# POSITIONING FOR A EUROPEAN RECOVERY WITH SMALL CAPS, PART II

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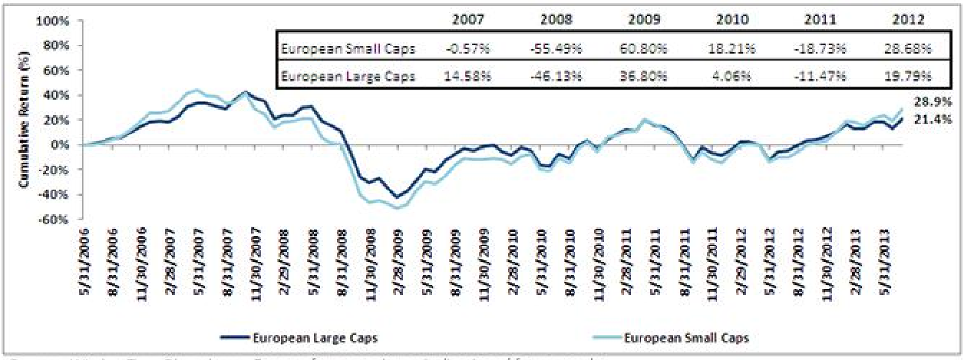
Europe has come a long way from just a year ago. 2012 was characterized by bouts of instability and questions as to the continued viability of the euro currency. Now, in 2013, we are starting to see potential signs of stabilization within Europe's economies, and this is starting to be reflected in the European equity markets. In Part 1, we focused on small caps for their potential domestic revenue exposure. Now we explore another potential benefit of small-cap exposure, given the current market backdrop. **Positioning for a Recovery: Small Caps and Cyclical Stocks** When economic and growth outlooks are uncertain, there is a tendency for equity investors to hunker down and turn to defensive sectors — sectors whose goods and services are more likely to hold up in the case of a slowdown. On the other hand, as a recovery begins to materialize, one often desires exposure to the more cyclical sectors, which are more highly leveraged to economic growth. In this vein, small caps are often reflective of a more cyclical (as opposed to a more defensive) allocation. One reason: small caps are often more sensitive to local economic conditions. In a recent blog post, Chris Gannatti outlined how revenues for the WisdomTree Europe SmallCap Dividend Index (European Small Caps) were more tied to Europe's economies than were the firms in the WisdomTree Europe Hedged Equity Index, which tends to include larger, more multinational firms. Below, I discuss how European small caps have performed in the last six years, which have seen some large swings in both the positive and the negative direction. Ultimately, if one is positioning for a European economic recovery, small caps, which are more cyclical, can provide an attractive and unique exposure. **Comparing Calendar Year Returns and Cumulative Returns of European Small Caps to the FTSE Developed Europe Index (European Large Caps) (5/31/2006–7/31/2013)**




Sources: WisdomTree, Bloomberg. Past performance is not indicative of future results.
A 6-year horizon was chosen to reflect the inception date of the WisdomTree Europe SmallCap Dividend Index.

• **Higher Beta Exposure:** European Small Caps have far outpaced European Large Caps during market rallies. Outperformance in 2009: 24%. Outperformance in 2010: Approximately 14%. Outperformance in 2012: Approximately 9%. True, European Small Caps did go down further in both 2008 and in 2011, but we find it interesting to note that since its inception, even while going down further during these years, cumulative returns are in fact higher over the full period of history available. • **Economic Sensitivity Rooted in Cyclical Exposures:** European Large Caps are market capitalization weighted, which means that they're biased toward larger companies. Some of the resulting exposures include very large telecommunication services or utilities firms. On the other hand, European Small Caps rebalance back toward the small-cap segment of European equities on an annual basis, steering away from larger European companies. The result: While European Small Caps have approximately 83% exposure to cyclical sectors, the European Large Caps have only a 64% exposure to cyclical sectors. **The Industries Driving These Cyclical Over-weights: • Consumer Discretionary:** European Small Caps have over 6% more weight in the cyclical stocks in this Consumer sector. The largest industry over-weight in this sector is in Retailing. An increase in European economic growth should have the potential to benefit these European consumer stocks. •

**Industrials:** European Small Caps have about twice as much weight (over 20%) in the Industrials sector as do European large caps—a sector that is often very sensitive to economic conditions. On an industry basis, there is an over-weight in capital goods companies involved in large projects that incorporate high levels of capital spending . This sector could be positioned closer to the front end of any increases in capital spending and the expansion of production capability. • **Information Technology:** European Small Caps have about 10% more weight in the IT sector than do European Large Caps, and on an industry basis, it's the technology hardware and equipment industries. Central here are firms trying to improve efficiency, for example through enhanced data storage and communications equipment. As long as productivity improvements are a central theme for companies trying to emerge from protracted slowdowns, this industry could remain important. **Conclusion** If data coming out of Europe continues to improve, European Small Caps offer an interesting contrast to European Large Caps. The performance history of European Small Caps shows more sensitivity to market trends—whether positive during up markets or negative during contractions. Additionally, the specific industry over-weights, as of July 31, 2013, appear highly leveraged toward an improving economic situation. **Unless otherwise stated, data source is Bloomberg.**

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## DEFINITIONS

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

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

**Leverage** : Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.

**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.

**WisdomTree Europe Hedged Equity Index** : Index designed to provide exposure to European equities while at the same time neutralizing exposure to fluctuations between the Euro and the U.S. dollar. Constituents are European dividend-paying firms with a least 50% of their revenues from outside of Europe. Weighting is by cash dividends paid.

**FTSE Developed Europe Index** : Measure of the performance of developed European companies, weighted by market capitalization.

**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.

**Capital spending** : Spending by a company typically made to enhance longer-term productive capacity.

**Productivity** : Measure of efficiency that details how much output is obtained per unit of input.