

LOOK TO JAPAN, EMERGING MARKETS FOR CHEAPEST VALUATIONS AMONG GLOBAL SMALL CAPS

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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, leading indicators are pointing to a rebound in many of the major developed markets. This optimism is evident in the performance of the small-cap equity markets year-to-date. Investors have a tendency to get overly enthused about growth prospects, which means that they tend to overpay for this potential growth. As a result of the increasing optimism and recent performance, we believe that [valuation risk](#) is one of the single greatest risks to current portfolio allocations in the small-cap space today. [Price-to-Dividend Ratio](#)

Apart from the [price-to-earnings ratio](#), another way to measure if investors are paying too high a price for the underlying fundamentals is the price-to-dividend ratio. In the chart below we will look at the 10-year price-to-dividend ratio of different regional indexes.

- When price growth equals dividend growth, there is no change in the price-to-dividend ratio—as dividends didn't become any more or less expensive relative to the price.
- When dividends grow faster than the price—there are greater amounts of dividends per unit of price—the price-to-dividend ratio drops, which reflects the markets getting cheaper.

Price-to-Dividend Ratios

| Index | Current Price-to-Dividend (P/D) Ratio | 10-Year (P/D) Average | Percentage Difference |
|---------------------------|---------------------------------------|-----------------------|-----------------------|
| Large Cap | | | |
| MSCI Emerging Markets | 39.75 | 44.26 | -10.19% |
| S&P 500 | 48.80 | 52.92 | -7.78% |
| MSCI EAFE | 38.29 | 39.40 | -2.81% |
| Small Cap | | | |
| MSCI Japan Small Cap | 59.41 | 71.89 | -17.36% |
| MSCI EM Small Cap | 48.14 | 54.11 | -11.04% |
| MSCI ACWI ex-US Small Cap | 47.52 | 51.79 | -8.25% |
| MSCI EAFE Small Cap | 47.61 | 49.50 | -3.83% |
| Russell 2000 | 80.43 | 81.41 | -1.20% |
| MSCI Europe Small Cap | 49.79 | 49.34 | 0.91% |

Sources: Bloomberg, MSCI, WisdomTree (09/30/03–09/30/13). "Current price-to-dividend ratio" is as of 09/30/13. Past performance is not indicative of future results. You cannot invest directly in an index. Subject to change.

• Global Small Caps

Show Similar Price-to-Dividend Ratios as the [S&P 500 Index](#) – Typically, one might expect small caps to trade at higher premiums than large caps as a result of their higher growth expectations. Of course, there are regional differences, but we find it interesting that the [MSCI EM Small Cap](#), [MSCI EAFE Small Cap](#) and [MSCI Europe Small Cap](#) indexes are all showing similar price-to-dividend ratios as the S&P 500 Index.

- **Highest Price-to-Dividend Ratio:** Note that the [Russell 2000 Index](#) has a price-to-dividend ratio of over 80x, which is more than 60% higher than that of the S&P 500. All foreign

small-cap indexes are significantly lower than the Russell 2000. • **Japan Small Caps Display Highest Discount to Historical Average** – Looking at the differences in the indexes' current price-to-dividend ratio compared to their 10-year average, Japan currently is selling at a discount of more than 17%. We feel this is important to note because the Japanese government has taken aggressive action to end [deflation](#) by adopting a bold [monetary policy](#) and has signaled it will follow up with fiscal and structural reforms. We believe these actions should continue to provide tailwind for Japanese large and especially small caps as the full effects are being felt by the local economy. • **Emerging Market Small Caps Appear Attractive** – Most economists expect emerging markets to grow faster than developed markets over the next decade, so we find it interesting that, as a region, they are currently priced at a discount. Also, emerging markets have displayed the highest regional dividend growth over the past 10 years, with large-cap dividends growing over 12% and small caps at almost 15% on an average annual basis.¹ I believe this has the potential to continue in the long term if emerging market growth expectations materialize. **Conclusion** without question, we feel investors should benefit by including exposure to global small caps in a diversified portfolio over the long term. After such strong recent short-term performance, we believe a focus on a fundamental rebalancing process becomes necessary to potentially manage valuation risk. While [market capitalization-weighted](#) indexes by their definition and investment process allocate the greatest weights to the firms with the largest market caps and the stocks that have appreciated the most, WisdomTree Indexes focus on [fundamentals](#)—either dividends or earnings—to determine their constituent weights. We believe this gives [WisdomTree Indexes](#) the potential to sell stocks that have become more expensive relative to their underlying fundamentals and buy stocks that have become less expensive relative to their underlying fundamentals. The cheapest part of the global small-cap market, when looking at current ratios versus their 10-year averages, appears to be Japan, followed by the emerging markets. I see both of these as attractive areas if one wants to diversify one's U.S. small-cap allocations.¹Sources: WisdomTree, MSCI (09/30/03–09/30/13).

Important Risks Related to this Article

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DEFINITIONS

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

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.

Risk: Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

Price-to-dividend ratio: Refers to the index price divided by the trailing 12-month dividends.

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.

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.

MSCI EAFE Small Cap Index: A free float-adjusted market capitalization equity index that captures small-cap representation across developed market countries around the world, excluding the U.S. and Canada.

MSCI Europe Small Cap Index: A free float-adjusted market capitalization-weighted index designed to measure the performance of developed equity markets in Europe, specifically focusing on the small-cap segment of these equity markets.

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.

Deflation: The opposite of inflation, characterized by falling price levels.

Monetary easing policies: Actions undertaken by a central bank with the ultimate desired effect of lowering interest rates and stimulating the economy.

Market capitalization-weighting: $\text{Market cap} = \text{share prices} \times \text{number of shares outstanding}$. 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.