

# SMART BETA IN ACTION: TAKING CHIPS OFF THE SMALL CAP EUROPEAN TABLE

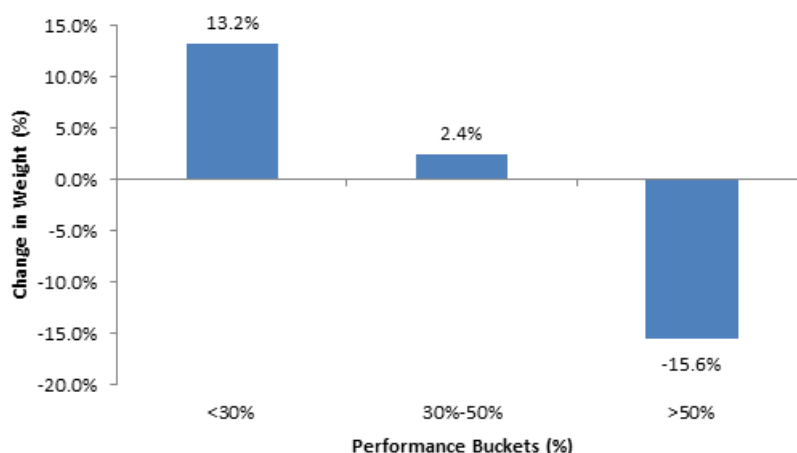
Jeremy Schwartz — Global Chief Investment Officer

07/21/2014

The [last blog post](#) in our series on our European equity Index rebalance touched on changes to sector and country weights in one of our Indexes, but we now turn to a discussion of the rebalance methodology and how it impacted individual constituents. European equity markets performed strongly throughout much of 2013 and into the first five months of 2014. [WisdomTree's Europe SmallCap Dividend Index](#) (WT Europe Small) was up more than 44% over this same period—the strongest performer within WisdomTree's developed international Index family. While it is difficult to time market tops and bottoms for individual stocks on a consistent basis, we believe there are benefits to undertaking a disciplined practice to rebalance weight based on changes in [relative valuation](#). **WT Europe Small as a Case Study** While the whole Index was up more than 44% between annual rebalance screenings, this is an average, and not every stock was up by this amount. If we think broadly in terms of sector performance, we find the following:

- **Seven Sectors Above 40%:** Telecommunication Services was the top-performing sector at more than 92% over the period. This was driven by one stock, Drillisch AG, which had an average weight of 2.38% over the period and a return of almost 140%<sup>1</sup>. Industrials, the low performer of this group of seven, were up nearly 42% over the period.
- **All Sectors Above 35%:** It speaks to a particularly strong period when not one sector delivered performance below 35%.
- There were four countries above 10% in weight. Of these, Italy was the leader, delivering 68% over the period. The United Kingdom lagged but still returned greater than 36%.

**How Chips Were Taken Off the Table** Shifting to a constituent level, it's important to remember that WT Europe Small is unique within the European small-cap equity space in that it weights constituent firms by dividends. **• Greater Dividends = Road to Greater Weight:** The typical firm receiving increased weight in WT Europe Small will have grown or at least maintained its dividends but have had lackluster price performance. Conversely, the typical firm receiving lower weight will have had stronger price performance but dividend growth that did not keep pace. **• Canceling Dividends Leads to Deletion:** Every constituent of WT Europe Small must be a dividend payer. Lack of dividends leads to a lack of representation. Fortunately, the dividend-paying culture of European firms is strong, leading to 290 qualifying constituents as of the 2014 screening date. **The Chips Coming Off the European Small-Cap Table** WisdomTree Europe SmallCap Dividend Index



Performance is measured from 5/31/13 to 5/31/14.

Sources: WisdomTree, Standard & Poor's, Bloomberg. Past performance is not indicative of future results. You cannot invest directly in an Index.

• Almost 50% of Weight in Top

**Performers:** Approximately 47% of the weight in WT Europe Small was in firms that delivered a return greater than 50% from May 31, 2013, to May 31, 2014. We can see that 15.6% of WT Europe Small's weight in these securities was trimmed as a result of the 2014 Index screening. • **Subtracting from Winners and Adding to Losers:** Regardless of how strong a year it must be to have "losers" defined as those returning less than 30%, we clearly see that weight is taken from those firms with returns greater than 50% over the prior year and redistributed to firms with returns below 30%. **Effectively Taking the "Decision" Off the Table** WT Europe Small's relative value rebalance, the mechanics of which are seen above, is helpful in that it attacks the market in a disciplined way every year. This is especially important after the strong performance of European small caps this year, in that we believe investors might tend to want to hold on to the stronger performers. In sticking to the investment mantra "buy low, sell high," a relative value rebalance may aid in accomplishing this notably difficult action—a key feature of how we think investors can become smarter with their [beta](#) exposures. For the full research on the WisdomTree European Indexes rebalance, [click here](#).<sup>1</sup> Drillisch AG was a 1.76% in the WisdomTree Europe SmallCap Dividend Index as of 6/30/14.

#### 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. Dividends are not guaranteed and a company's future abilities to pay dividends may be limited. A company currently paying dividends may cease paying dividends at any time. Performance, especially for very short time periods, should not be the sole factor in making your investment decision.

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](http://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

**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.

**Relative value** : The relationship between a particular attribute, e.g., a dividend, and the firm's share price compared to that of another firm.

**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.