WHY EUROPEAN SMALL CAPS PERFORMED STRONGLY IN 2013

Christopher Gannatti – Global Head of Research
02/06/2014

European equities have been in focus since approximately the second half of 2013 and into early 2014. After the global financial crisis of 2008–09, it was easy to find reasons to express negative viewpoints about Europe. However, as is so often the case in equity markets, the crisis occurred, valuations adjusted downward, and then performance started to turn around. **When Did Performance Start to Turn Around?** Whether one looks at the performance of the S&P Europe 350 Index (large-cap European equities) or the MSCI Europe Small Cap Index (small-cap European equities), the notable shift in performance from downward/flat to an upward trend occurred in June of 2012.[1] It's interesting to us that the performance shift occurred approximately one year prior to the European equity markets coming into serious focus for investors. **Being Economically Sensitive** Some of the best times, historically speaking, to consider different equity markets have been points of inflection—when the characteristics of a market shift in such a way as to bring new information to light and function as a catalyst for investors to change their thinking. In the second half of 2013, discussions about Europe's economic growth prospects improved. This occurred at the same time as economic growth expectations in emerging markets were largely adjusted downward. People started having more confidence in Europe not only because its growth prospects were improving but also because, judged against the other regional allocation options, Europe was improving its stature and started looking better as a potential allocation option. Positioning oneself to take the greatest potential advantage of this shift involves two elements, in our view: • **Small Caps**: In regional equity markets around the world, small-cap companies are often the most nimble. As economic growth expectations improve, they are the fastest in adjusting their business models to take advantage of the new situation. They also tend to have a greater share of their revenue streams coming from their local markets than do large-cap, global exporters. • **Industrials & Consumer Discretionary:** These are some of the sectors within small-cap stocks that are the most highly leveraged to changing economic growth prospects. Consumer Discretionary firms can quickly respond to the uptick in consumption of discretionary items as consumers feel better about their future economic prospects. Industrials can increase their capital spending initiatives as they prepare for the increased demand for their outputs from their customer bases. **The WisdomTree Europe SmallCap Dividend Index Was Strongly Exposed to These Elements** Between June 29, 2012, and December 31, 2013, the WisdomTree Europe SmallCap Dividend Index (WTESC) had an average exposure of greater than 40% to these two sectors (Consumer Discretionary and Industrials). WTESC also has its annual rebalance in June of each year to refocus on the small-cap segment of the dividend-paying equity market in Europe. **Did Exposure Translate to Performance?** Below, due to the availability of data, we note the performance of WTESC against the performance of the S&P Europe 350 Index, an index designed to measure the performance of large-cap European companies. **WTESC Captured the Trend of Improving Equity Performance in Europe (6/29/2012–12/31/2013)**

	Average % Weight[1]			Total Returns		Attribution[3]
	WTESC Index	S&P Europe 350 Index	Over-or-Underweight[2]	WTESC	S&P Europe 350	WTESC vs. S&P Europe 350
Index	100.00%	100.00%	N/A	80.18%	34.67%	45.51%
Industrials	25.14%	10.63%	14.52%	81.40%	61.04%	8.45%
Consumer Discretionary	17.99%	9.60%	8.39%	88.55%	68.02%	5.53%
Information Technology	11.96%	3.20%	8.75%	78.63%	74.52%	4.30%
Consumer Staples	7.70%	14.56%	-6.86%	92.56%	31.89%	3.91%
Energy	3.19%	10.37%	-7.19%	72.91%	21.57%	3.84%
Telecommunication Services	3.59%	5.66%	-2.07%	141.75%	42.70%	3.04%
Materials	8.11%	8.40%	-0.29%	49.85%	25.71%	2.73%
Utilities	2.13%	4.39%	-2.26%	111.37%	26.07%	2.09%
Health Care	4.27%	12.98%	-8.70%	106.31%	49.29%	1.03%
Financials	15.91%	20.21%	-4.30%	75.84%	70.44%	-0.57%

[1]Average % Weight: Average weight within the specified sector for each respective Index 6/29/2012 to 12/31/2013.

[2]Over- or Under-weight: Difference in weight (WTESC minus S&P Europe 350). Positive numbers indicate that WTESC is over-weight.

[3]Attribution: Compares the performance of one index or investment to another, noting particularly the differences in weights or holdings. This analysis quantifies both the positive and the negative effects of selecting or heavily weighting different stocks or sectors.

Source: Bloomberg. Past performance is not indicative of future results. You cannot invest directly in an index. Subject to change.

Average Annual Returns (as of 12/31/2013)

Index Name	WT Index Inception Date	1-Year	3-Year	5-Year	Since WT Index Inception
WisdomTree Europe SmallCap Dividend Index	6/1/2006	47.40%	15.52%	23.99%	6.63%
S&P Europe 350 Index		20.31%	9.15%	13.27%	3.16%

Source: Bloomberg. Past performance is not indicative of future results. You cannot invest directly in an index.

• **Outperformance by More Than 45%:** WTESC outperformed the S&P Europe 350 by more than 45% cumulatively from the June 2012 inflection point of Europe's market, with a total return of over 80% over the 18-month period. • **Industrials & Consumer Discretionary Explain One-Third of Differential:** WTESC's attribution relative to the S&P Europe 350 was helped in 9 out of 10 sectors, the exception being Financials (which had strong performance in both large caps and small caps but were under-weight in WTESC). Of the greater than 45% performance advantage, nearly one-third was explained by two sectors—Consumer Discretionary and Industrials—which both had some of the strongest returns in the small-cap category compared to the large-cap category but also received more than twice the cumulative weight in small caps than in large caps. • **Cyclical Recovery Drivers:** The next two sectors most responsible for WTESC's outperformance continue along the theme of a cyclically driven recovery. Information Technology is a sector that is sensitive to economic trends, and it received almost 4x the weight in small caps than in large caps, and these stocks had much better returns than European large caps in general. Also, Consumer Staples, a more defensive and less cyclical sector, is under-weight in small caps compared to large caps, and that under-weight contributed to WTESC's outperformance. **Completion with Economic Sensitivity** When investors think about Europe and making an allocation, many times their first thoughts are for the more well-known large-cap companies. While these have certainly performed well, we believe that investors who are excited about Europe's improving economic prospects should complement their positions with exposures to European small caps. These strategies may have the potential to capture the economic sensitivity driving the allocation decision in the first place. [1]Source: Bloomberg. Period: 6/29/2012 to 12/31/2013.

Important Risks Related to this Article

Investments focused in Europe are increasing the impact of events and developments associated with the region, which can adversely affect performance. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Investments focusing 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.

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

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

S&P Europe 350 Index : A float adjusted market capitalization-weighted measure of the performance of large cap equities within European markets.

MSCI Europe Small Cap Index : A free float-adjusted market capitalization-weighted index designed to measure the performance of developed equity markets in Europe, specifically focusing on the small-cap segment of these equity markets.

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

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.

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.

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

Cyclical sectors : Consumer Discretionary, Energy, Industrials, Materials, Financials and Information Technology sectors.