

Deep Capacity Can Be a Benefit to Index Based Investing: The Case of European Small Caps

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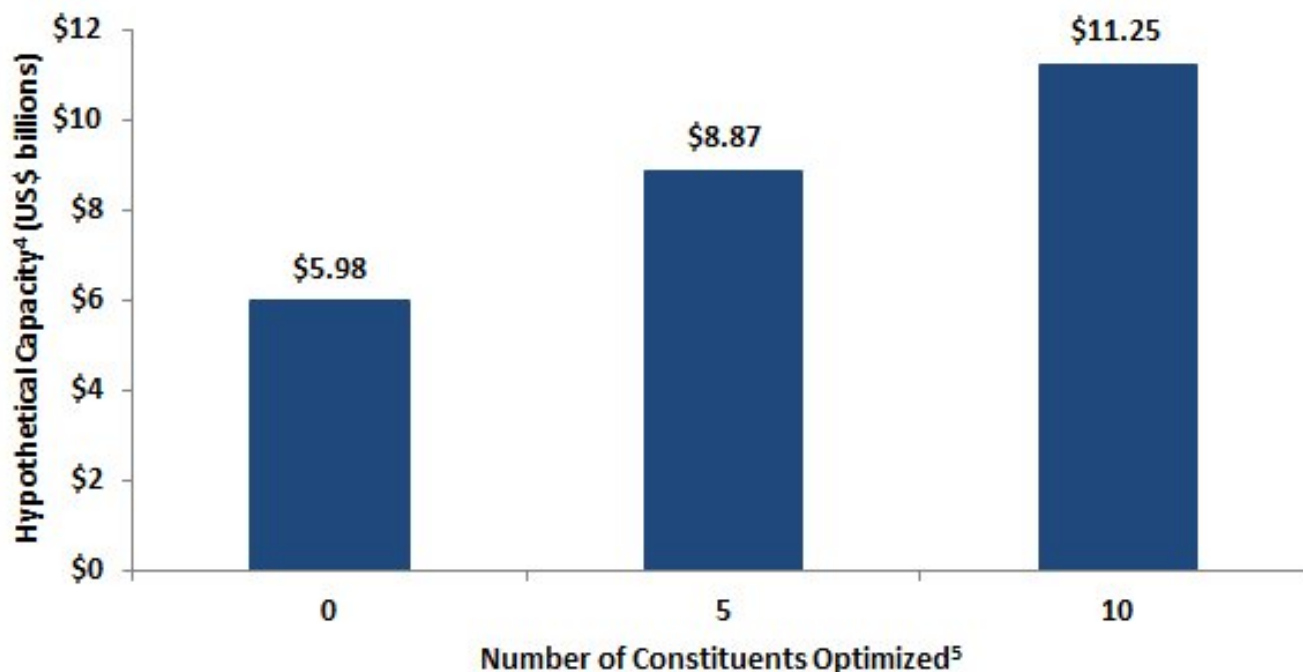
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Until fairly recently, investors relied principally on actively managed mutual funds to gain exposure to the markets—especially for small-cap options around the world, where many believe that opportunities are ripe for active managers to add value. Small-cap stocks, generally speaking, do not garner the same level of analyst coverage, and many believe informational inefficiencies provide richer opportunity sets for stock pickers to potentially outperform index benchmarks. After a strong performance during 2013, many have set their sights on European small caps¹ in particular, and significant levels of assets have flowed into Europe (as Zach discussed in this prior [blog post](#)). **Index-Based Strategies Offer a New Option** Although Europe is an important focus for developed international investors, there are limited choices available to those interested in targeting exposure to European small-cap companies. Looking at the U.S.-listed mutual funds and exchange-traded funds (ETFs) in Morningstar's Europe Stock category, as of December 31, 2013, there was only one ETF and three mutual funds specifically focused on small caps.² To give readers some idea of the size of these traditional mutual funds focused on European small caps, as of December 31, 2013, the largest had slightly over \$650 million, and the smallest almost \$28 million in assets. To put this in context, the largest U.S.-listed mutual fund in this same category had almost \$20 billion in assets as of that same date. As of December 4, 2013, the largest mutual fund strictly focused on small caps in the Morningstar Europe Stock category was actually closed to new investors.³ This highlights a central concern many have for active strategies in the small-cap space: managers often reach capacity because the companies being targeted for exposure within the funds are small, and for a fund to maintain a significant enough exposure in high-conviction ideas to potentially impact performance, larger and larger positions have to be taken. **A Benefit to Index-Based Investing: Breadth of Holdings Creates More Capacity** One of the benefits to index-based strategies is the breadth of holdings. Index-based strategies are not trying to make a small selection of stocks to outperform a market segment; they are trying to identify liquid and investable companies representative of a specific investment theme. In our view, the larger size of the investing universe for index-based strategies creates greater investment capacity. Of course, index methodology is crucial to determining both capacity and representation, as not every index tracking the performance of equities is designed with scale in mind. WisdomTree has built its Indexes with this potential for scalability in mind. To accomplish more capacity in its Index-tracking strategies, WisdomTree designed its European-focused equity Indexes to emphasize the cash dividends each company pays—but to do so in a way that looks at aggregate dividends paid, which gives greater weight to bigger companies. In most

cases, WisdomTree weights and rebalances its Indexes annually according to their *Dividend Stream*®.

Dividend Stream = Dividends per share x shares outstanding By including shares outstanding in the weighting, we believe we introduce greater potential capacity to the strategies tracking the performance of our Indexes after costs, fees and expenses. It is important to set a baseline when discussing the concept of capacity, as it can mean a number of different things. We define one measure of capacity as: “At what asset level would an index-tracking strategy hold more than 10% of a particular underlying holding?” **The WisdomTree Europe SmallCap Dividend Index Incorporates Scalability into Its Approach**



Sources: WisdomTree, Standard & Poor's; data as of 12/31/2013.

- **Scalable Methodology:** On December 31, 2013, the [WisdomTree Europe SmallCap Dividend Index](#) had 284 constituents. Almost \$6 billion of hypothetical assets could track this Index prior to its holding 10% of the market capitalization of any underlying firms.
- **Optimization Helps Further:** Were one to optimize around the 5 or 10 most constraining firms, the level of hypothetical assets prior to reaching a 10% position in any underlying firm could jump from \$6 billion to over \$11 billion. To be fair, optimization such as this could lead to greater potential for tracking error. For reference, the 5 and 10 most constraining firms represented approximately 8% and 11%, respectively, of the Index's weight as of December 31, 2013.
- **A Benefit to Proprietary Indexing:** One benefit to WisdomTree being the Index developer and ETF sponsor is WisdomTree maintains additional flexibility allowing us to increase the capacity of our Indexes and the ETFs that track their performance after costs, fees and expenses.

Innovative Methodology The WisdomTree Europe SmallCap Dividend Index is designed to zero in on European small-cap companies that pay dividends. Weighting by cash *Dividend Stream* lends a degree of scalability to the Index in that it accounts for the number of shares outstanding. There are few funds available today that provide exposure to European small caps, and the largest traditional mutual fund just closed to new investors recently. This blog post highlights the benefits of following an index-based approach to get exposure to this asset class,

of which there are very few vehicles open to investors. For current holdings in the WisdomTree Europe SmallCap Dividend Index, click [here](#). 1European small caps: Refers to constituents of the WisdomTree Europe SmallCap Dividend Index, which delivered nearly 50% returns for the 2013 calendar year. Source: Bloomberg. 2Source: Morningstar Direct. 3Source: Invesco.com. 4Refers to a hypothetical capacity level for assets tracking the performance of an Index, which denotes the level of assets where the Index would prescribe taking its first 10% position in an underlying constituent. 5These numbers refer to hypothetical optimizations in which every security in the Index is held ("0"), to omitting the 10 most constraining positions ("10").

Important Risks Related to this Article

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. 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. Investments focused in Europe are increasing the impact of events and developments associated with the region, which can adversely affect performance. ETF shares are not sold or bought at their net asset value (NAV) the way mutual fund shares are. ETF shares' market price may be at, above or below the fund's NAV. The fund's NAV will fluctuate with changes in the market value of its portfolio holdings, and the market price of an ETF's shares will fluctuate with changes in the NAV and the supply and demand in the market for the shares. The market price of ETF shares may differ significantly from their NAV during periods of market volatility. ETF shares may only be redeemed directly with the fund at NAV by authorized participants in very large redemption/creation units.