

---

# RE-THINKING YOUR SMALL-CAP ALLOCATION? THINK DIVIDENDS

Matt Wagner – Associate Director, Research  
07/20/2017

There seems to be a consensus forming regarding the investment thesis for developed international exposure: attractive [relative valuations](#) compared to the U.S. in tandem with subdued political risks, accommodative [monetary policy](#) and cohesive global economic growth that will spur investment and bolster corporate profits. Given all these apparent tailwinds, how should investors think about the best ways to access this market?

## Is Your Portfolio Small Enough?

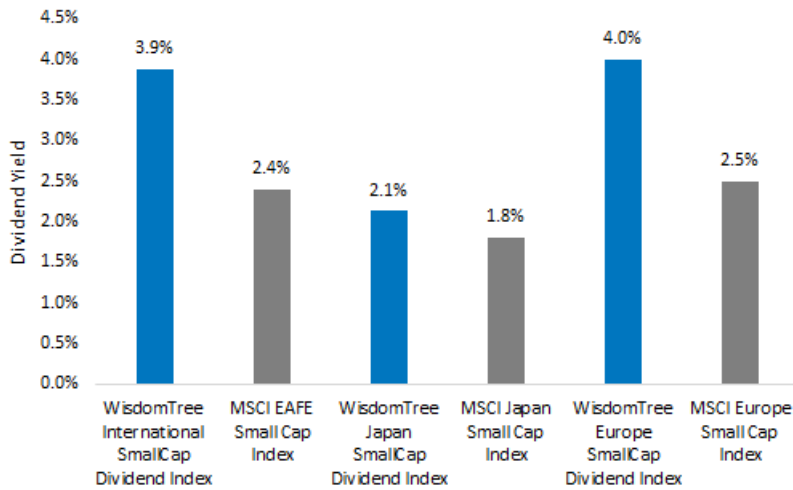
We recently highlighted that [U.S. small -caps have by most measures underperformed U.S. large caps in 2017 year-to-date](#) and have underperformed international small caps by an even greater margin. Despite the research and performance history to support a long-term strategic holding in [small caps](#), investors have been exiting in droves from the small-cap trade.

The specter of a considerable drawdown in the segment should the administration's fiscal stimulus plan disappoint rightly worries investors. But what should be more worrying is that many investors have missed out on diversifying their portfolios to access the small-cap value premiums in global markets.

## How Rules-Based Indexing Has Outperformed

WisdomTree pioneered small-cap international indexes in 2006, and we now have a more than 11-year track record of performance in this category. Among them are the [WisdomTree International SmallCap Dividend Index](#), the [WisdomTree Europe SmallCap Dividend Index](#) and the [WisdomTree Japan SmallCap Dividend Index](#). These Indexes use a [passive](#), rules-based [dividend-weighted](#) approach in targeting small-cap value in less efficient markets. As a result of dividend weighting, WisdomTree's Indexes boost [dividend yields](#) across these markets, in some cases by almost 150 [basis points \(bps\)](#) above the [market cap-weighted](#) benchmark.

Dividend Yields as of 6/30/17

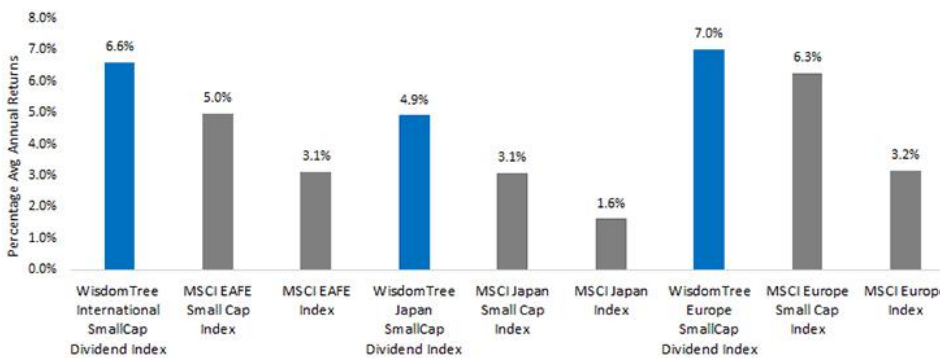


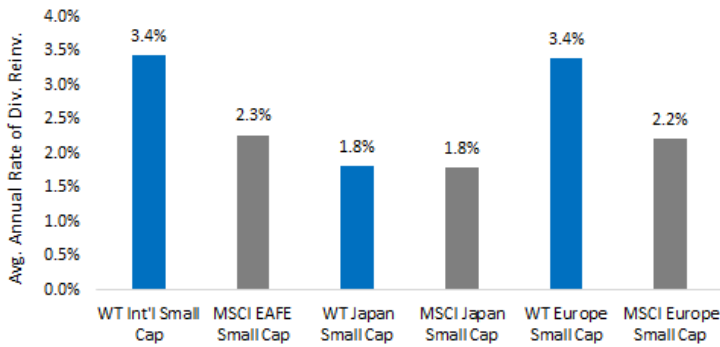
Source: Bloomberg, 6/30/17. Past performance is not indicative of future results. You cannot invest directly in an index.

Since their inception, the wisdomTree Indexes have average annual returns above their cap-weighted small-cap benchmarks in the range of 75 to 183 bps, and their [large-cap](#) benchmarks by even greater margins of 329 to 384 bps. This is just the most recent 11-year example of the benefits of including small caps with a value tilt in international allocations over just traditional large caps.

In breaking down the returns since inception of the wisdomTree dividend-weighted Indexes, you can see the significant increase in returns attributable to dividends. The largest difference is the 118bps increase in the average annual rate of dividend reinvestment for the wisdomTree Europe SmallCap Dividend Index versus the [MSCI Europe Small Cap Index](#).

### Average Annual Returns and Average Annual Rate of Dividend Reinvestment





Source: Bloomberg, 5/31/06–6/30/17. Past performance is not indicative of future results. You cannot invest directly in an index.

Stock prices are vulnerable to the [volatility](#) of the markets, particularly with small caps, but dividends typically provide stickier, more reliable returns. Academic research debates the theoretical significance of dividend policy on individual company returns—our research and live history of outperformance shows both the value of dividends and of dividend payers in contributing to excess returns in a rules-based indexing approach, particularly in less efficient markets such as these.

### International Small Caps: Relative Value and More

WisdomTree’s dividend-weighted methodology provides access to the small-cap [value](#) factor in a way that has resulted in not only increasing dividend yields but also tilting to more favorable [price-to-earnings ratios \(P/E\)](#).

In the table below, you can see how in each case the WisdomTree Index is less expensive than its market cap-weighted benchmark on a P/E basis, with the European index having the greatest discount of 21%. And when you consider the relative value between the U.S. and international indexes, the [Russell 2000 Index](#) is more than twice as expensive as the highest P/E WisdomTree Index.

Indexes	Fwd P/E
<b>WisdomTree International SmallCap Dividend</b>	<b>14.0x</b>
MSCI EAFE Small Cap	17.1x
<b>WisdomTree Japan SmallCap Dividend</b>	<b>13.1x</b>
MSCI Japan Small Cap	15.1x
<b>WisdomTree Europe SmallCap Dividend</b>	<b>14.4x</b>
MSCI Europe Small Cap	18.2x
S&P 500	18.6x
Russell 2000	29.2x

Source: Bloomberg, 6/30/17. You cannot invest directly in an index. Past performance is not indicative of future results.

Exposure to international dividend-weighted small caps can provide relatively inexpensive access to the small-cap premiums during a stage of economic growth, but investors should also keep in mind some other long-term benefits:

- **Portfolio Diversification:** The low correlation of returns between international small-cap indexes and U.S. equity markets can enhance portfolio diversification, particularly with Japan. The correlation of returns between the WisdomTree Japan SmallCap Dividend Index, the [S&P 500](#), and the Russell 2000 are .51 and .45 respectively.
- **Blunt the Risks of Currencies and Global Trade:** Small caps generate a greater share of their income domestically than do large caps, and they're less susceptible to trends in global trade or the reverberations on trade from currencies.
- **Higher Dividend Yields Globally than Can Be Found in the U.S.:** Developed international markets typically pay higher dividends than the U.S., an important consideration for income-seeking investors. The dividend yield on the Russell 2000 and S&P 500 is 1.43% and 1.97%, respectively, compared to 2.40% for the [MSCI EAFE Small Cap Index](#) and 3.15% for the [MSCI EAFE Index](#).<sup>1</sup>

<sup>1</sup>Bloomberg, 6/30/17.

#### Important Risks Related to this Article

Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty.

Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time.

Investments focusing on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development.

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

**Relative value**: The relationship between a particular attribute, e.g., a dividend, and the firm's share price compared to that of another firm.

**Monetary policy**: Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

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

**Passive**: Indexes that take a rules-based approach with regular rebalancing schedules that are not changed due to market conditions.

**Dividend weighted**: Constituent securities represented within the Index in proportion to their contribution to the dividend stream of the Index.

**Dividend yield**: A financial ratio that shows how much a company pays out in dividends each year relative to its share price.

**Basis point**: 1/100th of 1 percent.

**Market capitalization-weighting**: Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

**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.

**MSCI Europe Small Cap Index**: A free float-adjusted market capitalization-weighted index designed to measure the performance of developed equity markets in Europe, specifically focusing on the small-cap segment of these equity markets.

**Volatility**: A measure of the dispersion of actual returns around a particular average level.

**Value**: Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over time.

**Price-to-earnings (P/E) ratio**: Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

**Russell 2000 Index**: Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

**S&P 500 Index**: Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

**MSCI EAFE Small Cap Index**: A free float-adjusted market capitalization equity index that captures small-cap representation across developed market countries around the world, excluding the U.S. and Canada.

**MSCI EAFE Index**: is a market cap-weighted index composed of companies representative of the developed market structure of developed countries in Europe, Australasia and Japan.