

TARGETING BENCHMARK SIZE EXPOSURES WITH SMART BETA INDEXES

Christopher Gannatti — Head of Research, Europe
09/18/2014

Adding mid- or small-cap exposures to a portfolio, over long periods of time, has tended to change the overall risk and return picture. Benchmark-aware portfolio managers may be attracted to the enhanced return potential of mid and small caps, but they may also be leery of the added risk, or “size bet,” they assume by adding these exposures. But we’ve found that by using certain smart beta indexes, investors can employ mid- or small-cap strategies without taking a size bet relative to a benchmark. The table below illustrates this point: **Using Smart Beta Indexes without Making Size**

Matching the MSCI EAFE Size Factor	Market Factor	Size Factor	Value Factor	Momentum Factor	Average Annual Returns
WT DEFA Index	0.988	-0.230	0.060	0.010	4.99%
WT International LargeCap	0.980	-0.364	0.020	0.030	4.53%
55% WT International LargeCap/ 45% WT International MidCap	0.993	-0.156	0.099	-0.004	5.51%
77% WT International LargeCap/ 23% WT International SmallCap	0.985	-0.156	0.070	0.010	5.09%
77% WT DEFA/ 23% WT International MidCap	0.993	-0.156	0.091	-0.003	5.20%
91% WT DEFA/ 9% WT International SmallCap	0.989	-0.156	0.077	0.004	5.17%
MSCI EAFE	0.986	-0.156	0.047	0.008	3.87%

Matching the MSCI EAFE IMI Size Factor	Market Factor	Size Factor	Value Factor	Momentum Factor	Average Annual Returns
57% WT International LargeCap/ 22% WT International MidCap/ 21% WT International SmallCap	0.991	-0.069	0.105	-0.005	5.34%
81% MSCI EAFE/ 14% MSCI EAFE Mid Cap/ 5% MSCI EAFE Small Cap	0.995	-0.069	0.055	0.000	3.95%
MSCI EAFE IMI	0.994	-0.069	0.055	0.001	4.05%

Sources: WisdomTree, Bloomberg, Zephyr StyleADVISOR, Kenneth French Data Library. Period 6/1/06–6/30/14 due to inception dates of the WisdomTree Indexes shown. Past performance is not indicative of future results. You cannot invest directly in an index.

Bets

For definitions of terms

and Indexes in the chart, visit our [glossary](#).

- **How Large is LARGE?** In this table, a greater negative number in the size factor column indicates greater exposure to large-cap stocks. The MSCI EAFE Index comes in at -0.156, thereby setting the bar. The WT DEFA Index comes in at -0.230, while the WT International Large Cap Dividends comes in at -0.364, or more than twice as exposed to large caps as the MSCI EAFE Index.
- **Adding 9%–45% Weight to Mid or Small Caps to Match MSCI EAFE:** The fact that the WT DEFA and the WT International LargeCap Dividend are so large means that we can add anywhere from 9% to 45% exposure to mid- or small-cap stocks, defined by blends with the WT International MidCap Index or the WT International SmallCap Index. The important thing is that we can do this **without** taking any size bet relative to the MSCI EAFE Index, based on the returns exhibited over the period of time represented by the table, June 1, 2006, through June 30, 2014. We believe that it is beneficial to think in this manner because adding small or mid-caps can build a more complete exposure to a particular region, not to mention that all of the blends outperformed the MSCI EAFE Index over this period.
- **Blending with WT Int. LargeCap Dividend:** It’s clear that this Index is the largest, so when it is used as the foundation of a blend, it allows the use of 45% weight toward the [WT International MidCap Dividend Index](#) or 23% weight toward the [WT International SmallCap Dividend Index](#) while maintaining the same overall size exposure as the MSCI EAFE Index. The 45% weight toward [mid caps](#) certainly contributed to the 5.51% average annual return—the best of all blends shown in this table.
- **Blending with WT DEFA:** This Index isn’t quite as large as the WT International LargeCap Dividend and does include exposure to large-, mid- and small-cap size segments. Still, we have the flexibility to add 23% exposure to the WT International MidCap Dividend Index or 9% to the WT International SmallCap Dividend Index without taking a size bet relative to the MSCI EAFE.
- **What about the MSCI EAFE IMI?** Even MSCI has recognized that the MSCI EAFE Index is not necessarily a “total market” exposure, largely missing out on the small-cap size segment. That’s one of the main reasons that the MSCI EAFE IMI has been gaining attention; it does in fact include large-, mid- and small-cap stocks, and it is broader than the MSCI EAFE Index.
- Even though the MSCI EAFE IMI has greater exposure to small caps than the MSCI EAFE Index, as seen

by its -0.069 size factor loading, a WisdomTree blend of large cap, mid cap and small cap focused Indexes can match this size exposure while tilting significantly more weight toward mid- and small-cap stocks, specifically 43%. This is even true if we compare to the MSCI EAFE size-focused options, which stand at 19%. This is a big reason why we think the blend of 57% WT International LargeCap Dividend, 22% WT International MidCap Dividend and 21% WT International SmallCap Dividend Indexes delivered the second-best performance of the blends shown in this table, 5.34% average annual returns. Read full research on International Smart Beta [here](#).

Important Risks Related to this Article

Investments focusing on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty.

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

WisdomTree International MidCap Dividend Index : A fundamentally weighted index that measures the performance of the mid-capitalization segment of the US dividend-paying market. The Index is comprised of the companies that compose the top 75% of the market capitalization of the WisdomTree Dividend Index after the 300 largest companies have been removed. The index is dividend weighted annually to reflect the proportionate share of the aggregate cash dividends each component company is projected to pay in the coming year, based on the most recently declared dividend per share.

WisdomTree International SmallCap Dividend Index : A fundamentally weighted index measuring the performance of the small-capitalization segment of the US dividend-paying market. The Index is comprised of the companies that compose the bottom 25% of the market capitalization of the WisdomTree Dividend Index after the 300 largest companies have been removed. The index is dividend weighted annually to reflect the proportionate share of the aggregate cash dividends each component company is projected to pay in the coming year, based on the most recently declared dividend per share.

Mid-Cap : Characterized by exposure to the next 20% of market capitalization (after the top 70% have been removed) within the Value, Blend or Growth style zones with the majority of the fund's weight.