

REBALANCING EM SMALL CAPS DURING VOLATILE MARKETS

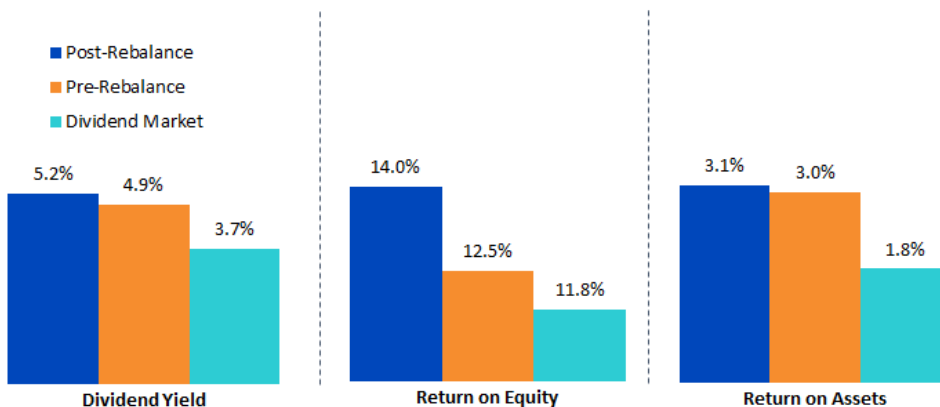
Ben Tan — Quantitative Research Analyst
 11/05/2018

As global trade disputes between the two largest economies continue to escalate, [volatility](#) has once again become a fact of global markets, as seen in the [VIX](#) spiking above 25¹. Perhaps due to their sensitivity to trade (and concentration in China), emerging market (EM) equities have sold off considerably during this period, falling by 10.7%² over the last month alone. Despite the turmoil, we believe this bout of volatility can create long-term opportunities. At WisdomTree, a key element of our Index methodology is our focus on yearly [rebalancing](#) based on fundamentals. To illustrate this process, we focus on [small-cap dividend](#) payers in EM.

Longer Trend Intact—Rebalancing to Stronger [Fundamentals](#) with Less Volatility

With EM selling off, we believe this may be an opportunity for EM investors to take a step back and reassess their portfolios. Coincidentally, the timing of WisdomTree’s dividend rebalances is allowing us to do the same, giving us the opportunity to review and refresh the Index weights and potentially take advantage of favorable entry points. Every year, per Index rules, WisdomTree can turn over the portfolio to reallocate Funds to potentially cheaper and undervalued constituents. This year, the [WisdomTree Emerging Markets SmallCap Dividend Index](#) rebalance increased the Index’s overall [dividend yield](#) and improved the quality of its overall basket. After rebalancing, the WisdomTree Emerging Markets SmallCap Dividend Index now offers a dividend yield of 5.2%, and has meaningfully enhanced quality metrics for [return on equity](#) and [return on assets](#).

Rebalancing to Higher Quality and Dividend Constituents

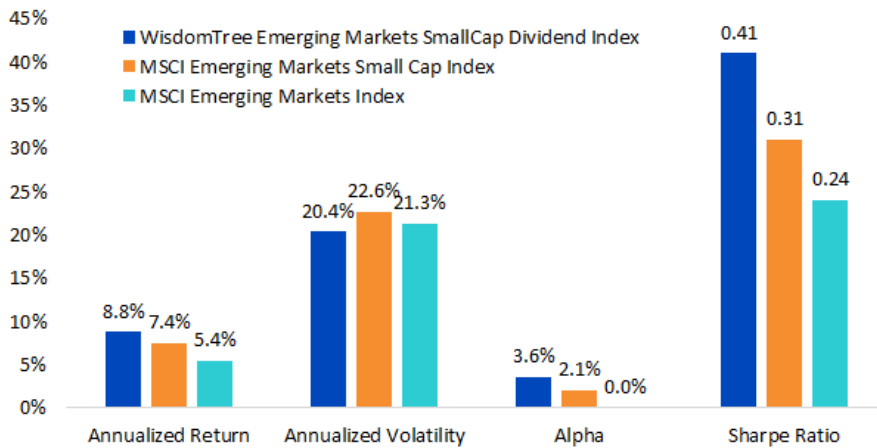


Source: WisdomTree. Dividend Market represents the WisdomTree Emerging Markets Dividend Index. Pre-Rebalance and Post-Rebalance represent the WisdomTree Emerging Markets SmallCap Dividend Index pre- and post-rebalance, as of 10/22/18. Past performance is not indicative of future results. You cannot invest directly in an index.

Historically, weighting EM small caps by their cash dividends and annually rebalancing back to that measure has resulted in higher returns and lower volatility. To some, it might be surprising that EM small caps have exhibited lower volatility than their large-cap counterparts, but over the last trailing five-year, ten-year and common inception periods, that has

been the case. Highlighting the standardized ten-year period in figure 2, you can see the return advantage has been over 300 [basis points \(bps\)](#) a year in performance. For investors with a longer-term view, recent underperformance in the market can represent a buying opportunity.

10-Year Summary Statistics



Source: WisdomTree, 9/30/08–9/30/18. Past performance is not indicative of future results. You cannot invest directly in an index.

Longer Trend Intact—Consumer Growth Is Still the Story

The use of dividend payers to construct the WisdomTree Emerging Markets SmallCap Index has yielded a portfolio that gives investors the ability to tap into local growth with a less volatile, higher income approach. EM small-cap growth is a good way to play local economic development. Despite recent setbacks, the EM growth story remains intact. Rising populations and income levels have created a burgeoning consumer class. People in many EM countries are also moving toward urbanized regions as their countries’ economies develop and they seek to move up the value chain. One of the lasting benefits for emerging countries is their ability to adopt technology at an incredible pace. The number of internet users in EM has grown to 1.8 billion since 2007 and is forecast to increase even more over the next decade.³ These are all positives for the growth story of EM local markets.

[Large-cap](#) names now appear much more tied to global growth than to local growth in emerging markets. By comparison, top-line growth numbers for small caps tend to be more closely tied to local economic growth factors. Specifically, small-cap dividend payers are concentrated in the information technology, consumer discretionary, and industrial sectors. These companies may be more locally focused, and many of them are bigger players in the smaller industries they are a part of.

China [A-Shares](#) Inclusion

With the inclusion of China A-shares in this year’s rebalance, we are increasing exposure to one of the largest consumer sectors in the world. WisdomTree’s Index added 100 Chinese domestic-listed small-cap companies, capping the exposure at roughly 5%, although total China exposure is around 22.4%.

In short, near-term volatility may be an opportunity for investors to reassess their EM exposure. By focusing on small-cap dividend payers, investors may also be able to reduce volatility relative to the large-cap multinationals currently being impacted by fears in global trade. In our view, the most recent rebalance continues to emphasize these trends.

¹Source: CBOE SPX Volatility Index (VIX), 10/30/18.

²Source: MSCI Emerging Market Index month-to-date returns, 10/30/18.

³Source: BCG, 10/22/18.

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

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

IMPORTANT INFORMATION

U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Kara Marciscano, Jianing Wu and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Volatility : A measure of the dispersion of actual returns around a particular average level. .

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.

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.

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

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

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.

Basis point : 1/100th of 1 percent.

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.

A-share : shares traded on the Shanghai and Shenzhen stock exchanges. This is contrast to Renminbi B shares which are owned by foreigners who cannot purchase A-shares due to Chinese government restrictions.