RISING EURO HURTING EXPORTERS – CAN SMALL CAPS BE AN ANSWER?

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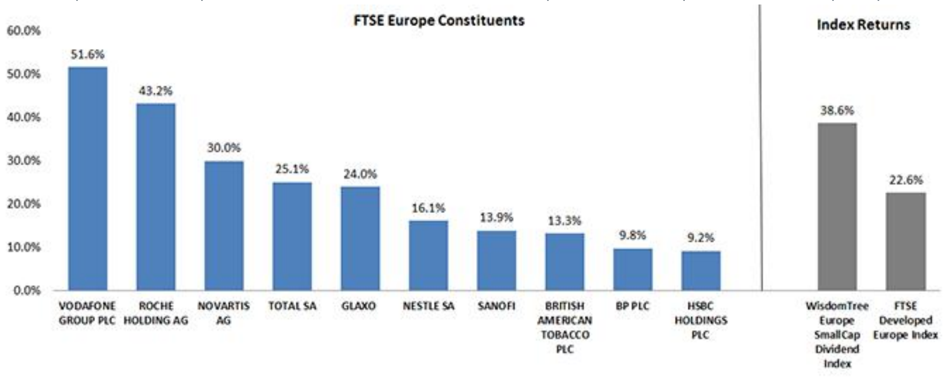
Europe's economy returned to growth in the second quarter, consumers have shown signs of improvement, and the manufacturing surveys are pointing toward expansion. This stabilization of the European economy is encouraging and a step toward alleviating a major concern for the global economy, but the strength of the euro appears to be hampering profits for some of the large-cap exporters. The luxury goods market is one example that is front and center of this trend. Bain analyst Claudia D'Arpizio described the strong euro as "totally negative for a large number of companies in the sector as their consolidated balance sheet is in euro."[1] This is the reverse of the Japanese trend, where a weak yen has boosted profits for large exporters. When European luxury-goods companies convert their revenues from outside Europe into a strengthening euro, it lowers their growth and profits. Companies discussing the euro impacting their latest results include: • Gucci parent Kering, which cited currency as contributing to a decline in Q3 revenue. • LVMH Moët Hennessy - Louis Vuitton SA, which said, "the growth in this year's third quarter was significantly offset by a large negative currency impact. … The weakness of the yen, in particular … resulted in a negative 6 percent impact."[2] • The CEO of Luxottica Group SpA, which makes eyeglasses, said the company is dealing with "unbelievable currency fluctuations"[1] this year in countries such as the U.S. While exporters are often influenced negatively by a rising currency because of their multinational focus, the revenue of small-cap companies is often focused more on the local economy. As of September 30, 2013, the top 10 constituents of the WisdomTree Europe SmallCap Dividend Index had weighted average revenues of 80% from Europe and over 83% of the Index weight is composed of cyclical stocks. Small caps do not typically export their products, but many still import raw materials and other goods from outside Europe as part of their production process. Unlike exports, imported goods become cheaper as the domestic currency appreciates against others, leading to an increase in purchasing power, which ultimately increases profitability by lowering costs. **Looking to Small Caps for Higher Beta** Another benefit—if one believes Europe is recovering—is that small caps are more sensitive to trends in the economy because of their cyclical exposure. In other words, small caps often have higher beta—or market reactions—to both the ups and downs in the markets. These trends can be seen in the year-to-date performance of large-cap versus small-cap stocks and indexes. In the chart below we examine the year-to-date returns of the 10 largest index constituents of the FTSE Developed Europe Index (FTSE Europe), used to represent large-cap equities. For comparison purposes we also chart the WisdomTree Europe SmallCap Dividend Index (WTESC) to represent European small-cap equities. **Year-**



Sources: Bloomberg, WisdomTree. Period 12/31/12–10/25/13. Past performance is not indicative of future results. You cannot invest directly in an index.

to-Date Performance *For current performance of the WisdomTree Europe SmallCap Dividend Index, please click here.* • **Small Caps Have Outperformed Large Caps –** Collectively, WTESC has outperformed FTSE Europe by 16%, but the return advantage is even more impressive when comparing individual large-cap stocks. WTESC has been able to outperform 8 out of 10 of the largest holdings and has more than doubled the returns of half of the stocks. Obviously there are differences in risks between an individual security and an index, but we still find it important to note that some of the largest-capitalization stocks in Europe have underperformed a diversified basket of small caps by so much. • **Large Caps Are More Export Oriented –** One potential reason for the performance lag has been attributed to the recent increase in the euro and the pound against developed and emerging trading partners. As other currencies depreciate against the euro or pound, products sold by companies in the respective countries become more attractive on the global market compared to products sold by European exporters. • European exporters, such as software provider SAP AG, German chemicals supplier BASF and French automaker Renault, have all cited the recent currency strength as potentially negative for revenue and earnings. **Small Caps Are More Local to Europe** If data coming out of Europe continues to improve, European small caps offer an interesting contrast to European large caps, and I think they could continue to perform well even during periods of currency strength. Small-cap stocks of a particular region are often more domestically sensitive, deriving more of their revenues from that region than their large-cap compatriots. **How to Focus on European Small Caps?** The WisdomTree Europe SmallCap Dividend Index is designed to focus solely on dividend-paying European small caps. With potential euro strength providing headwind for European exporters, it is important to consider the tools and options available across European equity indexes. European small-cap stocks may be some of the best positioned to benefit from a rebound in Europe's economy and, at the same time, sidestep the drawbacks of the recent currency strength. By contrast, if the currency were to reverse course—i.e., the dollar were to start strengthening against the euro —investors should consider these exporters that have underperformed, while at the same time hedging the currency risk.

For current holdings of the WisdomTree Europe SmallCap Dividend Index, please click here. [1]Manuela Mesco, "Strong Euro Hits Luxury-Goods Sector," The Wall Street Journal, 10/28/13. [2]Anchalee Worrachate and Alex Webb, "Euro Hedging Jumps as Europe Exporters Bemoan Gains: Currencies," Bloomberg, 10/24/13.

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DEFINITIONS

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.

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.

Cyclical stocks : Refers to stocks in the Consumer Discretionary, Energy, Industrials, Materials, Financials and Information Technology sectors.

Purchasing power parity : Academic concept stating that exchange rates should adjust so that equivalent goods and services cost the same across countries, after accounting for exchange-rate differences.

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.

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

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.