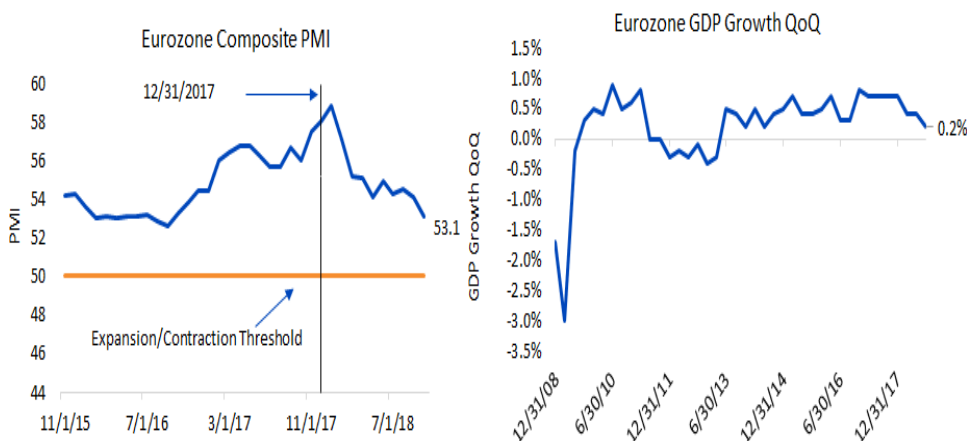


HOW TO DEVELOP A BALANCED PORTFOLIO AMID EUROPEAN VOLATILITY

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There's no sugarcoating it: the performance of European equities in 2018 has been disappointing. The weak performance year-to-date, as measured by the -10.56% return for the [MSCI Europe Index](#),¹ has been accompanied by a marked slowdown in economic growth in the [eurozone](#). Two major indicators used as bellwethers of economic growth, [composite PMI](#) and [real GDP growth](#), have both trended downward, albeit while still signaling economic expansion. Signs such as these—that this pullback is associated with weakening economic fundamentals—are cause for greater scrutiny for global asset allocators. Below, we discuss some ways investors may want to think about risk, and provide a few ways to diversify risk in Europe.



Sources: WisdomTree, Bloomberg, Markit. Composite PMI data from 11/30/15–10/31/18. GDP growth data from 12/31/08 to 9/30/18. Past performance is not indicative of future results.

European [Valuations](#): An Historical Review

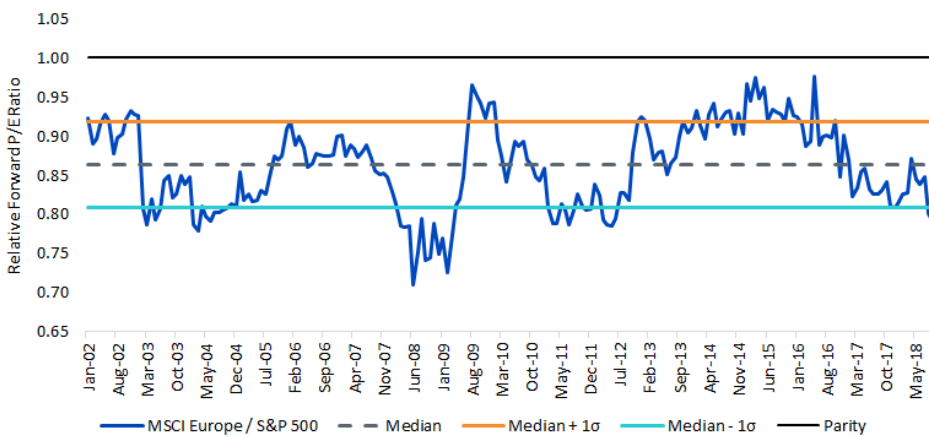
For equity investors, particularly those with a long-term investment horizon, uncertainty tends to bring opportunity. Based on forward [price-to-earnings \(P/E\) ratios](#), the MSCI Europe Index is currently priced, relative to the [S&P 500 Index](#), at valuations that were last regularly seen in 2011, at the height of the European sovereign debt crisis. Today's 16.1x [forward P/E](#) for the S&P 500 Index is an approximately 22% premium on the 13.2x forward P/E for the MSCI Europe Index.²

European equities tend to be more [volatile](#) than U.S. equities, and have thus traded at a

chronic discount to their U.S. counterparts. Over time, the median ratio of the MSCI Europe Index forward P/E to the S&P 500 Index has been 0.86. Today's ratio of 0.82 is nearly a full [standard deviation](#) below that median, signaling a potential buying opportunity. While the outlook for Europe is mixed, most notably due to [Brexit](#), Italy's budget and the end of [quantitative easing](#), today's valuations appear to appropriately compensate for those risks.

While short-term catalysts may prove illusive, most investors still maintain some exposure to Europe. In our view, an allocation to Europe blending [large-cap](#) multinationals that are directly tied to global growth with domestically-driven [small-caps](#) for a more balanced portfolio approach could add [value](#) in this type of environment.

MSCI Europe Index Forward Price-to-Earnings Relative to S&P 500 Index



Sources: WisdomTree, FactSet. Data 1/31/02–10/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

A Blended Approach: Multinationals and Small-Caps

While some investors may have a dedicated European large-cap exposure in their global portfolios, far fewer most likely have dedicated exposure to European small-caps. This could be a costly mistake. In the European market, there is a significant difference between large- and small-cap companies in terms of where they derive their revenue from, geographically. Similarly, they also provide different exposure across sectors. We believe a blend of large- and small-caps can offer a unique complement, particularly when currency volatility is mitigated with a [50% currency-hedged baseline as discussed in a recent post](#).

The [WisdomTree Europe SmallCap Dividend Fund \(DFE\)](#) and the [WisdomTree Europe Hedged Equity Fund \(HEDJ\)](#) both track indexes that have an annual rebalance back to relative value each June. This [rebalance](#) process results in these Funds taking the relative valuation discount of Europe a step further than seen in the broad [market-cap weighted](#) MSCI Europe and [FTSE Developed Europe All Cap Indexes](#). In the table below, we show a hypothetical portfolio of 50% HEDJ and 50% DFE relative to these two broad indexes. The higher [dividend yield](#) of 4.1% would be expected from a blend of two dividend-focused funds, but the disciplined annual rebalance back to fundamentals also results in lower valuations seen across P/E and [price-to-book \(P/B\) ratios](#).

Fundamentals Comparison

Name	Fundamentals				
	Div. Yield	P/E	Est. P/E	P/B	ROE
50% HEDJ / 50% DFE	4.1%	13.38	12.89	1.67	11.3%
FTSE Developed Europe All Cap Index	3.6%	14.34	13.39	1.72	12.1%
MSCI Europe Index	3.7%	14.11	13.15	1.73	12.2%

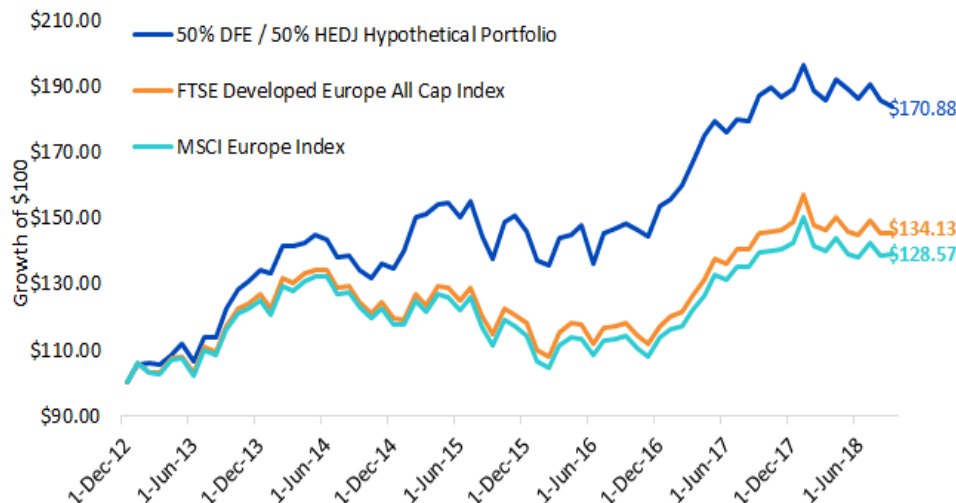
Sources: WisdomTree, FactSet, Bloomberg. Data as of 10/31/18. Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns. WisdomTree, its affiliates and their independent providers are not liable for any informational errors, incompleteness or delays or for any actions taken in reliance on information contained herein.

For standardized performance of the Funds in the chart please click their respective tickers: [DFE](#), [HEDJ](#).

Most investors would expect a portfolio with a 50% allocation to small-caps to be accompanied by a significant increase in volatility; however, that has not been the case for our hypothetical portfolio. Over nearly six years, this hypothetical portfolio could have significantly outperformed the two widely followed European benchmark indexes on both an absolute and [risk-adjusted basis](#). The [Sharpe ratio](#) of 0.72 for this hypothetical portfolio more than doubled the Sharpe ratio of 0.30 for the MSCI Europe Index.

In addition to the lower volatility benefits of both dividend weighting and currency hedging for the respective funds, HEDJ and DFE had only a modest correlation to each other (0.63),³ which helped to further reduce the volatility of the hypothetical blend. The driver of this lower [correlation](#) was often closely linked to the euro. During a weak euro environment, HEDJ tended to perform better by neutralizing the currency weakness for dollar-based investors. During a strong euro environment, DFE tended to perform better because of the tailwind of the currency return.

Cumulative Growth of \$100



Name	Return	Standard Deviation	Sharpe Ratio	vs. MSCI Europe Index	
				Beta	Correlation
50% DFE / 50% HEDJ Hypothetical Portfolio	9.62%	12.68%	0.72	0.90	0.92
FTSE Developed Europe All Cap Index	5.16%	13.07%	0.36	1.00	1.00
MSCI Europe Index	4.40%	13.03%	0.30	1.00	1.00

Source: WisdomTree, Zephyr StyleAdvisor, Bloomberg. Data from 12/31/2012—10/31/2018, beginning with the inception of the FTSE Developed Europe All Cap Index. Past performance is not indicative of future results.

You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns. WisdomTree, its affiliates and their independent providers are not liable for any informational errors, incompleteness or delays or for any actions taken in reliance on information contained herein.

For standardized performance of the Funds in the chart please click their respective tickers: [DFE](#), [HEDJ](#).

Conclusion

The low correlation between these two Funds and our long-held conviction in international small-caps as an under-owned asset class are at the core of why we favor combining these European exposures. In tilting toward the size premium as well as domestically-oriented growth prospects, we believe investors should use every tool in their arsenal for volatility reduction. While the outlook for Europe remains uncertain, taking a more diversified approach to risk could add value in the long run.

¹Sources: WisdomTree, Bloomberg. 12/31/17–11/15/18.

²Sources: WisdomTree, FactSet. 10/31/18.

³Sources: WisdomTree, Zephyr StyleAdvisor. 12/31/12-10/31/18.

For the top 10 holdings of DFE please visit the Fund's fund detail page at <https://www.wisdomtree.com/investments/etfs/equity/dfc>

For the top 10 holdings of HEDJ please visit the Fund's fund detail page at <https://www.wisdomtree.com/investments/etfs/equity/hedj>

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](#).

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You cannot invest directly in an index.

DEFINITIONS

MSCI Europe Index: A free float-adjusted market capitalization-weighted index designed to measure the performance of developed equity markets in Europe.

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).

Purchasing Managers' Index (PMI): An indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. A reading above 50 indicates an expansion of the manufacturing sector compared to the previous month; below 50 represents a contraction while 50 indicates no change.

Real growth: Refers to the rate of economic growth with the inflation rate subtracted from it.

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.

Price-to-earnings (P/E) ratio: Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

S&P 500 Index: Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Forward P/E ratio: Share price divided by compilation of analyst estimates for earnings-per-share over the coming 12-month period. These are estimates that may be subject to revision or prove to be incorrect over time.

Volatility: A measure of the dispersion of actual returns around a particular average level.

Standard deviation: measure of how widely an investment or investment strategy's returns move relative to its average returns for an observed period. A higher value implies more "risk", in that there is more of a chance the actual return observed is farther away from the average return.

Brexit: an abbreviation of "British exit" that mirrors the term Grexit. It refers to the possibility that Britain will withdraw from the European Union.

Quantitative Easing (QE): A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Large-Capitalization (Large-Cap): A term used by the investment community to refer to companies with a market capitalization value of more than \$10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

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

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over time.

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.

Market capitalization-weighting : 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.

FTSE Developed Europe All Cap Index : a market- capitalization index representing the performance of companies in developed European markets, including UK.

Dividend yield : A financial ratio that shows how much a company pays out in dividends each year relative to its share price.

Price-to-book ratio : Share price divided by book value per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

Risk-adjusted basis : When calculating the return, we refine the return by measuring how much risk is involved in producing that return.

Sharpe ratio : Measure of risk-adjusted return. Higher values indicate greater return per unit of risk, specifically standard deviation, which is viewed as being desirable.

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.