

European small-caps: What fundamentals are telling us

Published 27 March 2018

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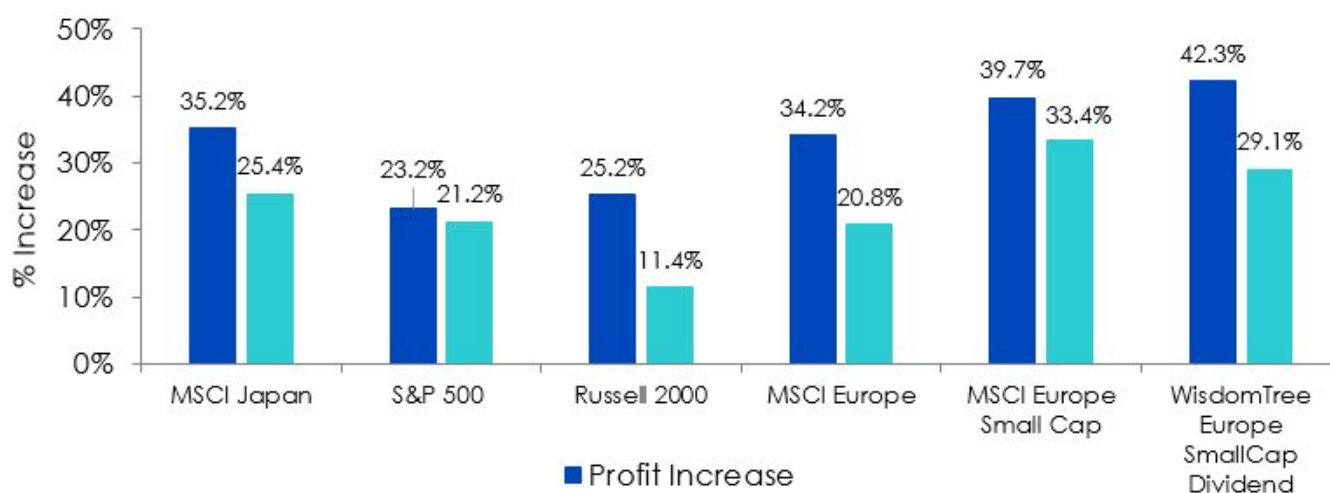
European small-caps have delivered very strong performance over the past few years. One reason for this is that they offer a high degree of exposure to the more cyclical parts of the European equity markets, and these areas have benefited as economic growth expectations and sentiment have been improving.

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. 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 US small-caps, as shown by the Russell 2000 Index, it is apparent that US valuations have hardly changed since the beginning of 2017 despite lacklustre returns. 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 during this period.

Price and profit growth

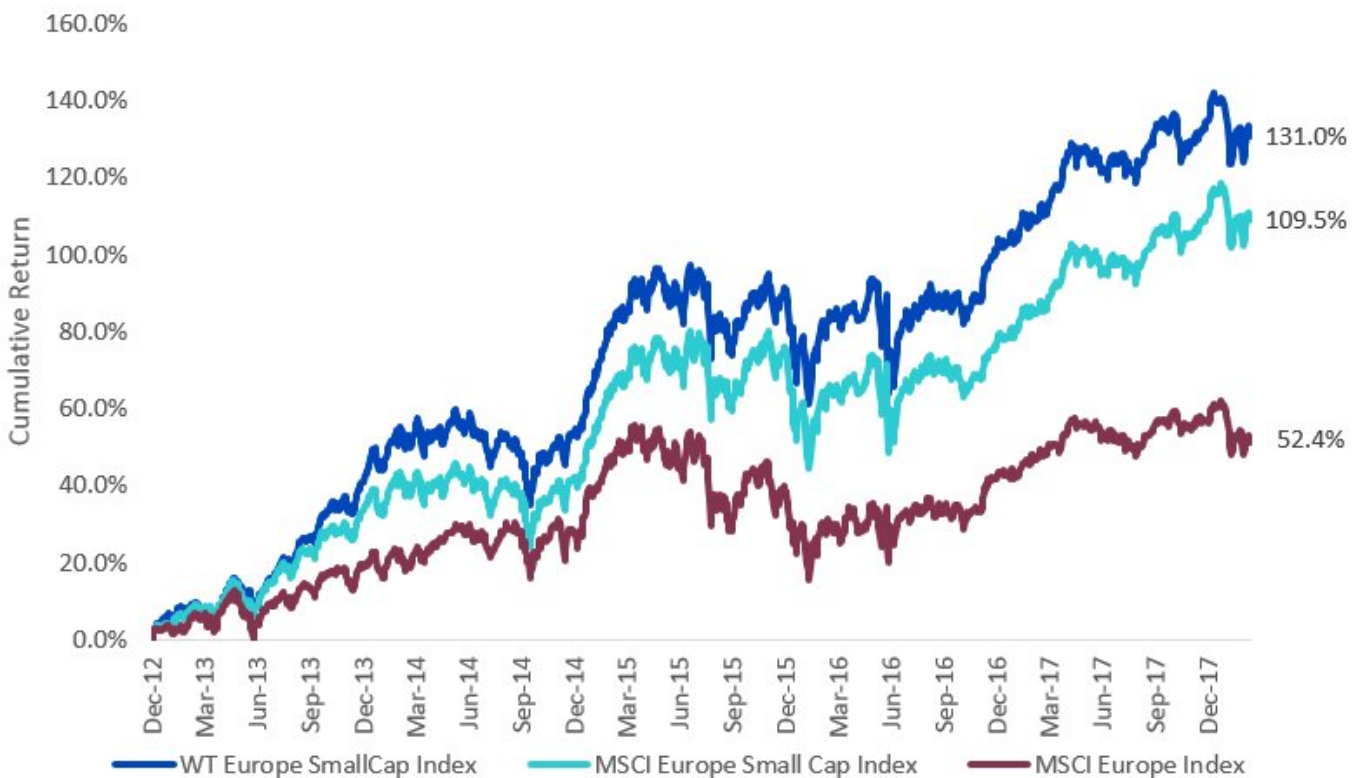


Sources: WisdomTree, FactSet, Bloomberg, as of 30/12/2016 to 28/2/18. Profit and price increase calculated in USD. P/E measured by forward price-to-earnings. You cannot invest directly in an index.

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.

Past performance is not indicative of future results.

Small-caps tapping into cyclical growth



Sources: WisdomTree, Bloomberg. Index returns in net total return EUR. You cannot invest directly in an index.

Past performance is not indicative of future results.

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 significantly 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 quarters¹, 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 accelerated in 2017 with a return advantage of more than 800 basis point (bps)³. When reviewing the picture of sector and size earnings growth since 2012, we see that small-cap earnings-per-share (EPS) growth outpaced 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 a greater than 80% index weight in what we define as cyclical sectors⁴, compared to a less than 70% weight for the MSCI Europe Index⁵.

Earnings growth (31/12/12–28/02/18)

Index	EPS Growth	Cyclical / Defensive
MSCI Europe/Info. Tech	73.2%	Cyclical
WT Europe SmallCap Div.	58.2%	N/A
MSCI Europe Small Cap	55.8%	N/A
MSCI Europe/Cons. Disc.	48.8%	Cyclical
MSCI Europe/Financials	20.0%	Cyclical
MSCI Europe/Industrials	17.8%	Cyclical
MSCI Europe/Materials	11.7%	Cyclical
MSCI Europe/Cons. Stap.	8.6%	Defensive
MSCI Europe	5.8%	N/A
MSCI Europe/Health Care	5.2%	Defensive
MSCI Europe/Telecom Serv.	-16.7%	Defensive
MSCI Europe/Utilities	-26.0%	Defensive
MSCI Europe/Energy	-42.6%	Cyclical

Sources: WisdomTree, FactSet. EPS growth in USD. Index returns in net total return USD. You cannot invest directly in an index.

Past performance is not indicative of future results.

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

2 Source: Trading Economics.

3 Source: Bloomberg, 12/30/16–9/29/17.

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

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

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