HOW A DIVIDEND REBALANCE WORKS IN MID- AND SMALL-CAP STOCKS

Christopher Gannatti — Global Head of Research
03/12/2018

For more than 11 years, WisdomTree has been running dividend-focused Indexes in the United States. Some of the strongest results against the more commonly followed market capitalization-weighted benchmark indexes have occurred in the mid- and small-cap size segments. How has this occurred? Was there anything unique going on during this period?

WisdomTree's 2017 U.S. dividend rebalancing process provides an appropriate time to reassess this question.

Significance of Growth Style Outperformance => Dividend Disadvantage?

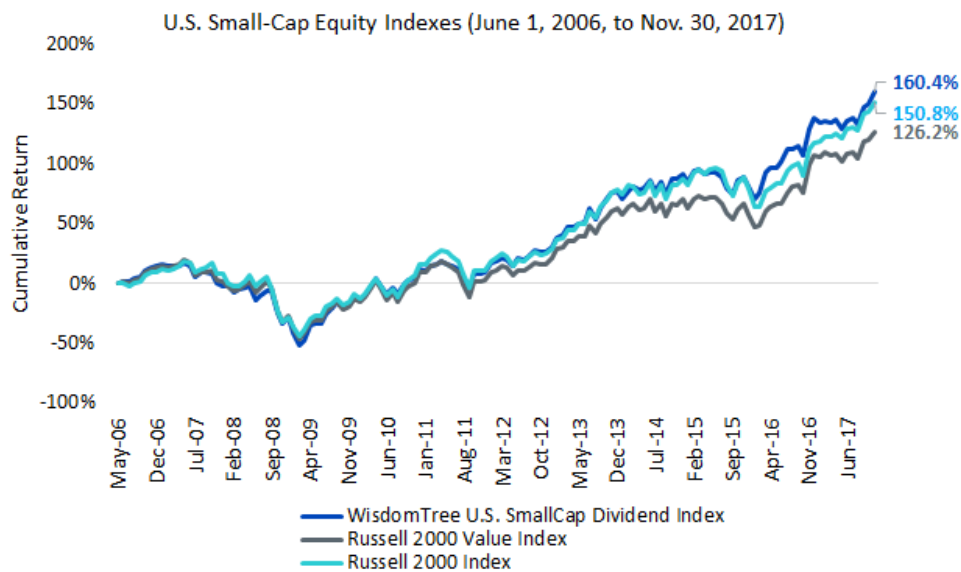Growth has dramatically outperformed value since WisdomTree's U.S. Dividend Indexes began their live track record—if we think about the types of companies that dominate the news cycle these days (FANG stocks, to name a few), it makes sense.[1]

- Since June 1, 2006, the Russell 2000 Growth Index returned 9.2% per year, nearly 2 full percentage points per year ahead of the Russell 2000 Value Index. As of November 30, 2017, the Russell 2000 Growth Index had 59% of its weight in stocks that didn't pay dividends in the prior year, which compared to the Russell 2000 Value Index at 34.7% on this same measure.

- Over the same period, the Russell Midcap Growth Index returned 9.5% per year, versus 8.8% per year for the Russell Midcap Value Index. More than one-third of the Russell Midcap Growth Index was in stocks that didn't pay dividends, whereas only about 16% of the Russell Midcap Value Index was in such stocks as of the same date.
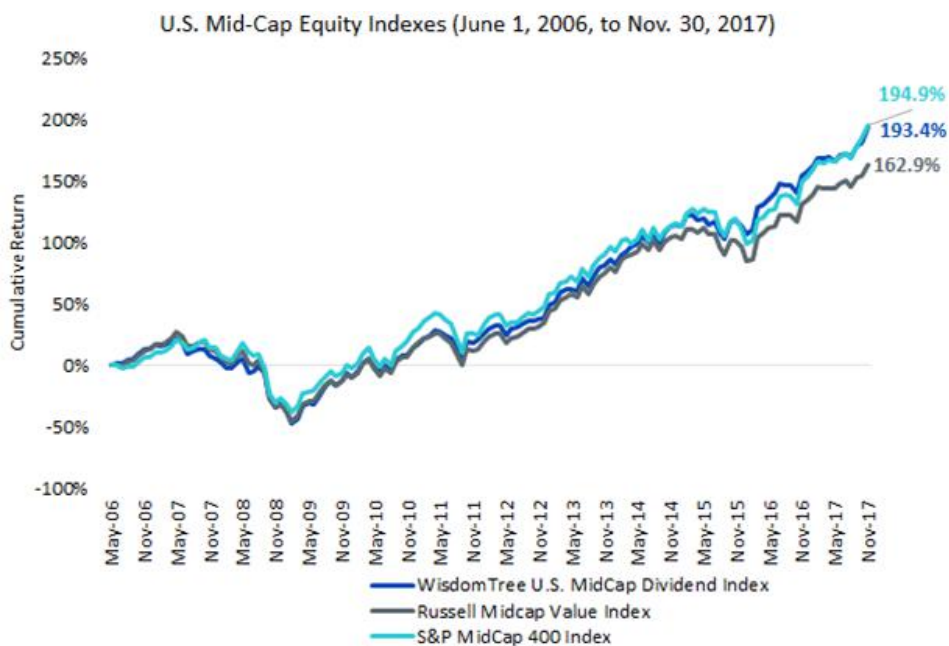
So a picture is developing. First, growth has dramatically outperformed over a period of more than 11 years. Second, "dividends" are more of a value than a growth phenomenon. It would appear that strategies focused on dividends would therefore be at a disadvantage over this period.

What's important to really measure, therefore, is whether the core benchmark—which includes BOTH the value AND growth stocks—had the advantage over the live performance history.

In Small-Caps, WisdomTree Outperformed; in Mid-Caps, WisdomTree Came Quite Close

U.S. Small-Cap Equity Indexes (June 1, 2006, to Nov. 30, 2017)

160.4%
150.8%
126.2%

— WisdomTree U.S. SmallCap Dividend Index
— Russell 2000 Value Index
— Russell 2000 Index

Index	Avg. Ann. Return	Avg. Ann. Risk	Sharpe Ratio	Beta vs. Russell 2000 Index	Correlation to Russell 2000 Index
WisdomTree U.S. SmallCap Dividend Index	8.67%	19.48%	0.40	0.95	0.93
Russell 2000 Value Index	7.35%	19.17%	0.33	0.99	0.98
Russell 2000 Index	8.32%	19.01%	0.39	1.00	1.00

U.S. Mid-Cap Equity Indexes (June 1, 2006, to Nov. 30, 2017)

194.9%
193.4%
162.9%

— WisdomTree U.S. MidCap Dividend Index
— Russell Midcap Value Index
— S&P MidCap 400 Index

Index	Avg. Ann. Return	Avg. Ann. Risk	Sharpe Ratio	Beta vs. S&P MidCap 400 Index	Correlation to S&P MidCap 400 Index
WisdomTree U.S. MidCap Dividend Index	9.80%	17.07%	0.52	0.94	0.94
Russell Midcap Value Index	8.76%	17.08%	0.46	0.98	0.98
S&P MidCap 400 Index	9.85%	17.02%	0.52	1.00	1.00

Sources: WisdomTree, Bloomberg, with data from 6/1/06 to 11/30/17. Past performance is not indicative of future results. You cannot invest directly in an index.

- **Small Caps:** The Russell 2000 Index is one of the most widely followed equity market benchmarks in the world. We saw earlier how the growth-oriented cut of this Index dramatically outperformed the value cut, and yet the WisdomTree U.S. SmallCap Dividend Index outperformed the Russell 2000 Index by 0.35% per year, equating to almost 10 percentage points cumulatively over the full period. Compared to the Russell 2000 Value Index, the WisdomTree U.S. SmallCap Dividend Index opened up a gap of more than 34 percentage points cumulatively over the period.

- **Mid-Caps:** The S&P MidCap 400 Index has been one of the toughest indexes for any equity strategy to outperform in the recent decade, but even though it includes non-dividend-paying mid-cap growth stocks, it outperformed the WisdomTree U.S. MidCap Dividend Index by only 1.5 percentage points cumulatively over more than 11 years. On a Sharpe ratio basis, the difference between these two mid-cap Indexes was almost indistinguishable.

Disciplined, Annual Rebalancing Has Made the Difference for WisdomTree

Even if it is true that "dividends" as a strategy tend to tilt more toward value than growth in mid-cap and small-cap U.S. equities, the live track record shows that WisdomTree's approach and methodology have generated more performance octane than the traditional value-oriented approaches. To review the core of WisdomTree's methodology:

- The most critical relationship regards the behavior of a stock's share price and the growth in its *Dividend Stream®* (dividend per share x number of shares outstanding).

- If the share price outperformed the growth in the stock's *Dividend Stream*, then that stock would tend to see reduction in weight at WisdomTree's rebalance.

- If the share price underperformed the growth in the stock's *Dividend Stream*, then that stock would tend to see increasing weight at WisdomTree's rebalance.
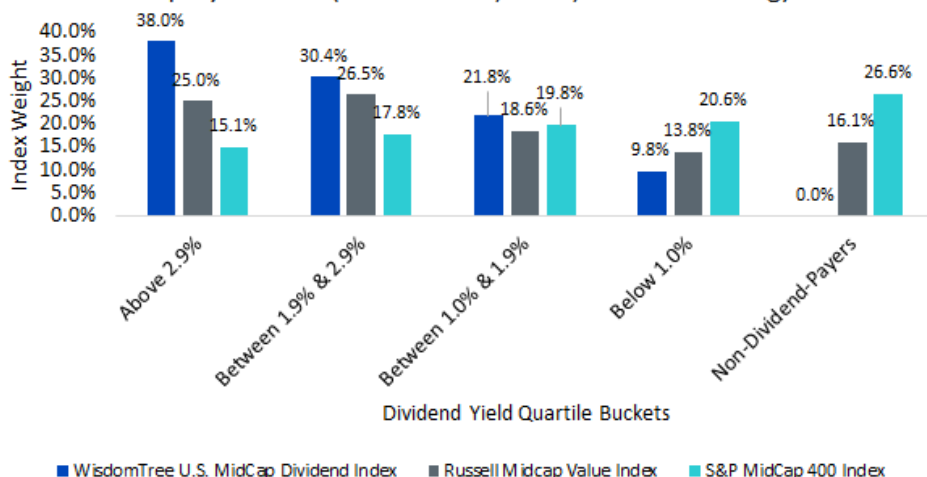
The concept retilts back toward growing fundamentals and away from appreciating share prices that aren't well-supported by improving fundamentals.

Illustrating a *Dividend Stream* Rebalancing Process for U.S. Mid- and Small-Cap Stocks

The Difference of Focusing on Dividends for U.S. Small-Cap Equity Indexes (as of Nov. 30, 2017, Index Screening)

Sources: WisdomTree, Bloomberg, with data as of 11/30/17 index screening date. Past performance is not indicative of future results. You cannot invest directly in an index.

- The WisdomTree U.S. SmallCap Dividend Index saw the 2017 rebalance push almost 43% of its weight into stocks with dividend yields above 3.4%. That created a massive difference compared to the Russell 2000 Index, which had only about 10.9% of its weight in such stocks; 47.2% of the Russell 2000 Index's weight was in stocks that hadn't paid any dividends over the prior 12 months.

- The WisdomTree U.S. MidCap Dividend Index saw the 2017 rebalance push 38% of its weight into stocks with dividend yields above 2.9%. Similar to what we saw with small caps, this created a very large difference compared to the S&P MidCap 400 Index.

Valuation Makers vs. Valuation Takers

We wrote about this with regard to our U.S. Earnings Indexes, where it is a bit more visible because an earnings-focused rebalance tends to lower the widely followed price-to-earnings (P/E) ratios. However, tilting weight toward higher-dividend-yielding stocks is simply a different way to lower valuations and create potential opportunities in markets that few would argue are inexpensive based on the strong overall U.S. equity markets we've seen.

[1]Performance period is 6/1/06 to 11/30/17. Weight in non-dividend-paying stocks is as of 11/30/17.

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

DEFINITIONS

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

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.

Growth : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

Value : 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 tim.

Russell 2000 Growth Index : Measures the performance of the small-cap growth segment of the U.S. equity universe. It includes those Russell 2000 Index companies with higher price-to-book ratios and higher forecasted growth values.

Russell 2000 Value Index : measures the performance of small-cap value segment of the U.S. equity universe. It includes those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values.

Russell Midcap Growth Index : Measures the performance of the mid-cap growth segment of the U.S. equity universe. It includes those Russell Midcap Index companies with higher price-to-book ratios and higher forecasted growth values.

Russell MidCap Value Index : measures the performance of the mid-cap value segment of the U.S. equity universe. It includes those Russell Midcap Index companies with lower price-to-book ratios and lower forecasted growth values.

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.

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.

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.

Dividend Stream : Refers to the regular dividends per share multiplied by the number of shares outstanding.

Price-to-earnings (P/E) ratio : Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.