

EUROPEAN SMALL CAPS ARE REVVING THEIR ENGINES

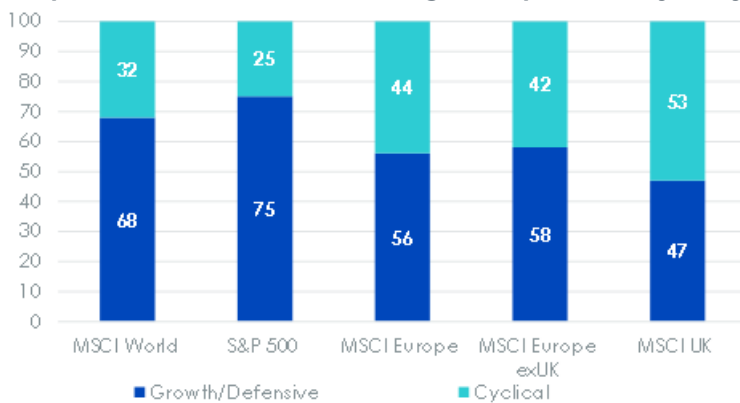
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For the first time in a while, we’re growing more optimistic on the European economy.

My colleague Aneeka Gupta from WisdomTree Europe recently provided some commentary on European macroeconomics that outlined a few valuable insights.

One of her most intriguing points related to the weight concentration of cyclically sensitive stocks in Europe versus other equity indexes from around the world. Europe has the second-highest concentration at 44%, nearly 20% more than the U.S.:

European Stock Market Consists of Higher Proportion of Cyclically Sensitive Stocks



Sources: WisdomTree, FactSet, MSCI, S&P, as of March 2021

She wrote:

Europe’s higher exposure to financials and cyclically sensitive sectors such as industrials, materials and energy are likely to benefit from pent-up domestic demand as the lockdown measures ease.

This got us excited about European equities, [small caps](#) and the [WisdomTree Europe SmallCap Dividend Fund \(DFE\)](#) in particular, because it reinforced an important distinction that we’ve been writing about recently: The reopening trade isn’t over. We believe it’s just getting started.

A Tale of Two Pandemics

Our excitement is a bit ironic, since it’s partially inspired by Europe’s struggle to suppress the coronavirus and vaccinate its citizens. We believe there’s a unique opportunity buried among the headlines about new lockdowns in the U.K., France and Germany, along with the bloc’s difficulty to approve, secure and distribute vaccines.

Europe’s expectations for both an economic and equity market recovery have been tempered by these difficulties, unlike the roaring equity rally that began in the U.S. late last year. That signals to us that the European economy is still slightly behind in the fight against COVID-19.

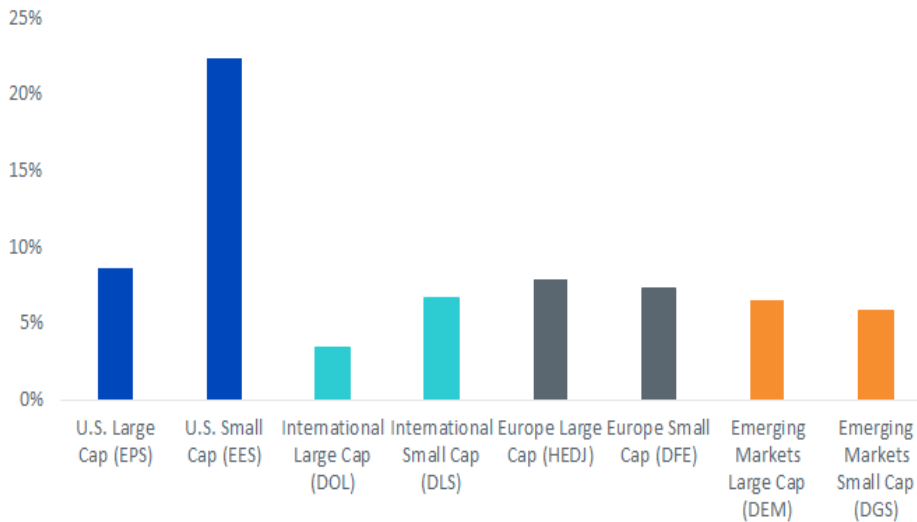
More importantly, for equity markets, that reiterates that there may still be time to pile into the European recovery trade, of which small caps are a major component.

Global Small Caps Are Patiently Waiting

Let’s compare the year-to-date performance of small- and large-cap equities in various regions around the world, using

WisdomTree’s product suite as a barometer.

YTD Performance of Large & Small Caps by Region



Source: WisdomTree, as of 3/26/21. Past performance is not indicative of future results. EPS = WisdomTree U.S. LargeCap Fund, EES = WisdomTree U.S. SmallCap Fund, DOL = WisdomTree International LargeCap Dividend Fund, DLS = WisdomTree International SmallCap Dividend Fund, HEDJ = WisdomTree Europe Hedged Equity Fund, DFE = WisdomTree Europe SmallCap Dividend Fund, DEM = WisdomTree Emerging Markets High Dividend Fund, DGS = WisdomTree Emerging Markets SmallCap Dividend Fund.

Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor’s shares, when redeemed, may be worth more or less than their original cost. Performance data for the most recent quarter-end and month-end is available at wisdomtree.com.

WisdomTree shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Total returns are calculated using the daily 4:00 p.m. EST net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times.

For standardized performance and the SEC-30 Day Yield of the Funds in the chart, please click [here](#).

Despite the fervor surrounding small caps this year, the excitement has been isolated to the U.S. In Europe, they’re performing in line with the broader region, suggesting that are still preparing for a potential takeoff.

Small Caps Clear the Runway for [Large Caps](#)

There are two more key reasons for our optimism on European small caps.

Similar to Aneeka’s point about European equities benefitting from pent-up demand as lockdowns begin to ease, we’re longtime believers in the importance of small-cap interlinkages within the global economy. Smaller companies are integral to global supply chains and are highly levered to overall levels of economic activity, even if they seldom deliver blockbuster results during earnings season.

Given that we just completed a full year with subdued economic activity, it’s hard to argue that even a modest revival may be a potential catalyst for small-cap outperformance.

If history is any indication, we may be correct. The historical [beta](#) since inception of DFE relative to the [MSCI Europe Ind ex](#) is a strong 1.25, meaning any secular economic recovery in Europe may be felt even more by its smaller companies.

Diversified [Factor Exposures](#)

Second, we’re confident that DFE has the ability to deliver beneficial factor exposures in today’s market. Besides [size](#) exposure, which is expected in a small-cap Fund, DFE seeks to deliver two other important factors: [quality](#) and [value](#).

We would argue that the former is important in any market environment, since it targets companies with efficient operations, strong balance sheets and healthy fundamentals. Quality is evidenced below by the 4.43% and 1.91% advantage in [return on equity \(ROE\)](#) and [return on assets \(ROA\)](#), respectively, against the MSCI Europe Index.

Fundamentals Comparison as of 2/28/2021						
	Price to Earnings (P/E)	Forward P/E	Dividend Yield	Return on Equity (ROE)	Return on Assets (ROA)	Leverage
DFE	17.1x	16.5x	3.35%	11.34%	2.86%	4.0x
MSCI Europe Index	27.5x	16.7x	2.64%	6.91%	0.95%	7.3x
Difference	-10.4x	-0.2x	0.72%	4.43%	1.91%	-3.3x

Sources: WisdomTree, FactSet, as of 2/28/21. Subject to change. You cannot invest directly in an index.

We feel [value investing](#), however, is experiencing a renaissance after living in the shadow of [growth](#) investing for the last decade. DFE’s emphasis on dividends, and weighting companies by their contribution to the [Dividend Stream®](#), seeks to deliver value characteristics through income generation and controlled [valuations](#).

That’s exhibited by the 72 [basis points \(bps\)](#) pickup in [dividend yield](#).

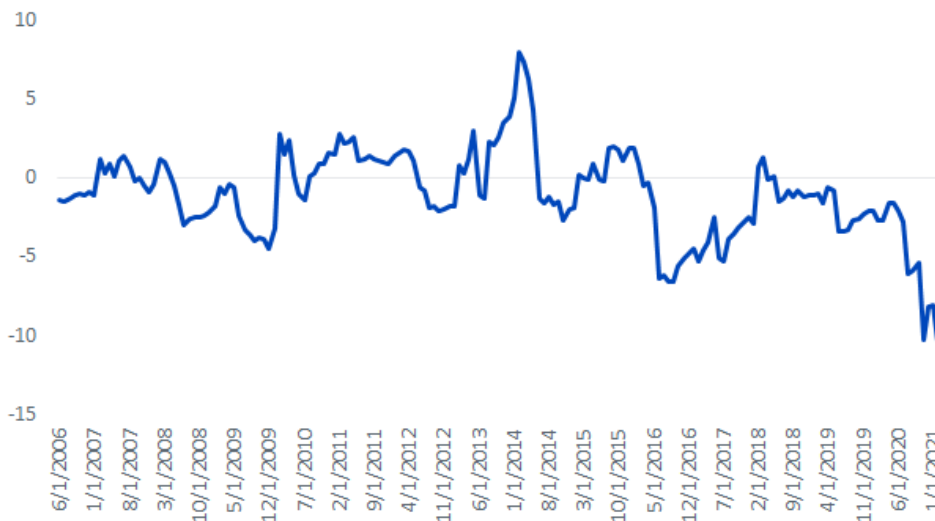
Bargain Buying

Moreover, we believe DFE also brings an attractive valuation profile to the table. In fact, the extent of its valuation discount reinforces our belief that U.S. small-cap excitement that has not spread overseas just yet.

DFE is trading at an all-time discount on a [price-to-earnings \(P/E\) ratio](#) basis compared to broader Europe. Since inception in June 2006, it maintained a one-point average discount to Europe in what became a difficult decade-plus for European equities.

At the end of February, however, this discount was the largest it’s ever been—a staggering 10 points—signaling that European small caps are still a bargain relative to their larger brethren.

P/E Spread Between DFE & MSCI Europe Index



Sources: WisdomTree, FactSet, as of 2/28/21. Past performance is not indicative of future results. You cannot invest directly in an index. Subject to change.

A Perfect Storm for a Small-Cap Rally

We’ve written extensively about our excitement for small caps this year, but European small caps are almost in a league of their own.

While the U.S. seems to have already embraced small-cap optimism as a preferred market narrative for 2021, we believe there is still time to enter the trade overseas.

In our view, there is a unique opportunity today to ride the economic recovery in Europe that has yet to find its footing. Our preferred way to access it is the WisdomTree Europe SmallCap Dividend Fund (DFE).

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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

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

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You cannot invest directly in an index.

DEFINITIONS

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

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.

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.

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

Factor : Attributes that based on its fundamentals or share price behavior, are associated with higher return.

Size : Characterized by smaller companies rather than larger companies by market capitalization. This term is also related to the Size Factor, which associates smaller market-cap stocks with excess returns vs the market over time.

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over time.

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.

Return on Equity (ROE) : Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

Return on assets (ROA) : Firm profits (after accounting for all expenses) divided by the firm's total assets. Higher numbers indicate greater profits relative to the level of assets utilized to generate them.

Growth : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

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

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.

Basis point : 1/100th of 1 percent.

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

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.