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# HOW EARNINGS INDEXES ARE BECOMING IMPORTANT DIVERSIFIERS

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It is truly amazing that in nearly every client meeting we attend a resounding chorus of agreement sounds when discussing the success of high-[dividend-yield](#) and low-[volatility](#) strategies in 2016. But can their large outperformance continue? The answer will depend on what happens with [interest rates](#). If they move higher, investors may look to parts of the market that have lower [valuation](#) multiples but are less interest rate sensitive. We recently described the [rebalancing](#) process [that results in the WisdomTree Earnings Indexes having lower valuation multiples than the market](#).

As investors flocked to higher [dividends](#) in 2016, many found the [WisdomTree MidCap Dividend](#) and [WisdomTree Small Cap Dividend Indexes](#) worthy of consideration. That was no accident:<sup>1</sup>

- The WisdomTree MidCap Dividend Index was up 12.99%.
- The WisdomTree SmallCap Dividend Index was up 15.93%.

For those focused on overall portfolio strategies that seek relatively higher dividend-paying stocks, in our view, these strategies will remain great complements to large-cap positions, and it's also worth noting that these Indexes will undergo their [annual rebalance screening](#) on November 30, 2016. Big outperforming constituents may not be able to hold onto their increased weights if they didn't grow their dividends commensurately.

But a dividend focus is not the only way to consider [smart beta](#) approaches to mid- and small-cap stocks.

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## **Our Mid- & Small-Cap Earnings Strategies Offer Intriguing Sector Complementarity to Dividends**

What if, instead of focusing solely on dividend-paying constituents, an investor were to focus on mid- and small-cap stocks through the lens of profitability? WisdomTree does just that with its mid-cap and small-cap earnings strategies. In 2016:

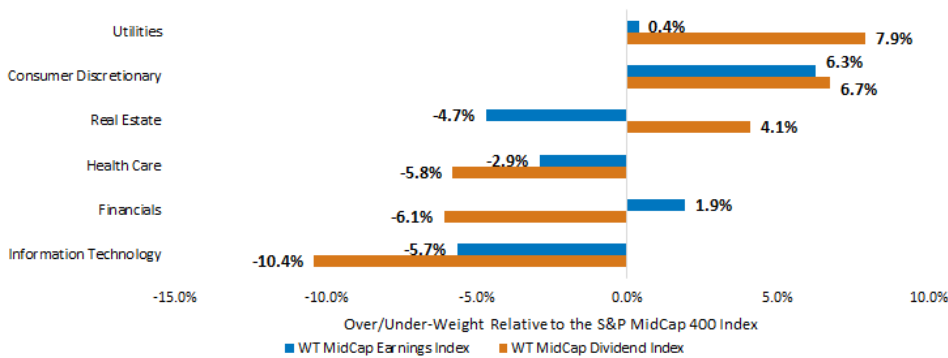
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- The [WisdomTree MidCap Earnings Index](#) was up 10.20%.
- The [WisdomTree SmallCap Earnings Index](#) was up 12.61%.

These are strong numbers, but not quite as strong as the dividend strategies. Sector exposures shed light as to why.

## **What Sector Bets Are Introduced to Mid-Caps? Dividends vs. Earnings**

### **Top 3 Over-Weight and Under-Weight Sectors of WT MidCap Dividend Index vs. S&P MidCap 400 Index, with WT MidCap Earnings Index also shown (as of 10/7/2016)**



Sources: WisdomTree, Bloomberg, with data as of 10/7/16. You cannot invest directly in an Index. Holdings subject to change.

For definitions of terms and indexes in the chart, visit our [glossary](#).

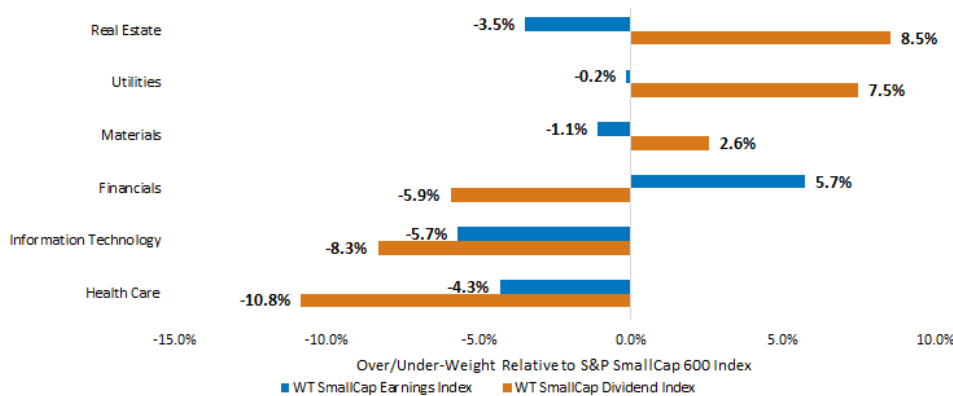
•**Utilities:** This has been a strong sector in 2016. These stocks may have benefited from being included in the “low-vol/min-vol” phenomenon as well as from having relatively higher dividend yields in—yet another—falling interest rate environment. The WisdomTree MidCap Dividend Index had nearly an 8.0% over-weight to this sector relative compared to the [S&P MidCap 400 Index](#). On the other hand, the WisdomTree MidCap Earnings Index was close to a market weight in that sector.

• **Real Estate:** This has been another very strong sector in 2016, and, as in the case of Utilities, the income-generating capability of the real estate constituents has found favor in today’s low-rate environment. The WisdomTree MidCap Dividend Index is a 4.1% over-weight, whereas the WisdomTree MidCap Earnings Index is a 4.7% under-weight when measured against the S&P MidCap 400 Index.

• **Financials:** The WisdomTree MidCap Dividend Index is under-weight Financials by 6 percentage points, which has helped during the declining rate environment. The WisdomTree MidCap Earnings Index has a 2% over-weight to Financials, which could be well positioned for a rising rate scenario.

**What Sector Bets Are Introduced to Small Caps? Dividends vs. Earnings**

**3 Targets WT Small Cap Dividend Index Over/Under-Weight Relative to S&P SmallCap 600 Index, with WT SmallCap Earnings Index shown (as of 10/7/2016)**



Sources: WisdomTree, Bloomberg, with data as of 10/7/16. You cannot invest directly in an index. Holdings subject to change.

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Utilities & Real Estate May be Yesterday's Top-Performing Sectors

It is impossible to know if these sectors can rally again in 2017, but when the U.S. [10-Year Treasury](#) note interest rate rose from 1.36% on July 8, 2016, to more than 1.70% on October 7, 2016, it showed us that these sectors are not invincible. They've had a great run, and it might be time to consider adding the diversifying potential of WisdomTree's earnings approach as we look forward to 2017.

<sup>1</sup>Source: Bloomberg, for period 12/31/15–10/7/16.

<sup>2</sup>Source: Bloomberg, for period 12/31/15–10/7/16.

<sup>3</sup>Source: Bloomberg, as of specified dates.

#### Important Risks Related to this Article

Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time. Investments focusing 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.

Diversification does not eliminate the risk of experiencing investment losses.

For more investing insights, check out our [Economic & Market Outlook](#)

**Dividend yield** : A financial ratio that shows how much a company pays out in dividends each year relative to its share price.

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

**Interest rates** : The rate at which interest is paid by a borrower for the use of money.

**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.

**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.

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

**Annual screening date** : The screening date refers to the date upon which characteristics of eligible constituent firms are measured, whereas the rebalance refers to when the results from the screening date are implemented by way of Index weights and constituents.

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

**S&P MidCap 400 Index** : provides investors with a benchmark for mid-sized companies. The index covers over 7% of the U.S. equity market, and seeks to remain an accurate measure of mid-sized companies, reflecting the risk and return characteristics of the broader mid-cap universe on an on-going basis.

**10-Year Treasury** : a debt obligation of the U.S. government with an original maturity of ten years.