

EUROPEAN SMALL CAPS: SENSITIVITY TO EUROPE'S BUDDING ECONOMIC RECOVERY AND UNIQUE LONG-TERM PERFORMANCE

+ Co-authored by **JEREMY SCHWARTZ** [CFA®, WisdomTree Director of Research]

CHRISTOPHER GANNATTI [CFA®, WisdomTree Associate Director of Research]

After the global financial crisis of 2008–09, one of the most maligned regions in the global economic landscape was Europe. Many focused on the banks being perceived as over-leveraged¹, not to mention the imbalances between different countries. It appeared that certain strong countries (such as Germany, France or the Netherlands) were destined to carry the weaker countries (Spain, Italy, Portugal, Ireland and Greece).

But as we begin 2014, sentiment among investors with regard to Europe seems to be building positive momentum. The foundation of this shift in sentiment appears to be a positive turn in economic data. Many believe the profit cycle still has room to catch up with the turn in gross domestic product (GDP)² indicators—as European indexes that are focused on small caps still see earnings that are about 50% below their prior peaks.³ Some analysts believe small-cap European companies have greater earnings growth prospects than large caps.

The European economic recovery is far from risk free, but factors on the policy front seem to be favorable to continuing the momentum. For example, the European Central Bank (ECB) lowered its main refinancing rate by 0.1% in June and announced a slew of measures including negative deposit rates, ending sterilization, and initiating targeted long term liquidity operations to support growth and stem dis-inflation in the Eurozone.⁴

DIALING UP ECONOMIC SENSITIVITY WITH EUROPEAN SMALL-CAP STOCKS

At WisdomTree, we believe that small caps have the potential to offer an interesting complement to many existing regional equity allocations—a phenomenon that is especially true for Europe today. We can explore this complementarity through the WisdomTree Europe SmallCap Dividend Index (WTESC), zeroing in on three distinct characteristics:

- + More Exposure to Europe's Local Recovery:** While European large-cap companies by and large are global revenue generators whose ultimate success is more highly leveraged to the global economy than just Europe, European small caps tend to earn their revenues from within Europe.
- + Over 83% Exposure to Cyclical Sectors:** These sectors, especially among small-cap companies, are poised to be sensitive to changes in economic expectations, such as increases in consumption or capital spending.
- + A positive long-term performance record.**

¹ Leverage: Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.

² Gross domestic product (GDP): The sum total of all goods and services produced across an economy.

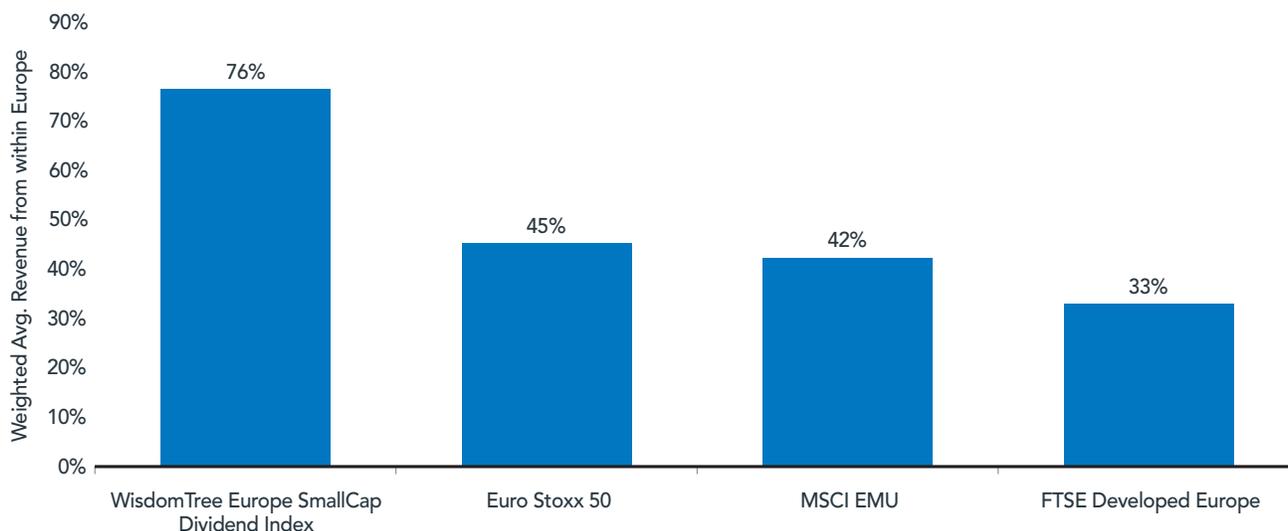
³ Source: Bloomberg. Indexes: MSCI Europe Small Cap and WisdomTree Europe SmallCap Dividend Index. "Peak" refers to highest measured trailing 12-month earnings per share for 6/1/2006–6/30/2014.

⁴ Source: Mario Draghi, Governing Council Meeting of the ECB, 6/11/14.

SMALL CAPS FOR DOMESTIC REVENUE EXPOSURE

Our first study concerns the weighted average revenues from within Europe for the top 10 constituents of some of the most widely followed European equity indexes (Euro Stoxx 50, MSCI EMU and FTSE Developed Europe Index). These indexes are focused on large-cap companies, either explicitly (the Euro Stoxx 50 focuses on 50 very large stocks in the eurozone) or as a by-product of a market capitalization-weighted⁵ methodology. WTESC represents WisdomTree's take on small-cap European dividend payers. None of these indexes' methodologies explicitly focuses on screening the geographic revenues of constituents, so these results are truly just a by-product of the equity market segment being focused upon.

FIGURE 1: WEIGHTED AVERAGE REVENUE FROM EUROPE FOR TOP 10 CONSTITUENTS [As of 12/31/2013]



Source: Bloomberg. Past performance is not indicative of future results. You cannot invest directly in an index.

+ WTESC has Delivered Greater European Revenues: While we recognize that these are only the top 10 holdings of each index, the comparison is fairly stark between WTESC and the large-cap indexes of European equities.

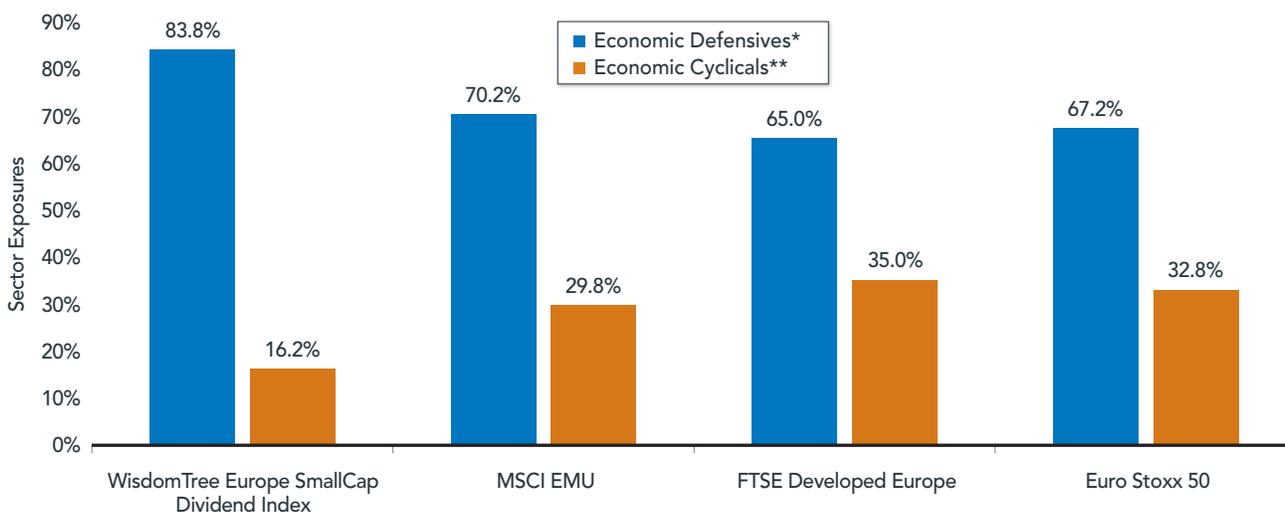
SMALL CAPS OFFER SECTOR EXPOSURES THAT CAN BENEFIT FROM ECONOMIC GROWTH INFLECTION

If we take the view that a particular economy (in this case Europe) is on the path to recovery, there are certain sectors that have greater potential to respond than others. In our estimation, the performance of the cyclical sectors—has the potential to be very sensitive to economic cycles.

⁵ Market capitalization-weighted: Market cap = share price x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

Other sectors—Consumer Staples, Health Care, Telecommunication Services and Utilities—are notably more defensive in nature, see their businesses fluctuate less with economic cycles and are often the favored sectors when future growth is perceived to be sluggish or a downturn in sentiment is expected.

FIGURE 2: ECONOMY CYCLICAL VS. ECONOMIC DEFENSIVE SECTOR EXPOSURES [As of 6/30/2014]



*Economic Defensives: Consumer Staples, Health Care, Telecommunication Services and Utilities.

**Economic Cyclicals: Consumer Discretionary, Industrials, Information Technology, Energy, Financials & Materials.

Source: Bloomberg. You cannot invest directly in an index. Subject to change.

- + **WTESC Incorporates Over 83% Exposure to Cyclicals: The largest-component sector would be Industrials, weighted at over 28%, indicating a potential to show significant sensitivity to upticks in economic activity.**
- + **Within Europe, the economic defensives contain companies that can be quite large. WTESC avoids these areas, most notably with its less than 3.5% weight in Utilities and Telecom Services.**

THE WISDOMTREE PERFORMANCE DIFFERENTIAL

Thus far, we’ve discussed indexes that are designed to measure the performance of different types of European equities, but at the end of the day, indexes are not directly investable. The WisdomTree Europe SmallCap Dividend Fund (DFE) is designed to track the returns of WTESC after costs, fees and expenses, so a more robust test of performance would involve measuring not the performance of the Index but the performance of DFE, a study we undertake in figures 3a and 3b.

FIGURE 3A: AVERAGE ANNUAL RETURNS [As of 6/30/2014]

Fund/Index	Fund Information			Total Return (NAV)					Market Price				
	Fund Ticker	Fund Exp. Ratio	Fund Inception Date	YTD	1-Year	3-Year	5-Year	Since Fund Inception	YTD	1-Year	3-Year	5-Year	Since Fund Inception
WisdomTree Europe SmallCap Dividend Fund	DFE	0.58%	6/16/06	7.29%	45.45%	15.66%	20.24%	7.46%	6.37%	45.80%	15.62%	20.28%	7.33%
WisdomTree Europe SmallCap Dividend Index				9.38%	49.34%	16.78%	20.88%	8.02%	9.38%	49.34%	16.78%	20.88%	8.02%
MSCI Europe Small Cap Index				5.53%	38.25%	12.42%	18.87%	8.16%	5.53%	38.25%	12.42%	18.87%	8.16%
FTSE Developed Europe Index				5.65%	29.61%	8.81%	13.30%	4.84%	5.65%	29.61%	8.81%	13.30%	4.84%
MSCI EMU Index				4.93%	33.54%	6.25%	10.36%	3.00%	4.93%	33.54%	6.25%	10.36%	3.00%
Euro Stoxx 50 Index				5.36%	34.30%	5.65%	9.05%	2.57%	5.36%	34.30%	5.65%	9.05%	2.57%

Source: WisdomTree.

Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Performance data for the most recent month-end is available at www.wisdomtree.com.

WisdomTree shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Total returns are calculated using the daily 4:00 p.m. EST net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times. You cannot invest directly in an index.

FIGURE 3B: DFE'S SMALL-CAP PERFORMANCE SURPRISES [7/1/2006–6/30/2014]

Peer Group: Morningstar ETF & Mutual Fund Europe Stock

Fund Name	1-Year			3-Year			5-Year			7/1/2006 to 6/30/2014		
	Return	Percent of Peer Group Beaten	Rank in Peer Group	Return	Percent of Peer Group Beaten	Rank in Peer Group	Return	Percent of Peer Group Beaten	Rank in Peer Group	Return	Percent of Peer Group Beaten	Rank in Peer Group
WisdomTree Europe SmallCap Dividend Fund	45.45%	100%	1	15.66%	100%	1	20.24%	100%	1	6.95%	85%	12
WisdomTree Europe SmallCap Dividend Index	49.34%	100%	1	16.78%	100%	1	20.88%	100%	1	7.50%	89%	9
MSCI Europe Small Cap Index	38.25%	98%	3	12.42%	90%	11	18.87%	98%	3	7.14%	88%	10
FTSE Developed Europe Index	29.27%	76%	28	8.47%	41%	59	12.97%	44%	50	4.55%	43%	44
MSCI EMU Index	33.54%	90%	12	6.25%	16%	83	10.36%	11%	78	3.02%	20%	61
Euro Stoxx 50 Index	34.30%	92%	10	5.65%	9%	90	9.05%	1%	87	2.56%	11%	68
Number of Managers		114			98			87			75	

Past performance is not indicative of future results. Source: Morningstar Direct.

2014 Morningstar, Inc. All rights reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. Past performance, rankings and ratings are no guarantee of future results. The Rank in Peer Group category is the funds' total-return percentile rank relative to all funds in the same Morningstar Category and is subject to change each month. Regarding ranking of funds, 1 = Best and 114 = Worst, using the 1-year time frame as an example where there were 114 managers with performance extending through the full period.

+ Not only is DFE a unique exchange-traded fund (ETF) in the marketplace, as the only U.S.-listed ETF to offer exposure to the small-cap segment of European stocks,⁶ it also stands out for its positive performance record over short- and long-term periods.

⁶ Source: Morningstar Direct. Of all U.S.-listed ETFs in Morningstar's Europe Stock Category, DFE was the only one tracking the performance of an index (after costs, fees and expenses) with specific focus on small-cap equities.

- + **One-Year Number Over 45%:** DFE delivered strongly over the past year and was the top performing option within Morningstar's Europe Stock category over this time frame. To provide some context, we do show that the MSCI Europe Small Cap Index also performed quite well over the period. There were, in fact, three mutual funds in this category that specifically focused on European small caps during this period, but DFE was the only ETF option, and as the top performer, DFE beat them all.
- + **Longer Periods Offer the "Surprise":** Over three years, five years and since July 1, 2006, the longest available period (given DFE's June 16, 2006, inception date), the performance numbers are, in our opinion, impressive. The since-inception figure warrants special attention because one would think that large-cap multinationals would be in a better position to weather the impending 2008–09 storm. One potential explanation could be that it was more important to avoid exposure to the large-cap European banks at that time than it was to generate exposure to global revenue streams. The five-year period actually brings the analysis back to mid 2009, so it is in essence a study of the snap back from some of the 2008–09 global financial crisis lows and shows both a high absolute return figure over 20% per year for five years, as well as strong relative returns compared to large-cap benchmarks.

WHAT SECTORS AND COUNTRIES DROVE THESE RESULTS?

While these numbers look strong, we believe that many would want to look under the hood to gain a better understanding of the types of exposures that are driving the results. For example, it may be interesting to know whether the more economically cyclical sectors that we discussed earlier are in fact leading the charge, as well as whether the strongest performance is coming from the peripheral countries or the core countries in Europe. We'll look at some data going back to June 2012 through June 30, 2014—as this is when the notable shift in European equities occurred from a downward/flat trend to a notable upward move—thereby analyzing how WTESC responded during a sustained upward market move.⁷

- + **The Sector Picture:** Four out of the six cyclical sectors maintained average weights above 10% in WTESC over the period—Industrials, Consumer Discretionary, Financials and Information Technology. All four of these sectors returned over 90% in this time period. Therefore, the sectors that we designated as being potentially sensitive did, in fact, exhibit strong performance.
- + **The Country Picture:** Four countries maintained average weights above 10% in WTESC over the period—United Kingdom, Italy, Sweden and Germany. Of these, Sweden was the worst performer, up more than 82%, whereas Italy was the best performer, up more than 138%. What is evident is that every country exposure in WTESC was positive over this period. The UK, Sweden and Germany offer examples of large exposures to more "core" European countries in WTESC that performed well, whereas Italy represents an exposure to a weaker, peripheral country that exhibited strong performance, recovering from some of its perceived issues.

⁷ Source for both bullets: Bloomberg, 6/29/2012–6/30/2014.

THE SO-CALLED “SECRET SAUCE”

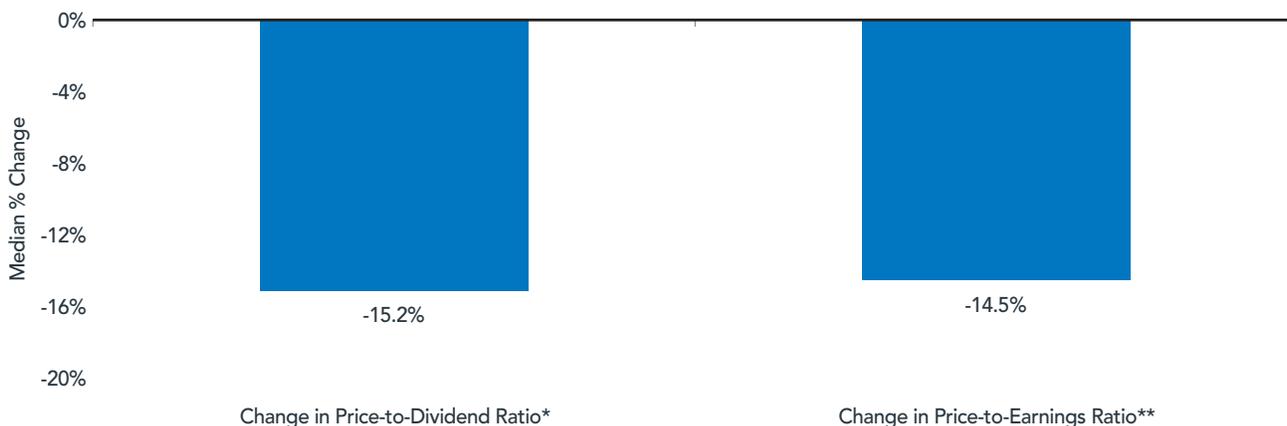
So, how did DFE (in tracking the performance of WTESC) do it—namely take one of the most volatile periods we have seen roil global equity markets, and deliver such strong performance, the whole time exhibiting a continual focus on, of all things, small-cap stocks?

First of all, we believe that the answer comes in the form of the relative simplicity of what WTESC’s methodology is looking to achieve—providing a measure of the performance of small-cap dividend payers in Europe. There is no committee expressing opinions about individual countries, sectors or even companies, selecting some and excluding others. Each year, we merely scan the dividend-paying universe of European equities, zeroing in on the smaller end of the market capitalization spectrum and weighting firms by the cash dividends they have paid. If there were two points to focus on to conceptualize this effective relative value⁸ rebalance in the case of WTESC, they would be dividend growth and price performance.

- + **Typical Additions in Weight:** Firms whose share prices may have performed poorly or stayed flat but whose dividends increased.
- + **Typical Reductions in Weight:** Firms whose share prices may have performed quite well but whose dividend growth was negative or flat.

If the “reward” can be thought of as greater representation in the Index, the path to get there does not come through gaining larger market capitalization (as it does with the other indexes in this piece) but rather through dividend growth that supersedes share price performance.

FIGURE 4: ILLUSTRATING THE RELATIVE VALUE REBALANCE AT WORK



Sources: WisdomTree, Standard & Poor’s. Past performance is not indicative of future results.
 *Change in price-to-dividend ratio: Median percentage change in the price-to-dividend ratio for live rebalances occurring based on 5/31/2007, 5/31/2008, 5/31/2009, 5/31/2010, 5/31/2011, 5/31/2012, 5/31/2013 and 5/31/2014 Index screenings. The price-to-dividend ratio is the inverse of the trailing 12-month dividend yield, and higher values indicate that the prior 12 months of dividends are more expensive, while lower values indicate they are less expensive. “Median” refers to the value at which 50% of all observations occur above and 50% occur below.
 **Change in price-to-earnings ratio: Median percentage change in the price-to-earnings ratio for live rebalances occurring based on 5/31/2007, 5/31/2008, 5/31/2009, 5/31/2010, 5/31/2011, 5/31/2012, 5/31/2013 and 5/31/2014 Index screenings.

⁸ Relative value: The relationship between a particular attribute, e.g., a dividend, and the firm’s share price compared to that of another firm.

Figure 4 attempts to quantify the impact seen on WTESC of each of eight live annual rebalances occurring since its inception on June 1, 2006.

- + **The Price-to-Dividend (P/D) Ratio:** This is the inverse of the dividend yield⁹. A declining P/D ratio is synonymous with an increasing dividend yield, in other words, prices have gone down relative to the prior 12 months of dividends paid. Since WTESC includes only dividend payers and weights constituents on the basis of their dividends paid over the prior 12 months, this result is not all that unexpected.
- + **The Price-to-Earnings (P/E) Ratio:** On the other hand, no part of WTESC's methodology explicitly focuses on reducing its P/E ratio, although from what we see here it has been a welcome side effect.

CONCLUSION: EXECUTING ECONOMIC SENSITIVITY

WTESC (and DFE which is built to track its performance after costs, fees and expenses) offers a unique way to truly express the investment view that Europe is poised for continuing momentum in its recovery. Additionally, WTESC is built to readjust its focus back to relative value each and every year. Given the strong equity performance in 2013-2014, the June 2014 rebalance readjusted weights back to the dividends the constituents have paid, mitigating the risk of the Index becoming overly exposed to expensive stocks. While past performance can never indicate future results, DFE has built an impressive track record doing exactly that.

⁹Dividend yield: A financial ratio that shows how much a company pays out in dividends each year relative to its share price.

Unless otherwise stated, data source is WisdomTree.

Investments focused in Europe are increasing the impact of events and developments associated with the region, which can adversely affect performance.

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. WisdomTree, its affiliates and their independent providers are not liable for any informational errors, incompleteness or delays or for any actions taken in reliance on information contained herein.

Dividends are not guaranteed, and a company's future ability to pay dividends may be limited. A company currently paying dividends may cease paying dividends at any time.

Investors should carefully consider the investment objectives, risks, charges and expenses of the Funds before investing. To obtain a prospectus containing this and other important information, call 866.909.WISE (9473) or visit wisdomtree.com. Read the prospectus carefully before you invest.

There are risks associated with investing, including possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Funds focusing their investments on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

WisdomTree Europe SmallCap Dividend Index: A fundamentally weighted index meant to measure the performance of dividend-paying European small-cap equities, weighted by cash dividends paid. 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. FTSE Developed Europe Index: Measure of the performance of developed European companies, weighted by market capitalization. MSCI EMU Index: A free float-adjusted market capitalization-weighted index designed to measure the performance of the markets in the European Monetary Union. Euro Stoxx 50 Index: Measures the performance of 50 large-cap blue-chip stocks in the eurozone.

WisdomTree Funds are distributed by ALPS Distributors, Inc.

Jeremy Schwartz and Christopher Gannatti are registered representatives of ALPS Distributors, Inc.

© 2014 WisdomTree Investments, Inc. "WisdomTree" is a registered mark of WisdomTree Investments, Inc.

WIS006603 3/2015

