THE EUROPEAN LOCAL RECOVERY: INTRODUCING A NEW INDEX

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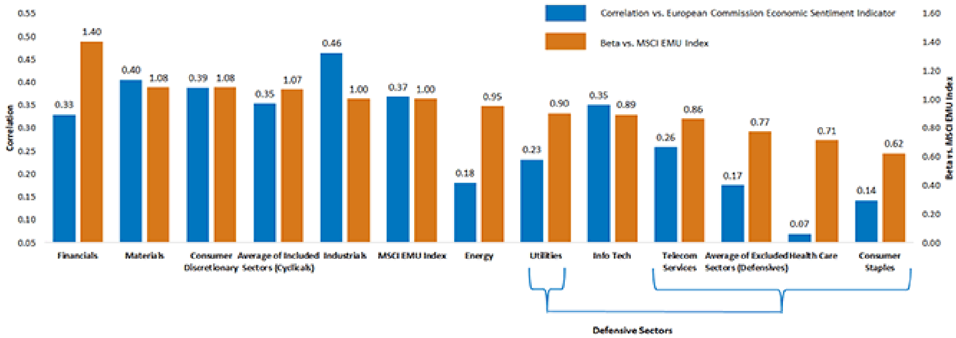
11/02/2015

Earlier, we discussed how positive trends in the European economy showing domestic growth are leading the eurozone, while global trade has been one of the weak points.[1] We also discussed how our favorite leading indicators of the economy—both M1 growth and the European Commission's Economic Sentiment Indicator—were showing positive signs that bode well for future trends in the local economy.[2] What could be a good way to position toward this local economic recovery? **Creating an Index to Respond Strongly as Economic Conditions Improve** At WisdomTree, we build innovative equity Indexes that offer the opportunity to express certain characteristics or have greater potential to respond to different economic trends. If an economic recovery in Europe is truly taking hold, we wanted to create an Index that best reflects these local economic conditions. WisdomTree thus created the WisdomTree Europe Local Recovery Index to reflect attributes of an improving domestic economy that is less reliant on the global export markets. Especially over the past five years, certain more defensive sectors of the MSCI EMU Index have exhibited lower correlation to changes in the economy and the leading indicator of activity, the European Commission's Economic Sentiment Indicator. These defensive sectors thus may not offer the most representative exposures to improving economic conditions within the eurozone. Over the past five years, those same defensive sectors have exhibited lower betas when measured against the returns of the MSCI EMU Index. In times of turmoil or uncertainty, this could be a potentially positive attribute, but if an investor truly believes in the prospects for a eurozone economic recovery, these lower-beta defensive sectors are likely to be least responsive to a more positive growth environment. **Defensive Sectors Less Correlated to Changes in Economic Activity and Sentiment**



Source: Bloomberg, with period looking back five years ending 9/30/15. Excluded sectors include Telecommunication Services, Utilities, Consumer Staples and Health Care. Included sectors include Consumer Discretionary, Financials, Materials, Industrials, Energy and Information Technology. Each sector index comes from the MSCI EMU Index universe. Correlation is calculated between the returns of the specified index and the changes in the European Commission's Economic Sentiment Indicator. Beta is calculated relative to the MSCI EMU Index.
Beta: Measure of the volatility of an index or investment relative to a benchmark.

For definitions of indexes in the chart, visit our glossary. **Positioning in Cyclicals: No Defensives** In positioning for local economy recovery, these data points lead us toward a preference for cyclical sectors over defensive sectors. Within the WisdomTree Europe

Local Recovery Index, the Consumer Staples, Health Care, Telecommunication Services and Utilities sectors are not eligible for inclusion. **Two important factors are driving allocations in the WisdomTree Europe Local Recovery Index: Stock Selection:** In addition to the aforementioned sector screens, there is also a geographic revenue requirement to ensure a domestic European focus: constituents must derive more than 50% of their revenue from inside Europe, giving focus to what is happening within Europe and less sensitivity to the global growth outlook. **Weighting:** We also employ a weighting methodology to maximize sensitivity to improving economic conditions. This process tilts the weight toward stocks whose returns have been most correlated to changes in economic conditions, defined by the European Commission's Economic Sentiment Indicator discussed above. This unique weighting methodology ranks stocks by their correlation to the Economic Sentiment Indicator and, using a smoothed weighting process, tilts weight from the traditional benchmark market capitalization weights toward stocks that are more responsive to changes in economic sentiment and activity. Formally, the weights are set by two factors: 25% according to their market capitalization percentages, and 75% according to how correlated each stock is to economic activity over the last five years (based on each stock's returns and its relationship to the European Commission's Economic Sentiment Indicator). **Bottom Line[3]: • Local Focus:** WisdomTree Europe Local Recovery Index has nearly 70% of its weighted average revenue coming from within Europe. • **Opposite of WisdomTree Europe Hedged Equity Index:** This is a distinctly complementary approach to that employed by the WisdomTree Europe Hedged Equity Index, which requires constituents to derive more than 50% of their revenue from outside Europe. The weighted average revenue exposure from Europe in that Index is only 30%. • **Unhedged Local Exposure Complements Hedged Exporters:** There has been a huge amount of interest in currency-hedged eurozone exporters in 2015. The unhedged local recovery basket provides a nice complement both from its unhedged nature and the distinctly different profile of stocks represented in the local recovery Index. Based on the macroeconomic trends discussed in our blog post *"A Recovering Eurozone Economy: Where Should You Position?,"* this local recovery index should also be a focal point for traditional unhedged replacements, as the local economy is showing relative strength within the European economy. [1]Sources: Bloomberg, Eurostat and WisdomTree, with data as of 6/30/15. [2]Sources: Bloomberg, European Commission, European Central Bank and WisdomTree, with data as of 9/30/15. [3]Sources: Bloomberg, FactSet, with data as of 9/30/15.

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DEFINITIONS

Eurozone (EZ) : Consists of the following 18 countries that have adopted the euro as their currency: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain (source: European Central Bank, 2014).

M1 : refers to the M1 money supply that includes physical money, such as coins and currency, as well as demand deposits, checking accounts, and Negotiable Order of Withdrawal accounts.

Defensive sectors : Consumer Staples, Health Care, Telecommunication Services and Utilities.

MSCI EMU Index : A free float-adjusted market capitalization-weighted index designed to measure the performance of the markets in the European Monetary Union.

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

Smoothed weighting process : refers to the smooth nature of constituent weights caused by tilting a traditional market capitalization weighting process.

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.

Unhedged : Strategy that includes the performance of both the underlying asset as well as the currency in which it is denominated. The performance of the currency can either help or hurt the total return experienced.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.