
WHAT DRIVES EMERGING MARKET SMALL-CAP PERFORMANCE?

Jeremy Schwartz – Global Chief Investment Officer
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WisdomTree recently rolled out a new performance attribution tool to help our clients understand drivers of the equity market performance, both for our Indexes as well as the market. We have pushed the attribution envelope beyond just standard breakdowns such as by sector, country or [market cap](#) into [fundamental](#) factors. As we continue to expand our library of attribution data, there are many insights that can be gleaned from this tool. Today, we highlight emerging market small-cap performance attribution.

Do You Need an Active Manager for Inefficient Markets?

One common belief is that emerging markets are “inefficient,” particularly, [small caps](#), so one must use an [active](#) manager for this segment. WisdomTree challenges that notion, and some of our best relative performance has come in this inefficient market segment. Since inception, the [WisdomTree Emerging Markets SmallCap Dividend Index](#) has outperformed its cap-weighted benchmarks by 349 [basis points \(bps\)](#) per year. This strategy weights by [dividends](#) and tilts weight to higher-[dividend-yielding](#) stocks.

One can see just how big the tilts are using a dividend yield quintile attribution. This attribution starts by creating dividend-yielding portfolios from the market cap index (five quintiles, separate from two buckets of zero-dividend payers and a category for when there is no data). We then look at the weight of each index in these dividend-yield portfolios and their performance. As you can see in the tool below, as of May 31, 2018:

- The WisdomTree dividend-weighted strategy had 40.24% allocated to the top-dividend-yield quintile versus just 14.0% for the market cap-weighted index, a big differential. This higher allocation was a large driver of performance (231 basis points of the 349 basis points of total outperformance).
- The second-biggest driver of performance was the under-weight to the non-dividend-paying segment of emerging markets small-cap indexes—these stocks declined over the since-inception time period—underperforming the broad market by nearly 600 bps per year for more than a decade and the WisdomTree Index by nearly 950 bps *per year* over this since-inception period. The cap-weighted index had a significant amount of weight allocated to this non-dividend-paying segment (approximately 20% of the index), while the WisdomTree Index, by definition, includes only dividend-paying stocks at its [rebalance](#).

Index Performance Attribution

WTEMSC - WisdomTree Emerging Markets SmallCap Dividend Index VS. MXPESC - MSCI Emerging Markets Small Cap Index

Dividend Yield Attribution As of: 5/31/2018

MTD QTD YTD 1Y 3Y 5Y 10Y Since Inception

Category	Attribution Component			Total Attribution	Average Category Weight			Category Performance	
	Allocation	Stock Selection	Interaction		Index Weight	Benchmark Weight	+/- Wgt	WT Index Return	Benchmark Return
1st Quintile (Highest Div. Yield)	2.96%	-0.24%	-0.41%	2.31%	40.24%	14.00%	26.24%	8.53%	9.93%
2nd Quintile	0.72%	-0.82%	-0.52%	-0.63%	25.52%	15.78%	9.74%	5.21%	8.36%
3rd Quintile	-0.03%	-0.17%	-0.22%	-0.42%	16.89%	16.21%	0.69%	5.74%	6.07%
4th Quintile	-0.11%	-0.29%	0.09%	-0.32%	10.28%	15.88%	-5.61%	3.34%	4.22%
5th Quintile (Lowest Div. Yield)	1.00%	-0.67%	0.32%	0.65%	4.19%	17.08%	-12.89%	-3.68%	-2.03%
Zero Div. Yield	2.02%	1.82%	-1.79%	2.05%	0.23%	18.01%	-17.78%	6.18%	-3.50%
N/A	0.08%	-0.16%	-0.07%	-0.15%	2.66%	3.04%	-0.38%	-7.64%	-6.83%
Total	6.65%	-0.53%	-2.62%	3.49%	-	-	-	5.92%	2.42%

Sources: WisdomTree, FactSet, 8/1/07–5/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

The over-weights in the top dividend-yielding stocks is one way this index introduces a “[value](#)” discipline and helps provide the index with higher-dividend yields and improvements on other valuation criteria. Yet value is only one of the factors screening by dividends provides exposure to. We also often say dividend weighting enhances the quality of the basket. One way to see this impact is through attribution on [return on equity \(ROE\)](#) (profitability) metrics and quintiles.

- The cap-weighted [MSCI Emerging Markets Small Cap Index](#) has a greater weight to unprofitable companies and that can be found with 9.23% allocated to negative earnings and another 9.18% in a category with no data—this no data is likely because the companies were unprofitable—showing about 20% of the index in unprofitable stocks (similar to why these companies are not paying dividends above). These stocks dramatically underperformed the market with both the N/A and negative earnings underperforming the broader market by more than 800 bps per year for over a decade. WisdomTree had much less exposure to these segments.
- By contrast, the biggest over-weights in the WisdomTree Emerging Markets SmallCap Dividend Index were to the higher-ROE quintiles.

Index Performance Attribution

WTMESC - WisdomTree Emerging Markets SmallCap Dividend Index VS. MXEFSC - MSCI Emerging Markets Small Cap Index

Return on Equity Attribution As of: 5/31/2018

MTD YTD QTD 1Y 3Y 5Y 10Y Since Inception

Category	Attribution Component			Total Attribution	Average Category Weight			Category Performance	
	Allocation	Stock Selection	Interaction		Index Weight	Benchmark Weight	+/- Wgt	WT Index Return	Benchmark Return
1st Quintile (Highest ROE)	0.84%	-0.46%	-0.22%	0.16%	26.62%	18.47%	8.15%	7.88%	8.11%
2nd Quintile	0.16%	0.60%	0.25%	1.01%	20.55%	17.38%	3.17%	9.04%	5.97%
3rd Quintile	0.01%	0.68%	0.05%	0.74%	19.71%	16.46%	3.25%	7.17%	4.07%
4th Quintile	-0.01%	0.35%	0.02%	0.37%	16.90%	15.67%	1.23%	5.11%	3.34%
5th Quintile (Lowest ROE)	0.14%	-0.01%	0.13%	0.27%	11.48%	13.60%	-2.12%	-0.19%	0.35%
Negative Return	0.77%	-0.29%	0.05%	0.54%	3.94%	9.23%	-5.29%	-12.77%	-6.21%
N/A	0.50%	0.67%	-0.75%	-0.41%	0.79%	9.18%	-8.38%	-31.40%	-6.57%
Total	2.41%	1.55%	-0.47%	3.49%	-	-	-	5.92%	2.42%

Sources: WisdomTree, FactSet, 8/1/07–5/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

Another reason why it may make sense to invest in emerging market small caps is the different country and sector mix one can get in these companies. The sector exposure tends to be more Industrials, Consumer, Tech and Financials and less commodity-heavy sector exposure. This has resulted in small caps having less risk than large caps over the last decade. One can see just how exposed the index is to countries and sectors in this report.

Index Performance Attribution

WTMESC - WisdomTree Emerging Markets SmallCap Dividend Index VS. MXEFSC - MSCI Emerging Markets Small Cap Index

Sector Attribution As of: 5/31/2018

MTD YTD QTD 1Y 3Y 5Y 10Y Since Inception

Category	Attribution Component			Total Attribution	Average Category Weight			Category Performance	
	Allocation	Stock Selection	Interaction		Index Weight	Benchmark Weight	+/- Wgt	WT Index Return	Benchmark Return
Industrials	-0.15%	0.99%	0.12%	0.95%	18.17%	15.61%	2.57%	2.29%	-2.36%
Information Technology	0.22%	0.80%	-0.13%	0.90%	14.65%	15.61%	-0.95%	5.61%	1.86%
Consumer Discretionary	-0.09%	0.81%	0.06%	0.78%	15.75%	16.86%	-1.12%	6.12%	1.84%
Consumer Staples	0.05%	0.58%	0.00%	0.64%	8.06%	7.86%	0.20%	12.57%	7.46%
Real Estate	0.04%	0.05%	0.27%	0.36%	7.63%	7.79%	-0.16%	5.69%	5.01%
Energy	0.02%	0.19%	0.09%	0.30%	2.60%	2.26%	0.34%	7.19%	-0.23%
Financials	0.17%	-0.00%	-0.05%	0.12%	12.66%	10.74%	1.92%	5.72%	6.40%
Materials	-0.10%	0.37%	-0.17%	0.09%	11.28%	12.72%	-1.44%	4.17%	2.73%
Other	0.02%	0.00%	-0.01%	0.01%	0.03%	0.00%	0.03%	-0.86%	0.00%
Health Care	-0.22%	0.54%	-0.35%	-0.04%	2.40%	6.34%	-3.93%	13.73%	7.34%
Utilities	-0.01%	-0.11%	0.02%	-0.10%	5.55%	3.20%	2.35%	3.84%	5.51%
Telecommunication Services	-0.01%	-0.37%	-0.14%	-0.51%	1.21%	1.02%	0.19%	-17.47%	3.89%
Total	-0.06%	3.84%	-0.29%	3.49%	-	-	-	5.92%	2.42%

Sources: WisdomTree, FactSet, for the period 8/1/07–5/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

This new attribution feature has a lot of great insights at what factors drove both WisdomTree Index returns as well as cap-weighted benchmark returns. If you want to see quick drivers across time periods and indexes—U.S., developed world, emerging markets and factors including sectors, dividend yield, price/earnings ratio and profitability benchmarks—this tool can help you understand the market in new ways. Access the Index Performance Attribution [here](#).

All data as of May 31, 2018, and sourced from WisdomTree and FactSet.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

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You cannot invest directly in an index.

DEFINITIONS

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.

Fundamentals: Attributes related to a company's actual operations and production as opposed to changes in share price.

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

Active: Funds that attempt to outperform the market by selecting securities a portfolio manager believe to be the best.

Basis point: 1/100th of 1 percent.

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

Dividend yields: Refers to the trailing 12-month dividend yield. Dividends over the prior 12 months are added together and divided by the current share price. Higher values indicate more dividends are being generated per unit of share price.

Rebalance: An index is created by applying a certain set of selection and weighting rules at a certain frequency. WisdomTree rebalances, or re-applies its rules based selection and weighting process on an annual basis.

Value: Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over time.

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

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.