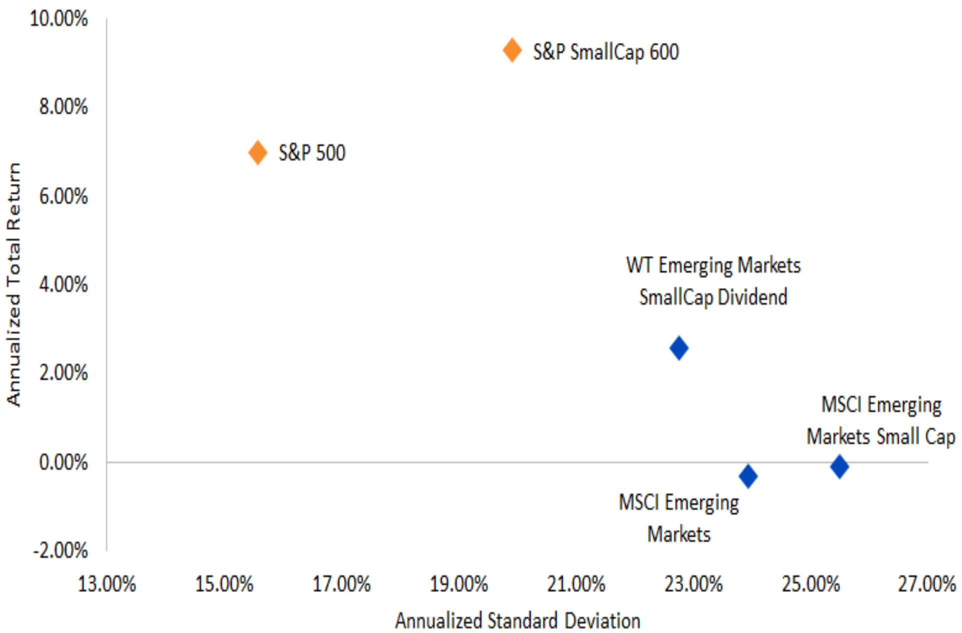
IS IT POSSIBLE FOR SMALL CAPS TO OUTPERFORM LARGE CAPS WITH LESS RISK?

Christopher Carrano — Vice President of Strategic Research at Venn by Two Sigma
03/08/2017

Most investors have heard of the "size premium," the well-documented and academically studied tendency for small-cap companies to outperform large-cap companies over time, but with additional risk. For example, we can see this phenomenon in the table below. The S&P SmallCap 600 Index outperformed the S&P 500 Index by 229 basis points (bps) annualized over 9.5 years,[1] but did so while increasing standard deviation by over 4 percentage points relative to the S&P 500.[2]

But what if it were possible to capture the size premium with volatility similar to large caps while also helping to complete balanced, globally diversified exposure? Well, in the emerging market (EM) space, it has been possible. Though the relative outperformance is less pronounced than in the U.S., over the last 9.5 years, the MSCI Emerging Markets Small Cap Index was able to outperform the MSCI Emerging Markets Index while increasing annualized volatility by just 1.6 percentage points.[3] This was a much narrower spread in volatility than was seen when moving down the size spectrum in the U.S., but it did maintain the relationship between large- and small-cap risk, nonetheless.

Index Risk and Return, 8/1/07–12/31/16



Index	WT Inception Date	Ann. Std. Dev. Since WT Inception	Average Annual Total Returns as of 12/31/16 1-Year	3-Year	5-Year	Since WT Inception
S&P SmallCap 600		19.93%	26.56%	9.47%	16.62%	9.27%
S&P 500		15.58%	11.96%	8.87%	14.66%	6.98%
MSCI Emerging Markets Small Cap		25.51%	2.28%	-1.27%	3.51%	-0.12%
MSCI Emerging Markets		23.94%	11.19%	-2.55%	1.28%	-0.33%
WisdomTree Emerging Markets SmallCap Dividend	8/1/2007	22.76%	15.89%	-0.63%	3.66%	2.55%

Sources: WisdomTree, Bloomberg, Zephyr StyleADVISOR, as of 12/31/16. Ann. Std. Dev.= Annualized Standard Deviation.

Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns.

For definitions of indexes in the chart, visit our glossary.

Less Volatility While Maintaining Excess Returns

The question then becomes, what if one differentiated EM small-cap exposure, aiming to gain superior risk-adjusted returns relative to cap-weighting? Could it then be possible for EM small caps to have even less volatility than cap-weighted large caps while maintaining excess returns?

WisdomTree achieved this counterintuitive conclusion over the same 9.5 years previously observed, beginning when it launched the WisdomTree Emerging Markets SmallCap Dividend Index. This small-cap Index has managed to outperform both cap-weighted large- and small-cap indexes by an average of over 250 bps per year while actually reducing annualized volatility relative to cap-weighted EM large caps by more than a percentage point.[4] A small-cap index outperforming a large-cap index with less risk may be hard to believe, but we think it all starts with intuitive, intelligent and simple design.

WisdomTree's Approach

WisdomTree created the parent Index—the WisdomTree Emerging Markets Dividend Index—which seeks to capture virtually all investable EM stocks that pay dividends, in 17 countries. We then cut that Index by excluding the top 90% by market cap and weighting the remaining 10% small-cap companies by their share of the aggregate dividends paid over the last year, rather than market value. This creates differentiated sector exposures and access to value and quality characteristics, and it typically raises the dividend yield relative to cap weighting. In fact, as of 12/31/16, the WisdomTree Emerging Markets SmallCap Dividend Index exhibited a dividend yield of 4.5%, compared to the 2.5% of the MSCI Emerging Markets index and the 2.2% of the MSCI Emerging Markets Small Cap index.[5]

Conclusion

With almost a decade of history, the WisdomTree Emerging Markets SmallCap Dividend Index has proven its ability to be a "better beta" for the emerging markets small-cap asset class. It seeks to provide broad, diversified and differentiated EM exposure, and has managed to do it with lower volatility than even the comparable large-cap, cap-weighted index. On October 30, 2007, WisdomTree launched an exchange-traded fund (ETF) that seeks to track this Index, the WisdomTree Emerging Markets SmallCap Dividend Fund (DGS). WisdomTree believes DGS can play an important role in the completion of a globally diversified portfolio.

[1]Here and throughout the post, 9.5 years was selected to reflect a common time period with the WisdomTree Emerging Markets SmallCap Dividend Index.

[2]The S&P 500 Index had 96% weight in large caps and the S&P SmallCap 600 Index had 63% weight in small caps as of 12/31/16. Source: WisdomTree, FactSet.

[3]The MSCI Emerging Markets Index had 63% weight in large caps and the MSCI Emerging Markets Small Cap Index had 91% weight in small caps as of 12/31/16. Source: WisdomTree, FactSet.

[4]The WisdomTree Emerging Markets SmallCap Dividend Index had 82% weight in small caps as of 12/31/16. Source: WisdomTree, FactSet.

[5]WisdomTree, FactSet as of 12/31/16

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. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Funds focusing on a single sector and/or smaller companies generally experience greater price volatility. Investments in emerging, offshore or frontier markets are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation, intervention and political developments. Due to the investment strategy of this Fund, it may make higher capital gain distributions than other ETFs. 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

Small caps : new or relatively young companies that typically have a market capitalization between $200 million to $2 billion.

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.

S&P SmallCap 600 Index : Market capitalization-weighted measure of the performance of small cap equities within the United States, with constituents required to demonstrate profitability prior to gaining initial inclusion.

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.

Basis point : 1/100th of 1 percent.

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.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Emerging market : Characterized by greater market access and less potential for operational risks when compared to frontier markets, which leads to a larger base of potentially eligible investors.

MSCI EM Small Cap Index : Includes small cap representation across 21 Emerging Markets countries. The small cap segment tends to capture more local economic and sector characteristics relative to larger Emerging Markets capitalization segments.

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.

Risk-adjusted returns : Returns measured in relation to their own variability. High returns with a high level of risk indicate a lower probability that actual returns were close to average returns. High returns with a low level of risk would be more desirable, as they indicate a higher probability that actual returns were close to average returns.

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.

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

Market Capitalization : 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.

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.

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over tim.

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

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.