

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:

- Unravelling 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.

What has led to multiple contraction for European small caps has been improving earnings, as well as improving earnings growth expectations.

From a valuation perspective, European small caps offer an attractive discount when comparing to global large cap peers, and the WisdomTree Europe SmallCap Dividend Index takes a valuation discipline a step further when compared to the MSCI Europe Small Cap Index. The WisdomTree Index has an annual rebalance back to fundamentals each May when re-weighting constituents based on cash dividends paid over the prior 12 months, and the result that we have seen for the over 11-year live history is that this process results in a valuation sensitive Index.

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Price and profit growth

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Sources: WisdomTree, FactSet, Bloomberg, 29/9/17. Profit and price increase calculated in EUR. 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



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Sources: WisdomTree, Bloomberg. Index returns in net total return EUR. 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 50% cumulatively since 31 December 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 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 nearly 650 basis points (bps).² 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 sectors³, compared to a 66% weight for the MSCI Europe Index.⁴

Earnings growth (31/12/12–29/9/17)

Index	EPS Growth	Cyclical/Defensive
MSCI Europe/Info. Tech	86.1%	Cyclical
WT Europe SmallCap Div.	67.2%	N/A
MSCI Europe Small Cap	57.8%	N/A
MSCI Europe/Cons. Disc.	50.4%	Cyclical
MSCI Europe/Industrials	26.1%	Cyclical
MSCI Europe/Financials	25.6%	Cyclical
MSCI Europe/Health Care	14.5%	Defensive
MSCI Europe/Cons. Stap.	13.8%	Defensive
MSCI Europe	8.9%	N/A
MSCI Europe/Materials	3.3%	Cyclical
MSCI Europe/Telecom Serv.	-13.2%	Defensive
MSCI Europe/Utilities	-21.3%	Defensive
MSCI Europe/Energy	-49.6%	Cyclical

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Sources: WisdomTree, FactSet. EPS growth in EUR. Past performance is not indicative of future results. You cannot invest directly in an index.

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.

Investors may also be interested in reading...

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

² Source: *Bloomberg*, 30/12/16–29/9/17.

³ Cyclical sectors: All sectors excluding Health Care, Telecommunication Services, Utilities and Consumer Staples.

4 Sources: *WisdomTree, FactSet, 29/9/17.*

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