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EURO STOXX SMALL INDEX: A LIQUID GATEWAY TO HIGH PERFORMING EUROZONE SMALL-CAP STOCKS

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Introduction

Exchange-traded funds that provide exposure to US small-cap companies are among the largest in the world, and investors have been rewarded for their participation in this subset of the US equity market. Less well known, however, are Eurozone small-cap companies. The Eurozone developed country equity market is characterized by visible performance differentials among size segments. Small-cap companies have not only significantly outperformed large-cap firms in recent years but also in the longer term and on an absolute and risk-adjusted basis.

With the Eurozone's economy starting to stabilize in 2012, and the expectation of continued growth, investors may want to look to Eurozone small caps to allocate capital. This paper provides an overview of the Eurozone small-cap market using the EURO STOXX Small Index. Our aim is to help investors understand Eurozone small-cap investment exposure in an effort to promote insightful investment decisions.

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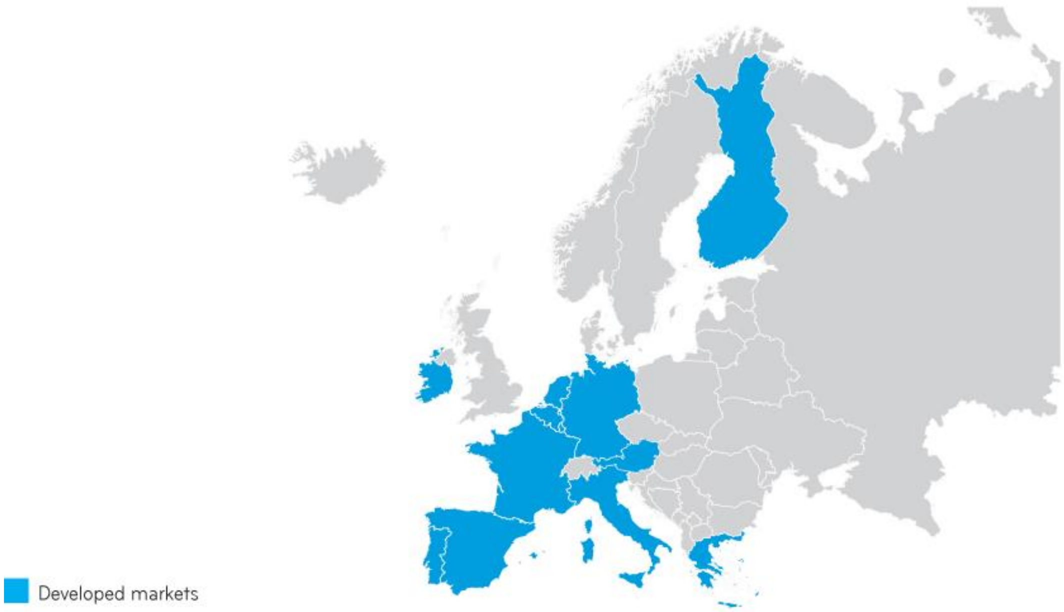
1 Eurozone coverage

The Eurozone is an economic and monetary union (EMU) of 18 member states that have adopted the euro (€) as their common currency. It is a highly capitalized equity market, with approximately 5 trillion US dollars in free-float market cap. The Eurozone currently includes 18 countries of which STOXX classifies 12 as developed markets: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain. The EURO STOXX Small Index is made up of small-cap companies from these 12 countries.

FIGURE 1: GRAPHICAL REPRESENTATION OF EUROZONE COUNTRIES CLASSIFIED AS DEVELOPED MARKETS BY STOXX.



As of 2013, Eurozone GDP was second to the United States globally and accounted for 17% of the world's output. In fact, the Eurozone is similar to the United States in that it represents an enormous block of economic output that derives significant benefit from having a single currency. Prior to the euro, the need to exchange currencies meant extra costs, risk and a lack of efficiency in cross-border transactions. With a single currency, doing business in the Eurozone is more cost effective and less risky. These benefits are particularly important for smaller companies that profit disproportionately from lower operating costs.

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2 Methodology

Before we discuss how the EURO STOXX Small Index is created, it is important to understand the initial selection universe, which is the STOXX Europe 600 Index. This index is a broad developed market benchmark that captures approximately 90% of Europe's free-float market cap. We chose the 90% threshold because it represents the tradable portion of Europe's equity market.

Investors may note that popular benchmarks that cover the US market capture from 95% to 98% of the free-float market cap. In our view, a smaller percentage of the market cap should be included in broad, investable indices for Europe. As noted in a previous paper, "the most commonly used approaches to classify size segments in the US stock market do not work well in the European market environment, where there are fewer listed companies, the smallest of which are smaller and less liquid than the smallest listed companies in the US market."[1]

The EURO STOXX Small Index is derived by determining the euro-traded small-cap companies in the STOXX Europe 600 Index. The first step in this process is defining the Europe size indices. We do this by dividing the STOXX Europe 600 Index constituents into thirds. The upper third is the STOXX Europe Large 200 Index, the middle third is the STOXX Europe Mid 200 Index and the lower third is the STOXX Europe Small 200 Index. As of June 2014, the top 200 covered 80.4% of the free-float market cap, the middle 200 covered 13.5% and the smallest 200 covered 6.2%. The second and final step is determining the euro-traded stocks in the STOXX Europe Small 200 Index.

As of June 2014, the EURO STOXX Small Index had 96 constituents. These companies represented about 300 billion US dollars in free-float market cap and the smallest 6% of the tradable Eurozone equity market. The average market cap was 3.0 billion US dollars and the largest and smallest companies had market caps of 5.9 billion US dollars and 1.57 billion US dollars respectively.

[1] Eibl, Angelika. "2013 European equity investment landscape: A guide for US investors." STOXX.com. October 2013.

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3 Risk-return characteristics

A significant characteristic of the European equity market is the return premium provided by small caps. This is seen in Figure 2, which compares the performance of the EURO STOXX Small, Mid and Large indices over the most recent full market cycle. Since 2001, the small-cap market outperformed the large-cap market by more than 2 to 1 (9.9% per year for EURO STOXX Small versus 4.0% per year for EURO STOXX Large).

FIGURE 2: GRAPHICAL REPRESENTATION OF INDEX PERFORMANCE. SOURCE: STOXX DATA FROM JAN. 2001 TO JUN. 2014

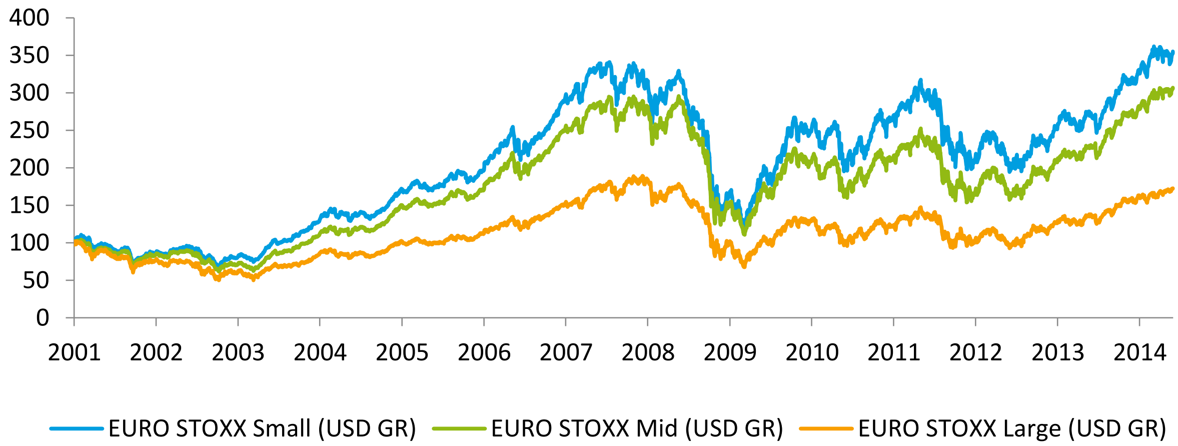

Table 1 compares the risk and return characteristics of the three size indices and the EURO STOXX Total Market Index (TMI). With average annualized performance of 12.9%, measured from June 2009 through May 2014, the small-cap index outperformed the large-cap index and the TMI by more than 2 percentage points per year. This outperformance has been generated with similar volatility levels, leading to higher Sharpe ratios across the board.

TABLE 1

	EURO STOXX Small (USD GR)	EURO STOXX Mid (USD GR)	EURO STOXX Large (USD GR)	EURO STOXX TMI (USD GR)
Performance	12.9%	12.2%	10.7%	11.1%
Risk	23.5%	22.8%	23.6%	23.2%
Sharpe Ratio	0.55	0.53	0.45	0.47
Beta to TMI	0.98	0.97	1.01	1.00
Drawdown	48.1%	47.9%	50.9%	49.9%

Source: Annualized STOXX data from Jun. 2009 to Jun. 2014.

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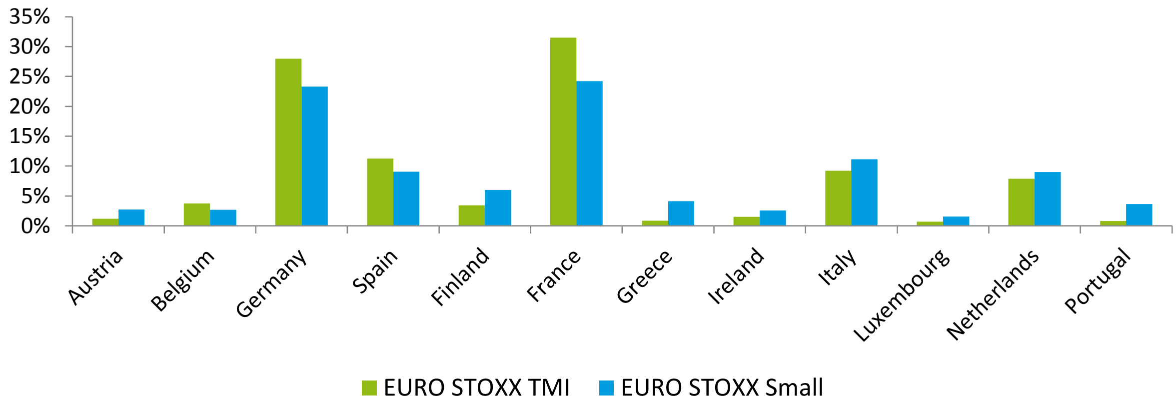
4 Country and sector breakdown

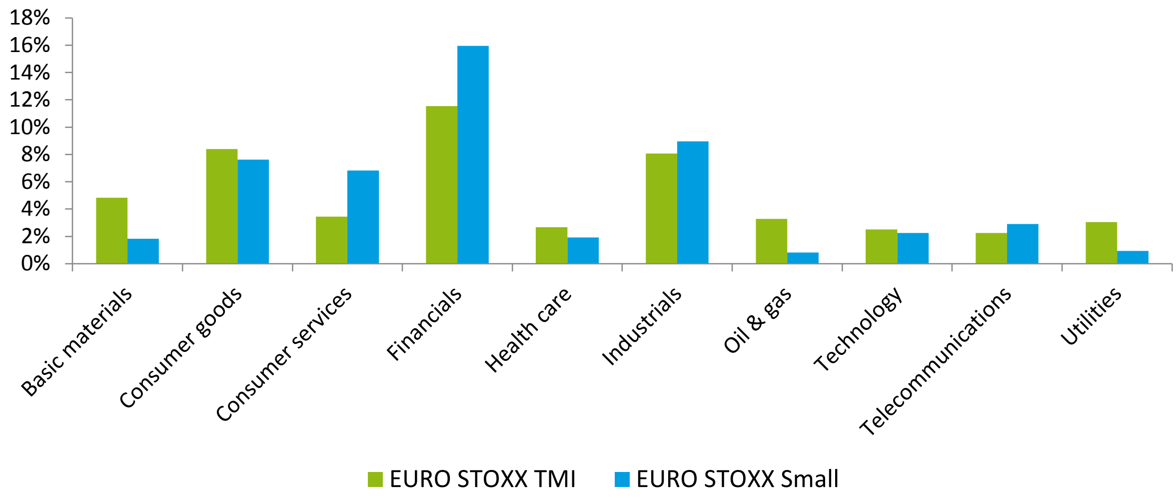
Among the 12 countries currently represented in the EURO STOXX Small Index, the two largest economies in the Eurozone – Germany and France – have the largest weight, followed by Italy and Spain (see Figure 3). Compared to the total Eurozone equity market, the EURO STOXX Small Index is less exposed to Europe's southern periphery.

FIGURE 3: COUNTRY ALLOCATION. SOURCE: STOXX DATA AS OF JUN. 3, 2014.



Financials, industrials and consumer goods and services dominate the EURO STOXX Small Index (see Figure 4). Those industries include global players, such as Hugo Boss, Air France, KLM and Hermes International.

FIGURE 4: INDUSTRY ALLOCATION. SOURCE: STOXX DATA AS OF JUN. 3, 2014. DATA IS BASED ON ICB CLASSIFICATION SYSTEM.



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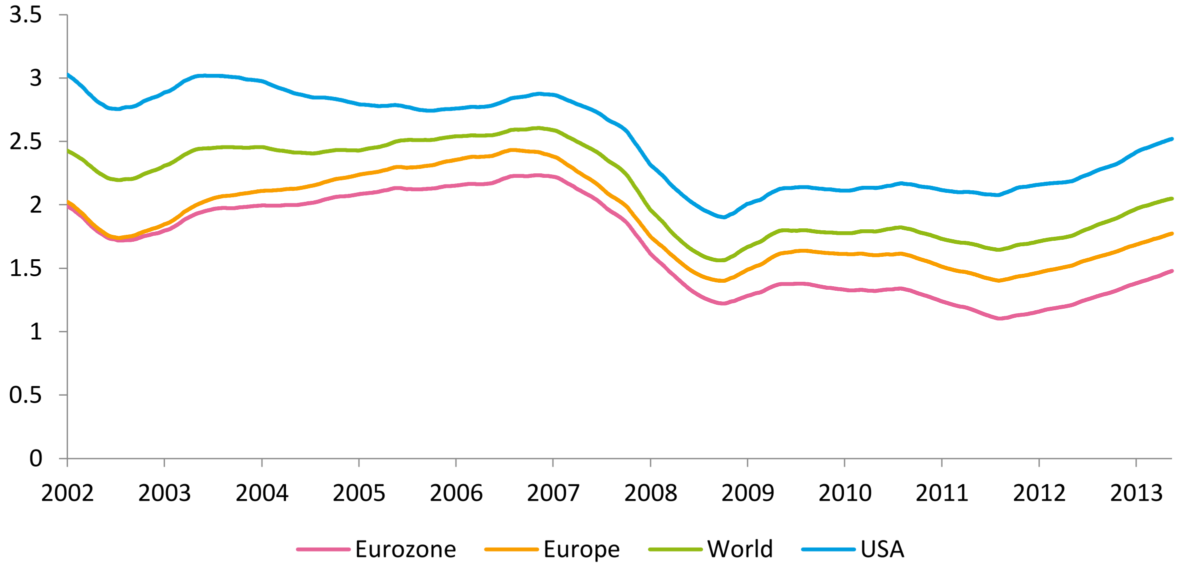
5 Current valuation

Compared to other major equity markets, Europe – with the Eurozone in particular – currently offers very attractive investment opportunities. Scaling price-to-book value reveals that the Eurozone is undervalued on a relative scale. With a price-to-book ratio of 1.5, it is 40% cheaper compared to the US equity market (PB ratio of 2.5) and still 25% cheaper than the global equity market's weighted PB average of 2.0 (see Figure 5). Even historically, the euro equity market is undervalued, with a PB ratio of 1.5 (average over May 2013 until May 2014), which is 12% below the long-term average from 2002 to 2014.

FIGURE 5: YEARLY AVERAGES OF PRICE-TO-BOOK RATIOS OF MAJOR EQUITY MARKETS. AVERAGES ARE BASED ON BROAD COUNTRY INDICES. SOURCE: BLOOMBERG, STOXX.



Measures as yearly averages

In addition to attractive valuation measures, adding Eurozone exposure to a US portfolio also makes sense from a portfolio diversification perspective. With a value of 78%, the correlation between the US and the Eurozone equity markets has been consistently low over the last decade, making Eurozone exposure a very attractive addition for a US-centric equity portfolio.

6 Conclusion: new opportunities in the "Old World"

Eurozone small-cap companies offer valuable investment exposure that has been overlooked by investors in the recent past. It is the closest analogue to the US small-cap market based on the region's output and its single currency. We believe that Eurozone small-cap companies (as measured by the EURO STOXX Small Index) have the potential to increase portfolio Sharpe ratios given the relative low volatility and low correlation to the US market. With Eurozone recovery in focus, it is an exposure worth investors' attention.

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