

# UBS ETF *Market Matters*

## *Eurozone Small Caps*

- Global small cap investors were historically compensated excess risk-adjusted return, of 0.22% p.a., the so-called "small-cap premium".
- Eurozone small caps historically delivered the highest risk-adjusted return, in relation to standard exposure.
- Within Eurozone equity indices, the MSCI EMU Small Cap Index currently features the highest earnings growth.
- The more cyclical nature of small caps benefits from an ongoing improvement in the economic environment in the Eurozone.

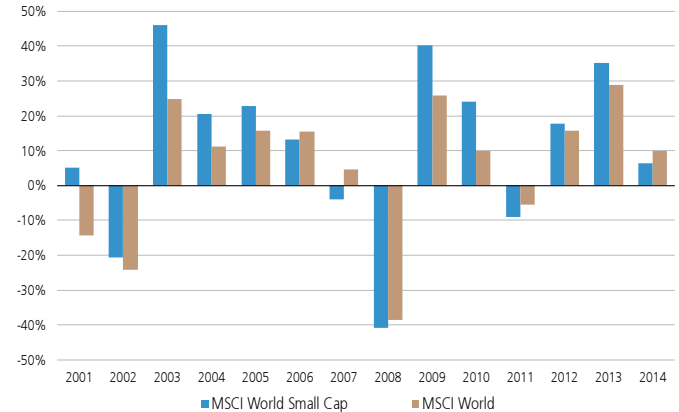
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Small companies are thought to be prone to risks and more illiquid than large ones: many argue they must therefore offer better returns than larger corporates. Simply put, small caps investors expect additional compensation for taking on more risk. **Figure 1** shows year-on-year returns (in local currency, so without any impact from foreign exchange fluctuations - a continuously hedged portfolio) of global developed small caps (MSCI World Small Caps) next to the standard benchmark capturing large and mid caps (MSCI World). Market valuations of small and large caps move globally in the same direction (except 2001 and 2007). The annualised return of small caps is 8.5% vs. 3.9% p.a. for large caps, with volatility of small caps being indeed higher (17.3% vs. 14.7% respectively). Nonetheless, for taking on additional units of risk (the risk-adjusted return), investors were historically compensated an excess return of 0.22% p.a., the so-called "small-cap premium". For more complete insight, a granular region-based performance is shown in **Figure 2**. The risk (measured by annualised standard deviation of monthly net returns) is generally higher for small caps, however only marginally in the case of Japan and EMU. The small caps in the EMU region historically delivered the highest excess return of 0.27% per additional unit of risk (and 5.4% p.a. in absolute terms), in relation to standard exposure (7.4% ÷ 19.8% - 2.0% ÷ 18.8%). In absolute terms, US small caps delivered the most superior return, followed by the UK ones.

### Eurozone Small Caps: Catching Up

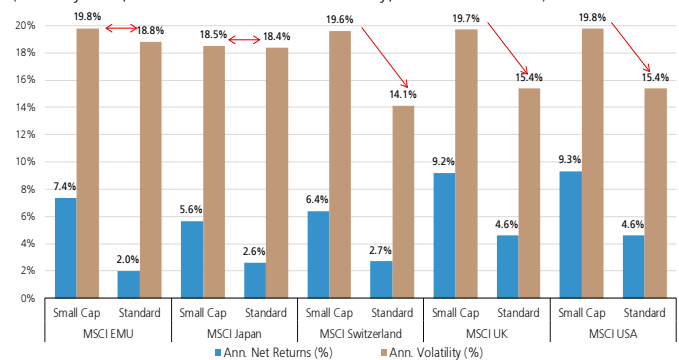
The business growth of small caps is shown in **Figure 3**, which plots the current internal growth rate (measuring dynamics of retained earnings to book value). This metric is used as smaller companies tend to focus on growth and therefore reinvest their earnings instead of paying them out in the form of dividends (i.e. dividend yields decrease with market cap going down). The profitability of EMU small caps was hit particularly hard during the Eurozone sovereign crisis (2011 and 2012), despite the fact that this index remains diversified across EMU countries. The last two years, however, have experienced a *momentum*, and Eurozone small caps are closing the growth gap to other developed economies. The UBS Wealth Management Chief Investment Office thinks that mid and small caps can indeed benefit from favourable growth trends in Eurozone, as they tend to be more cyclical and have higher operational gearing to the region's economy (Source: UBS Chief Investment Office WM, "Growth lifts mid and small caps", April 2015). Given the expected increase of Eurozone earnings (monetary stimulus, weaker Euro and lower oil prices), it is worth comparing performance of small caps in relation to other equity strategies.

**Figure 1:** Performance of developed small caps (yearly data, total return net in local currency, Dec.'00 – Dec.'14)



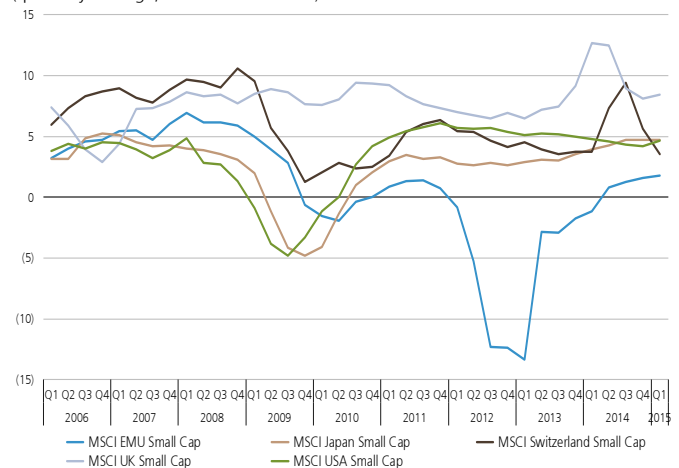
Source: MSCI, UBS Global AM, as of 31 March 2015

**Figure 2:** Index Risk and Return Annualised Characteristics (monthly data, total return net in local currency, Dec.'00 – Mar.'15)



Source: MSCI, UBS Global AM, as of 31 March 2015

**Figure 3:** Current Internal Growth Rate (quarterly average, Jan.'06 – Mar.'15)



Source: MSCI, UBS Global AM, as of 31 March 2015

For all charts/tables: Past performance is not a reliable indicator for the future.

### Small Caps vs. Broad Market: A Closer Look

The comparison of Eurozone equity strategies embeds the following exposures:

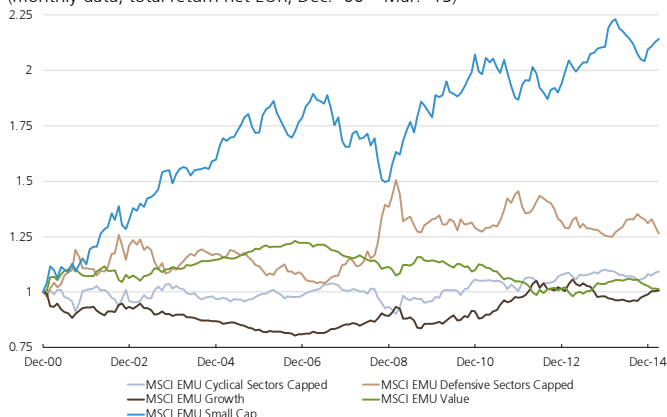
- MSCI EMU Cyclical Sectors Capped
- MSCI EMU Defensive Sectors Capped
- MSCI EMU Value
- MSCI EMU Growth
- MSCI EMU Small Cap

These strategies are related to the standard MSCI EMU (large and mid caps, market capitalisation weighted). While the use of MSCI EMU Cyclical Sectors Capped and MSCI EMU Defensive Sectors Capped enables rotation between sectors defined by their responsiveness to economic indicators, the use of MSCI EMU Value and MSCI EMU Growth allows entering standard equity *style* exposure. These strategies are derived from the sub-universe of large and mid caps. In contrast, the MSCI EMU Small Cap aims to harvest the small cap premium. **Figure 4** shows the historical performance of Eurozone equity indices. Firstly, these equity strategies differ considerably in terms of performance, e.g. cyclical and defensive sectors mirror their performance. Secondly, the relative performance of the *sector* rotation or *style* exposure oscillates closely to the standard benchmark  $\pm 20\%$  (except defensive sectors which remained more robust in 2007-2008 and 2011-2012). Thirdly, the EMU small caps have experienced periods of particularly strong performance over the broad market in 2001-2006, 2009-2010 and 2013. Comparing the relative performance to earnings, shown in **Figure 5**, it is clear that the small cap over-performance overlaps with periods when their earnings (are expected to) improve, which also appears at the beginning of 2015. In addition, small caps currently feature the best growth in earnings across indices considered. An important aspect to consider when investing in small caps - which typically trade at higher multiples due to higher growth potential - is valuation risk. For example, the price-to-book-value of the EMU Small Caps is currently increasing towards 1.9x (average of 1.5x over 2006-2014), whilst trading on average at 2.3x in the years 2006-2007.

### Eurozone Small Caps: Other Facts

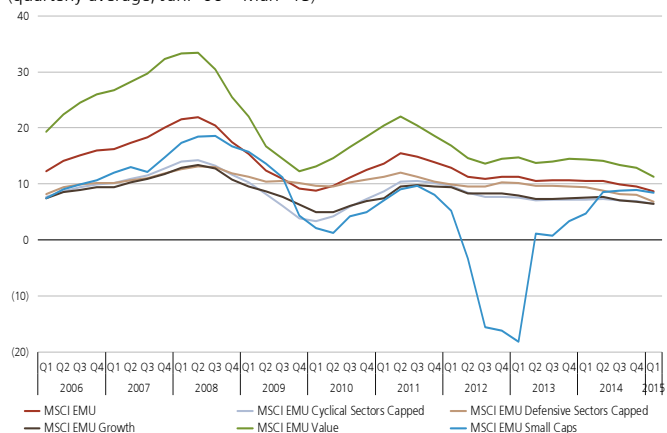
The MSCI EMU Small Cap Index captures 450 stocks whose free-float market capitalisation amounts to EUR 401bn (vs. 240 stocks with capitalisation of EUR 3'728bn in the MSCI EMU). The small cap exposure is more *diversified* than the large cap, e.g. the top ten companies add up to 10.7% vs. 24.3%, respectively. In addition, small caps are more diversified across countries, e.g. exposure to the top three countries (Germany, France and Italy) adds up to 59%, compared to 75% (France, Germany and Spain) of the large cap segment. Finally, small caps tend to be more *cyclical*, with combined 80% of the index weight towards cyclical sectors as shown in **Figure 6** (industrials, financials, consumer discretionary, information technology and materials), in view of the MSCI classification (Source: MSCI Cyclical and Defensive Sectors Indexes Methodology, June 2014). The more cyclical nature of small caps benefits from an ongoing improvement in the economic environment in the Eurozone.

**Figure 4:** Relative performance of Eurozone equity indices (monthly data, total return net EUR, Dec. '00 – Mar. '15)



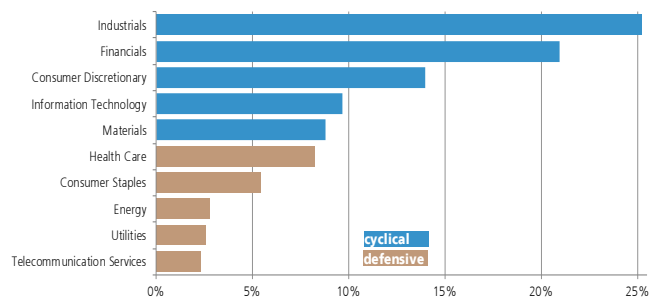
Source: MSCI, UBS Global AM, as of 31 March 2015

**Figure 5:** 12-Month Index Trailing EPS (quarterly average, Jan. '06 – Mar. '15)



Source: MSCI, UBS Global AM, as of 31 March 2015

**Figure 6:** MSCI EMU Small Cap Index: Sector Weights



Source: MSCI, UBS Global AM, as of 31 March 2015

For all charts/tables: Past performance is not a reliable indicator for the future.

**Table 1:** Eurozone UBS ETFs

Fund name	TER (ex ante)	AuM	Base Ccy.	Replication	Domicile	Incept. date	ISIN	Valor
UBS ETF (LU) MSCI EMU UCITS ETF	0.23%	2'351	EUR	Physical	Luxembourg	19.09.2002	LU0147308422	1 429 074
UBS ETF (LU) MSCI EMU hedged CHF UCITS ETF	0.33%	517	CHF	Physical	Luxembourg	31.07.2013	LU0950669175	21 965 427
UBS ETF (LU) MSCI EMU hedged GBP UCITS ETF	0.33%	809	GBP	Physical	Luxembourg	21.10.2013	LU0937835733	21 846 308
UBS ETF (LU) MSCI EMU hedged GBP UCITS ETF	0.33%	809	GBP	Physical	Luxembourg	30.09.2013	LU0950669688	21 971 617
UBS ETF (LU) MSCI EMU hedged USD UCITS ETF	0.33%	1'558	USD	Physical	Luxembourg	04.06.2014	LU0937835576	21 846 310
UBS ETF (LU) MSCI EMU hedged USD UCITS ETF	0.33%	1'558	USD	Physical	Luxembourg	30.08.2013	LU0950669415	21 971 410
UBS ETF (LU) MSCI EMU hedged SGD UCITS ETF	0.33%	13	SGD	Physical	Luxembourg	30.06.2014	LU1048312653	24 017 583
UBS ETF (IE) MSCI EMU SF UCITS ETF	0.02%	218	EUR	Synthetic	Ireland	23.03.2011	IE00B5B1MZ58	12 632 798
UBS ETF (LU) EURO STOXX 50 UCITS ETF	0.15%	801	EUR	Physical	Luxembourg	29.10.2001	LU0136234068	1 272 980
<b>UBS ETF (LU) MSCI EMU Small Cap UCITS ETF</b>	<b>0.33%</b>	<b>42</b>	<b>EUR</b>	<b>Physical</b>	<b>Luxembourg</b>	<b>17.10.2011</b>	<b>LU0671493277</b>	<b>13 711 559</b>
UBS ETF (LU) MSCI EMU Value UCITS ETF	0.25%	20	EUR	Physical	Luxembourg	05.10.2009	LU0446734369	10 461 013
UBS ETF (IE) MSCI EMU Growth SF UCITS ETF	0.23%	8	EUR	Synthetic	Ireland	06.10.2011	IE00B4MFJH03	13 894 397
UBS ETF (IE) MSCI EMU Cyclical UCITS ETF	0.25%	32	EUR	Physical	Ireland	04.09.2014	IE00BMP3HJ57	24 501 805
UBS ETF (IE) MSCI EMU Defensive UCITS ETF	0.25%	9	EUR	Physical	Ireland	04.09.2014	IE00BMP3HL79	24 501 900

AuM in CHF, million, data as of 28 April 2015

## How to contact us

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