HOW TO ACCESS SHAREHOLDER YIELD IN U.S. SMALL CAPS

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In U.S. equities, investors love the idea of small-cap stocks. Some of these companies represent the entrepreneurial spirit, and it's no secret that many investors dream of the "lottery-like" experience of finding the next Facebook, Amazon, Netflix or Google before it becomes a giant company—collecting stratospheric returns along the way.

More Realistic Strategies in U.S. Small Caps

Of course, the chance of finding such blockbuster firms early in their life cycles is extremely low, and we think it would be difficult for most investors to build strategic allocations with that type of thinking. Fortunately, history has shown that certain characteristics of U.S. small-cap stocks have been associated with long-term outperformance.

One tilt that has been associated with stronger returns is U.S. small caps that are buying back their shares—and it's notable that traditional market capitalization-weighted benchmarks miss it.

Net Buybacks: Beneficial/Highest Net Issuance: Significantly Lower Returns

		Share Issuance						
		Net Buybacks	Zero Issuance	Lowest	Low	Mid	High	Highest
Size Segment	Smallest	16.31%	12.54%	13.94%	14.46%	14.94%	10.70%	4.22%
	Small	14.75%	13.75%	14.41%	14.00%	13.24%	12.85%	5.82%
	Mid	15.76%	12.26%	13.78%	14.71%	13.37%	11.71%	5.92%
	Large	15.57%	10.98%	11.91%	11.94%	13.48%	10.73%	6.80%
	Largest	11.73%	11.97%	9.94%	9.88%	11.62%	8.74%	5.68%

Sources: WisdomTree, Kenneth French Data Library, with period from 6/30/1963 to 10/31/2017.

- The highest return (darkest shade of green) was found in the smallest companies with net buybacks. While the small cap or "size" premium has been followed for many years, newer thinking seeks to mix the concept of focusing on small stocks with other factors, such as quality. One avenue through which to create a small-cap exposure with high quality is small stocks that are buying back shares.

- Also noteworthy is that, across all the size segments, the worst returns were in those stocks with the highest share issuance. We think it could make a lot of sense—whenever thinking about a U.S. equity exposure—to at least be aware of the net buyback ratio of that exposure to try to avoid those firms that are issuing the most stock.

Market Capitalization-Weighted Small-Cap Indexes Miss This Focus

Index Name	Trailing 12-Month Dividend Yield	Net Buyback Ratio	Shareholder Yield (Net Buyback Ratio + Trailing 12-Month Dividend Yield)
WisdomTree U.S. SmallCap Quality Dividend Growth Index	2.15%	1.03%	3.18%
WisdomTree U.S. SmallCap Earnings Index	1.15%	0.39%	1.54%
S&P SmallCap 600 Value	1.39%	-0.12%	1.27%
S&P SmallCap 600	1.21%	-0.36%	0.85%
MSCI USA Small Cap	1.37%	-0.71%	0.66%
S&P SmallCap 600 Growth	1.04%	-0.60%	0.44%
Russell 2000 Value	1.81%	-1.80%	0.01%
Russell 2000	1.23%	-1.52%	-0.29%
Russell 2000 Growth	0.67%	-1.26%	-0.58%

Sources: WisdomTree, FactSet. Data is as of 11/30/17. You cannot invest directly in an index.

For definitions of indexes in the chart, visit our glossary.

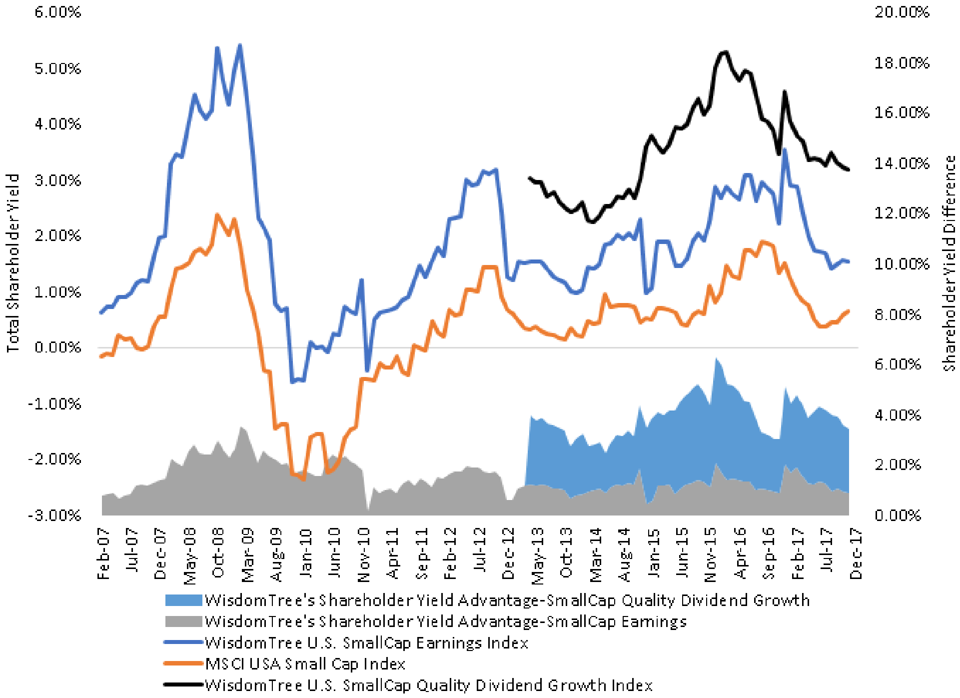
- Looking at the net buyback ratio for the S&P, MSCI and Russell Indexes shown in the table, we see they all have negative values, meaning that there is greater aggregate share issuance than share buybacks. It is clear that the Russell Indexes had the most issuance. We think it's notable to point out that S&P does have a requirement that constituents have four quarters of positive generally accepted accounting principles (GAAP) net income prior to initial inclusion, and that firms that are profitable have less potential need to issue new shares, diluting their current ownership.

- The WisdomTree U.S. SmallCap Quality Dividend Growth Index directly focuses on long-term earnings growth, as well as three-year averages of return on equity (ROE) and return on assets (ROA). The WisdomTree U.S. SmallCap Earnings Index eliminates exposure to firms that did not display cumulative profitability over the prior four quarters leading up to the annual screening date. Both of these Indexes purposefully tilt away from the lowest quality, most speculative small-cap companies, and notably both of them had positive net buyback ratios.

Consistency: An Important Attribute for Any Active Manager

Now, we recognize that these non-market capitalization-weighted indexes that try to capture a version of "modern alpha" are newer and that most investors are far more familiar with analyzing active managers. A critical attribute that tends to be highly valued in any due diligence process is consistency—a record of live performance that shows that the current set of characteristics has been consistently achieved over more than just the most recent time frame.

WisdomTree's Methodologies Have Consistently Increased Shareholder Yield



Sources: WisdomTree, FactSet, with data from beginning of live calculation for each Index (2/1/07 for WisdomTree U.S. SmallCap Earnings Index; 4/12/13 for WisdomTree U.S. SmallCap Quality Dividend Growth Index). You cannot invest directly in an index. Past performance is not indicative of future results.

- The methodology of the WisdomTree U.S. SmallCap Earnings Index has led to a fairly stable improvement in shareholder yield compared to the MSCI USA Small Cap Index that has been persistent for almost 11 years. An annual rebalance during which firms that have become unprofitable are systematically removed has been critical in generating this advantage.
- In our opinion, we would expect the WisdomTree U.S. SmallCap Quality Dividend Growth Index to rival any U.S. small-cap equity index on a shareholder yield basis. First, it focuses on dividend payers and is weighted by the *Dividend Stream®*, thereby raising the dividend yield portion of the equation. Additionally, the focus on ROE/ROA tends to tilt away from those firms that have the highest share issuance and are more speculative in nature. While it hasn't been around as long as the WisdomTree U.S. SmallCap Earnings Index, we don't believe that the higher shareholder yield we've seen there represents a fluke.

Setting Up a Long-Term Strategic Allocation to U.S. Small Caps

While no one can say precisely what future returns will be, we think that well-known historical work supports the concept of small caps being combined with quality.[1] Those companies that have been buying back shares, it's no secret as well, have been performing more strongly than those companies that have been issuing the most shares. We think that both the WisdomTree U.S. SmallCap Earnings and Quality Dividend Growth Indexes offer interesting avenues to access the concept of small-cap quality.

[1]Example of historical research touching on theme: Clifford Asness, et al., “Size Matters, if You Control Your Junk,” SSRN, first draft written 1/15.

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You cannot invest directly in an index.

DEFINITIONS

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.

Net Buyback Yield : A company's net share buyback is the difference between the capital raised by issuing new shares and the money the company spent on buying back any outstanding shares. A positive net share buyback means that more was spent on buying back existing shares than received from issuing new shares. Net buyback yield is the amount of a company's net buybacks divided by its market capitalization. Please note that net buyback yield does not represent a dividend paid by the company.

Size : Characterized by smaller companies rather than larger companies by market capitalization. This term is also related to the Size Factor, which associates smaller market-cap stocks with excess returns vs the market over time.

Equity premium : the excess return that investors may receive over the risk free rate as compensation for taking on the relatively higher risk associated with equit.

Factor : Attributes that based on its fundamentals or share price behavior, are associated with higher return.

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over tim.

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 USA Small Caps Index : a small-cap US equity index aiming to capture the performance of the securities within this size segment. .

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.

Generally Accepted Accounting Principles (GAAP) : Principles of accounting utilized in the U.S. that deal with different aspects and assumptions that are deemed acceptable in calculating the earnings of a firm.

Long-Term Earnings Growth Expectations : Compilation of analyst estimates of the growth in operating earnings expected to occur over the next full business cycle, typically 3 to 5 years, sourced from Bloomberg.

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.

Active manager : Portfolio managers who run funds that attempt to outperform the market by selecting those securities they believe to be the best.

Modern Alpha : Modern Alpha® combines the outperformance potential of active with the benefits of passive—to offer investor strategies that are built for performance.

Dividend Stream : Refers to the regular dividends per share multiplied by the number of shares outstanding.

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