

# MANAGING VALUATION RISK BY REBALANCING

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With equity markets forging new all-time highs, we think it is especially important to ask whether these moves are justified by the underlying [fundamentals](#). We also think it is important to be mindful of how an annual [rebalance](#), steering a portfolio back to an underlying fundamental such as [dividends](#), can help manage [valuation risks](#) —a key factor in the inclusion of non-cap-weighted indexes 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 figure 1, we quantify the dividend growth for companies that received increases in weight or decreases in weight and compare that to the overall universe.<sup>1</sup> **Figure 1: WisdomTree Dividend Index (WTDI) Trends**

Weight Change	Median Dividend Stream® Growth	Median Total Return
Raise	13.3%	0.8%
Lower	4.5%	22.9%
All	8.0%	9.5%

Sources: WisdomTree, Bloomberg, as of 11/30/2014

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

For definitions of terms in the chart,

please visit our [glossary](#). • **Dividend Growers Saw Weight Increase:** The companies that saw their weight increase at the rebalance had a [median dividend growth](#) of 13.3%, which was greater than the median dividend growth of all companies (at 8.0%). Companies that saw their weight lowered at the rebalance had a median dividend growth of just 4.5%. • **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 8 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 13 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 figure 2, we highlight a few of the top additions and deletions to further specify the contributors. **Figure 2: WisdomTree Dividend Index (WTDI) Details**

• **Energy Earned Largest**

Action	Name	GICS Sector Name	Prior Weight	Final Weight	Weight Change	Dividend Stream® Growth	Total Return
Raise	Exxon Mobil Corp	Energy	2.42%	2.85%	0.43%	6%	0%
	Bank of America Corp	Financials	0.11%	0.51%	0.40%	393%	8%
	Chevron Corp	Energy	1.67%	1.97%	0.31%	5%	-8%
Lower	Apple Inc	Information Technology	4.01%	2.69%	-1.33%	0%	53%
	Intel Corp	Information Technology	1.60%	1.13%	-0.47%	4%	61%
	Microsoft Corp	Information Technology	2.95%	2.49%	-0.46%	9%	29%

Sources: WisdomTree, Bloomberg; prior weight is as of 11/30/14

Prior weight is the weight before annual screening. Final weight reflects anticipated rebalance weight as of annual screening. Dividend Stream growth and total return period is 11/30/13–11/30/14. Past performance is not indicative of future results. You cannot invest directly in an index. Subject to change.

**Increase:** The biggest increase in weight for any sector in WTDI occurred in Energy—an increase of 1.7%, which was driven primarily by its poor performance over the period. As figure 2 shows, Exxon and Chevron contributed to this increase in weight, having grown their dividends faster than their prices over the period, ultimately improving the fundamental relationship between price and dividends. • **Financials Led *Dividend Stream@* Growth:** Over the period, the Financials sector displayed the strongest percentage growth, earning the sector a 1.3% increase in weight in WTDI. Bank of America saw the largest increase in weight in the sector after increasing its dividend per share fivefold over the year, from \$0.01 to \$0.05, which translated to a *Dividend Stream* growth of almost 400%. • **Information Technology Saw Its Weight Lowered:** The biggest decrease in weight for any sector in WTDI occurred in Information Technology—a decrease of 2.4%, which was driven primarily by its strong performance over the period. As noted in figure 2, Apple, Intel and Microsoft all helped contribute to this decrease in weight, having grown their dividends more slowly than their prices over the period, thus ultimately decreasing the fundamental relationship between price and dividends. **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 current holdings of the WisdomTree Dividend Index, please [click here](#).* <sup>1</sup>The overall universe is defined as the WisdomTree Dividend Index (WTDI)

**Important Risks Related to this Article**

Dividends are not guaranteed and a company's future ability to pay dividends may be limited. A company currently paying dividends may cease paying dividends at any time.

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.

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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.

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

**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.

**Median dividend yield/median earnings yield** : Meant to calculate the median payout ratio, which is the median dividend per share divided by the median earnings per share.