

# BUFFETT'S CHECKLIST APPLIED TO SMALL CAPS

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Recently, I highlighted a passage from Warren Buffett's annual shareholder letter that reveals how Buffett thinks about [attractive investment options](#). His list detailed six requirements for potential acquisitions, but we focused on one in particular:

*Businesses earning good [returns on equity \(ROE\)](#) while employing little or no [debt](#).<sup>1</sup>*

**Buffett Primarily Limited to Large Caps** One of the downsides of Buffett's success is that his potential acquisition list is mostly limited to [large-cap](#) equities because of the size of Berkshire Hathaway. Buffett has previously addressed this: *We do need to deploy cash, but we can't put many billions to work every year in spectacular businesses. To move the needle at Berkshire, they have to be big transactions.*<sup>2</sup> He also said: *If I was running \$1 million today, or \$10 million for that matter, I'd be fully invested. Anyone who says that size does not hurt investment performance is selling. The highest rates of return I've ever achieved were in the 1950s. I killed the Dow. You ought to see the numbers. But I was investing peanuts then. It's a huge structural advantage not to have a lot of money. I think I could make you 50% a year on \$1 million.*

*No, I know I could. I guarantee that.*<sup>3</sup> **Getting Diversified Small Cap Exposure That Passes Buffett's ROE Rule** Warren Buffett is always going to be a master stock picker, but for the rest of us, getting diversified exposure to stocks that have "Buffett" characteristics via an index-based strategy can be a compelling strategy. *Investors, of course, can, by their own behavior, make stock ownership highly risky. And many do. Active trading, attempts to "time" market movements, inadequate diversification, the payment of high and unnecessary fees to managers and advisors, and the use of borrowed money can destroy the decent returns that a life-long owner of equities would otherwise enjoy. ... The commission of the investment sins listed above is not limited to "the little guy." Huge institutional investors, viewed as a group, have long underperformed the unsophisticated index-fund investor who simply sits tight for decades.*<sup>4</sup>

If we combine Buffett's principle of focusing on stocks with high returns on equity and little to no debt with his belief in the "unsophisticated index" approach to investing and apply it to small-cap stocks, I think of the [WisdomTree U.S. SmallCap Dividend Growth Fund \(DGRS\)](#), whose underlying investment strategy selects companies based on their high ROE and high [return on assets \(ROA\)](#) characteristics. **The Dividend Growth Formula: WisdomTree's Buffett Factor Approach** wisdomTree offers a series of Funds—our "Dividend Growth" family—that employs ROE and ROA as a driving force for stock selection. The reason we included ROA in powering stock selection is that it penalizes the use of debt ([leverage](#)) in delivering ROE; therefore, the companies that qualify for our Dividend Growth Funds tend to also employ little debt. **Top 20 Holdings of DGRS**

Ticker	Company Name	Weight	Return on Equity	Debt as % of Assets	P/E Ratio	Dividend Yield
PBF	PBF Energy Inc	2.2%	24.7%	24.1%	7.7x	3.5%
NUS	Nu Skin Enterprises Inc	2.1%	36.8%	15.3%	18.5x	2.3%
TAL	Tal International Group Inc	1.7%	20.7%	71.1%	11.2x	8.8%
LXK	Lexmark International Inc	1.7%	11.7%	19.3%	17.1x	3.4%
OLN	Olin Corp	1.6%	14.0%	25.0%	21.1x	2.5%
BOH	Bank of Hawaii Corp	1.5%	15.7%	5.9%	16.5x	2.9%
NJR	New Jersey Resources Corp	1.4%	14.8%	28.8%	17.5x	2.8%
PTEN	Patterson-UTI Energy Inc	1.3%	8.1%	18.3%	10.3x	2.1%
BGS	B&G Foods Inc	1.3%	15.2%	62.2%	23.9x	4.6%
DIN	DineEquity Inc	1.2%	31.1%	59.5%	26.9x	3.0%
AI	Arlington Asset Investment Corp	1.2%	22.4%	80.2%	7.7x	14.5%
GES	Guess? Inc	1.2%	12.6%	0.5%	14.4x	4.8%
MDP	Meredith Corp	1.2%	14.0%	30.6%	16.7x	3.1%
PRA	ProAssurance Corp	1.2%	11.3%	4.8%	14.6x	8.4%
OMI	Owens & Minor Inc	1.1%	9.7%	22.2%	18.5x	3.0%
CMC	Commercial Metals Co	1.0%	9.1%	36.1%	12.1x	3.0%
MDC	MDC Holdings Inc	1.0%	14.0%	38.5%	18.4x	3.5%
SEM	Select Medical Holdings Corp	1.0%	16.8%	53.8%	16.1x	2.7%
PCH	Potlatch Corp	1.0%	37.8%	60.8%	18.5x	3.6%
DK	Delek US Holdings Inc	0.9%	22.8%	20.4%	18.0x	2.5%
	<b>Sum/Average</b>	<b>26.9%</b>	<b>18.2%</b>	<b>33.9%</b>	<b>16.3x</b>	<b>4.3%</b>

Sources: WisdomTree, Bloomberg, as of 3/31/15. Holdings are subject to change. Past performance is not indicative of future results.

At WisdomTree, we believe that focusing on quality factors, such as high profitability and low leverage, through rules-based processes can be a compelling investment strategy over the long term. We also believe that these are common traits among firms that consistently grow their [dividends](#) and have a high potential to increase their dividends in the future. These high-quality, dividend-growing small caps are also selling at attractive [valuations](#) compared to broad based small caps, which we think creates a timely opportunity.

<sup>1</sup>The annual shareholder letter for Berkshire Hathaway, Inc., [available here](#). <sup>2</sup>Scott Patterson and Douglas A. Blackmon, "Buffett Bets Big on Railroad," The Wall Street Journal, 11/4/09. <sup>3</sup>Anthony Bianco, "Homespun Wisdom from the 'Oracle of Omaha,'" Businessweek, 7/5/99. <sup>4</sup>The annual shareholder letter for Berkshire Hathaway, Inc., [available here](#).

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## DEFINITIONS

**Return on Equity (ROE)**: Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

**Corporate debt**: Bonds a company issues in order to raise money.

**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.

**Leverage**: Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.

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

**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.