# THE DIFFERENCE BETWEEN SMALL CAP ISSUERS AND BUYBACKERS

**Jeremy Schwartz — Global Chief Investment Officer**
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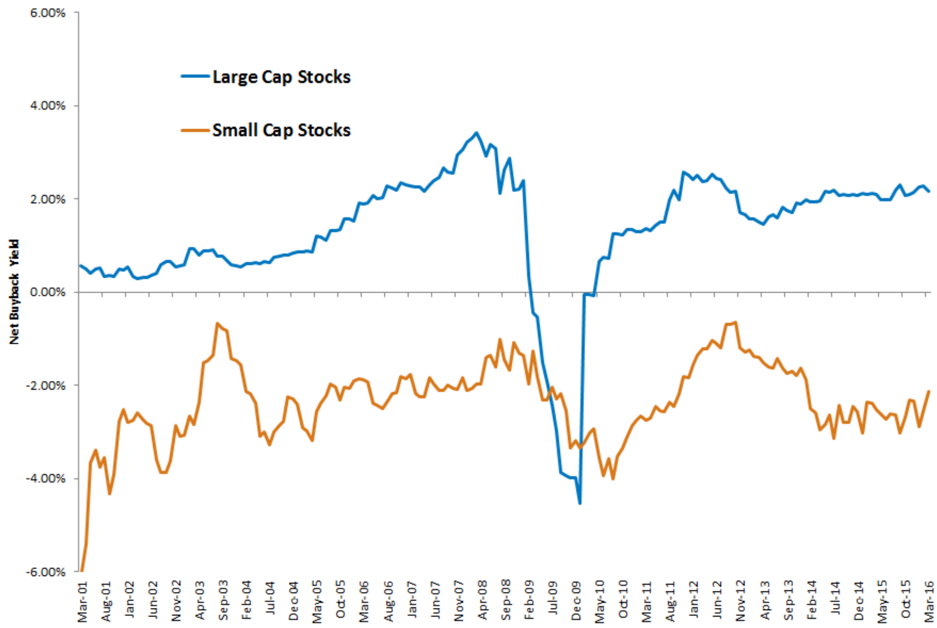
In the long-term academic research, one important conclusion has dictated an enormous amount of capital allocation preferences: the historical tendency for small-cap value stocks to outperform small-cap growth stocks. Small-cap growth has been a fairly poor-performing long-run asset class, and over the last 50 years, small-cap value has outperformed small-cap growth by 7.6% per year.[1] Why has this occurred? One simple explanation could be that people have been overexcited by the growth prospects of small-cap growth companies and effectively paid too much for the future growth options (think lottery ticket-type payoffs). In contrast, the small-cap value category is characterized by too pessimistic an outlook and people underpricing the potential of those stocks. **A Preference for Growth** In today's world, growth is scarce, and there is a preference for companies that can achieve above-subnormal growth. Growth indexes have been outperforming value for much of the last decade—driven in part by the financial crisis that caused a deep underperformance of value strategies from 2007 to 2009.[2] Should investors for the foreseeable future forget their bias to allocate more to small-cap value in favor of growth in a low-growth world? The analysis below helps illustrate one of the high hurdles that comes with small-cap growth strategies. Small-cap companies are almost constantly issuing shares to fund their growth, much more than large-cap companies. In the U.S., large-cap companies have been displaying fairly consistent 2% net buyback yields in recent years.[3] **The Buyback Difference: Small vs. Large** Large-cap stocks had a net buyback yield of 1.3%, while small-cap stocks had a net buyback yield of -2.3% on average over the last 15 years.

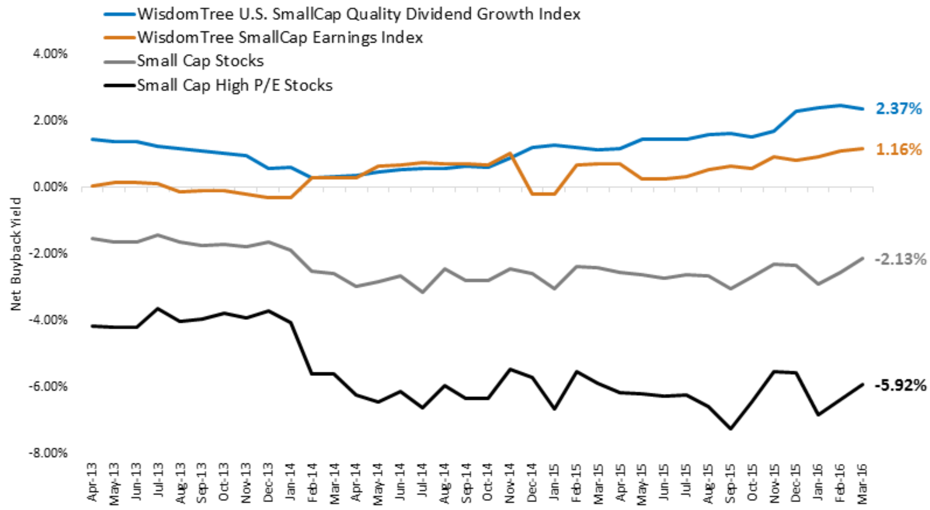
**Net Buyback Yields: Large Cap vs. Small Cap**




Sources: WisdomTree, FactSet, 3/31/01–3/31/16. Large-cap stocks represent the largest 500 securities by market cap, from a universe of the 3,000 largest US listed and US domiciled by market cap, weighted by market cap and reconstituted monthly. Small-cap stocks represent the bottom 2,000\securities by market cap, from a universe of the 3,000 largest US listed and US domiciled by market cap, weighted by market cap and reconstituted monthly. Net buyback yield does not measure dividends or investment returns from stocks; and is not intended to represent the past or future performance of any particular index or investment product. Historical results do not guarantee future results.

In small caps, there is a large

difference in the buyback yields of companies with high valuations (either companies losing money and needing to raise capital to fund their existence or companies selling at high price-to-earnings [P/E] ratios) compared to profitable companies and lower-priced companies. Over the last three years, the high-priced small-cap stocks had an average net buyback yield of -5.5%, meaning there was a net capital issuance, and therefore a *per-share* drag of over 5% per year that they must overcome to drive future per-share earnings growth. When an investor selects just profitable companies and weights them by their *Earnings Streams*, the average buyback yield has been slightly positive over this same period.[4] That was one net benefit of selecting and weighting universes by profits—you got an average improvement of almost 6 percentage points per year for the net buyback yields. One critical reason this occurred was the shift to lower-priced companies within that small-cap universe and the shift away from higher-priced stocks, which are doing the most capital raising. Managers are often responding to incentives: If they think their stocks are low priced, they are issuing fewer shares, whereas companies with higher valuations issue more stock and thus have a higher *per-share* hurdle to overcome. **Small-Cap Dividend Growers Were Also Higher Net Buybackers** The WisdomTree U.S. SmallCap Quality Dividend Growth Index (small-cap dividend growers), which selects companies based on high return on equity (ROE), high return on assets (ROA) and high earnings growth expectations, raised the net buyback yield even further. In contrast to the 5.9% net share issuance over the last year from the expensive small-cap stocks, the small-cap dividend growers had a 2.37% net buyback yield (over a 8-percentage-point differential).[5] The net issuance that is taking place in this small-cap expensive-stock universe is one of the reasons I believe the small-cap growth category has a tough time outperforming the small-cap value category over time. Companies that are constantly issuing shares have to achieve a higher growth rate to overcome the dilution from raising shares outstanding. The companies in our SmallCap Quality Dividend Growth Index are actually reducing their shares outstanding and are priced in such a way that expectations are lower and easier to overcome. In a world in which growth is scarce, the WisdomTree U.S. SmallCap Quality Dividend Growth Index represents an interesting mix of both relatively attractive current dividend levels (especially compared to market cap-weighted indexes) and currently more attractive net buyback yields that could support per-share earnings growth. I believe this makes a powerful case for why these stocks could perform comparably well across time. **Small-Cap Net Buyback Yields**




Sources: WisdomTree, FactSet, 3/31/01–3/31/16. Large-cap stocks represent the largest 500 securities by market cap, from a universe of the 3,000 largest US listed and US domiciled by market cap, weighted by market cap and reconstituted monthly. Small-cap stocks represent the bottom 2,000 securities by market cap, from a universe of the 3,000 largest US listed and US domiciled by market cap, weighted by market cap and reconstituted monthly. Net buyback yield does not measure dividends or investment returns from stocks; and is not intended to represent the past or future performance of any particular index or investment product. Historical results do not guarantee future results.

[1]Source: Fama & French, 3/31/1966–3/31/2016. Click here for more information about their methodology. The portfolios, which are constructed at the end of each June, are the intersections of 2 portfolios formed on size (market equity, ME) and 3 portfolios formed on the ratio of book equity to market equity (BE/ME). Small Cap Value would be the smallest 50% by ME and the highest 30% by BE/ME. Small Cap Growth would be the smallest 50% by ME and the lowest 30% by BE/ME. [2]Sources: WisdomTree, Bloomberg, 4/30/06–4/30/16. References the MSCI ACWE Growth Index outperformance of MSCI ASWI Value Index. [3]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. [4]High-priced small-cap stocks refer to the 50% highest-priced stocks from a P/E perspective within the small-cap stock universe. Small-cap profitable stocks weighted by *Earnings Stream* refers to the WisdomTree SmallCap Earnings Index. [5]Sources: WisdomTree, FactSet, as of 3/31/16.

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## DEFINITIONS

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

**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 tim.

**Growth** : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

**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.

**Valuation** : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

**Earnings Stream®** : Earnings per share x the number of shares outstanding. For an index, these totals are added for all constituents.

**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.

**Earnings growth estimates** : Bloomberg analysts' long-term earnings growth expectations, which encompass the estimated growth in operating earnings per share over the company's next full business cycle, typically three to five years.

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

**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.

**MSCI ACWI Growth Index** : A free-float adjusted market capitalization-weighted index that is designed to measure securities exhibiting overall growth style characteristics of developed and emerging markets.

**MSCI ACWI Value Index** : A free-float adjusted market capitalization-weighted index that is designed to measure securities exhibiting overall value style characteristics of developed and emerging markets.