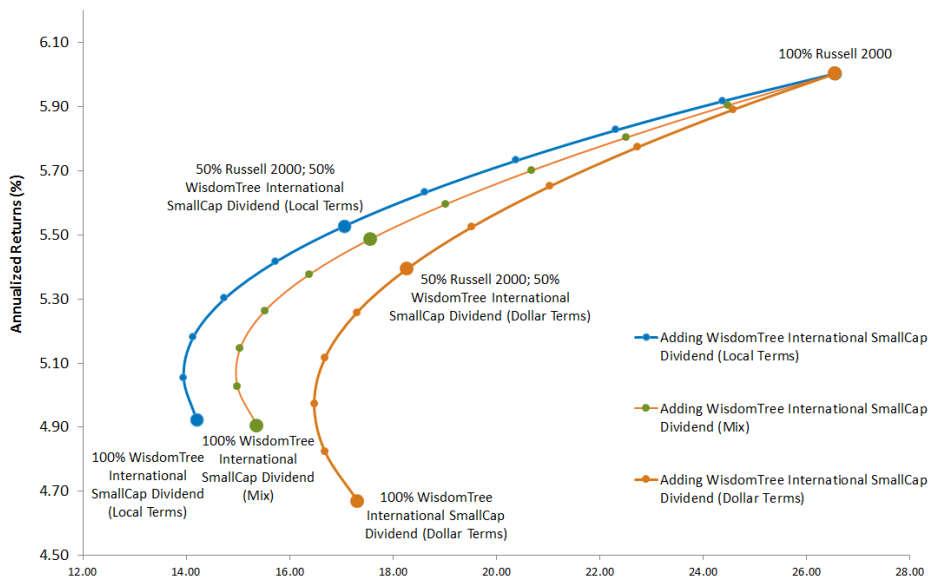


# WHY DIVERSIFICATION IS NOT DEAD: A SMALL CAP EXAMPLE

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“Diversification is dead” has been a common refrain in recent years. Over the last decade, global asset allocators have received complaints from clients who wondered why they were invested in anything beyond the [S&P 500 Index](#), or really any broad measure of U.S. equities, as the U.S. markets outperformed the rest of the world. Annualized and cumulative returns for the last 10 years:<sup>1</sup> • S&P 500 Index: 7.5% per year, or 106.3% cumulatively • Developed international equities ([MSCI EAFE Index](#)): 1.7% per year, or 18.5% cumulatively • Emerging market equities ([MSCI Emerging Markets Index](#)): 3.9% per year, or 46.6% cumulatively Anyone who had a global allocation lagged behind those who were focused solely on the U.S. markets, as the typical investor in the U.S. tends to be. One can argue, however, that these disappointing past years for international and emerging market equity returns make it all the more likely those markets could be set to outperform going forward, as they have lower market [valuation](#) multiples and performance tends to “mean revert.” A particularly bad stretch for international and emerging market equities means I would look more favorably on their prospects, not less favorably. Yet there is a further case outside of forward-looking *returns*’ prospects to look overseas. Small caps provide a segment of the market where there may be a surprising benefit to international diversification: [risk](#) reduction. **Diversification Is Also about Lowering Risk Profiles** One of the central tenets of diversification is that by investing across a broader section of the asset pie, an investor can potentially achieve a similar return at a lower risk profile. That may be especially true in the small-cap arena. In the last 10 years, looking at the risk levels—measured by annualizing the [standard deviation](#) of daily index returns—you see the [Russell 2000 Index](#) with a [volatility](#) level of 26.6%, while the [WisdomTree International SmallCap Dividend Index](#) had a volatility level of just 17.3%. That means the volatility of daily index returns for international small-cap [dividend](#) payers was more than one-third lower than that of the Russell 2000. Investors might think, “International small caps—that sounds risky,” but data over the last 10 years shows that U.S. small caps had significantly higher volatility in the daily index returns. One reason for this is that international companies tend to be predominantly dividend payers compared to the Russell 2000, in which almost 20% of companies tend to be unprofitable and nearly half the companies tend to be non-dividend payers.<sup>2</sup> Interestingly, showing the principles of diversification, a 50/50 approach of developed international small caps combined with the Russell 2000 and [rebalanced](#) annually back to the 50/50 allocation delivered a risk level that was almost as low as the international small-cap dividend payers and substantially lower than the volatility of U.S. small caps on their own. **Surprise! Developed International Small-Cap Equities Had Lower Risk than U.S. Equities over Past Decade Adding WisdomTree International SmallCap Dividend Index to U.S. Equity Allocations (6/30/2006–**



6/30/2016)

Annualized Risk (%)

Index Blend	WisdomTree International SmallCap Dividend (Local Terms)		WisdomTree International SmallCap Dividend (Mix)		WisdomTree International SmallCap Dividend (Dollar Terms)	
	Return	Risk	Return	Risk	Return	Risk
100% Russell 2000	6.00%	26.55%	6.00%	26.55%	6.00%	26.55%
50% Russell 2000; 50% WisdomTree International SmallCap Dividend	5.53%	17.05%	5.49%	17.56%	5.39%	18.26%
100% WisdomTree International SmallCap Dividend	4.92%	14.20%	4.91%	15.37%	4.67%	17.32%

Sources: WisdomTree, FactSet, with data for the 10-year period as of 6/30/2016. The Mix is the blend of 50% Local Terms and 50% Dollar Terms. Past performance is not indicative of future results. You cannot invest directly in an index. Risk is measured as the volatility of daily returns, annualized.

**Currency Hedging Could**

**Reduce Risk Further** The analysis above is not even the lowest-risk way of investing in international small caps, in our view. That analysis assumes investors took currency risk unhedged, as has been the case for years. More recently, WisdomTree has advocated that investors consider either full passive currency-hedged strategies or, more recently, dynamic hedged strategies that can raise or lower the currency-hedge ratio based on proprietary signals implemented once per month. WisdomTree has Indexes for developed international small caps that include both passive hedging and dynamic hedging. The data above illustrates that hedging currency risk (shown in the difference between local and U.S. dollar index returns) to focus on the returns for international stocks without added currency could further reduce risk. The international small-cap stocks, measured without currency impact, had a volatility of 14.2%, while the stocks with the currency impact had a volatility of about 17.3%. What’s interesting about this is the 14.2% volatility of the international small-cap dividend payers— there is a dramatic almost 50% volatility reduction on international small caps looking at these stocks without the currency impact and judging relative to the 26.55% average annual risk seen with the Russell 2000. Some investors believe there is a diversification benefit that comes with having currency exposure unhedged. The combinations of U.S. small-cap stocks with international small-cap dividend payers shown here casts doubt on that premise. The lowest-risk combination was the Russell 2000 with international small caps (without currency), and currency risk failed to provide any real “diversification” benefits. Adding international stocks on top of U.S. stocks did, however, help lower volatility significantly compared to being allocated to U.S. small-cap stocks only. **Conclusion** While some investors look at the recent past and conclude “Who needs global allocations when U.S. companies operate all over the world?” the analysis presented here shows that in the small-cap arena, there are significant benefits from a risk mitigation perspective to allocate to international small-cap dividend payers combined with the Russell 2000. And if my expectation proves correct and the past decade of U.S. dominance over international markets reverts, there would be a further benefit that these lower risk levels could come with higher returns as well.

<sup>1</sup>Source: Bloomberg, with data from 8/31/2006 to 8/31/2016. <sup>2</sup>Sources: WisdomTree, Bloomberg, with data as of 8/31/2016. Refers to companies that did not pay any dividends in the 12 months prior to 8/31/2016 and companies that do not have a trailing 12-month trailing 12-month P/E ratio as of 8/31/2016. Past performance is not indicative of future results. You cannot invest directly in an index.

**Important Risks Related to this Article**



Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Diversification does not eliminate the risk of experiencing investment losses. Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time. Hedging can help returns when a foreign currency depreciates against the U.S. dollar, but it can hurt when the foreign currency appreciates against the U.S. dollar.

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**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 Markets Index** : a broad market cap-weighted Index showing performance of equities across 23 emerging market countries defined as "emerging markets" by MSCI.

**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.

**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.

**Standard deviation** : measure of how widely an investment or investment strategy's returns move relative to its average returns for an observed period. A higher value implies more "risk", in that there is more of a chance the actual return observed is farther away from the average return.

**Russell 2000 Index** : Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

**Volatility** : A measure of the dispersion of actual returns around a particular average level.&nbsp;. . .

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

**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.

**Currency hedging** : Strategies designed to mitigate the impact of currency performance on investment returns.

**Unhedged** : Strategy that includes the performance of both the underlying asset as well as the currency in which it is denominated. The performance of the currency can either help or hurt the total return experienced.