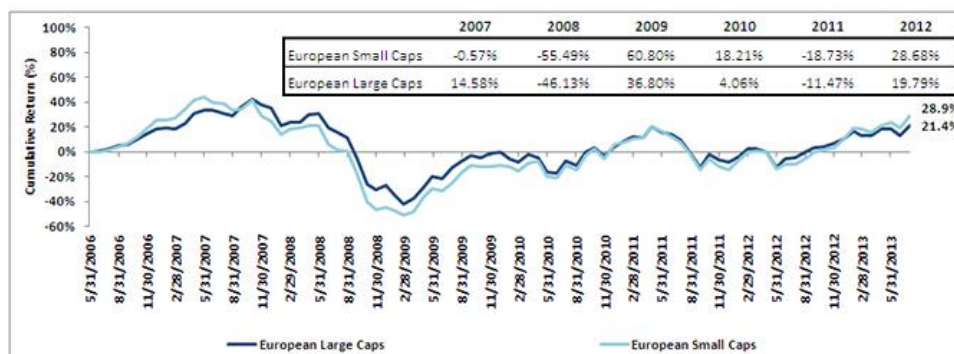


# POSITIONING FOR A EUROPEAN RECOVERY WITH SMALL CAPS, PART II

Jeremy Schwartz — Global Chief Investment Officer  
09/05/2013

Europe has come a long way from just a year ago. 2012 was characterized by bouts of instability and questions as to the continued viability of the euro currency. Now, in 2013, we are starting to see potential signs of stabilization within Europe's economies, and this is starting to be reflected in the European equity markets. In [Part 1](#), we focused on small caps for their potential domestic revenue exposure. Now we explore another potential benefit of small-cap exposure, given the current market backdrop. **Positioning for a Recovery: Small Caps and Cyclical Stocks** When economic and growth outlooks are uncertain, there is a tendency for equity investors to hunker down and turn to [defensive sectors](#) — sectors whose goods and services are more likely to hold up in the case of a slowdown. On the other hand, as a recovery begins to materialize, one often desires exposure to the more [cyclical sectors](#), which are more highly [leveraged](#) to economic growth. In this vein, small caps are often reflective of a more cyclical (as opposed to a more defensive) allocation. One reason: small caps are often more sensitive to local economic conditions. In a recent blog post, Chris Gannatti outlined how revenues for the [WisdomTree Europe SmallCap Dividend Index](#) (European Small Caps) were more tied to Europe's economies than were the firms in the [WisdomTree Europe Hedged Equity Index](#), which tends to include larger, more multinational firms. Below, I discuss how European small caps have performed in the last six years, which have seen some large swings in both the positive and the negative direction. Ultimately, if one is positioning for a European economic recovery, small caps, which are more cyclical, can provide an attractive and unique exposure.

## Comparing Calendar Year Returns and Cumulative Returns of European Small Caps to the FTSE Developed Europe Index (European Large Caps) (5/31/2006–7/31/2013)



Sources: WisdomTree, Bloomberg. Past performance is not indicative of future results.  
A 6-year horizon was chosen to reflect the inception date of the WisdomTree Europe SmallCap Dividend Index.

European Small Caps have far outpaced European Large Caps during market rallies. Outperformance in 2009: 24%. Outperformance in 2010: Approximately 14%. Outperformance in 2012: Approximately 9%. True, European Small Caps did go down further in both 2008 and in 2011, but we find it interesting to note that since its inception, even while going down further during these years, cumulative returns are in fact higher over the full period of history available.

- **Economic Sensitivity Rooted in Cyclical Exposures:** European Large Caps are market capitalization weighted, which means that they're biased toward larger companies. Some of the resulting exposures include very large telecommunication services or utilities firms. On the other hand, European Small Caps rebalance back toward the small-cap segment of European equities on an annual basis, steering away from larger European companies. The result: While European Small Caps have approximately 83% exposure to cyclical sectors, the European Large Caps have only a 64% exposure to cyclical sectors.
- **The Industries Driving These Cyclical Over-weights:**
  - **Consumer Discretionary:** European Small Caps have over 6% more weight in the cyclical stocks in this Consumer sector. The largest industry over-weight in this sector is in Retailing. An increase in European economic growth should have the potential to benefit these European consumer stocks.

**Industrials:** European Small Caps have about twice as much weight (over 20%) in the Industrials sector as do European large caps—a sector that is often very sensitive to economic conditions. On an industry basis, there is an over-weight in capital goods companies involved in large projects that incorporate high levels of capital spending. This sector could be positioned closer to the front end of any increases in [capital spending](#) and the expansion of production capability. • **Information Technology:** European Small Caps have about 10% more weight in the IT sector than do European Large Caps, and on an industry basis, it's the technology hardware and equipment industries. Central here are firms trying to improve efficiency, for example through enhanced data storage and communications equipment. As long as [productivity](#) improvements are a central theme for companies trying to emerge from protracted slowdowns, this industry could remain important. **Conclusion** If data coming out of Europe continues to improve, European Small Caps offer an interesting contrast to European Large Caps. The performance history of European Small Caps shows more sensitivity to market trends—whether positive during up markets or negative during contractions. Additionally, the specific industry over-weights, as of July 31, 2013, appear highly leveraged toward an improving economic situation. **Unless otherwise stated, data source is Bloomberg.**

#### Important Risks Related to this Article

Investments focusing on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development. You cannot invest directly in an index.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

## **IMPORTANT INFORMATION**

**U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.**

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages ([www.msci.com](http://www.msci.com))

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

## **DEFINITIONS**

**Defensive sectors** : Consumer Staples, Health Care, Telecommunication Services and Utilities.

**Cyclical sectors** : Consumer Discretionary, Energy, Industrials, Materials, Financials and Information Technology sectors.

**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.

**WisdomTree Europe SmallCap Dividend Index** : A fundamentally weighted index meant to measure the performance of small-cap European dividend-paying equities weighted by cash dividends paid.

**WisdomTree Europe Hedged Equity Index** : Index designed to provide exposure to European equities while at the same time neutralizing exposure to fluctuations between the Euro and the U.S. dollar. Constituents are European dividend-paying firms with a least 50% of their revenues from outside of Europe. Weighting is by cash dividends paid.

**FTSE Developed Europe Index** : Measure of the performance of developed European companies, weighted by market capitalization.

**Beta** : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

**Capital spending** : Spending by a company typically made to enhance longer-term productive capacity.

**Productivity** : Measure of efficiency that details how much output is obtained per unit of input.