

# MANAGING VALUATION RISK BY REBALANCING

Jeremy Schwartz – Global Chief Investment Officer  
12/23/2013

During periods of strong short-term performance, as seen in 2013, it is especially important to ask whether these moves are justified by the underlying [fundamentals](#). We think it is important to be mindful of how an annual [rebalance](#) back to an underlying fundamental such as dividends can help manage [valuation risks](#)—a key factor in why the non-cap-weighted indexes are included in the “[smart beta](#)” category of indexes. **Quantifying the Fundamental Rebalance** with [market capitalization-weighted](#) indexes, when constituents increase in price compared to other stocks, they gain greater weight and increase their impact on the performance of the index. WisdomTree Indexes employ a rules-based rebalancing mechanism that adjusts relative weights based on underlying dividend trends. During the rebalancing process, which occurs once per year for each Index, the relationship between price change and dividend growth is measured. In the table below we quantify the dividend growth for companies that received increases in weight or decreases in weight, and compared that to the overall universe. **Figure 1: WisdomTree Dividend Index (WTDI) Trends**

Weight Change	Median Dividend Stream <sup>®</sup> Growth	Median Total Return
Raise	17.0%	19.0%
Lower	5.1%	43.0%
All	8.4%	34.4%

Sources: WisdomTree, Bloomberg, as of 11/30/2013.  
Past performance is not indicative of future results. You cannot invest directly in an index.

**• Dividend Growers Saw**

**Weight Increase:** The companies that saw their weight increase at the rebalance had a [median](#) dividend growth of 17.0%, which was greater than the median dividend growth of all companies (at 8.4%). Companies that saw their weight lowered at the rebalance had a median dividend growth of just 5.1%. **• Underperformers Typically Saw Weight Increase:** Performance is also a key driver of relative changes. The typical stock that saw its weight increase had a median total return that was over 15 percentage points lower than the median of all stocks. **• Outperformers Reduced at Rebalance:** The typical stock that saw its weight lowered at the rebalance had a median total return 9 percentage points above all stocks. This is one of the keys to managing valuation risks. **A Detailed Look at the Individual Drivers** The above was a higher-level overview of the total Index, but in the chart below we highlight a few of the top weight increases and decreases to help further specify the contributors. **Figure 2: WisdomTree Dividend Index (WTDI) Details**

Action	Name	GICS Sector Name	Prior Weight	New Weight	Weight Change	Dividend Stream* Growth	Total Return
Raise	APPLE INC	Information Technology	2.67%	3.00%	0.32%	10%	-3%
	ORACLE CORP	Information Technology	0.30%	0.60%	0.29%	89%	11%
	INTL BUSINESS MACHINES CORP	Information Technology	0.90%	1.13%	0.23%	7%	-4%
Lower	BRISTOL-MYERS SQUIBB CO	Health Care	0.90%	0.63%	-0.27%	3%	63%
	JOHNSON & JOHNSON	Health Care	2.30%	2.03%	-0.27%	10%	40%
	BOEING CO/THE	Industrials	0.60%	0.40%	-0.20%	10%	84%

Sources: WisdomTree, Bloomberg. Prior weight is as of 11/30/13. New weight reflects anticipated rebalance weight. Dividend Stream growth and total return period is 11/30/12–11/30/13.

Past performance is not indicative of future results. You cannot invest directly in an index. Subject to change.

*For current holdings*

*of the WisdomTree Dividend Index, please click [here](#).*

- **Information Technology Earned Largest Increase:** The biggest increase in weight for any sector in WTDI occurred in Information Technology—an increase of 0.9%, which was driven primarily by its dividend growth. As noted above; Apple, Oracle and IBM all helped contribute to this increase in weight, having grown their dividends faster than their prices over the period and thus ultimately improving the fundamental relationship between price and dividends.
- **Health Care Saw Weight Lowered:** Over the period, the Industrial and Health Care sectors saw the largest reduction in weight within WTDI. Both sectors saw strong absolute returns over the period, which made it harder for their dividend growth to keep pace. The three examples above that saw a reduction in weight help illustrate this trend, with an average return of 62% over the period, but an average dividend growth below 8%.

**Importance of Incorporating a Relative Rebalance** The WisdomTree annual rebalance is a key element of the added value of WisdomTree’s Index methodology and can help manage valuation risks. WisdomTree Indexes use dividend growth as a key factor in determining which companies get increased weight at a rebalance. We interpret another year of double-digit dividend growth as a very positive indicator of underlying market fundamentals and believe it helps provide a notable foundation for potential future gains.

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](#).

**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](http://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, 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

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

**Valuation risk**: The risk of buying or over-weighting a particular stock that has appreciated significantly in price relative to its dividends, earnings or any other fundamental metric.

**Smart Beta**: A term for rules-based investment strategies that don't use conventional market-cap weightings.

**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.

**WisdomTree Dividend Index**: Measures the performance of dividend-paying companies incorporated in the United States that pay regular cash dividends and meet WisdomTree's eligibility requirements. Weighted by indicated cash dividends.

**Median**: The median is the value within a dataset at which 50% of all observations occur above and 50% occur below.