

Looking Beyond ETFs That Track Broad Based European Indexes

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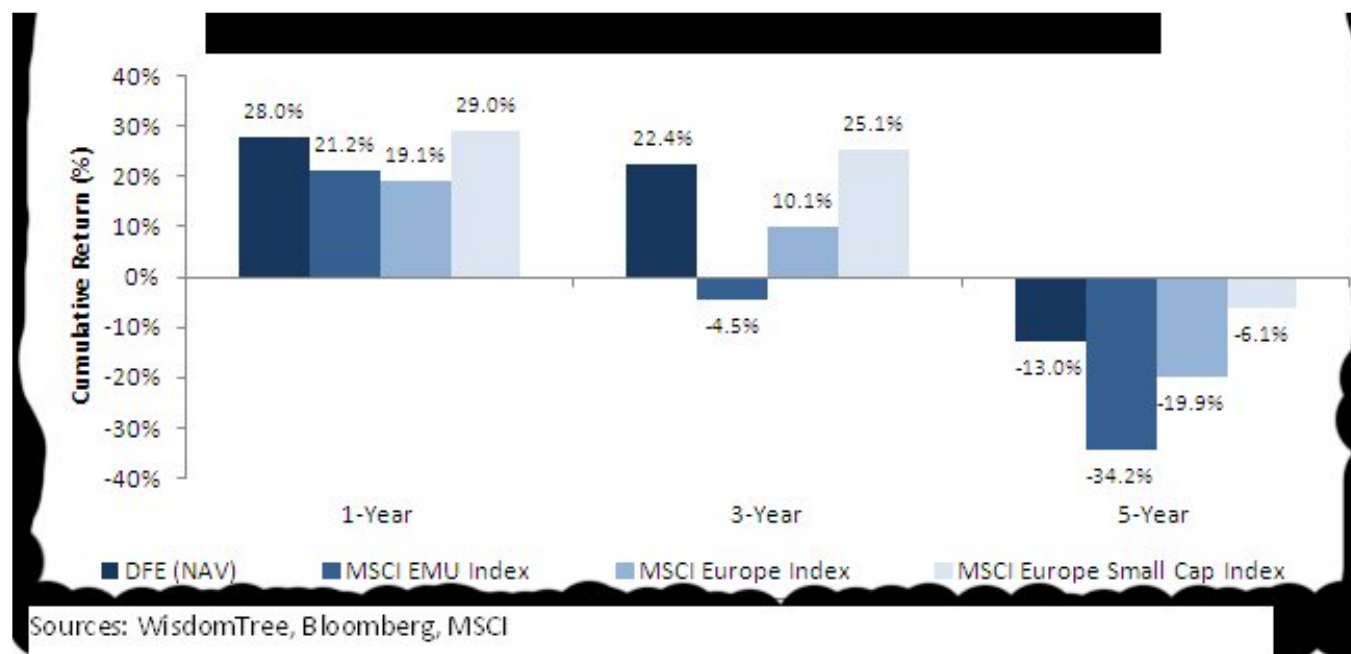
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In a recent [blog](#), I wrote that investor flows into European exchange-traded funds (ETFs) had been high in 2012 and that investors should consider how much conviction they have for the euro—meaning whether they believe its value will increase or decrease against other currencies. If they don't have much conviction and aren't sure if it will tend to appreciate or depreciate against other currencies, they could consider a neutral 50/50 baseline allocation that splits their exposure evenly between European investments with currency exposure and others that hedge currency exposure. **Minimize Regret with 50/50 Framework** I believe this 50/50 hedged /not hedged model helps minimize the potential for regret. With hindsight, one will always know if taking or hedging the currency exposure would have been better—but to make that call ahead of time is extremely difficult. With the 50/50 model, the risk of regret is mitigated by the diversification of the overall approach: part of the portfolio will be helped if the currency appreciates, and part of the portfolio will mitigate the impact of currency depreciation. In this blog, I will explore an option for the part of this 50/50 allocation that does have the currency exposure (i.e., that is not hedged) but goes beyond the traditional broad-based, large-cap baskets of stocks that most focus on (which tend to be represented by indexes such as the MSCI Europe Index or the MSCI EMU Index). Both of these MSCI indexes are market capitalization weighted¹—meaning that the firms with the largest market caps receive the highest weights. Ultimately, this results in the exposure of these indexes being tilted away from small-cap firms and toward large-cap firms. **Only European Small Cap ETF** There are ETFs tracking small caps in most parts of the world, which include such regions as the United States, developed international markets, emerging markets and many specific individual countries. But there is currently only one exchange-traded Fund (ETF) in the U.S. that focuses strictly on European small-cap companies: the [WisdomTree Europe SmallCap Dividend Fund \(DFE\)](#), an ETF from WisdomTree designed to track the WisdomTree Europe SmallCap Dividend Index. This Index targets small-cap dividend-paying European companies and weights these companies by the dollar value of the cash dividends that they have paid.² This dividend-focused methodology helps tap into where we see valuation opportunities—most typically, firms that increase their dividends over the course of the year but whose share prices fall or stagnate would see increases in weight during the annual Index rebalance, while firms that simply maintain or shrink their dividends but whose share prices rise would typically see decreases in weight. Generally speaking, we believe that European equity markets are particularly ripe with potential bargains, given the ongoing uncertainty regarding their potential for sluggish economic growth. **Why Consider Small Cap Equities in Europe?** The answer starts with the real-time performance history of DFE (NAV). DFE has performed quite well compared to its broad-based, large-cap brethren in Europe when one looks at one-year, three-year or five-year

cumulative returns as of December 31, 2012. Of course, comparing DFE to its own benchmark, the MSCI Europe Small Cap Index, one sees that European small-cap stocks in general have tended to deliver strong performance compared to the two broader, more large-cap tilted MSCI indexes over these periods.

Cumulative Returns of DFE (NAV) vs. Select European Regional Indexes (12/31/2007-12/31/2012)



Avg. Ann. Returns as of 12/31/2012				Total Return (NAV)				Market Price			
	Ticker	Exp. Ratio	WTFund Inception Date	1-Year	3-Year	5-Year	Since WTFund Inception	1-Year	3-Year	5-Year	Since WTFund Inception
WisdomTree Europe SmallCap Dividend Fund	DFE	0.38%	6/16/2006	27.86%	8.86%	-2.75%	1.88%	30.81%	8.42%	-1.90%	2.04%
WisdomTree Europe SmallCap Dividend Index				28.68%	7.33%	-2.42%	2.20%	28.68%	7.33%	-2.42%	2.20%
MSCI Europe Small Cap Index				28.97%	7.76%	-1.26%	3.81%	28.97%	7.76%	-1.26%	3.81%
MSCI EMU Index				21.17%	-1.51%	-8.01%	-0.03%	21.17%	-1.51%	-8.01%	-0.03%
MSCI Europe Index				19.12%	3.24%	-4.34%	1.93%	19.12%	3.24%	-4.34%	1.93%

Sources: WisdomTree, Bloomberg, MSCI

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.

Small Caps: More Sensitive to Economic Cycles Small-cap equity exposures³ typically are lower than large-cap equity exposures⁴ in the more defensive sectors such as Utilities and Telecommunication Services, the bulk of which are usually large companies. Small caps tend to have much more exposure in Industrials and the two Consumer sectors (Staples and Discretionary). As a result, small caps tend to be more cyclical and therefore more sensitive to the ups and downs of the economy and markets than large caps. This cyclical nature can be seen in the 2012 calendar year—a strongly positive year for DFE (NAV) as

well as the three MSCI indexes shown in the figure above. DFE (NAV) and the MSCI Europe Small Cap Index led the other two more large-cap-tilted MSCI indexes by a considerable margin. On a five-year basis, DFE (NAV) and MSCI's three European market indexes all have cumulative returns in negative territory. However, the MSCI EMU Index is down the most—more than 33%. During this down cycle, DFE actually declined much less on a cumulative basis. To be fair, DFE declined significantly more during the 2008 bear market.⁵ But its performance starting in the 2009 calendar year through the 2012 calendar year more than caught up.⁶ What this illustrates to me is that if investors moving into European ETFs are starting to bank on a cyclical recovery coming out of Europe and are trying to get access to some of the relatively low prices of European equities,⁷ I believe the European small-cap equity story and specifically DFE is worthy of strong consideration. **Take the euro out of Europe (Video)**

¹Market capitalization-weighted: Market cap = share price x number of shares outstanding. Firms with larger values receive higher index weights. For these indexes, MSCI also uses a float-adjustment mechanism, which, put simply, means that for certain firms that have large proportions of government ownership or other typically more illiquid shares that do not trade, MSCI proportionately adjusts their weights downward so as to account for these types of shareholders who do not tend to trade their shares.

²For each firm, dividends per share over the 12 months leading up to the Index screening date (5/31 of each year) are multiplied by the shares outstanding as of this same date to get the cash dividend amount. Firms with higher values receive higher weights.

³Refers to exposures of the WisdomTree Europe SmallCap Dividend Index as of 12/31/2012. Source: Bloomberg.

⁴Refers to both the MSCI EMU Index and the MSCI Europe Index as of 12/31/2012. Source: Bloomberg.

⁵During the 2008 calendar year, DFE (NAV) returned -55.01%, the MSCI Europe Small Cap Index returned -54.24%, the MSCI EMU Index returned -47.57%, and the MSCI Europe Index returned -46.42%.

⁶A hypothetical investment of \$1.00 in DFE (NAV) on 12/31/2007 would have been worth 86.98 cents on 12/31/2012. This is greater than the numbers for either the MSCI EMU Index (65.13 cents) or the MSCI Europe Index (80.10 cents) over the same period. The MSCI Europe Small Cap Index was highest at 94.27 cents for the period.

⁷Refers to the MSCI Europe Index and the MSCI EMU Index having higher trailing 12-month dividend yields than the S&P 500 Index, the MSCI EAFE Index and the MSCI Emerging Markets Index, meaning that these European indexes have lower prices relative to the trailing 12-month dividends that have been paid as of 12/31/2012. Source: Bloomberg.

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. You cannot invest directly in an index.