

# THE SHORT- AND LONG-TERM CASE FOR EUROPEAN SMALL CAPS

Jeremy Schwartz — Global Chief Investment Officer

06/19/2017

There's revitalized interest in Europe, as investors look away from stretched [valuations](#) in the U.S. to lower valuations across the world.

Many focus on U.S. [large caps](#) as being an expensive market, but perhaps this is even more true for [small-cap](#) indexes.

Here's a table that looks at [trailing 12-month](#) valuations across U.S. and European indexes:

Index Name	Trailing 12m P/E Ratio	Estimated P/E Ratio
Russell 2000	44.6x	28.6x
S&P 600	26.4x	22.0x
WT Small-Cap Dividend (U.S.)	23.4x	20.3x
S&P 500	21.6x	18.7x
MSCI Europe	24.6x	15.9x
WT Europe SmallCap Dividend	18.2x	15.5x

Source: Bloomberg, 6/2/17. Estimated P/E ratio based on current year estimated earnings. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance.

For definitions of indexes in the chart, visit our [glossary](#).

## Where in the Economic Recovery Cycle Is Europe?

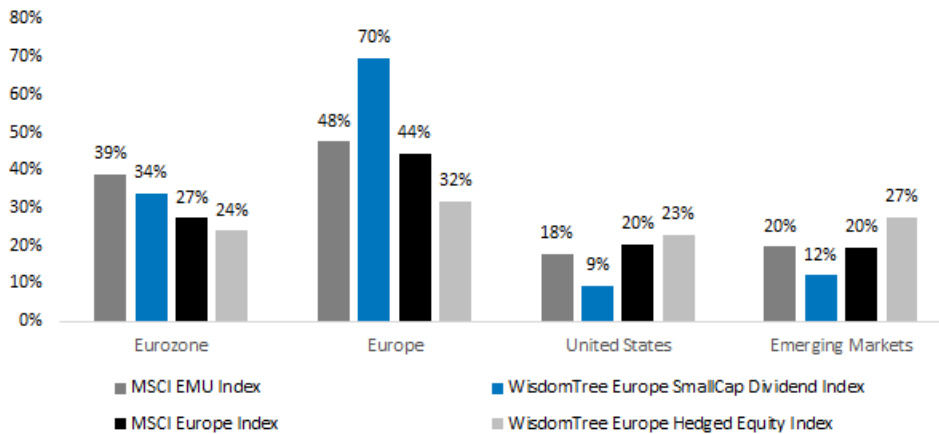
Josh Brown made a comment on Twitter about current European investment prospects: "Screaming buy. It's 2012 there."<sup>1</sup>

If it is truly 2012 in Europe with more catch up in the economy to come, one should optimize exposure to the European economic growth cycle.

When thinking about geographic revenue exposures, the chart below provides some color on the different sources of revenue for large caps and small caps, a consideration for investors that have a certain macroeconomic view.

Large-cap Europe often tilts exposure to more global, growth oriented companies and the global business cycle prospects. Conversely, small-cap Europe derives more of its revenue and profits from the local European economies.

## Geographic Revenue Exposure as of 4/30/17



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

### The Longer-Term Case for Small Caps?

A continued economic recovery could support the short-term case for European small caps, but what about the long-term case?

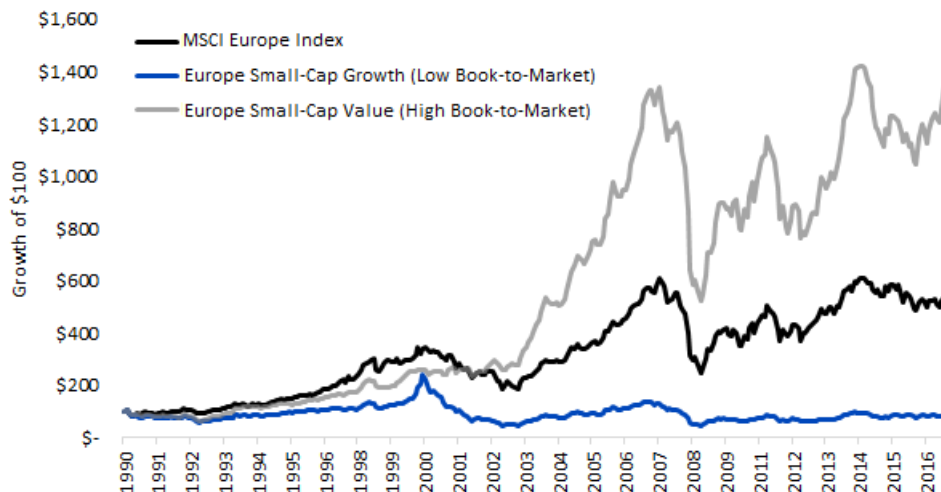
We've long heard the research that there is a small-cap [value premium](#). Was this true for Europe?

Absolutely.

Data from [Fama-French](#) shows the long-term compounding of European small-cap value versus small-cap growth to be dramatic.

European small-cap growth had negative returns over the last 30 years, while small-cap value compounded over 10.4% per year.

### Cumulative Returns to Europe Small-Cap Growth vs. Value



Source: Fama-French Factor Library, data from 6/30/1990 to 3/31/2017. 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.

The 5x5 matrix for size x valuations that Fama-French produces for Europe supports a clear long-term case for European small caps.

### Long-Term Returns of European Factor Portfolios

		Book to Market				
		Lowest	Low	Mid	High	Highest
Size Segment	Smallest	-0.37%	4.98%	6.26%	8.06%	10.38%
	Small	3.48%	6.26%	7.42%	9.34%	10.05%
	Mid	4.05%	7.20%	7.29%	7.47%	9.56%
	Large	6.21%	6.98%	8.02%	7.38%	8.13%
	Largest	5.27%	7.51%	7.49%	8.43%	6.37%

Source: Fama-French Factor Library, data from 6/30/1990 to 3/31/2017.

Even over the last decade, which saw a growth-driven market particularly for large caps, European small caps performed well.

### 10-Year Returns of European Factor Portfolios

		Book to Market				
		Lowest	Low	Mid	High	Highest
Size Segment	Smallest	-3.55%	1.07%	1.86%	1.22%	1.68%
	Small	3.36%	4.45%	2.75%	2.41%	0.63%
	Mid	2.39%	3.61%	2.62%	1.48%	-0.64%
	Large	5.92%	3.39%	3.19%	1.53%	-3.13%
	Largest	4.37%	3.63%	0.43%	-0.69%	-2.49%

Source: Fama-French Factor Library, data from 3/31/2007 to 3/31/2017.

The [WisdomTree Europe SmallCap Dividend Index \(WTESC\)](#) tilts exposure to these European small-cap [value](#) stocks.

The Index launched in 2006 and has a strong 10-year track record compared to traditional large-cap [market cap](#)

benchmarks.

Index	Cumulative Returns	Avg. Annual Returns
MSCI Europe	42.9%	3.3%
WTESC	113.5%	7.1%

Source: Bloomberg, 5/31/2006–5/31/2017. 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.

<sup>1</sup><https://twitter.com/ReformedBroker/status/867319485363081219>.

#### Important Risks Related to this Article

Investments focused in Europe increase the impact of events and developments associated with the region, which can adversely affect performance.

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**

**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.

**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.

**Trailing 12-month earnings** : is the sum of a company's earnings for the previous 12 month.

**Value Premium** : The greater risk-adjusted return of value stocks over growth stock.

**Fama-French** : Refers to a factor-based model to describe stock returns developed by Eugene Fama and Kenneth French. Their original three-factor model breaks down the components of stock returns to market risk, company size and book to market ratio, or value. &nbsp;

**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.

**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.