

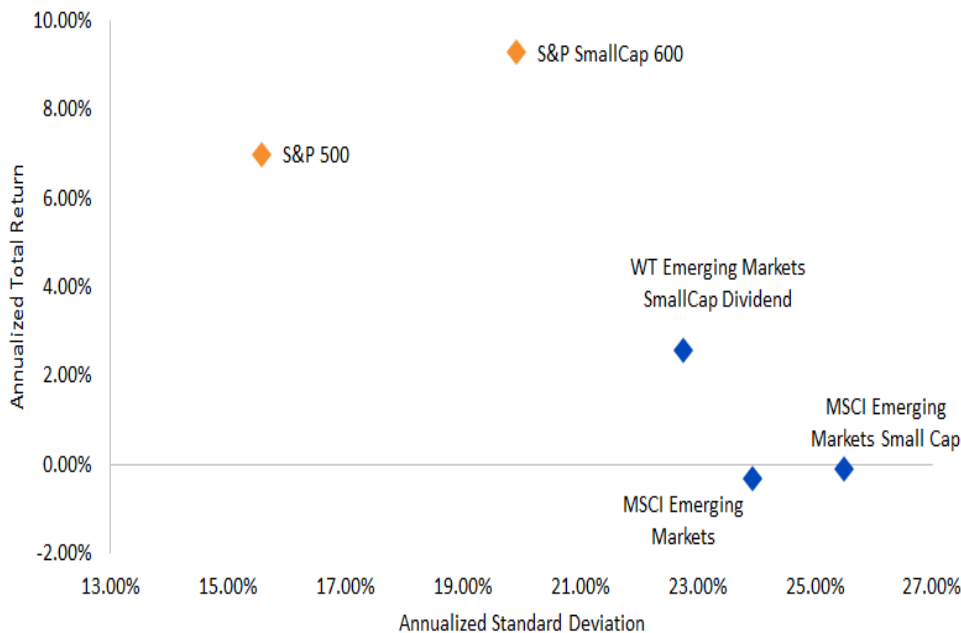
# IS IT POSSIBLE FOR SMALL CAPS TO OUTPERFORM LARGE CAPS WITH LESS RISK?

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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,<sup>1</sup> but did so while increasing [standard deviation](#) by over 4 percentage points relative to the S&P 500.<sup>2</sup>

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.<sup>3</sup> 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.<sup>4</sup> 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.<sup>5</sup>

### 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.

<sup>1</sup> Here and throughout the post, 9.5 years was selected to reflect a common time period with the [WisdomTree Emerging Markets SmallCap Dividend Index](#).

<sup>2</sup> 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.

<sup>3</sup>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.

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

<sup>5</sup>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](#)

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**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.**

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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.&nbsp;nbsp;.

**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 time.

**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 time.

**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.