

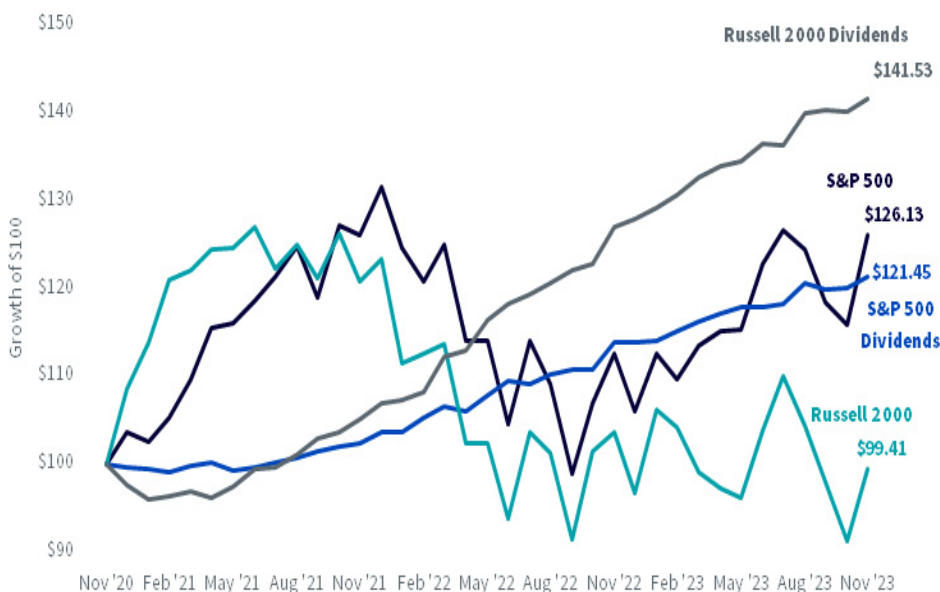
THE FUNDAMENTAL DISCONNECT IN SMALL CAPS: PRICE VS. DIVIDEND GROWTH

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A unique phenomenon has emerged in U.S. [small-cap](#) equities. Amid the economic recovery during the post-pandemic environment, U.S. companies continued to pay an increasing amount of dividends to shareholders, without interruption.

Small caps led the charge, growing trailing 12-month dividend totals for the Russell 2000 Index by over 40% since November 2020, a measure that nearly doubled the 21% growth in S&P 500 dividends.

Fundamental Disconnect: Small Cap Prices Down while Dividends Up >40% over the Last 3 Years



Sources: WisdomTree, FactSet, as of 11/30/23. Dividends=Trailing 12-Month. Growth of \$100 in index levels using price returns, rather than total returns. Past performance is not indicative of future results. You cannot invest directly in an Index.

[Large-cap](#) equity prices had their ups and downs over the last three years but mostly kept pace with dividend growth during this cycle, despite initially overshooting during the frenzied bull market of 2021. Through November 2023, the [S&P 500 price index](#) is up a cumulative 26% over the past three years while its dividends grew 21%. Large-cap markets seemed to appropriately reward this fundamental improvement.

Yet this reward is completely absent in small-cap markets. [Russell 2000](#) dividends grew 41% over the past three years, yet the index is virtually flat since then.

This fundamental disconnect signals small-cap equities are getting nominally cheaper despite significant improvements in a key driver of returns.

Though we cannot forecast when this trend may reverse, we see the [Federal Reserve's](#)

eventual pivot to easier [monetary policy](#) as a catalyst for a broader small-cap rally. Even the market’s reaction over the first few days after the December [FOMC](#) meeting was a step in that direction.

Small caps with dividend growth potential that are resilient to several macroeconomic scenarios warrant further consideration.

Fortunately, we recently rebalanced the [WisdomTree U.S. SmallCap Quality Dividend Growth Index \(WTSDG\)](#), which is tracked by the [WisdomTree U.S. SmallCap Quality Dividend Growth Fund \(DGRS\)](#). This construct applies a quality focus to the dividend-paying small-cap market to provide dividend growth potential for [volatile](#) periods.

Let’s assess how its composition and fundamentals changed during our screening and reconstitution processes.

WisdomTree U.S. SmallCap Quality Dividend Growth Index (WTSDG)

WTSDG expands upon our flagship dividend-weighted methodology by incorporating additional parameters to improve the quality profile and dividend growth potential of the U.S. small-cap universe.

Beginning with the WisdomTree U.S. SmallCap Dividend Index (WTSDI) universe, we select the top 50% of companies with the best combined rank of growth and quality factors based on a composite score. The growth component of this score includes longer-term earnings growth expectations while the quality component assesses three-year trend observations of [return on equity \(ROE\)](#) and [return on assets \(ROA\)](#). The result is a stock basket that remains [value](#)-biased yet features “[growth-lite](#)” characteristics that bring it closer to a core small-cap allocation from a stylistic standpoint.

Sector Composition: Post-Rebalance Comparison

WTSDG	vs. Pre-Rebalance	vs. Russell 2000 Value
Communication Services	-0.07%	0.47%
Consumer Discretionary	-0.92%	3.24%
Consumer Staples	-0.71%	2.65%
Energy	2.90%	-0.74%
Financials	2.11%	-1.38%
Health Care	0.98%	-5.17%
Industrials	-4.06%	-0.21%
Information Technology	-0.60%	-2.06%
Materials	-3.41%	1.07%
Real Estate	0.65%	-0.66%
Utilities	3.13%	2.79%

Sources: WisdomTree, FactSet, as of 11/30/23. You cannot invest directly in an Index. Bolded sector labels indicate new over-weights described in the text.

After the rebalance, WTSDG’s changes are sizable yet primarily concentrated within a few sectors. Relative to pre-rebalance data, the most notable additions are in Energy and Communication Services, while Financials, Materials and Real Estate headline the reductions.

Compared to the Russell 2000 Index, however, the effects are more visible. Negligible changes from the pre-rebalance data did little to impact a large existing over-weight in Consumer Discretionary or large under-weights in Health Care and Information Technology versus the broader small-cap market. Notable pickups to Communication Services and Energy, however, resulted in new over-weights in those sectors, while over-weights in Industrials and Consumer Staples increased as well.

Financials was essentially diminished to market weight through the 6.5% reduction at the rebalance, while an existing under-weight in Real Estate was reduced further and an



over-weight in Materials was pared.

Within this sector mix, WTSDG delivers slightly greater style diversification than the value-oriented indexes discussed earlier. Though it remains under-weight in small-cap growth heavyweights in Health Care and Informational Technology, the emphasis on high-quality, dividend-paying companies opens it up more to the Consumer Staples and Discretionary sectors. It also trims its exposure to Financials and Utilities, two sectors that are more prominent in value indexes.

The additional focus on quality rewarded WTSDG's fundamentals after the rebalance as well.

Fundamental Comparison after Rebalance

WTSDG	Pre-Rebalance	Post-Rebalance	Rebalance Improvement	Russell 2000	Relative to Russell 2000
Constituents	281	251	--	1432	--
% Large Cap	0.0%	0.0%	0.0%	0.0%	0.0%
% Mid Cap	56.4%	54.9%	-1.5%	54.1%	0.9%
% Small Cap	43.6%	45.1%	1.5%	45.9%	-0.9%
Dividend Yield	3.0%	2.9%	-0.1%	2.4%	0.5%
Price-to-Earnings	14.0x	11.2x	-2.8x	20.0x	-8.8x
Weight in Unprofitable Companies	6.49%	0.00%	-6.49%	21.23%	-21.23%
Return on Equity	14.5%	17.3%	2.8%	5.3%	12.1%
Return on Assets	3.4%	4.2%	0.9%	1.0%	3.2%
Leverage	4.3x	4.1x	-0.2x	5.2x	-1.1x

Sources: WisdomTree, FactSet, as of 11/30/23. You cannot invest directly in an index.

The rebalance once again reduced the weight in unprofitable companies back to zero, illustrating the emphasis on efficient companies with robust and proven operations. This is a key differentiator of the marriage between quality and size, as the Russell 2000 is 21% laden with profitless companies.

Meanwhile, ROE and ROA grew nearly 4% combined relative to pre-rebalance data, and over 15% versus the market. This tandem also reduced overall leverage multiples by over one point versus the Russell 2000, which is beneficial while rising interest costs exact a toll on [small-cap balance sheets](#).

Normally, investors might expect that an improved quality profile with innate defensive characteristics would require a premium valuation to the market, but WTSDG is an outlier. The rebalance trimmed nearly three more points off its [price-to-earnings \(P/E\) multiple](#), leaving it almost nine points lower than the overall small-cap market.

We think this combination of improved quality at a significant discount provides an attractive entry point for allocators looking for broader market participation in 2024.

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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.

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.

Federal Reserve: The Federal Reserve System is the central banking system of the United States.

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.

Federal Open Market Committee (FOMC): The branch of the Federal Reserve Board that determines the direction of monetary policy.

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

Return on Equity (ROE): Measures a corporation’s profitability by revealing how much profit a company generates with the money shareholders have invested.

Return on assets (ROA): Firm profits (after accounting for all expenses) divided by the firm’s total assets. Higher numbers indicate greater profits relative to the level of assets utilized to generate them.

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.

Growth: Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

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.