

# ADDRESSING VALUATION RISK BY REBALANCING

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With equity markets up more than 250% since the 2009 lows and slightly off all-time highs<sup>1</sup>, we think it is especially important to ask whether the underlying [fundamentals](#) justify these moves. We also think it is important to be mindful of how an annual [rebalance](#), steering a portfolio back to an underlying fundamental such as [dividends](#), can help manage [valuation risks](#)—a key factor in the inclusion of non-[cap-weighted](#) indexes in the "[smart beta](#)" category of indexes. Quantifying the Fundamental Rebalance with market capitalization-weighted indexes, when constituents increase in price compared to other stocks, they gain greater weight and increase their impact on the performance of the index. WisdomTree Dividend Indexes employ a rules-based rebalancing mechanism that adjusts relative weights based on underlying dividend trends. During the rebalancing process, which occurs once per year for each Index, the relationship between price change and dividend growth is measured. In figure 1, we quantify the dividend growth for companies that received an increase in weight or a decrease in weight and compare that to the overall universe<sup>2</sup>.

Figure 1: [WisdomTree Dividend Index \(WTDI\) Median Dividend Stream<sup>®</sup> Growth](#) and [Median Total Return](#)

| Weight Change | Median Dividend Stream <sup>®</sup> Growth | Median Total Return |
|---------------|--|---------------------|
| Raised        | 9.7%                                       | -11.1%              |
| Lowered       | 5.2%                                       | 14.6%               |
| All           | 6.6%                                       | 5.0%                |

Sources: WisdomTree, Bloomberg, 11/30/14 -11/30/15.

Past performance is not indicative of future results. You cannot invest directly in an index.

*For definitions of terms*

*in the chart, please visit our [glossary](#).*

- **Dividend Growers Saw Weight Increase:** The companies that saw their weight increase at the rebalance had a [median dividend growth](#) of 9.7%, which was greater than the median dividend growth of all companies (at 6.6%). Companies that saw their weight lowered at the rebalance had a median dividend growth of just 5.2%.
- **Underperformers Typically Saw Weight Increase:** Performance is also a key driver of relative changes. The typical stock that saw its weight increase had a median total return that was more than 16 percentage points lower than the median of all stocks.
- **Outperformers Reduced at Rebalance:** The typical stock that saw its weight lowered at the rebalance had a median total return 9.6 percentage points above all stocks. This is one of the keys to managing valuation risks.

A Detailed Look at the Individual Drivers The above was a higher-level overview of the total Index, but in figure 2, we highlight a few of the top individual additions and deletions to further specify the contributors. There weren't any major shifts in sectors at this year's rebalance, with no sector receiving an increase or decrease of more than 0.8%.

Figure 2: [WisdomTree Dividend Index \(WTDI\) Details](#)

| Action  | Name                          | Sector Name            | Prior Weight | Final Weight | Weight Change | Dividend Stream® Growth | Total Return |
|---------|-------------------------------|------------------------|--------------|--------------|---------------|-------------------------|--------------|
| Raised  | Wal-Mart Stores               | Consumer Staples       | 1.07%        | 1.41%        | 0.34%         | 2%                      | -31%         |
|         | Procter & Gamble              | Consumer Staples       | 1.44%        | 1.62%        | 0.19%         | 4%                      | -15%         |
|         | Int'l Business Machines (IBM) | Information Technology | 0.97%        | 1.14%        | 0.17%         | 16%                     | -11%         |
| Lowered | General Electric              | Industrials            | 2.63%        | 1.96%        | -0.67%        | -2%                     | 17%          |
|         | Microsoft Corp                | Information Technology | 2.93%        | 2.59%        | -0.34%        | 13%                     | 17%          |
|         | McDonald's Corp               | Consumer Discretionary | 1.03%        | 0.74%        | -0.29%        | -1%                     | 22%          |

Sources: WisdomTree, Bloomberg.

Prior weight is the weight before annual screening. Final weight reflects anticipated rebalance weight as of annual screening. *Dividend Stream* growth and total return period is 11/30/14–11/30/15. Past performance is not indicative of future results. You cannot invest directly in an index. Subject to change.

#### • Financials Led

**Dividend Stream Growth:** Over the period, the Financials sector displayed the strongest percentage growth at 13%, earning the sector a 0.4% increase in weight in WTDI. American International Group (AIG) and Citigroup both saw their weights increase over the period after significant dividend-per-share increases of 120% and 400%, respectively. The Financials sector's dividends are still recovering from their collapse, and it remains the only sector below 2007 dividend levels.

• **Energy Earned Largest Increase:** The biggest increase in weight for any sector in WTDI occurred in Energy—an increase of 0.7%, which was driven primarily by its poor performance over the period. Although the aggregate dividends for the sector slightly contracted, that contraction wasn't as bad as the sector's price contraction over the period, ultimately improving the sector's relative valuation.

• **Industrials and Information Technology Saw Their Weight Lowered:** The biggest decreases in weight for WTDI occurred in the Industrials and Information Technology sectors—a decrease of 0.7% and 0.6%, respectively. As noted in figure 2, General Electric and Microsoft helped contribute to this decrease in weight, having grown their dividends more slowly than their prices over the period, thus ultimately decreasing the fundamental relationship between price and dividends.

**Importance of Incorporating a Relative Rebalance** The WisdomTree annual rebalance is a key element of the added value of WisdomTree's Index methodology and can help manage valuation risks. WisdomTree Indexes use dividend growth as a key factor in determining which companies get increased weight at a rebalance. We interpret another year of above-average dividend growth as a positive indicator of underlying market fundamentals and believe it helps provide a notable foundation for potential future gains. [View current holdings of the WisdomTree Dividend Index.](#)

<sup>1</sup>Sources: WisdomTree, Bloomberg. Equity market refers to the S&P 500 Index from 3/9/09–11/30/15. <sup>2</sup>Overall universe: The overall universe is defined as the WisdomTree Dividend Index (WTDI), its inception date was 6/1/06.

#### Important Risks Related to this Article

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## DEFINITIONS

**Fundamentals**: Attributes related to a company's actual operations and production as opposed to changes in share price.

**Rebalance**: An index is created by applying a certain set of selection and weighting rules at a certain frequency. WisdomTree rebalances, or re-applies its rules based selection and weighting process on an annual basis.

**Dividend**: A portion of corporate profits paid out to shareholders.

**Valuation risk**: The risk of buying or over-weighting a particular stock that has appreciated significantly in price relative to its dividends, earnings or any other fundamental metric.

**Market Capitalization**: 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.

**Smart Beta**: A term for rules-based investment strategies that don't use conventional market-cap weightings.

**Dividend Stream**: Refers to the regular dividends per share multiplied by the number of shares outstanding.

**Median Dividend Growth**: The growth in median dividend yield for the specified universe.