

THE EUROPEAN SMALL-CAP RALLY: WHAT FUNDAMENTALS ARE TELLING US

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For investors trying to anticipate the next big inflection point for European equities amid a year of strong gains and moderate [volatility](#), what should they be looking for from one of the best developed market equity trades of the year thus far in European [small caps](#)?

Year-to-date, Europe has largely paid off as a [contrarian](#) trade as a result of the

- Unraveling of the "[Trump trade](#)"
- Market-friendly European election outcomes
- Improving corporate earnings and economic growth

Market Multiples *Falling on Strong Earnings Gains*

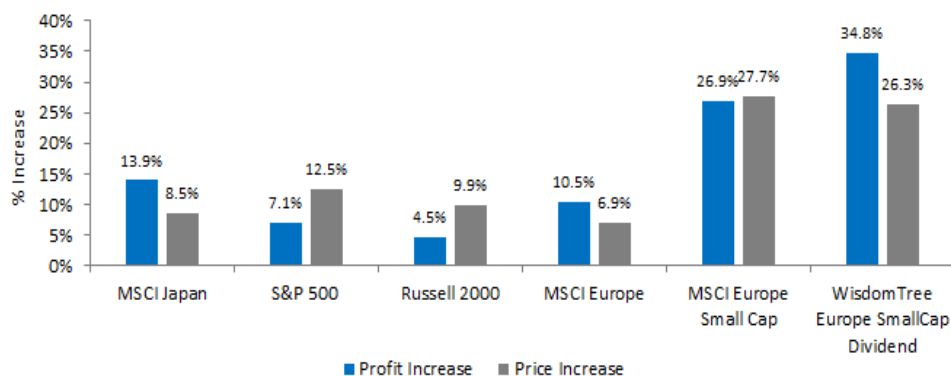
A typical concern for investors is buying *yesterday's trade* after share prices have run up and [valuations](#) have been stretched. When reviewing European small-cap valuations, surprisingly, this asset class is even less expensive today than at the beginning of the year when measured by [price-to-earnings \(P/E\) ratios](#).

In decomposing the P/E ratio, the metric is agnostic to the currency impact as the numerator and denominator are denominated in the same currency. What has led to multiple contraction for European small caps has been improving earnings, as well as improving earnings growth expectations.

In comparing the multiple contraction in European small caps to U.S. small caps, as shown by the [Russell 2000 Index](#), it is apparent that U.S. valuations have hardly changed since the beginning of the year despite lackluster returns. While U.S. small caps may surprise to the upside this fall if Washington delivers on corporate tax reform, from a valuation perspective, Europe offers an attractive discount when comparing the [WisdomTree Europe SmallCap Dividend Index](#) to the Russell 2000 Index. The valuation discount is particularly notable despite the WisdomTree Index's price increase outpacing that of the Russell Index by more than 15 percentage points.

Index	Avg. Ann. Return	Avg. Ann. Risk	Sharpe Ratio	Beta vs. Russell 2000 Index	Correlation to Russell 2000 Index
WisdomTree U.S. SmallCap Dividend Index	8.67%	19.48%	0.40	0.95	0.93
Russell 2000 Value Index	7.35%	19.17%	0.33	0.99	0.98
Russell 2000 Index	8.32%	19.01%	0.39	1.00	1.00

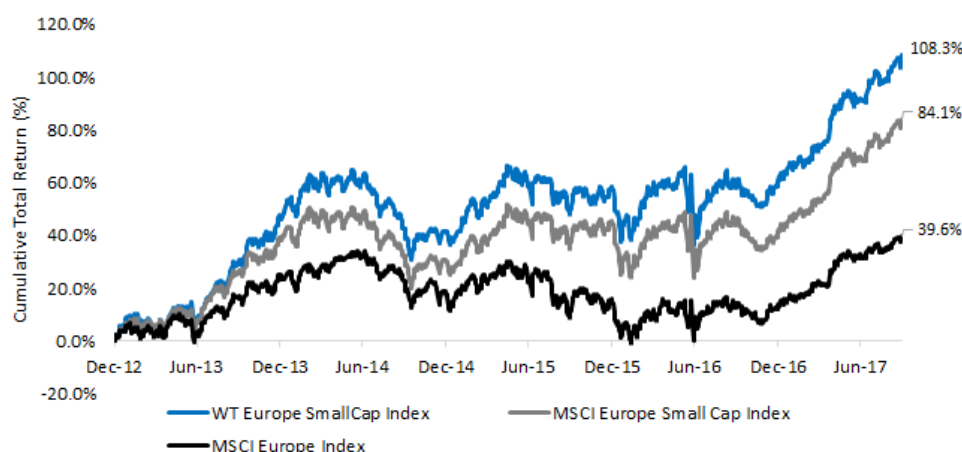
Price and Profit Growth



Sources: WisdomTree, FactSet, Bloomberg, 9/29/17. Profit and price increase calculated in USD. P/E measured by forward price-to-earnings. 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.

Small Caps Tapping into Cyclical Growth

Cumulative Index Total Return (Dec. 31 2012–Sept. 29 2017)



Sources: WisdomTree, Bloomberg. Index returns in net total return USD. Past performance is not indicative of future results. You cannot invest directly in an index.

A slow eurozone recovery, beginning in large part in early 2013 with a commitment to extreme [monetary policy](#) by the European Central Bank (ECB), has resulted in small caps outperforming [large](#) by approximately 45% cumulatively since December 31, 2012, as measured by the [MSCI Europe](#) and [MSCI Europe Small Cap Indexes](#). As [gross domestic product \(GDP\)](#) steadily increased over the past several quarters,¹ the [European Commission's Economic Sentiment Indicator](#) reached a 10-year high² and the United Kingdom was able to broadly weather the economic impacts of the [Brexit](#) vote, the outperformance of small caps has accelerated in 2017 with a return advantage of more than 700 [basis points \(bps\)](#).³ When reviewing the picture of sector and size earnings growth since 2012, we see that small-cap [earnings-per-share \(EPS\)](#) growth outpaces nearly every sector that we define as [cyclical](#) during this [secular recovery](#).

The WisdomTree Europe SmallCap Dividend Index takes this cyclical growth responsiveness a step further with a methodology that imposes a [quality](#) bias and results in an interesting sector tilt toward cyclicals. The WisdomTree Index requires that companies pay [dividends](#) on an annual basis to maintain eligibility for inclusion, and those selected dividend payers are then weighted by their regular cash dividends. As a result, the Index tilts largely toward profitable

companies that have enough earnings to support their level of cash dividends. From a sector perspective, the methodology yields an 83% index weight in what we define as cyclical sectors⁴, compared to a 66% weight for the MSCI Europe Index.⁵

Earnings Growth (12/31/12–9/29/17)

Index	EPS Growth	Cyclical/Defensive
MSCI Europe/Info. Tech	66.9%	Cyclical
WT Europe SmallCap Div.	49.9%	N/A
MSCI Europe Small Cap	41.5%	N/A
MSCI Europe/Cons. Disc.	34.9%	Cyclical
MSCI Europe/Industrials	13.1%	Cyclical
MSCI Europe/Financials	12.7%	Cyclical
MSCI Europe/Health Care	2.7%	Defensive
MSCI Europe/Cons. Stap.	2.1%	Defensive
MSCI Europe	-2.4%	N/A
MSCI Europe/Materials	-7.4%	Cyclical
MSCI Europe/Telecom Serv.	-22.2%	Defensive
MSCI Europe/Utilities	-29.4%	Defensive
MSCI Europe/Energy	-54.8%	Cyclical

Sources: WisdomTree, FactSet. EPS growth in USD. Index returns in net total return USD. Past performance is not indicative of future results. You cannot invest directly in an index.

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

Conclusion: Accessing Value and Growth

For believers in both the small-cap value premium and the European growth story generally, now may be the time to take note of the relatively inexpensive multiples for the WisdomTree Europe SmallCap Dividend Index coupled with underlying profit growth. The [WisdomTree Europe SmallCap Dividend Fund \(DFE\)](#) was launched in June 2006 to track this Index, and the growth uptick in 2017, coupled with the outperformance of small caps, is just the most recent example of this strategy's use as a vehicle to access cyclical growth.

¹Source: "Eurozone GDP growth accelerates to 0.6% in Q2," Financial Times, 8/1/17.

²Source: Trading Economics.

³Source: Bloomberg, 12/30/16–9/29/17.

⁴Cyclical sectors: All sectors excluding Health Care, Telecommunication Services, Utilities and Consumer Staples.

⁵Sources: WisdomTree, FactSet, 9/29/17.

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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.

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You cannot invest directly in an index.

DEFINITIONS

Volatility : A measure of the dispersion of actual returns around a particular average level.

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

Contrarian : Practice of seeing what the majority of market participants are focused on and attempting to look in the complete opposite direction.

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.

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.

Russell 2000 Index : Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

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.

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

MSCI Europe Small Cap Index : A free float-adjusted market capitalization-weighted index designed to measure the performance of developed equity markets in Europe, specifically focusing on the small-cap segment of these equity markets.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

European Commission Economic Sentiment Indicator : refers to a composite indicator made up of five sectoral confidence indicators with different weights: Industrial confidence indicator, Services confidence indicator, Consumer confidence indicator, Construction confidence indicator Retail trade confidence indicator.

Brexit : an abbreviation of "British exit" that mirrors the term Grexit. It refers to the possibility that Britain will withdraw from the European Union.

Basis point : 1/100th of 1 percent.

Earnings per share : Total earnings divided by the number of shares outstanding. Measured as a percentage change as of the annual Index screening date compared to the prior 12 months. Higher values indicate greater growth orientation.

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

Secular Growth : Long term positive trend where the longer-term positive movements cancel out any shorter-term negative movements.

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.

Dividend : A portion of corporate profits paid out to shareholders.