

SMALL CAP DIVIDEND PAYERS WITH GROWTH POTENTIAL

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All eyes have been on the Federal Reserve (Fed) and its accommodative monetary policies lately. Since the 2008–09 global financial crisis, the Fed, as well as other central banks around the world, has been undertaking policies aimed at increasing liquidity and keeping interest rates low. However, as the U.S. economic picture improves, one must consider the possibility of the Fed ending some of the extraordinary measures it's been taking. On just a hint of its possibly curtailing these actions by mid-2014, longer-term interest rates in the U.S. started to rise considerably.¹

Dividend Growth Theme for Rising Rates As higher interest rates bring more competition for equities, assets with cash flows that can increase have the potential to become relatively more attractive. One index that embodies the dividend growth theme is the [NASDAQ US Dividend Achievers Select Index](#) (Achievers Select). It is widely followed, and its main selection rules require companies to have increased their dividends consistently every year for 10 years. Many appreciate its focus on large-cap, blue-chip companies that are considered higher quality than the broader equity market because they meet the 10-year dividend growth requirement.

No Index Can Cover All Bases Any index methodology trying to emphasize particular attributes selects certain types of securities and excludes others. Achievers Select is certainly strong on selecting large firms with established dividend histories. However, we believe it's also important to point out two classes of companies that are notably absent:

- Recent dividend initiators (or firms re-establishing a dividend)
- Small-cap companies

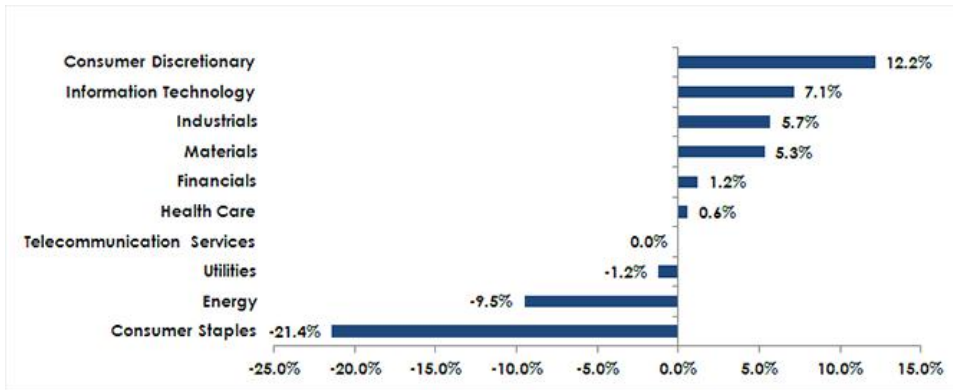
Themes of Quality and Dividend Growth Aren't Confined to Large-Cap Companies WisdomTree created the [U.S. SmallCap Dividend Growth Index \(WTSDBG\)](#) to help provide a solution for the theme of quality and dividend growth that extends beyond large caps to the small-cap companies. We believe U.S. small-cap companies that pay regular dividends constitute a significant opportunity set. WisdomTree's broadly focused SmallCap Dividend Index had 657 constituents and a market capitalization of approximately \$552 billion as of June 30, 2013.²

The WisdomTree U.S. SmallCap Dividend Growth Index, on an annual basis, tries to identify the regular small-cap dividend payers that have the greatest potential to increase their dividends. As we have explained in prior blogs, it does so through a combined attention to [long-term earnings growth expectations](#), three-year average [return on equity \(ROE\)](#) and three-year average [return on assets \(ROA\)](#). In other words, the focus is on growth factors (earnings growth expectations) and quality factors (ROE and ROA).

Complement Potential to Achievers Select We believe this new small-cap dividend growth Index is highly complementary to the Achievers Select. A few particular elements stand out as of June 30, 2013:

1. **Very few common constituents** This one, we believe, is fairly simple. Achievers Select has a methodology that leads it toward including larger companies—the very firms that have been around long enough to generate 10-year histories of consecutive dividend increases. It is also weighted by [market capitalization](#), which, put simply, means the largest firms get the biggest weights. With very few common constituents between the small-cap dividend growth companies and the Achievers Select comprising a combined weight of less than 1% of Achievers Select, we believe they are highly complementary exposures.
2. **Very Different Sector Exposures: Less Defensive and More Cyclical**

WTSDG Weight minus NASDAQ U.S. Dividend Achievers Select Index Weight



Source: WisdomTree, Bloomberg, as of 6/30/2013. Subject to change.

The biggest differences among sectors between WTSDG and the Achievers Select occur in the consumer sectors. The WisdomTree U.S. SmallCap Dividend Growth Index has a 21.4% under-weight in Consumer Staples and a 12.2% over-weight in Consumer Discretionary compared to the Achievers Select. If one believes in an improving U.S. economic picture—one where consumers may increase their discretionary purchasing—this could be of interest. Other cyclical sector over-weights compared to the Achievers Select include Information Technology, Industrials and Materials. **3. Small Caps More Sensitive to U.S. Local Economy** Neither the Achievers Select nor WTSDG focus on where constituents generate their revenues, but small-cap companies are often less globally based and more focused on a local economy. We looked at the weighted average geographic revenues for the top 10 constituents of the Achievers Select and WTSDG to illustrate this point. The WT small-cap Index derived more than 80% of its revenue from the United States, compared to less than 50% for the Achievers Select.³ While we understand that these are not the entire constituent lists, we believe that the logical conclusion—that large caps tend to be more multinational in their revenue distribution than small caps—seems to come through, and again this points to an interesting way of thinking about consequences for an improving U.S. economy. **Diversification Is about Being Different** The dividend growth and quality theme has been very popular, but we believe there were no good measures of these stocks outside of large caps. The WisdomTree U.S. SmallCap Dividend Growth Index is able to provide this precise focus, allowing people to extend this theme over a more complete swath of U.S. equities. Additionally, the completely different way of going about it (compared to the Achievers Select) provides great complementary potential. ¹These interest rates refer to the U.S. 10-Year Treasury Note ²Source: Bloomberg. ³Source: Bloomberg, as of 6/30/2013.

Important Risks Related to this Article

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DEFINITIONS

NASDAQ US Dividend Achievers Select Index: Designed to track the performance of dividend-paying companies in the U.S. that have increased their annual dividend payments for the last 10 or more consecutive years.

WisdomTree U.S. SmallCap Dividend Growth Index (WTSDG): A fundamentally weighted index designed to track the performance of dividend-paying companies in the U.S. small-cap equity universe that wisdomTree believes have the potential to increase their dividends due to certain factors, which include estimated earnings growth, return on equity and return on assets. Weighting is by indicated cash dividends.

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.

Market Capitalization: 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.