

GLOBAL SMALL CAPS DELIVER STRONG RETURNS: WILL YOUR INDEX REBALANCE?

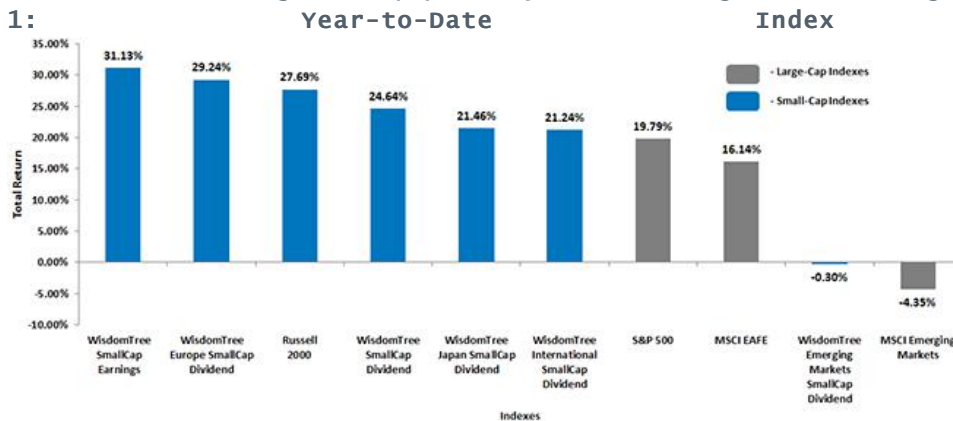
Jeremy Schwartz – Global Chief Investment Officer
10/29/2013

For the first three quarters of 2013, U.S. equity markets, measured by the [S&P 500](#), have performed strongly, leading broad developed and emerging indexes with a return of nearly 20%. Impressive, yes, but if one looks further down the [capitalization](#) spectrum in the U.S. markets and across global markets, there have been even better returns in global [small caps](#) during this cyclical upturn. Typically, small-cap companies have higher growth rates and potential, are more cyclically sensitive and tend to lead [large caps](#) in performance during economic expansions. Although global economic growth is below trend, the economy has emerged from the great recession, and leading indicators are pointing to a rebound in many of the major developed markets—the United States, Europe and Japan. This optimism is evident in the recent performance of equity markets year-to-date.

Small-Cap Performance Evaluation In the chart below we will compare a cross section of WisdomTree’s small-capitalization Indexes across the global landscape with common large-cap indexes to highlight the differences in the global small-cap opportunity set.

- We will use the S&P 500, [MSCI EAFE](#) and [MSCI Emerging Markets](#) indexes to represent domestic, developed international and emerging market large-cap equities, respectively.
- Also, we will use the [Russell 2000 Index](#) to represent a broad measure of U.S. small-cap equities. These indexes were chosen because of their scope in their respective asset classes and their general popularity for tracking and measuring these segments.

Figure 1:



Sources: Bloomberg, WisdomTree (12/31/13–09/30/13). Past performance is not indicative of future results. You cannot invest directly in an index. Subject to change.

For definitions of

indexes in the charts, please visit our [Glossary](#).

- **Small Caps Outperformed Large Caps** – All but one of the small-cap indexes above outperformed domestic, international and emerging market large-cap indexes mentioned. The chart illustrates the importance of looking beyond the large-cap market. The Russell 2000 Index, a market barometer for small caps, outperformed the S&P 500, MSCI EAFE and MSCI EM indexes by 7.90%, 11.55% and 32.04%, respectively.
- **WisdomTree SmallCap Earnings Index** – This was the best performer over the reviewed period, outperforming the Russell 2000 Index by 3.44%. The [WisdomTree SmallCap Earnings Index](#) includes only companies that demonstrate a prior four

quarters of cumulative positive earnings and then weights those companies based on their relative earnings. On the other hand, the Russell 2000 Index is weighted by market capitalization and may include companies that are not profitable. After such strong performance in small-cap stocks, we believe a focus on a disciplined rebalancing process gains significant importance.

- **International Small-Cap Strategies Also Leading Large Caps** – Both in the developed international and the emerging markets, small-cap indexes are outperforming their large-cap peers, as demonstrated by the [WisdomTree International SmallCap Dividend Index](#) leading the MSCI EAFE by over 5 percentage points and the [WisdomTree Emerging Markets SmallCap Dividend Index](#) leading the MSCI Emerging Markets Index by over 4 percentage points.
- **Looking Abroad to Diversify Small Caps** – Many investors incorporate small-cap strategies for the United States as part of their portfolio but have yet to expand these allocations internationally. The relatively strong returns in the United States may indicate a useful time to diversify some of the U.S. small caps to some of the foreign small-cap indexes, such as the emerging markets, that have not experienced such large gains.

The Importance of Valuations From a valuation standpoint, we think it is important to be mindful of the strong performance these indexes have displayed and what that means for current portfolio allocations. With [market capitalization-weighted](#) indexes, when constituents increase in price compared to other stocks, they are gaining a greater weight and impact on the performance of the index. At WisdomTree, we believe a focus on [fundamentals](#) is necessary, but that it is even more important after periods of such strong short-term performance. [WisdomTree Indexes](#) employ a rules-based rebalancing mechanism that adjusts relative weights based on underlying fundamentals. During the rebalancing process, which occurs once per year for each Index, the relationship between share price performance and either dividend growth or earnings growth is measured.

- **Firms that increased their earnings or dividends but whose share prices have remained constant or declined will typically see increases in weights.**
- **Firms whose earnings or dividends decreased but whose share prices have remained constant or risen will typically see decreases in weights.**

Conclusion Adding exposure to small caps can offer increased diversification and return potential, but there are critical differences in investment strategies. In our opinion, a rules-based approach that focuses and rebalances based on underlying fundamentals may enable investors to better capitalize on the small-cap segment, especially given the large performance run small caps have experienced recently. Read the full research [here](#).

Important Risks Related to this Article

Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Investments in emerging, offshore or frontier markets are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation and intervention or political developments. Diversification does not eliminate the risk of experiencing investment losses. Investments focusing on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility.

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)

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

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.

Size capitalization: A measure by which a company's size is classified. Large caps are usually classified as companies that have a market cap over \$10 billion. Mid caps range from \$2 billion to \$10 billion. Small caps are typically new or relatively young companies and have a market cap between \$200 million to \$2 billion.

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.

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.

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.

WisdomTree SmallCap Earnings Index (WTSEI): measures the performance of earnings-generating companies within the small-capitalization segment of the U.S. Stock Market. The index is comprised of the companies in the bottom 25% of the market capitalization of the WisdomTree Earnings Index after the 500 largest companies have been removed.

WisdomTree International SmallCap Dividend Index: A fundamentally weighted index measuring the performance of the small-capitalization segment of the US dividend-paying market. The Index is comprised of the companies that compose the bottom 25% of the market capitalization of the WisdomTree Dividend Index after the 300 largest companies have been removed. The index is dividend weighted annually to reflect the proportionate share of the aggregate cash dividends each component company is projected to pay in the coming year, based on the most recently declared dividend per share.

WisdomTree Emerging Markets SmallCap Dividend Index: A subset of the WisdomTree Emerging Markets Dividend Index measuring the performance of the smallest firms by market capitalization weighted by cash dividends.

Valuation: Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

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.

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

