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# GET THE MOST OUT OF EMERGING MARKETS

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We're halfway through 2019, but the past six months have probably felt more like a lifetime for investors amid the flurry of geopolitical headlines. While global equities largely recovered 2018's losses to begin the year, the latter half of 2019 may prolong the existing uncertainty. Trade disputes, global economic growth concerns, central bank activity and whatever else the president can tweet in 280 characters or fewer will likely continue to fuel market activity in the near term.

Through the first six months of the year, emerging markets have lagged most developed markets. The [MSCI Emerging Markets Index](#) has gained about 10.5% through the end of June, but a large portion of these returns were front-loaded.

On one hand, the region entered the year with [price-to-earnings](#) and [forward price-to-earnings valuations](#) near three-year lows, suggesting the region was likely to have an enduring rally. On the other, we've seen emerging markets broadly up over 14% year-to-date in April, only to fall to just over 2% during May's sell-off.

In light of this [volatility](#), we believe a [dividend](#)-weighted approach to emerging market [small-cap](#) equities strikes an intriguing balance between return potential and volatility mitigation.

## Why Emerging Market Small Caps?

The [WisdomTree Emerging Markets SmallCap Dividend Index](#) was introduced in 2007 to target some of the most generous dividend payers within emerging markets. Over the past 10 years, the [MSCI Emerging Markets Small Cap Index](#) had an average [dividend payout ratio](#) of nearly 45%,<sup>1</sup> eclipsing the broader MSCI Emerging Markets Index by over 10%.

This suggests that small-cap companies in emerging markets, despite their growth profiles, are inclined to return their profits to investors in the form of dividends.

Additionally, when an index is weighted by a fundamental metric such as dividends, the result is a tilt toward [value](#)-oriented equities, which can double as a form of volatility management. For example, during the market sell-off this past May, WisdomTree's Index provided nearly 160 [basis points \(bps\)](#) of downside protection versus broad emerging markets.

## The Value of Value

The returns from our approach speak for themselves. Year-to-date, the WisdomTree Index has amassed nearly 600 bps of outperformance relative to its MSCI small-cap counterpart, with 328 bps attributed to being 28% over-weight in the highest [dividend-yielding](#) equities. Remember, the higher-yielding companies simultaneously provide extra income at attractive prices, which helps magnify returns.

Looking deeper, we show that nearly 90% of the WisdomTree Index’s weight is consolidated into the top three quintiles ranked by dividend yield, and this allocation has resulted in two-thirds of the total year-to-date outperformance.

Dividend Yield Attribution: YTD									
Category	Attribution Component				Average Category Weight			Category Performance	
	Allocation	Selection	Interaction	Total	WisdomTree Emerging Markets SmallCap Dividend Index	MSCI Emerging Markets Small Cap Index	Active Weight	WisdomTree Emerging Markets SmallCap Dividend Index	MSCI Emerging Markets Small Cap Index
1st Quintile (Highest Div. Yield)	1.89%	0.50%	0.90%	3.28%	43.74%	15.86%	27.88%	16.97%	13.62%
2nd Quintile	0.46%	-0.03%	0.00%	0.43%	27.07%	17.69%	9.38%	11.22%	11.52%
3rd Quintile	0.01%	0.28%	0.02%	0.30%	16.84%	15.45%	1.39%	9.01%	7.14%
4th Quintile	-0.04%	-0.24%	0.13%	-0.16%	9.07%	15.41%	-6.34%	5.47%	7.06%
5th Quintile (Lowest Div. Yield)	1.20%	0.71%	-0.59%	1.33%	2.50%	16.26%	-13.76%	2.65%	-1.39%
Zero Div. Yield	0.56%	1.21%	-1.22%	0.55%	0.16%	19.01%	-18.85%	9.27%	3.70%
N/A	-0.10%	0.17%	0.08%	0.16%	0.62%	0.32%	0.30%	23.53%	-17.11%
<b>Total</b>	<b>3.98%</b>	<b>2.61%</b>	<b>-0.69%</b>	<b>5.89%</b>	<b>100.00%</b>	<b>100.00%</b>	<b>0.00%</b>	<b>12.60%</b>	<b>6.71%</b>

Sources: WisdomTree, FactSet, as of 6/30/19. Analysis period: 12/31/18–6/30/19. Past performance is not indicative of future results. You cannot invest directly in an index.

Dissecting outperformance further, the tilt to value is apparent if we analyze returns by [earnings yield](#) quintiles. In this framework, WisdomTree’s Index is almost 75% consolidated into the top three quintiles corresponding to low price-to-earnings (P/E) ratios, implying attractive valuations. This results in an over-weight greater than 20% to the MSCI Emerging Markets Small Cap Index, and the results are evident. Being over-weight in these top three quintiles explains 60% of the outperformance year-to-date.

Earnings Yield Attribution: YTD									
Category	Attribution Component				Average Category Weight			Category Performance	
	Allocation	Selection	Interaction	Total	WisdomTree Emerging Markets SmallCap Dividend Index	MSCI Emerging Markets Small Cap Index	Active Weight	WisdomTree Emerging Markets SmallCap Dividend Index	MSCI Emerging Markets Small Cap Index
1st Quintile (Lowest P/E)	0.55%	0.72%	0.39%	1.65%	24.07%	15.35%	8.72%	17.84%	12.87%
2nd Quintile	0.50%	0.39%	0.22%	1.11%	28.16%	18.58%	9.59%	13.98%	11.71%
3rd Quintile	-0.07%	0.69%	0.18%	0.80%	21.60%	17.46%	4.14%	8.76%	4.90%
4th Quintile	-0.01%	0.28%	-0.04%	0.22%	17.29%	19.05%	-1.76%	8.19%	7.09%
5th Quintile (Highest P/E)	0.37%	1.59%	-1.01%	0.95%	7.15%	18.83%	-11.68%	12.37%	3.92%
Negative Earners	0.85%	1.40%	-1.25%	1.00%	1.10%	10.35%	-9.25%	9.66%	-2.87%
N/A	-0.09%	0.20%	0.05%	0.16%	0.62%	0.38%	0.24%	23.53%	-17.71%
<b>Total</b>	<b>2.10%</b>	<b>5.25%</b>	<b>-1.46%</b>	<b>5.89%</b>	<b>100.00%</b>	<b>100.00%</b>	<b>0.00%</b>	<b>12.60%</b>	<b>6.71%</b>

Sources: WisdomTree, FactSet, as of 6/30/19. Analysis period: 12/31/18–6/30/19. Past performance is not indicative of future results. You cannot invest directly in an index.

While the market environment over the past year has exhibited significant bouts of volatility, the success of the WisdomTree Emerging Markets SmallCap Dividend Index is not just a short-term anomaly. Extending our analysis back to the Index’s inception in 2007 shows that being over-weight in the highest dividend-yielding quintile of equities explains nearly half of the 318 bps of outperformance.

Dividend Yield Attribution: Since Inception									
Category	Attribution Component				Average Category Weight			Category Performance	
	Allocation	Selection	Interaction	Total	WisdomTree Emerging Markets SmallCap Dividend	MSCI Emerging Markets Small Cap Index	Active Weight	WisdomTree Emerging Markets SmallCap Dividend	MSCI Emerging Markets Small Cap Index
1st Quintile (Highest Div. Yield)	2.42%	-0.15%	-0.25%	2.02%	40.53%	14.13%	26.41%	8.11%	9.38%
2nd Quintile	0.54%	-0.57%	-0.34%	-0.37%	25.63%	15.85%	9.78%	4.14%	7.16%
3rd Quintile	-0.02%	-0.09%	-0.14%	-0.25%	16.86%	16.11%	0.75%	4.07%	4.25%
4th Quintile	-0.04%	-0.18%	0.06%	-0.16%	10.19%	15.82%	-5.64%	1.50%	2.24%
5th Quintile (Lowest Div. Yield)	0.74%	-0.39%	0.15%	0.50%	4.13%	17.12%	-12.99%	-4.49%	-3.22%
Zero Div. Yield	1.50%	1.46%	-1.45%	1.51%	0.23%	18.18%	-17.95%	4.65%	-4.75%
N/A	0.06%	-0.09%	-0.04%	-0.07%	2.43%	2.80%	-0.36%	-6.12%	-9.68%
<b>Total</b>	<b>5.20%</b>	<b>-0.02%</b>	<b>-2.00%</b>	<b>3.18%</b>	<b>100.00%</b>	<b>100.00%</b>	<b>0.00%</b>	<b>4.35%</b>	<b>1.17%</b>

Sources: WisdomTree, FactSet, as of 6/30/19. Analysis period: 6/30/07–6/30/19. Past performance is not indicative of future results. You cannot invest directly in an index.

Similarly, being 17% over-weight in the top quintiles (exhibiting the lowest P/E multiples) explains a large portion of the outperformance. Likewise, being 17% *under*-weight in the bottom quintiles (exhibiting the highest P/E multiples, plus those with negative earnings) explains the rest.

Earnings Yield Attribution: Since Inception									
Category	Attribution Component				Average Category Weight			Category Performance	
	Allocation	Selection	Interaction	Total	WisdomTree Emerging Markets SmallCap Dividend	MSCI Emerging Markets Small Cap Index	Active Weight	WisdomTree Emerging Markets SmallCap Dividend	MSCI Emerging Markets Small Cap Index
1st Quintile (Lowest P/E)	0.69%	-0.24%	0.03%	0.48%	21.95%	14.85%	7.10%	7.39%	9.41%
2nd Quintile	0.33%	-0.05%	0.05%	0.33%	23.12%	16.90%	6.22%	6.71%	6.98%
3rd Quintile	0.00%	0.57%	-0.02%	0.55%	21.94%	18.24%	3.70%	5.30%	2.17%
4th Quintile	0.04%	0.94%	-0.13%	0.84%	18.18%	19.39%	-1.21%	6.20%	1.78%
5th Quintile (Highest P/E)	0.43%	0.18%	-0.36%	0.24%	10.24%	18.94%	-8.70%	-1.21%	-1.83%
Negative Earners	0.86%	-0.02%	-0.10%	0.75%	3.71%	10.91%	-7.20%	-11.21%	-9.52%
N/A	0.07%	-0.07%	-0.01%	-0.01%	0.86%	0.76%	0.10%	-24.34%	-10.85%
<b>Total</b>	<b>2.41%</b>	<b>1.31%</b>	<b>-0.54%</b>	<b>3.18%</b>	<b>100.00%</b>	<b>100.00%</b>	<b>0.00%</b>	<b>4.35%</b>	<b>1.17%</b>

Sources: WisdomTree, FactSet, as of 6/30/19. Analysis period: 6/30/07–6/30/19. Past performance is not indicative of future results. You cannot invest directly in an index.

### How to Capitalize on the Emerging Markets Small-Cap Opportunity

While the success of a dividend-weighted approach to small-cap equities is apparent, the benefits also apply to broader emerging markets as well, where there’s naturally more exposure to larger MSCI companies along the size spectrum. WisdomTree’s Index has outpaced the conventional MSCI Emerging Markets Index over the past 3-, 5-, and 10-year periods as well, giving credence to dividend-oriented strategies in the developing world.

Emerging markets have the potential to offer investors much more than just diversified global exposure, including additional dividend income, volatility management and attractive valuations. While it is often difficult to find a comprehensive strategy that can help maximize this potential for investors, the [WisdomTree Emerging Markets SmallCap Dividend Fund \(DGS\)](#) may prove to be a favorable opportunity.

*Unless otherwise stated, all data comes from Bloomberg as of June 30, 2019.*

<sup>1</sup>Source: WisdomTree, FactSet, as of 6/30/19.

#### Important Risks Related to this Article

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## DEFINITIONS

**MSCI Emerging Market Index**: The MSCI Em (Emerging Markets) Index is a free-float weighted equity index that captures large and mid cap representation across Emerging Markets (EM) countries.

**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.

**Forward P/E ratio**: Share price divided by compilation of analyst estimates for earnings-per-share over the coming 12-month period. These are estimates that may be subject to revision or prove to be incorrect over time.

**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.

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

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

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

**MSCI EM Small Cap Index**: Includes small cap representation across 21 Emerging Markets countries. The small cap segment tends to capture more local economic and sector characteristics relative to larger Emerging Markets capitalization segments.

**Dividend Payout Ratio**: The percentage of earnings paid to shareholders in dividends. Calculated as yearly dividends per share over earnings per share.

**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.

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

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

**Earnings yield**: The earnings per share for the most recent 12-month period divided by the current market price per share. The earnings yield (which is the inverse of the P/E ratio) shows the percentage of each dollar invested in the stock that was earned by the company.