Global Small Caps Deliver Strong Returns: Will Your Index Rebalance?

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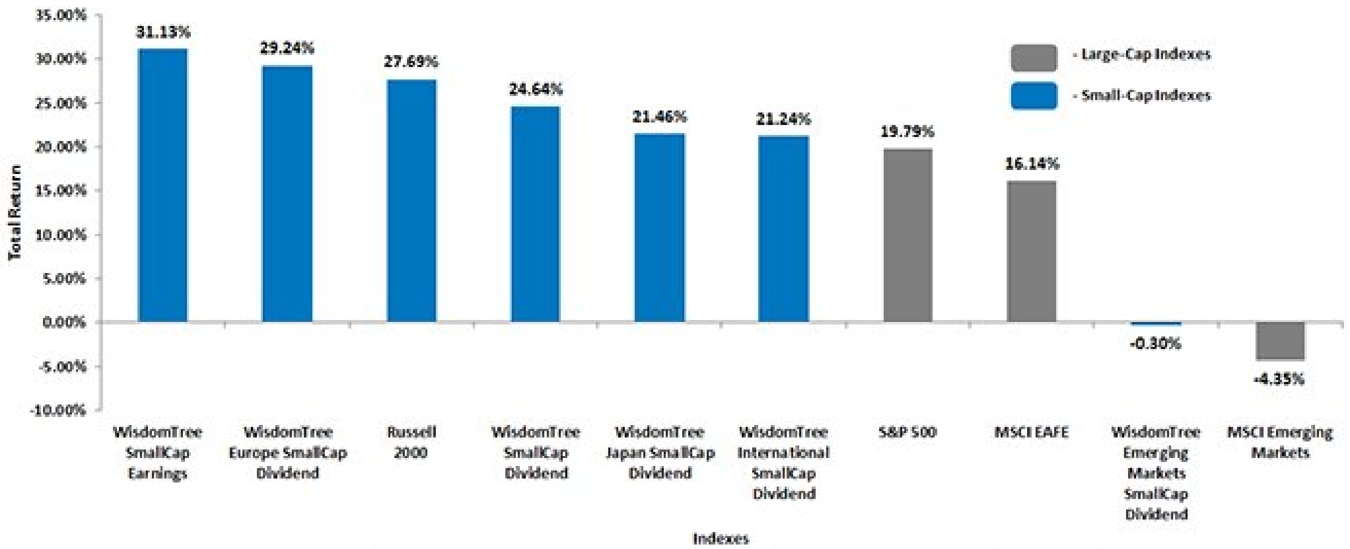
For the first three quarters of 2013, U.S. equity markets, measured by the S&P 500, have performed strongly, leading broad developed and emerging indexes with a return of nearly 20%. Impressive, yes, but if one looks further down the capitalization spectrum in the U.S. markets and across global markets, there have been even better returns in global small caps during this cyclical upturn. Typically, small-cap companies have higher growth rates and potential, are more cyclically sensitive and tend to lead large caps in performance during economic expansions. Although global economic growth is below trend, the economy has emerged from the great recession, and leading indicators are pointing to a rebound in many of the major developed markets—the United States, Europe and Japan. This optimism is evident in the recent performance of equity markets year-to-date. **Small-Cap Performance Evaluation** In the chart below we will compare a cross section of WisdomTree's small-capitalization Indexes across the global landscape with common large-cap indexes to highlight the differences in the global small-cap opportunity set. • We will use the S&P 500, MSCI EAFE and MSCI Emerging Markets indexes to represent domestic, developed international and emerging market large-cap equities, respectively. • Also, we will use the Russell 2000 Index to represent a broad measure of U.S. small-cap equities. These indexes were chosen because of their scope in their respective asset classes and their general popularity for tracking and measuring these segments. **Figure 1: Year-to-Date Index Performance**



Sources: Bloomberg, WisdomTree (12/31/13–09/30/13). Past performance is not indicative of future results. You cannot invest directly in an index. Subject to change.

For definitions of indexes in the charts, please visit our Glossary. • **Small Caps Outperformed Large Caps** – All but one of the small-cap indexes above outperformed domestic, international and emerging market large-cap indexes mentioned. The chart illustrates the importance of looking beyond the large-cap market. The Russell 2000 Index, a market barometer for small caps, outperformed the S&P 500, MSCI EAFE and MSCI EM indexes by 7.90%, 11.55% and 32.04%, respectively. • **WisdomTree SmallCap Earnings Index** – This was the best performer over the reviewed period, outperforming the Russell 2000 Index by 3.44%. The WisdomTree SmallCap Earnings Index includes only companies that demonstrate a prior four quarters of cumulative positive earnings and then weights those companies based on their relative earnings. On the other hand, the Russell 2000 Index is weighted by market capitalization and may include companies that are not profitable. After such strong performance in small-cap stocks, we believe a focus on a disciplined rebalancing process gains significant importance. • **International Small-Cap Strategies Also Leading Large Caps** – Both in the developed international and the emerging markets, small-cap indexes are outperforming their large-cap peers, as demonstrated by the WisdomTree International SmallCap Dividend Index leading the MSCI EAFE by over 5 percentage points and the WisdomTree Emerging Markets SmallCap Dividend Index leading the MSCI Emerging Markets Index by over 4 percentage points. • **Looking Abroad to Diversify Small Caps** – Many investors incorporate small-cap strategies for the United States as part of their portfolio but have yet to expand these allocations internationally. The relatively strong returns in the United States may indicate a useful time to diversify some of the U.S. small caps to some of the foreign small-cap indexes, such as the emerging markets, that have not experienced such large gains. **The Importance of Valuations** From a valuation standpoint, we think it is important to be mindful of the strong performance these indexes have displayed and what that means for current portfolio allocations. With market capitalization-weighted indexes, when constituents increase in price compared to other stocks, they are gaining a greater weight and impact on the performance of the index. At WisdomTree, we believe a focus on fundamentals is necessary, but that it is even more important after periods of such strong short-term performance. WisdomTree Indexes employ a rules-based rebalancing mechanism that adjusts relative weights based on underlying fundamentals. During the rebalancing process, which occurs once per year for each Index, the relationship between share price performance and either dividend growth or earnings growth is measured. • **Firms that increased their earnings or dividends but whose share prices have remained constant or declined will typically see increases in weights.** • **Firms whose earnings or dividends decreased but whose share prices have remained constant or risen will typically see decreases in weights.** **Conclusion** Adding exposure to small caps can offer increased diversification and return potential, but there are critical differences in investment strategies. In our opinion, a rules-based approach that focuses and rebalances based on underlying fundamentals may enable investors to better capitalize on the small-cap segment, especially given the large performance run small caps have experienced recently. Read the full research here.

Important Risks Related to this Article

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