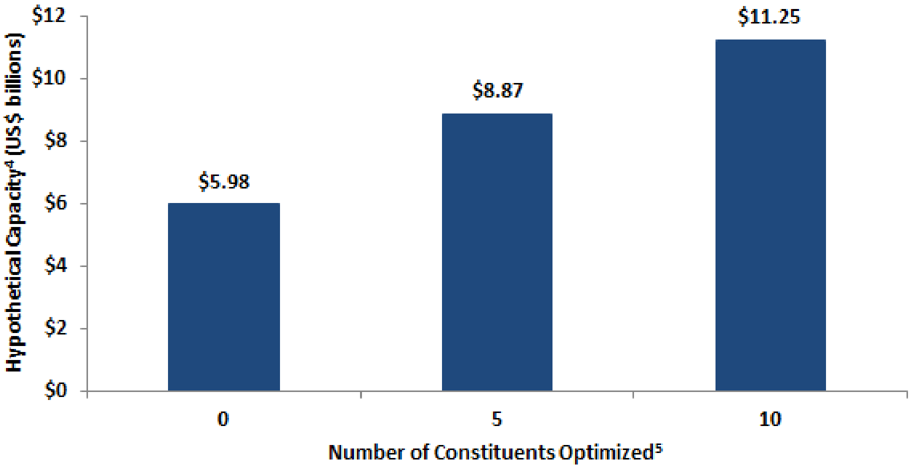
DEEP CAPACITY CAN BE A BENEFIT TO INDEX BASED INVESTING: THE CASE OF EUROPEAN SMALL CAPS

Jeremy Schwartz – Global Chief Investment Officer
01/28/2014

Until fairly recently, investors relied principally on actively managed mutual funds to gain exposure to the markets—especially for small-cap options around the world, where many believe that opportunities are ripe for active managers to add value. Small-cap stocks, generally speaking, do not garner the same level of analyst coverage, and many believe informational inefficiencies provide richer opportunity sets for stock pickers to potentially outperform index benchmarks. After a strong performance during 2013, many have set their sights on European small caps[1] in particular, and significant levels of assets have flowed into Europe (as Zach discussed in this prior blog post). **Index-Based Strategies Offer a New Option** Although Europe is an important focus for developed international investors, there are limited choices available to those interested in targeting exposure to European small-cap companies. Looking at the U.S.-listed mutual funds and exchange-traded funds (ETFs) in Morningstar's Europe Stock category, as of December 31, 2013, there was only one ETF and three mutual funds specifically focused on small caps.[2] To give readers some idea of the size of these traditional mutual funds focused on European small caps, as of December 31, 2013, the largest had slightly over $650 million, and the smallest almost $28 million in assets. To put this in context, the largest U.S.-listed mutual fund in this same category had almost $20 billion in assets as of that same date. As of December 4, 2013, the largest mutual fund strictly focused on small caps in the Morningstar Europe Stock category was actually closed to new investors.[3] This highlights a central concern many have for active strategies in the small-cap space: managers often reach capacity because the companies being targeted for exposure within the funds are small, and for a fund to maintain a significant enough exposure in high-conviction ideas to potentially impact performance, larger and larger positions have to be taken. **A Benefit to Index-Based Investing: Breadth of Holdings Creates More Capacity** One of the benefits to index-based strategies is the breadth of holdings. Index-based strategies are not trying to make a small selection of stocks to outperform a market segment; they are trying to identify liquid and investable companies representative of a specific investment theme. In our view, the larger size of the investing universe for index-based strategies creates greater investment capacity. Of course, index methodology is crucial to determining both capacity and representation, as not every index tracking the performance of equities is designed with scale in mind. WisdomTree has built its Indexes with this potential for scalability in mind. To accomplish more capacity in its Index-tracking strategies, WisdomTree designed its European-focused equity Indexes to emphasize the cash dividends each company pays—but to do so in a way that looks at aggregate dividends paid, which gives greater weight to bigger companies. In most cases, WisdomTree weights and rebalances its Indexes annually according to their *Dividend Stream®*. ***Dividend Stream* = Dividends per share x shares outstanding** By including shares outstanding in the weighting, we believe we introduce greater potential capacity to the strategies tracking the performance of our Indexes after costs, fees and expenses. It is important to set a baseline when discussing the concept of capacity, as it can mean a number of different things. We define one measure of capacity as: "At what asset level would an index-tracking strategy hold more than 10% of a particular underlying holding?" **The [WisdomTree Europe SmallCap Dividend Index] Incorporates Scalability into Its Approach**



Sources: WisdomTree, Standard & Poor's; data as of 12/31/2013.

• **Scalable Methodology:** On December 31, 2013, the WisdomTree Europe SmallCap Dividend Index had 284 constituents. Almost $6 billion of hypothetical assets could track this Index prior to its holding 10% of the market capitalization of any underlying firms. • **Optimization Helps Further:** Were one to optimize around the 5 or 10 most constraining firms, the level of hypothetical assets prior to reaching a 10% position in any underlying firm could jump from $6 billion to over $11 billion. To be fair, optimization such as this could lead to greater potential for tracking error. For reference, the 5 and 10 most constraining firms represented approximately 8% and 11%, respectively, of the Index's weight as of December 31, 2013. • **A Benefit to Proprietary Indexing:** One benefit to WisdomTree being the Index developer and ETF sponsor is WisdomTree maintains additional flexibility allowing us to increase the capacity of our Indexes and the ETFs that track their performance after costs, fees and expenses. **Innovative Methodology** The WisdomTree Europe SmallCap Dividend Index is designed to zero in on European small-cap companies that pay dividends. Weighting by cash *Dividend Stream* lends a degree of scalability to the Index in that it accounts for the number of shares outstanding. There are few funds available today that provide exposure to European small caps, and the largest traditional mutual fund just closed to new investors recently. This blog post highlights the benefits of following an index-based approach to get exposure to this asset class, of which there are very few vehicles open to investors. For current holdings in the WisdomTree Europe SmallCap Dividend Index, click here. [1]European small caps: Refers to constituents of the WisdomTree Europe SmallCap Dividend Index, which delivered nearly 50% returns for the 2013 calendar year. Source: Bloomberg. [2]Source: Morningstar Direct. [3]Source: Invesco.com. [4]Refers to a hypothetical capacity level for assets tracking the performance of an Index, which denotes the level of assets where the Index would prescribe taking its first 10% position in an underlying constituent. [5]These numbers refer to hypothetical optimizations in which every security in the Index is held ("0"), to omitting the 10 most constraining positions ("10").

Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Funds focusing their investments on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Please read the Fund's prospectus for specific details regarding the Fund's risk profile. Dividends are not guaranteed, and a company's future ability to pay dividends may be limited. A company currently paying dividends may cease paying dividends at any time. Investments focused in Europe are increasing the impact of events and developments associated with the region, which can adversely affect performance. ETF shares are not sold or bought at their net asset value (NAV) the way mutual fund shares are. ETF shares' market price may be at, above or below the fund's NAV. The fund's NAV will fluctuate with changes in the market value of its portfolio holdings, and the market price of an ETF's shares will fluctuate with changes in the NAV and the supply and demand in the market for the shares. The market price of ETF shares may differ significantly from their NAV during periods of market volatility. ETF shares may only be redeemed directly with the fund at NAV by authorized participants in very large redemption/creation units.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our Economic & Market Outlook

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. 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 entity involved in compiling, computing or creating any MSCI information (collectively, the “MSCI Parties”) expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Actively managed mutual funds : Investment strategies that are not designed to track the performance of an underlying index.

Small caps : new or relatively young companies that typically have a market capitalization between $200 million to $2 billion.

Active manager : Portfolio managers who run funds that attempt to outperform the market by selecting those securities they believe to be the best.

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset’s price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

Rebalance : An index is created by applying a certain set of selection and weighting rules at a certain frequency. WisdomTree rebalances, or re-applies its rules based selection and weighting process on an annual basis.

Dividend Stream : Refers to the regular dividends per share multiplied by the number of shares outstanding.

WisdomTree Europe SmallCap Dividend Index : A fundamentally weighted index meant to measure the performance of small-cap European dividend-paying equities weighted by cash dividends paid.

Market Capitalization : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

Tracking Error : Can be discussed as both the standard deviation of excess return relative to a specific benchmark, or absolute excess return relative to a specific benchmark.