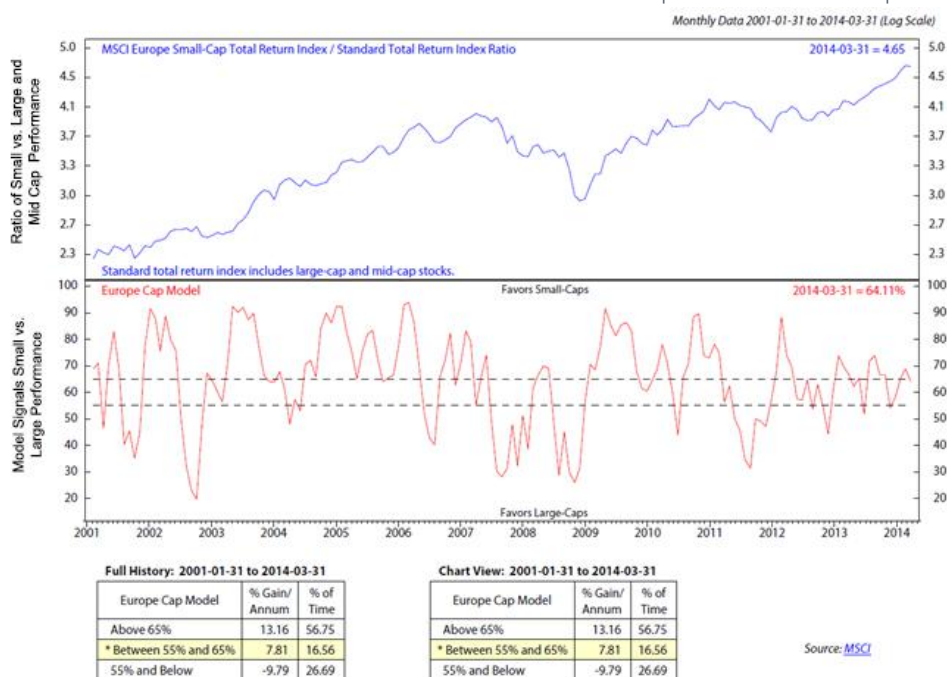


POSITIVE SIGNALS FOR EUROPEAN SMALL CAPS

Tripp Zimmerman — Director, Research
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The stabilization of the European economy last year was encouraging for global markets, and in the second half of 2013 many investors quickly acted on these green shoots by allocating more than \$20 billion to European-focused exchange-traded funds (ETFs) in their search for investment opportunities.¹ With continued positive economic growth readings at the end of last year and leading indicators signaling further expansion during 2014, sentiment among investors continues to build positive momentum. **Positioning for Earnings Recovery** One reason to have a continued positive view of European equities is that the current stage of the economic cycle—being very early in the economic recovery—may imply that the earnings cycle is about to ramp up to a higher gear. For investors who share this view, it may be beneficial to increase their allocations to [small caps](#), which had higher growth expectations than their [large-caps](#) peers² and typically provide more exposure to the economically sensitive sectors. Ned Davis Research (NDR) has created a model to help determine the relative attractiveness of European small caps compared to large caps. The model calculates a composite score by looking at a combination of [fundamentals](#), economic indicators and technical indicators³ to determine the relative attractiveness of European small caps.

Europe Cap Model



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• Small Caps Displayed

Strong Momentum – The top chart compares the performance of European small caps as represented by the MSCI Europe Small Cap Index against large caps and [mid-caps](#) as represented by the [MSCI Europe Large Cap Index](#) and [MSCI Europe Mid Cap Index](#). The chart moving higher means small caps are exhibiting stronger relative performance. This relative strength of small caps, visible through the line's upward trend, is typically a positive technical signal. •

Composite Model Positive for Small Caps – As of March 31, 2014, the composite model is between the 55% and 65%

threshold, which is a level that is favorable to small caps. I find it impressive that when the composite reading is within this threshold, small caps *outperformed* large caps by more than 7.8%, and when the reading is below 55%, small caps *underperformed* by more than 9.7%. This model would suggest it's a good time to favor small caps and that following past periods when the model looked like this, small caps enjoyed a performance differential over large caps. We will keep tabs on this NDR model and let readers of our research know when it falls below 55%, which is when the model would favor large caps. Of course, it is important to remember that past performance can't predict future results.

Potential Implementation The European economic recovery is far from risk free, but the accommodative monetary policies seem to be favorable to continuing the momentum and could even provide a backstop if growth does not materialize. For example, the European Central Bank (ECB) has reaffirmed its commitment to keeping [interest rates](#) low by stating, "We firmly reiterate that we continue to expect the key ECB interest rates to remain at present or lower levels for an extended period of time."⁴ Given this accommodative monetary policy, positive economic growth outlook and my belief that we are potentially still in the early innings of the earnings cycle, I remain positive on Europe and small caps in particular. I also want to emphasize the importance of diversifying and believe there are different ways to play the European recovery theme, depending on one's conviction. To read our full valuation and growth update for Europe, please click [here](#).

¹Sources: WisdomTree, Bloomberg. ²Source: Ned Davis Research (12/31/13). ³Technical indicators attempt to predict the future price levels, or simply the general price direction, of a security by looking at past patterns.

⁴Mario Draghi, European Central Bank Press Release (04/03/14).

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DEFINITIONS

Small caps : new or relatively young companies that typically have a market capitalization between \$200 million to \$2 billion.

Large-Capitalization (Large-Cap) : A term used by the investment community to refer to companies with a market capitalization value of more than \$10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

Fundamentals : Attributes related to a company's actual operations and production as opposed to changes in share price.

Mid-Cap : Characterized by exposure to the next 20% of market capitalization (after the top 70% have been removed) within the Value, Blend or Growth style zones with the majority of the fund's weight.

MSCI Europe Large Cap Index : captures large cap representation across the 15 Developed Markets (DM) countries in Europe.

MSCI Europe Mid Cap Index : captures mid cap representation across the 15 Developed Markets (DM) countries in Europe.

Interest rates : The rate at which interest is paid by a borrower for the use of money.