
THE 2024 SMALL-CAP PLAYBOOK: VALUE AND DIVIDENDS

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12/27/2023

U.S. [small caps](#) struggled for the past two years as [rising borrowing costs](#) and [pressure from higher interest rates](#) challenged the asset class and stifled risk appetite.

Since 2021, investors in beta products tracking [market cap-weighted](#) small-cap indexes have had a disappointing experience, with virtually no silver linings like this year's success of the Magnificent 7 in the large-cap universe.

So, where should investors along the lower end of the equity size spectrum turn after two years of losses? We think there's value to uncover in small-cap strategies based on fundamentals rather than exclusive broad market ownership.

For those curious about fundamentals, we recently conducted an annual rebalance for the [WisdomTree U.S. SmallCap Dividend Index \(WTSDI\)](#), which is tracked by the [WisdomTree U.S. SmallCap Dividend Fund \(DES\)](#). Let's assess how its composition and fundamentals changed during our screening and reconstitution processes.

WisdomTree U.S. SmallCap Dividend Index (WTSDI)

The WisdomTree U.S. SmallCap Dividend Index applies a dividend-weighted methodology to the U.S. small-cap market. Beginning with the dividend-paying U.S. equity universe (resulting in the WisdomTree U.S. Dividend Index (WTDI)), we remove the 300 largest companies by market cap to create the WisdomTree U.S. LargeCap Dividend Index (WTLDI). We then create the WisdomTree U.S. MidCap Dividend Index (WTMDI) from the top 75% of market capitalization remaining. The residual 25% of market cap is reserved for a dividend-weighted small-cap basket.

Because of the [volatile](#) nature of small-cap equities, we often see more pronounced changes to WTSDI during the annual rebalance, and this year's was no exception. However, most changes remain consistent with the inherent value bias in the strategy resulting from its dividend emphasis.

Sector Composition – Post-Rebalance Comparison

WTSDI	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 and under-weights described in the text.

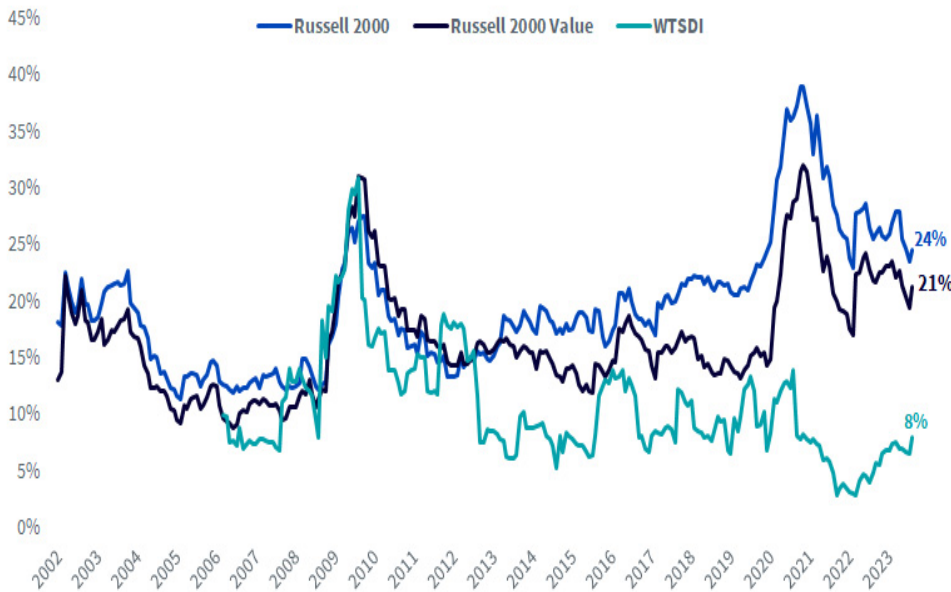
The small-cap Index increased its exposure to Financials, a traditional heavyweight in value-oriented indexes, due to lower valuation ratios and the banking sector’s preference for paying cash dividends. Energy and Utilities, two additional value-oriented sectors, also received notable pickups. These additions primarily came at the expense of Industrials and Materials.

But WTSDI’s sector composition diverges from the [Russell 2000 Value Index](#), which is broader and contains a swath of unprofitable companies.

It remains over-weight in the two Consumer sectors relative to the market, but those over-weights were slightly pared by the rebalance. Materials exhibited the same behavior but to a greater extent. The opposite happened within Energy and Financials, where the post-rebalance pickups helped reduce existing under-weights to the Russell 2000 Value. A new over-weight was established in utilities, where rebalance additions put WTSDI 2.8% ahead of the market, while Industrials were reduced to approximately market weight.

The sector changes highlight the fluid nature of the U.S. small-cap universe and the value of a fundamental emphasis in a predominantly low-quality market with a prevalence of unprofitable companies.

Weight in Unprofitable Companies over Time



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

Over the past decade, both the small-cap and small-cap value markets held roughly 20% of index weight in unprofitable companies, on average. Today, they account for one-fifth to one-quarter of each market after peaking at about 40% and 35%, respectively, during the height of the pandemic. WTSDI’s portion, meanwhile, remains below 10%.

Evidently, fundamentals matter for U.S. small caps, and wisdomTree’s annual rebalance for WTSDI illustrates how they are enhanced compared to market cap-weighted composite ownership.

Fundamental Comparison after Rebalance

WTSDI	Pre-Rebalance	Post-Rebalance	Rebalance Improvement	Russell 2000 Value	Relative to Russell 2000 Value
Constituents	672	677	--	1432	--
% Large Cap	0.0%	0.0%	0.0%	0.0%	0.0%
% Mid Cap	51.3%	51.3%	0.0%	54.1%	-2.7%
% Small Cap	48.7%	48.7%	0.0%	45.9%	2.7%
Dividend Yield	3.5%	3.9%	0.4%	2.4%	1.5%
Price-to-Earnings	12.3x	13.0x	0.6x	20.0x	-7.0x
Return-on-Equity	12.5%	11.1%	-1.4%	5.3%	5.8%
Return-on-Assets	2.3%	2.2%	0.0%	1.0%	1.2%
Leverage	5.5x	5.0x	-0.6x	5.2x	-0.3x

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

The screening and reconstitution process resulted in a 40-basis-point increase to trailing dividend yield and a reduced leverage multiplier compared to pre-rebalance metrics. Despite the 1.4% decline in ROE, all these measures are considerably better than those of the Russell 2000 Value Index. WTSDI delivers a 1.5% improvement to dividend yield and a 7% combined increase to ROE and ROA that results in a 0.3-point reduction to leverage.

Once again, these enhancements do not cost more in terms of valuation, either. WTSDI’s trailing P/E remains seven points below that of the U.S. small-cap value market.

Our methodology has rewarded over the long run as well, where we see the value of dividend-weighting the small-cap market. Since inception in June 2006, WTSDI outperformed the Russell 2000 Value Index by more than 70 basis points per year. Screening for dividends enabled us to select outperforming stocks and reduce the influence of underperformers across the top four quintiles of dividends over the 17-year period. This substantially explained all outperformance.

Dividend Yield Attribution – WTSDI vs. Russell 2000 Value Index – June 2006–November 2023

Category	Total Attribution Impact	Average Category Weight		Category Performance	
		Index Weight	Benchmark Weight	WT Index Return	Benchmark Return
1st Quintile (Highest Div. Yield)	0.20%	34.8%	14.8%	7.2%	5.7%
2nd Quintile	0.10%	24.9%	14.7%	6.4%	5.8%
3rd Quintile	0.17%	18.8%	12.8%	7.0%	5.8%
4th Quintile	0.12%	13.3%	10.0%	7.0%	6.4%
5th Quintile (Lowest Div. Yield)	-0.17%	6.6%	9.1%	6.9%	9.1%
Zero Div. Yield	-1.04%	0.1%	26.3%	-5.7%	6.8%
N/A	1.34%	1.5%	12.4%	-2.6%	-6.5%
Total	0.7%	100.0%	100.0%	6.8%	6.1%

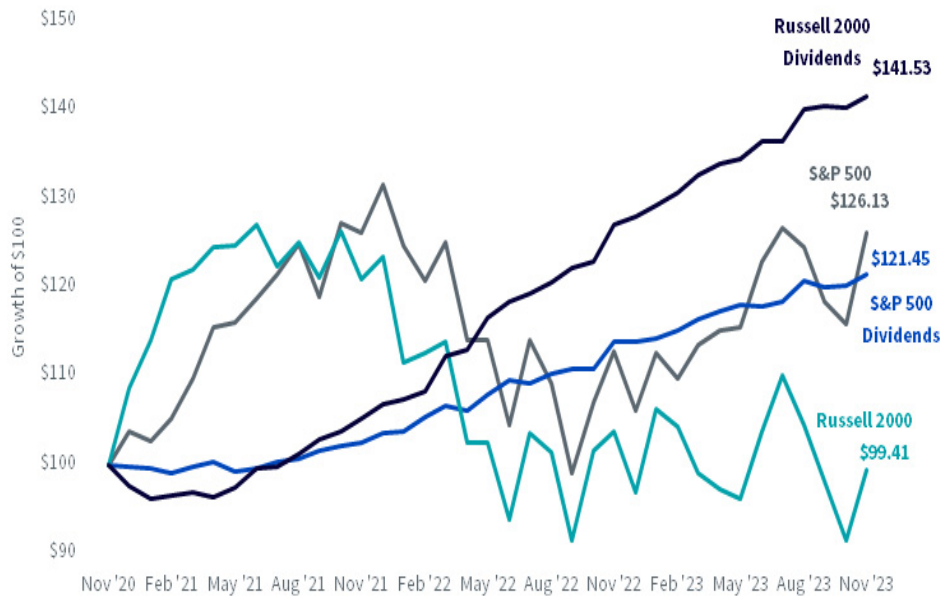
Sources: WisdomTree, FactSet, as of 11/30/23. Past performance is not indicative of future results. You cannot invest directly in an index.

On to 2024...

Heading into next year, we believe WTSDI can provide compelling opportunities for whatever equity market environment lays ahead, especially once market sentiment reverses in small caps’ favor. Dividend-paying small caps may receive an overdue tailwind as well if prevailing trends in large caps are any indication.

Over the past three years, S&P 500 price returns have largely kept pace with the growth of dividends despite briefly overshooting the fundamentals during 2021. Small caps cannot say the same, however, as the Russell 2000 has only *fallen* on a price return basis for the last three years, although its trailing dividend growth greatly surpasses that of the S&P.

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 months. 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.

We don't think this trend can, or should, continue. Once the tide turns in small caps' favor, we think they will be poised for outperformance.

Between sectoral shifts and fundamental improvements, and positive trends among dividend-paying companies, we are encouraged that dividend-weighting the U.S. small-cap equity market may continue to be additive for a portfolio.

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DEFINITIONS

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

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.

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

Russell 2000 value Index: measures the performance of small-cap value segment of the U.S. equity universe. It includes those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values.

Basis point: 1/100th of 1 percent.

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.