

DON'T OVERLOOK DEVELOPED INTERNATIONAL SMALL CAPS

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What do the [S&P 500](#), [MSCI EAFE](#) and [MSCI Emerging Markets](#) indexes have in common? While regional exposures clearly differ, the dominant exposure is to large-cap stocks. Today, we ask a question:

Why don't more investors utilize the full [market capitalization](#) size spectrum (large cap, mid-cap and small cap) when looking at international opportunities?

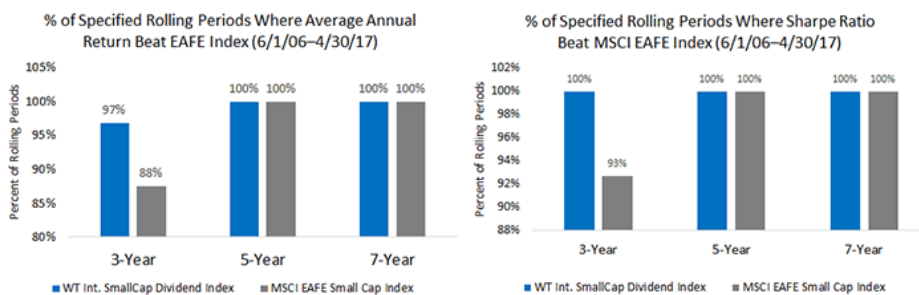
Initial Hypothesis: The [Risk/Return Trade-offs](#) Simply Aren't Beneficial

In thinking of possible reasons, we can start with the idea that the risk/return trade-offs must not be beneficial relative to an MSCI EAFE Index exposure—if, in fact, we focus our attention on the developed international sphere. The [WisdomTree International SmallCap Dividend Index](#) has been calculated live for nearly 11 years, and we can of course compare returns to the [MSCI EAFE Small Cap Index](#) benchmark. For the full period, from June 1, 2006, to April 30, 2017,¹ we found the following:

- The MSCI EAFE Index delivered 2.85% per year
- The MSCI EAFE Small Cap Index delivered 4.70% per year.
- The WisdomTree International SmallCap Dividend Index delivered 6.33% per year.

But this is just a single period, one might say. How about a rolling period analysis over these 11 years?

Rolling Period Analysis: 3-Year, 5-Year & 7-Year vs. MSCI EAFE Index over these 11 years?



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

The key question across this initial analysis regards adding incremental return versus the MSCI EAFE Index, since it already has the lion's share of investor attention within developed international stocks.

- On a rolling five- and seven-year basis by way of average annual returns, both the WisdomTree International SmallCap Dividend Index and MSCI EAFE Small Cap Index beat the MSCI EAFE Index in 100% of the rolling periods measured. Three-year rolling period results also strongly favored the small-cap indexes.

However, we understand what most might be saying—small caps add risk. Yes, the returns may have been stronger and may have had good consistency of outperformance, but the risk profile still may have favored the MSCI EAFE Index if we were to look at the picture on a [risk-adjusted basis](#).

- Looking at the rolling five- and seven-year [Sharpe ratio](#) comparisons, both the WisdomTree International SmallCap Dividend Index and MSCI EAFE Small Cap Index beat the MSCI EAFE Index in 100% of the rolling periods studied. The WisdomTree Index also had a higher Sharpe ratio than the MSCI EAFE Index in 100% of the rolling three-year periods studied.

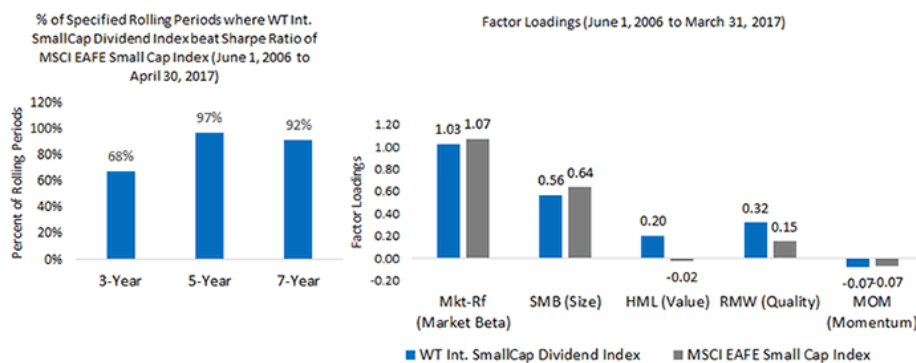
So, this nearly 11-year period that includes all sorts of “interesting events” (Global Financial Crisis of 2008–2009, Greek Debt Crisis in Europe, Brexit vote) advocates quite strongly for developed international small caps.

Is WisdomTree Adding Anything versus the MSCI EAFE Small Cap Index?

For starters, over the last 11 years we saw a pickup of about 160 [basis points \(bps\)](#) in return—so we know that, from the Index’s cumulative return over 11 years, dividend weighting did improve results.

But looking further at rolling period analysis, we jump directly to a rolling period Sharpe ratio comparison so we can look at risk-adjusted returns. We also illustrate a [factor](#) analysis to see what (if anything) beyond the so-called “[size](#)” [premiums](#) is being tapped into.

Developed International Small Caps: Sharpe Ratio & Factors



Sources: WisdomTree, Bloomberg, Kenneth French Data Library. Past performance is not indicative of future results. You cannot invest directly within an index. Mkt-Rf (Market returns minus the risk-free rate): A market capitalization-weighted measure of the returns of all firms. SMB (Small minus big): Measured as the market value of equity, with smaller values indicating smaller market capitalization companies and larger values indicating larger market capitalization companies. HML (High minus low): Measured as the ratio of book value of equity to market value of equity of a firm, with higher values indicating a lower market price relative to this fundamental factor. RMW (Robust minus weak): Measures aspects of operating profitability. MOM (Momentum): Measuring resilience of positive trends in share price behavior, with stronger resilience in exhibiting positive trends leading to higher momentum.

- Measuring the rolling period Sharpe ratios, on a three-year basis the WisdomTree International SmallCap Dividend Index beat the MSCI EAFE Small Cap Index two-thirds of the time. Rolling five- and seven-year periods indicated the WisdomTree International SmallCap Dividend Index’s risk-adjusted returns were better more than 90% of the time. So there is no question that the WisdomTree strategy delivered strongly relative to what many would consider to be international small-cap “[beta](#),” but was this because of the small-cap premium or some other factor?

- Loadings to two distinct premiums, [value](#) and [quality](#), were the most important factor differentiation between the WisdomTree International SmallCap Dividend Index and the MSCI EAFE Small Cap Index. The WisdomTree strategy loaded significantly more positively in both of these factors, and these factors added value over this period.

[Active, Passive](#) or WisdomTree?

Many today are questioning their more active exposures, and a lot of flows have been going toward passive approaches. The WisdomTree International SmallCap Dividend Index represents the core of what WisdomTree was looking to develop nearly 11 years ago—transparent, rules-based strategies that can add value at a low cost² to strategic allocations. We'd say the live track record indicates initial success, and we believe in the potential of reapplying this discipline in the future.

¹Source: Bloomberg, with data for specified period 6/1/06–4/30/17.

²Ordinary brokerage commissions apply.

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You cannot invest directly in an index.

DEFINITIONS

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

MSCI EAFE Index : is a market cap-weighted index composed of companies representative of the developed market structure of developed countries in Europe, Australasia and Japan.

MSCI Emerging Market Index : The MSCI Em (Emerging Markets) Index is a free-float weighted equity index that captures large and mid cap representation across Emerging Markets (EM) countries.

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.

Risk : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

100% Passively Hedged Approach : Strategy designed to have the full currency exposure hedged, regardless of any changes in market conditions.

Risk-adjusted basis : When calculating the return, we refine the return by measuring how much risk is involved in producing that return.

Sharpe ratio : Measure of risk-adjusted return. Higher values indicate greater return per unit of risk, specifically standard deviation, which is viewed as being desirable.

Basis point : 1/100th of 1 percent.

Factor : Attributes that based on its fundamentals or share price behavior, are associated with higher return.

Size Factor : the average returns of small portfolios minus the average returns of the large portfolios after adjusting for growth or value tendencies.

Premium : When the price of an ETF is higher than its NAV.

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.

Value Factor : 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.

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over time.

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