

BUFFETT'S CHECKLIST APPLIED TO SMALL CAPS

Jeremy Schwartz — Global Chief Investment Officer

04/16/2015

Recently, I highlighted a passage from Warren Buffett's annual shareholder letter that reveals how Buffett thinks about [attractive investment options](#). His list detailed six requirements for potential acquisitions, but we focused on one in particular: *Businesses earning good [returns on equity \(ROE\)](#) while employing little or no [debt](#).*¹ **Buffett Primarily Limited to Large Caps** One of the downsides of Buffett's success is that his potential acquisition list is mostly limited to [large-cap](#) equities because of the size of Berkshire Hathaway. Buffett has previously addressed this: *We do need to deploy cash, but we can't put many billions to work every year in spectacular businesses. To move the needle at Berkshire, they have to be big transactions.*² He also said: *If I was running \$1 million today, or \$10 million for that matter, I'd be fully invested. Anyone who says that size does not hurt investment performance is selling. The highest rates of return I've ever achieved were in the 1950s. I killed the Dow. You ought to see the numbers. But I was investing peanuts then. It's a huge structural advantage not to have a lot of money. I think I could make you 50% a year on \$1 million. No, I know I could. I guarantee that.*³ **Getting Diversified Small Cap Exposure That Passes Buffett's ROE Rule** Warren Buffett is always going to be a master stock picker, but for the rest of us, getting diversified exposure to stocks that have "Buffett" characteristics via an index-based strategy can be a compelling strategy. *Investors, of course, can, by their own behavior, make stock ownership highly risky. And many do. Active trading, attempts to "time" market movements, inadequate diversification, the payment of high and unnecessary fees to managers and advisors, and the use of borrowed money can destroy the decent returns that a life-long owner of equities would otherwise enjoy. ... The commission of the investment sins listed above is not limited to "the little guy." Huge institutional investors, viewed as a group, have long underperformed the unsophisticated index-fund investor who simply sits tight for decades.*⁴ If we combine Buffett's principle of focusing on stocks with high returns on equity and little to no debt with his belief in the "unsophisticated index" approach to investing and apply it to small-cap stocks, I think of the [WisdomTree U.S. SmallCap Dividend Growth Fund \(DGRS\)](#), whose underlying investment strategy selects companies based on their high ROE and high [return on assets \(ROA\)](#) characteristics. **The Dividend Growth Formula: WisdomTree's Buffett Factor Approach** WisdomTree offers a series of Funds—our "Dividend Growth" family—that employs ROE and ROA as a driving force for stock selection. The reason we included ROA in powering stock selection is that it penalizes the use of debt ([leverage](#)) in delivering ROE; therefore, the companies that qualify for our Dividend Growth Funds tend to also employ little debt.

Ticker	Company Name	Weight	Return on Equity	Debt as % of Assets	P/E Ratio	Dividend Yield
PBF	PBF Energy Inc	2.2%	24.7%	24.1%	7.7x	3.5%
NUS	Nu Skin Enterprises Inc	2.1%	36.8%	15.3%	18.5x	2.3%
TAL	Tal International Group Inc	1.7%	20.7%	71.1%	11.2x	8.8%
LXK	Lexmark International Inc	1.7%	11.7%	19.3%	17.1x	3.4%
OLN	Olin Corp	1.6%	14.0%	25.0%	21.1x	2.5%
BOH	Bank of Hawaii Corp	1.5%	15.7%	5.9%	16.5x	2.9%
NJR	New Jersey Resources Corp	1.4%	14.8%	28.8%	17.5x	2.8%
PTEN	Patterson-UTI Energy Inc	1.3%	8.1%	18.3%	10.3x	2.1%
BGS	B&G Foods Inc	1.3%	15.2%	62.2%	23.9x	4.6%
DIN	DineEquity Inc	1.2%	31.1%	59.5%	26.9x	3.0%
AI	Arlington Asset Investment Corp	1.2%	22.4%	80.2%	7.7x	14.5%
GES	Guess? Inc	1.2%	12.6%	0.5%	14.4x	4.8%
MDP	Meredith Corp	1.2%	14.0%	30.6%	16.7x	3.1%
PRA	ProAssurance Corp	1.2%	11.3%	4.8%	14.6x	8.4%
OMI	Owens & Minor Inc	1.1%	9.7%	22.2%	18.5x	3.0%
CMC	Commercial Metals Co	1.0%	9.1%	36.1%	12.1x	3.0%
MDC	MDC Holdings Inc	1.0%	14.0%	38.5%	18.4x	3.5%
SEM	Select Medical Holdings Corp	1.0%	16.8%	53.8%	16.1x	2.7%
PCH	Potlatch Corp	1.0%	37.8%	60.8%	18.5x	3.6%
DK	Delek US Holdings Inc	0.9%	22.8%	20.4%	18.0x	2.5%
	Sum/Average	26.9%	18.2%	33.9%	16.3x	4.3%

Sources: WisdomTree, Bloomberg, as of 3/31/15. Holdings are subject to change. Past performance is not indicative of future results.

Top 20 Holdings of DGRS

At WisdomTree, we believe that focusing on quality factors, such as high profitability and low leverage, through rules-based processes can be a compelling investment strategy over the long term. We also believe that these are common traits among firms that consistently grow their [dividends](#) and have a high potential to increase their dividends in the future. These high-quality, dividend-growing small caps are also selling at attractive [valuations](#) compared to broad based small caps, which we think creates a timely opportunity.

¹The annual shareholder letter for Berkshire Hathaway, Inc., [available here](#). ²Scott Patterson and Douglas A. Blackmon, "Buffett Bets Big on Railroad," The Wall Street Journal, 11/4/09. ³Anthony Bianco, "Homespun Wisdom from the 'Oracle of Omaha,'" Businessweek, 7/5/99. ⁴The annual shareholder letter for Berkshire Hathaway, Inc., [available here](#).

Important Risks Related to this Article

Diversification does not eliminate the risk of experiencing investment losses. There are risks associated with investing, including possible loss of principal. Funds focusing their investments on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Dividends are not guaranteed and a company currently paying dividends may cease paying dividends at any time. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

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)

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

Return on Equity (ROE) : Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

Corporate debt : Bonds a company issues in order to raise money.

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.

Leverage : Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.

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

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.