
UNEXPECTED SOURCES OF SHARE BUYBACKS

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A few years ago, WisdomTree coined the phrase “Forgotten Dividend Payers” to refer to [mid-cap](#) and [small-cap](#) companies that pay [dividends](#). In a [yield](#)-starved environment, within the United States one could dip down the [market capitalization](#)-size spectrum to find higher [dividend yields](#).

The [Share Buyback](#) Phenomenon

Share buybacks have generated a lot of attention within the low-yield environment that we’ve seen since the global financial crisis of 2008–2009. For example, in 2017, we saw Apple commit to a program to return \$300 billion to shareholders by March 2019. \$210 billion of this would be in the form of a share buyback.¹ The reality for U.S. large-cap firms—especially U.S. large-cap technology firms—is that they choose to utilize share buybacks as an important means of returning cash to shareholders.

But what about small caps?

Long-Term Record Indicates Small Caps with [Net Buybacks](#) Have Been Strong
(6/30/1963–6/30/2017)

		Share Issuance						
		Net Buybacks	Zero Issuance	Lowest	Low	Mid	High	Highest
Size Segment	Smallest	16.35%	12.52%	13.76%	14.22%	14.93%	10.63%	4.23%
	Small	14.74%	13.78%	14.45%	14.00%	13.17%	12.84%	5.68%
	Mid	15.81%	11.98%	13.86%	14.50%	13.30%	11.60%	5.88%
	Large	15.53%	11.20%	11.73%	12.00%	13.37%	10.57%	6.75%
	Largest	11.68%	11.82%	9.85%	9.72%	11.49%	8.47%	5.72%

Sources: WisdomTree, Kenneth French Data Library. Data is for the period 6/30/63–6/30/17. Five-by-five matrix with the horizontal axis referring to five net share issuance quintiles, plus those with net buybacks and those with zero net issuance, and the vertical axis referring to five market capitalization size quintiles. Darker green means higher average annual returns; darker red means lower average annual returns. Past performance is not indicative of future results.

- Looking at the boxes, one can't help but notice that most of the darkest green boxes (highest average annual returns) occurred in the "Net Buybacks" column. This means that firms that were buying back shares tended to outperform firms that were issuing shares. Additionally, the firms on the smaller end of the market capitalization spectrum (higher rows vertically) also tended to do better than the firms on the larger end of the spectrum (lower rows vertically).
- One question that people may ask is, how many firms are represented within the smallest quintile that are engaging in share buybacks? Clearly, it wouldn't be a static number, but to give people a sense, the lowest number of firms in this category was 61 in May and June 1970. For context, in June 2017, there were 290 firms in this category. So we would feel comfortable that the 16.35% per year would represent a diversified array of U.S. small-cap companies.²

In the Shift to Passive Investing, How Do U.S. Small-Cap Indexes Do on Share Buybacks?

Recently, investors have been largely shifting their assets from [actively managed](#) strategies to [passively](#) managed strategies, many of which are in exchange-traded funds (ETFs). This means that small-cap strategies tend to be accessed via different variants of the [Russell 2000 Index](#), the [S&P SmallCap 600 Index](#), and the [MSCI USA Small Cap Index](#).

In a way, these "[beta](#)" indexes represent the U.S. small-cap equity market. True, some are more selective than others, but their characteristics indicate more what U.S. small caps as a whole are doing rather than any stock selection or weighting strategy.

Decomposition of Shareholder Yield across U.S. Small-Cap Indexes (as of 9/29/17)

Index Name	Net Buyback Ratio	Trailing 12-Month Dividend Yield	Shareholder Yield (Net Buyback Ratio + Trailing 12-Month Dividend Yield)
WisdomTree U.S. SmallCap Quality Dividend Growth	1.07%	2.24%	3.31%
WisdomTree U.S. SmallCap Dividend	-0.62%	3.47%	2.85%
WisdomTree U.S. SmallCap Earnings	0.30%	1.19%	1.49%
S&P SmallCap 600 Value	-0.12%	1.42%	1.29%
S&P SmallCap 600	-0.53%	1.24%	0.71%
MSCI USA Small Cap	-0.98%	1.42%	0.44%
S&P SmallCap 600 Growth	-0.94%	1.07%	0.13%
Russell 2000 Value	-2.06%	1.89%	-0.18%
Russell 2000	-1.54%	1.27%	-0.27%
Russell 2000 Growth	-1.04%	0.68%	-0.36%

Sources: WisdomTree, FactSet, FTSE Russell, MSCI, Standard & Poor's. Data is as of 9/29/17. You cannot invest directly in an index. Past performance is not indicative of future results.

For definitions of indexes in the chart, visit our [glossary](#).

- The [WisdomTree U.S. SmallCap Quality Dividend Growth Index](#) and the [WisdomTree U.S. SmallCap Earnings Index](#) stand out as the only U.S. small-cap indexes shown (out of a relatively broad set) that had positive net buyback ratios. We will discuss why these two Indexes are uniquely positioned to do this with some consistency as opposed to this being a one-time, unique occurrence in this period.
- It's also notable to compare the S&P SmallCap 600 Index, the MSCI USA Small Cap Index and the Russell 2000 Index in terms of their net buyback ratios. They are all negative (meaning that in aggregate these firms are issuing shares), but the Russell 2000 Index was approximately three times as negative (meaning approximately three times as much share issuance) as the S&P SmallCap 600 Index.

WisdomTree's Approach to Small-Cap Quality

So, the long-term data would suggest that small-cap stocks that are buying back their shares have tended to generate stronger long-term returns than small caps that are issuing more shares. We mentioned earlier that both the WisdomTree U.S. SmallCap Quality Dividend Growth Index and the WisdomTree U.S. SmallCap Earnings Index are positioned to screen out low-quality firms that may be at greater risk of issuing shares to raise new capital.

- **WisdomTree U.S. SmallCap Earnings Index:** Each year, this Index eliminates firms with negative core earnings and re-tilts weight toward firms with the greatest core earnings. The result is that the firms at greatest risk of using share issuance to raise capital may not even be in the Index in the first place.
- **WisdomTree U.S. SmallCap Quality Dividend Growth Index:** Each year, this Index undertakes a growth and quality screen, thereby zeroing in on firms with stronger relative earnings growth *and* higher return on equity and return on assets (therefore, low leverage).

Conclusion: Small-Cap Quality Dividend Growth Is Best Positioned to Have Higher Net Buybacks

If you were to ask which single WisdomTree U.S. small-cap Index is best positioned to capture any long-term premium associated with small-cap firms that buy back their

shares, our answer would be the WisdomTree U.S. SmallCap Quality Dividend Growth Index. The fact is that the quality and growth screens have a unique side effect of screening out those firms at the greatest risk of issuing shares to raise capital. It may not mean outperformance over every year, but we think the long term could be quite exciting.

¹Source: "Apple Reports Second Quarter Results," Apple Newsroom press release, 5/2/17.

²Source: "25 Portfolios Formed on Size and Net Share Issuance," Kenneth French Data Library, updated as of 6/30/17.

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DEFINITIONS

Mid-Cap: Characterized by exposure to the next 20% of market capitalization (after the top 70% have been removed) within the Value, Blend or Growth style zones with the majority of the fund's weight.

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

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

Yield: The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

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.

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

Share buybacks: Firms using cash to purchase their own outstanding shares; may positively impact the share price.

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.

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

Passive: Indexes that take a rules-based approach with regular rebalancing schedules that are not changed due to market conditions.

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.

S&P SmallCap 600 Index: Market capitalization-weighted measure of the performance of small cap equities within the United States, with constituents required to demonstrate profitability prior to gaining initial inclusion.

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

Beta: A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.