

Why you can't afford to miss European small caps

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WisdomTree

Contributor

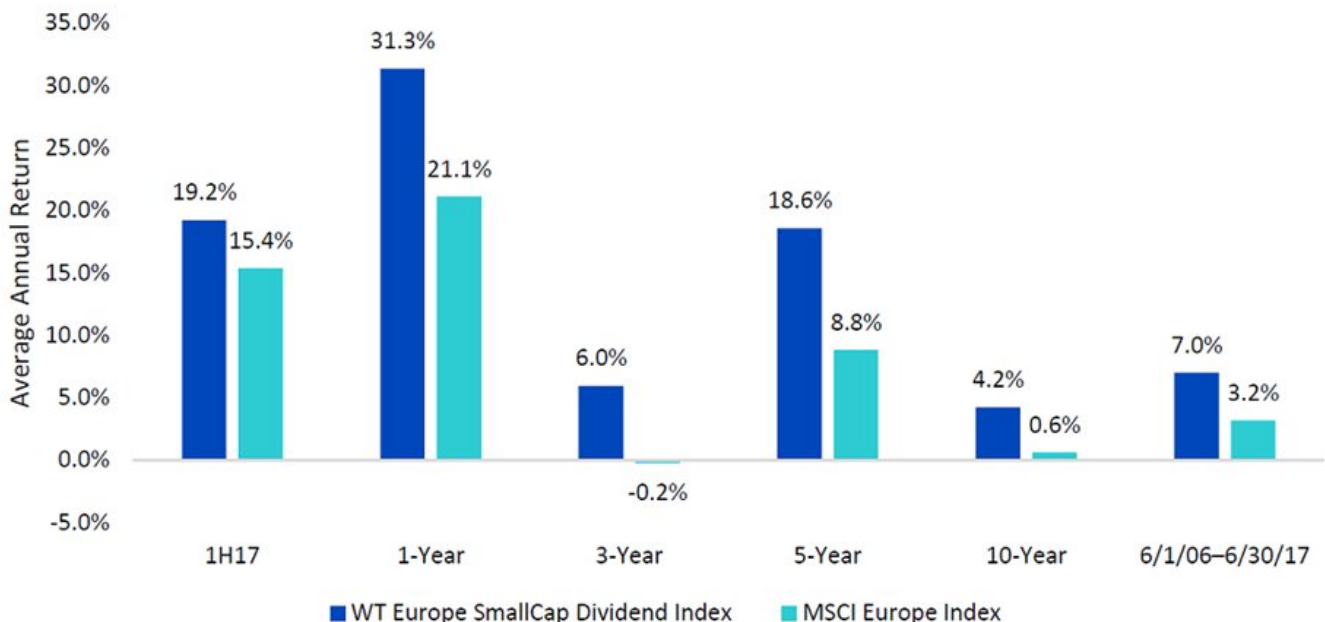
After getting past a variety of elections—most notably the French presidential election—without anti-market sentiment spreading throughout Europe, we have seen a relatively large shift in equity market performance. Fundamentals within Europe were allowed to drive performance as opposed to equity markets needing to be wary of Brexit or Trump-like election surprises.

Europe's fundamentals and, particularly, rebounding earnings have been strong¹.

Small-cap stocks can respond quickly to strong economic/fundamental data

In Europe, we've seen the cyclical nature of small caps—and it happens to be connected to a distinct outperformance over European large caps over the longer term.

European small caps—both short- and long-term track record looks strong



Source: WisdomTree, Bloomberg

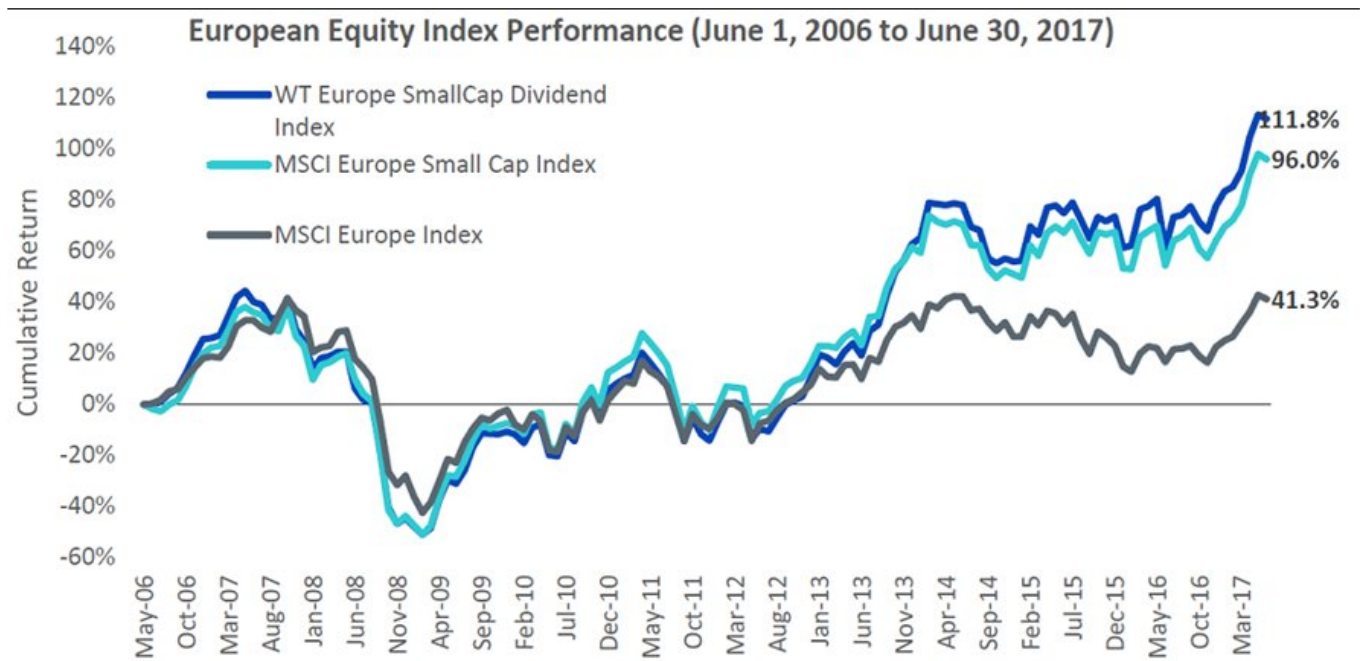
Characteristics of the WisdomTree Europe SmallCap Dividend Index today:

- **Revenue:** First, it's notable that almost 70% of weighted average revenue comes from inside of Europe². Investors who are excited about European equities today are largely excited by what is happening within Europe, and small caps tend to be a purer play on this theme.
- **Cyclical exposures:** Second, it's notable that more than 83% of the weight of the WisdomTree Europe SmallCap Dividend Index is in cyclical sectors³. This gives the Index a very offense-oriented positioning, and when positive catalysts (such as labour market reform bills) come in, there tends to be a greater potential to respond.
- **Track record:** Finally, in the first half of the year the performance has been over-10%, while the one-year performance has been over 27% to 30 June 2017, in euro terms. The WisdomTree Europe SmallCap Dividend Index has been live since 1 June 2006, which gives investors more than 11 years to assess its performance.

Is adding European small caps to European equity exposures additive?

Across many of the clients that we speak to there has been a notable trend in behaviour. Equity exposures tend to be very stratified in that there may be region-specific strategies, style-specific strategies, factor strategies and size-segment-specific strategies. In short, there are myriad ways in which the performance of equities tends to be accessed.

European small caps have distinctly outperformed since 1 June 2006 and rolling period sharpe ratio analysis also looks strong



Source: WisdomTree, Bloomberg

Index Name

Avg. Ann. Return

Avg. Ann. Std. Dev.

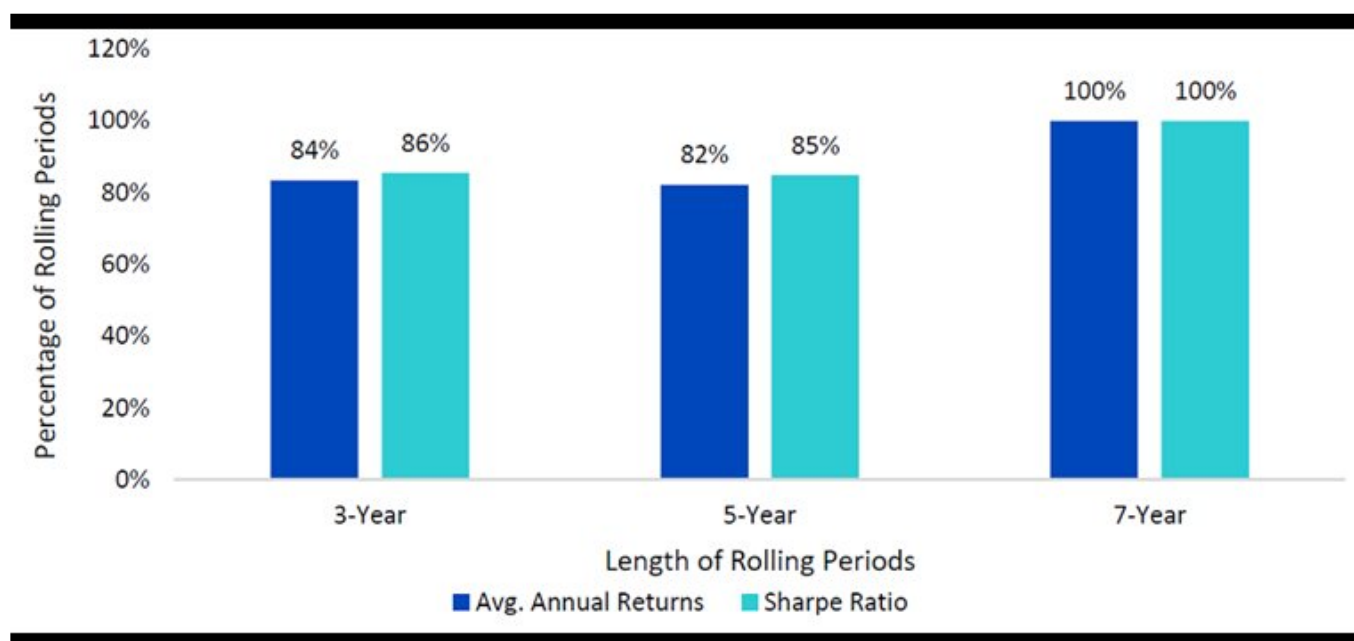
Sharpe Ratio

WisdomTree Europe SmallCap Dividend Index

MSCI Europe Small Cap Index

MSCI Europe Index

Percentage of specified rolling periods where WT Europe SmallCap Dividend Index Sharpe Ratio Beat MSCI Europe Index Sharpe Ratio 01/06/2006 to 30/06/2016



Source: WisdomTree, Bloomberg

- **Small caps can steer around more global concerns:** We can see clearly that there was a divergence around May 2013. Both the WisdomTree Europe SmallCap Dividend Index and the MSCI Europe Small Cap Index opened up significant outperformance over the MSCI Europe Index. As concerns about European banks and energy firms have occurred at times between May 2013 and June 2017, it's important to remember that in most cases these are large companies.
- We additionally looked at rolling subperiods of three, five and seven years. Now, our prior chart indicates a track record of outperformance, but it is really just one period of slightly more than 11 years. What about different subperiods of three, five or seven years? While on a rolling seven-year basis the WisdomTree Europe SmallCap Dividend Index both outperforms and has a higher Sharpe ratio in 100% of periods observed, both the three and five-year rolling period analysis gives the nod to the WisdomTree strategy a bit more than 80% of the time when compared to the MSCI Europe Index.

Disciplined rebalance process

The strong gains witnessed above might lead the contrarian to think: “won’t these gains just be reversed if they have come too far?” Every June, WisdomTree conducts an annual rebalance that is designed to manage market valuation risk and reduce exposures to stocks whose prices appreciated more than underlying fundamentals—and, in our case, this is measured by changes in dividend streams. This leads to the WisdomTree European SmallCap Dividend Index to have a dividend yield of 3.6%, a P/E ratio around 16x on trailing 12 month and 14x on forward 12 month basis, and a price-to-cash flow of less than 10x. A relative attractive investment picture emerges as far as the valuation discount of WisdomTree Europe SmallCap Dividend Index is concerned to MSCI Europe SmallCap and MSCI Europe.

Valuations point to potential opportunity in Europe over the US

Valuation Metrics

WT Europe SmallCap Dividend Index

MSCI Europe Small Cap Index

MSCI Europe Index

Dividend Yield

Trailing P/E Ratio

Estimated P/E Ratio

Price/Book Ratio

Price/Sales Ratio

Price/Cash Flow Ratio

Sources: WisdomTree, Factset. You cannot invest directly in an index

1 Bloomberg, with data as of 30/06/17.

2 WisdomTree, FactSet, with data as of 31/05/17.

3 WisdomTree, Bloomberg, with data as of 30/07/2017.

Important Risks Related to this Article

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