relationship over longer periods. In the absence of an informed view, we believe a market-neutral allocation to small-cap equity is favourable. This approach may offer the potential to capture the broad market opportunity over the long term.

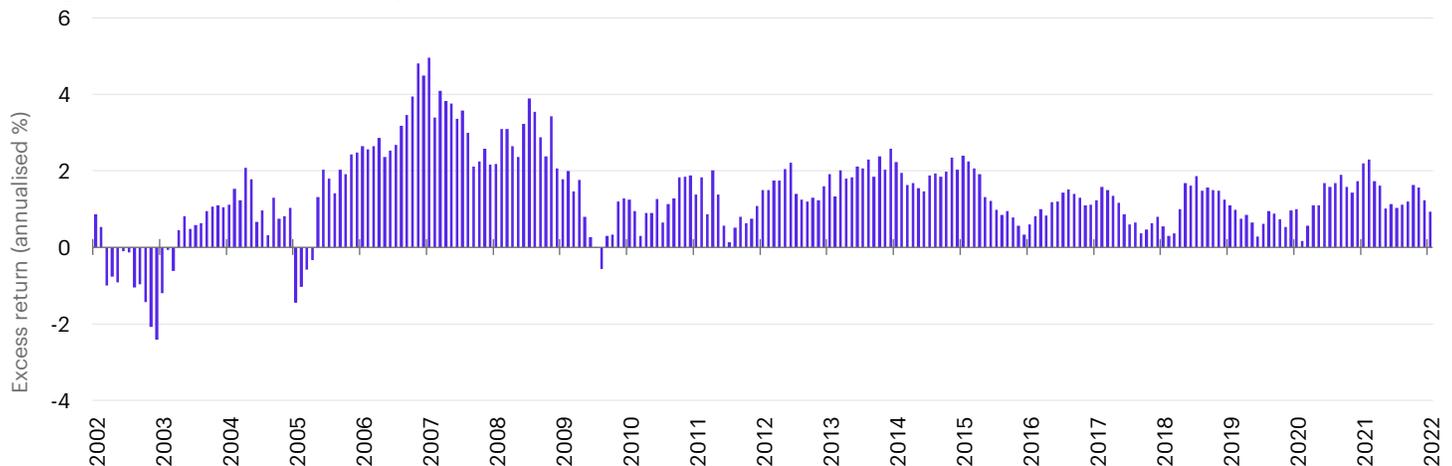
Global small-cap equity: domain of active management

Historically, the majority of actively managed global small-cap strategies have outperformed their passive benchmarks with regularity: in 90% of rolling three-year periods since 2000, the majority of global small-cap managers outperformed their benchmarks, gross of fees. Even assuming a 1% fee hurdle, our data shows that the majority of global small-cap strategies outperformed their benchmarks in 55% of rolling three-year periods since 2000.

FIGURE 3

Median global small-cap strategy outperformance relative to respective benchmark

(Rolling three-year periods Jan-00 through Dec-22)



Sources: Allspring and eVestment. The universe depicted includes all strategies in eVestment's Global Small Cap Equity universe, including inactive products today that were live during the historical periods. For each strategy, the excess return is relative to the manager's preferred benchmark (MSCI ACWI Small Cap Index, MSCI World Small Cap Index, or S&P Developed Small Cap Index).

Past performance is not a guarantee or reliable indicator of future results.



Figure 3 shows the median excess return (gross of fees) of global small-cap strategies in rolling three-year periods since 2000. Except for periods of negative excess return in 2003 and 2005, the median cumulative excess returns of global small-cap strategies have surpassed their benchmarks.

Of course, investors aren't using active managers to obtain just median performance. They expect stronger outperformance from top-quartile global small-cap managers. In our examples, we've used the median cumulative outperformance simply to illustrate the potential opportunity for active managers within global small caps. These managers have a much broader set of stock opportunities to select from in their efforts to outperform the index than large-cap managers do, as evidenced by the number of holdings within their respective indexes: within the MSCI ACWI Small Cap Index, there are 6,269 small-cap companies, whilst within the MSCI ACWI, there are 2,885.³

Moreover, the disparity between the number of analysts covering small-cap stocks versus large-cap stocks creates greater informational inefficiencies for active managers seeking an edge to exploit. The median analyst coverage of US large-cap stocks was 13 in 2017 compared with a median of 5 analysts for mid-cap stocks and fewer still for small-cap stocks.⁴

Also, active managers can address environmental, social and governance (ESG) risks/opportunities with small companies and potentially influence the company to strengthen consideration of ESG in making decisions. The inherent nimbleness of small-cap companies along with easier access to their senior leaders can help in bringing investors' concerns forward and potentially effect action. In turn, greater engagement and influence with small companies on ESG considerations can create a halo effect that encourages other companies to be better stewards on ESG issues.

Concluding remarks

We believe that equity diversification in European DC markets can be enhanced with a market-cap-neutral allocation to global small-cap equities and that global small caps provide strong potential for active managers to add excess return to equity portfolios.

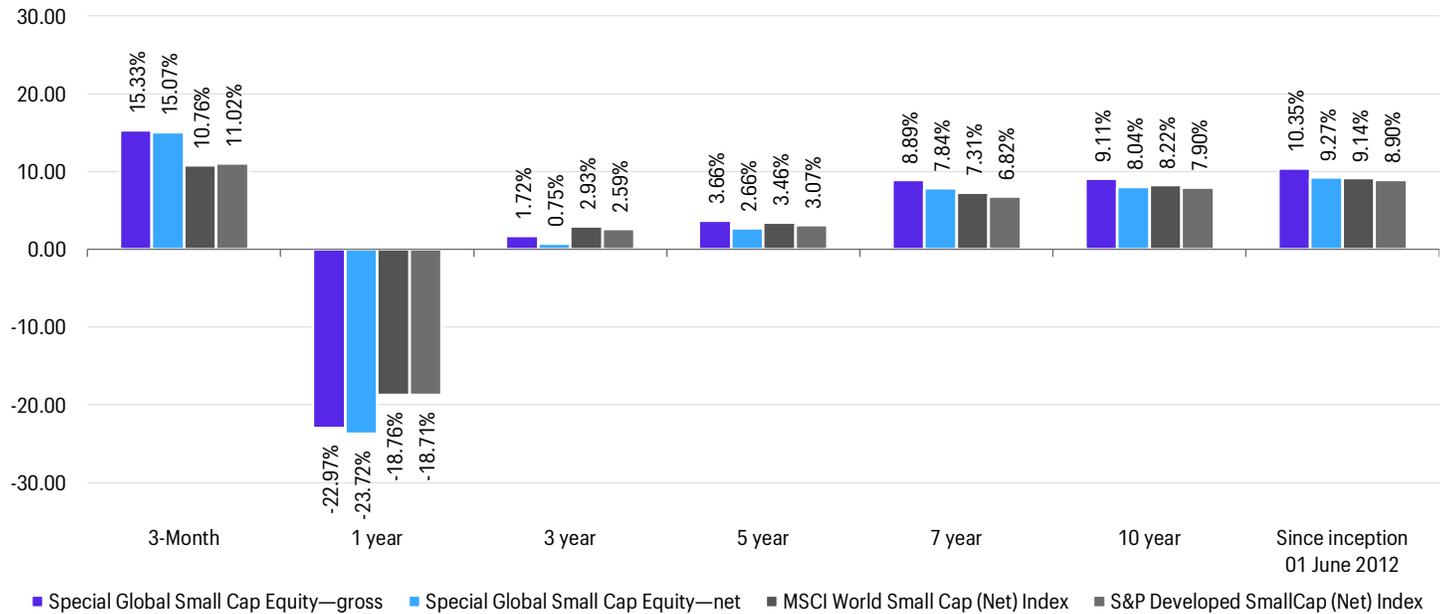
ENDNOTES

1. Cerulli—European Retirement Industry 2022
2. Mercer European Asset Allocation Insights 2021—DC Trends
3. MSCI as of 31 December 2022
4. Martineau and Zoican, "Crowded Analyst Coverage", University of Toronto, 19 March 2020



APPENDIX

Special Global Small Cap Equity performance



INVESTMENT OBJECTIVE

Seeks to deliver long-term capital appreciation by investing primarily in global small-capitalization companies with above average capital appreciation potential and below average risk.

BENCHMARKS

Primary: MSCI World Small Cap (Net) Index

Secondary: S&P Developed Small Cap (Net) Index

INCEPTION DATE

01 June 2012

STRATEGY RISKS

Market risk: Stock values fluctuate in response to the activities of individual companies and general market and economic conditions.

Management risk: Investment decisions, techniques, and analyses implemented by the manager may not lead to expected returns of the team.

Style risk: Style factor exposure including but not limited to, beta, growth, value, liquidity, etc. can perform differently and shift in and out of favor through a market cycle.

Smaller company securities risk: Securities of smaller market capitalization companies tend to have more volatility and less liquidity compared to larger companies.

As of 31 December 2022

Source: Allspring Global Investments benchmark/index source: FactSet. All returns for periods greater than one year are annualised.

Past performance is not a reliable indicator of future results.



GIPS® composite report

Special Global Small Cap Equity

PERIOD	GROSS ANNUAL RETURN (%)	NET ANNUAL RETURN (%)	PRIMARY INDEX RETURN (%)	SECONDARY INDEX RETURN (%)	COMPOSITE 3 YR STD DEV (%)	PRIMARY INDEX 3 YR STD DEV (%)	SECONDARY INDEX 3 YR STD DEV (%)	INTERNAL DISPERSION (%)	NUMBER OF ACCOUNTS	COMPOSITE ASSETS (\$-MM)	TOTAL FIRM ASSETS (\$-MM)
2022	-22.97	-23.72	-18.76	-18.71	21.55	24.11	24.34	N.A.	7	845.1	374,321
2021	22.75	21.61	15.75	14.77	17.39	21.39	21.52	N.A.	4	569.9	483,747
2020	11.30	10.24	15.96	15.71	18.56	22.80	22.97	N.A.	3	383.3	508,914
2019	26.37	25.14	26.19	25.55	11.66	12.94	13.07	N.A.	1	290.0	419,579
2018	-10.01	-10.91	-13.86	-14.17	12.05	12.61	12.72	N.A.	1	271.0	371,582
2017	25.95	24.72	22.66	22.79	10.42	10.93	10.78	N.A.	1	270.2	385,111
2016	20.44	19.26	12.71	11.08	11.53	12.22	12.00	N.A.	1	225.8	330,718
2015	0.38	-0.62	-0.31	0.24	10.64	11.26	11.09	N.A.	1	223.4	349,342
2014	1.68	0.67	1.90	1.81	N.A.	N.A.	N.A.	N.A.	1	257.8	351,065
2013	29.05	27.79	32.38	32.04	N.A.	N.A.	N.A.	N.A.	1	306.8	357,113

Primary Index: MSCI World Small Cap (Net)

Secondary Index: S&P Developed SmallCap (Net)

IP = Returns are for the period from June 1, 2012 (Inception) through December 31, 2012.

Source: Allspring.

1. Allspring Global Investments (Allspring) claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Allspring has been independently verified for the periods January 1, 1997 through December 31, 2021. The verification reports are available upon request. A firm that claims compliance with the GIPS standards must establish policies and procedures for complying with all the applicable requirements of the GIPS standards. Verification provides assurance on whether the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation and distribution of performance, have been designed in compliance with the GIPS standards and have been implemented on a firm-wide basis. Verification does not provide assurance on the accuracy of any specific performance report.

2. For the purpose of complying with GIPS, the GIPS firm is defined as Allspring. Since the GIPS firm's creation in 1996, the firm has acquired a number of investment teams and/or assets through mergers or acquisitions which include assets and/or investment teams from Wells Capital Management, EverKey Global Partners, Wells Fargo Asset Management (International) Limited, Analytic Investors, LLC, Golden Capital Management, LLC, Wells Fargo Asset Management Luxembourg S.A. and Wells Fargo Funds Management, LLC (WFFM).

3. The Special Global Small Cap Equity Composite (Composite) includes all discretionary accounts managed in this style. The strategy seeks long term capital appreciation by principally investing in equity securities of small sized global companies in developed markets. The U.S. portion of the portfolio is managed with a valuation tilt, while the international portfolio is managed with a growth tilt. Stock selection seeks to identify high quality companies that are well managed, are positioned to achieve above average increases in revenue, possess free cash flow, or otherwise have strong prospects for continued growth or that are undervalued relative to an assessment of their intrinsic value. Investment results are measured versus the MSCI World Small Cap (Net) Index and the S&P Developed SmallCap (Net) Index. The benchmark was changed from S&P Developed SmallCap (Net) Index to MSCI World Small Cap (Net) Index on June 1, 2022, for all periods. The S&P Developed SmallCap (Net) Index was kept as the secondary benchmark. The Composite creation and inception date is June 1, 2012.

4. Composite returns are net of transaction costs and non-reclaimable withholding taxes, if any, are expressed in US dollars, and reflect the reinvestment of dividends and other earnings. Gross Composite returns do not reflect the deduction of investment advisory fees. Net Composite returns are calculated using a model investment advisory fee, which is the maximum annual advisory fee based upon the fee schedule in effect during each respective performance period. Any changes to the fee schedule are reflected in the calculation of the net Composite returns beginning with the period in which the fee schedule is revised. Actual fees may vary depending on, among other things, the applicable fee schedule and portfolio size. Allspring's fee schedules are available upon request and may also be found in Part 2 of Form ADV. The published fee schedule for this strategy is 0.95% for the first \$50mm, and 0.85% over \$50mm. Additional information regarding Allspring's policies for valuing investments, calculating performance and preparing GIPS Composite Reports is available upon request. The firm's list of broad distribution pooled funds and list and descriptions of the limited distribution pooled funds are also available upon request.

5. Internal dispersion is the equal weighted standard deviation of the annual gross returns of all accounts included in the Composite for the entire year. For years where there are fewer than 5 accounts in the Composite for the entire year, dispersion is not presented as it is not a meaningful statistical calculation. The 3-year annualized standard deviation measures the variability of the gross composite returns and the index returns over the preceding 36-month time period. The notation "N.A." (not available) will appear for periods, if any, where 36 monthly returns are not available for the Composite and/or the index.

6. Index returns are provided to represent the investment environment existing during the time periods shown and are not covered by the report of independent verifiers. The MSCI World Small Cap (Net) Index captures small cap representation across 23 Developed Markets (DM) countries. With 4,502 constituents, the index covers approximately 14% of the free float-adjusted market capitalization in each country. The market capitalization range that defines the small cap universe is USD 200 – 1,500 million in terms of the company's full market capitalization. The S&P Developed SmallCap (Net) Index comprises the stocks representing the lowest 15% of float-adjusted market cap in each developed country. It is a subset of the S&P Global BMI Index. The S&P Global BMI Index is a comprehensive, rules-based index designed to measure global stock market performance. The index covers all publicly listed equities with float adjusted market values of US\$ 100 million or more and annual dollar value traded of at least US\$ 50 million in all included countries. The S&P Global BMI is made up of the S&P Developed BMI and the S&P Emerging BMI indices. For comparison purposes, the index is fully invested, which includes the reinvestment of income. The returns for the index do not include any transaction costs, management fees or other costs.

7. Actual performance results may differ from Composite returns, depending on the size of the account, investment guidelines and/or restrictions, inception date and other factors. Performance for some accounts in this Composite may be calculated by third-parties that use different security pricing and performance methodologies. Past performance is not indicative of future results. As with any investment vehicle, there is always the potential for gains as well as the possibility of losses. For a complete list of Allspring composite descriptions, please see www.allspringglobal.com/assets/public/pdf/legal/allspring-composite-descriptions.pdf. GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein. .



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