

Look to Japan, Emerging Markets for Cheapest Valuations Among Global Small Caps

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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, leading indicators are pointing to a rebound in many of the major developed markets. This optimism is evident in the performance of the small-cap equity markets year-to-date. Investors have a tendency to get overly enthused about growth prospects, which means that they tend to overpay for this potential growth. As a result of the increasing optimism and recent performance, we believe that valuation risk is one of the single greatest risks to current portfolio allocations in the small-cap space today.

Price-to-Dividend Ratio Apart from the [price-to-earnings ratio](#), another way to measure if investors are paying too high a price for the underlying fundamentals is the price-to-dividend ratio. In the chart below we will look at the 10-year price-to-dividend ratio of different regional indexes. • When price growth equals dividend growth, there is no change in the price-to-dividend ratio—as dividends didn't become any more or less expensive relative to the price. • When dividends grow faster than the price—there are greater amounts of dividends per unit of price—the price-to-dividend ratio drops, which reflects the markets getting cheaper. **Price-to-Dividend Ratios**

Index	Current Price-to-Dividend (P/D) Ratio	10-Year (P/D) Average	Percentage Difference
Large Cap			
MSCI Emerging Markets	39.75	44.26	-10.19%
S&P 500	48.80	52.92	-7.78%
MSCI EAFE	38.29	39.40	-2.81%
Small Cap			
MSCI Japan Small Cap	59.41	71.89	-17.36%
MSCI EM Small Cap	48.14	54.11	-11.04%
MSCI ACWI ex-US Small Cap	47.52	51.79	-8.25%
MSCI EAFE Small Cap	47.61	49.50	-3.83%
Russell 2000	80.43	81.41	-1.20%
MSCI Europe Small Cap	49.79	49.34	0.91%

Sources: Bloomberg, MSCI, WisdomTree (09/30/03–09/30/13). "Current price-to-dividend ratio" is as of 09/30/13. Past performance is not indicative of future results. You cannot invest directly in an index. Subject to change.

• **Global Small Caps Show Similar Price-to-Dividend Ratios as the S&P 500 Index** – Typically, one might expect small caps to trade at higher premiums than large caps as a result of their higher growth expectations. Of course, there are regional differences, but we find it interesting that the MSCI EM Small Cap, MSCI EAFE Small Cap and MSCI Europe Small Cap indexes are all showing similar price-to-dividend ratios as the S&P 500 Index. • **Highest Price-to-Dividend Ratio:** Note that the Russell 2000 Index has a price-to-dividend ratio of over 80x, which is more than 60% higher than that of the S&P 500. All foreign small-cap indexes are significantly lower than the Russell 2000. • **Japan Small Caps Display Highest Discount to Historical Average** – Looking at the differences in the indexes' current price-to-dividend ratio compared to their 10-year average, Japan currently is selling at a discount of more than 17%. We feel this is important to note because the Japanese government has taken aggressive action to end deflation by adopting a bold monetary policy and has signaled it will follow up with fiscal and structural reforms. We believe these actions should continue to provide tailwind for Japanese large and especially small caps as the full effects are being felt by the local economy. • **Emerging Market Small Caps Appear Attractive** – Most economists expect emerging markets to grow faster than developed markets over the next decade, so we find it interesting that, as a region, they are currently priced at a discount. Also, emerging markets have displayed the highest regional dividend growth over the past 10 years, with large-cap dividends growing over 12% and small caps at almost 15% on an average annual basis.¹ I believe this has the potential to continue in the long term if emerging market growth expectations materialize. **Conclusion** Without question, we feel investors should benefit by including exposure to global small caps in a diversified portfolio over the long term. After such strong recent short-term performance, we believe a focus on a fundamental rebalancing process becomes necessary to potentially manage valuation risk. While market capitalization-weighted indexes by their definition and investment process allocate the greatest weights to

the firms with the largest market caps and the stocks that have appreciated the most, WisdomTree Indexes focus on fundamentals—either dividends or earnings—to determine their constituent weights. We believe this gives [WisdomTree Indexes](#) the potential to sell stocks that have become more expensive relative to their underlying fundamentals and buy stocks that have become less expensive relative to their underlying fundamentals. The cheapest part of the global small-cap market, when looking at current ratios versus their 10-year averages, appears to be Japan, followed by the emerging markets. I see both of these as attractive areas if one wants to diversify one's U.S. small-cap allocations. ¹Sources: WisdomTree, MSCI (09/30/03–09/30/13).

Important Risks Related to this Article

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 and intervention or political developments. Diversification does not eliminate the risk of experiencing investment losses. Investments focused in Japan are increasing the impact of events and developments associated with the region, which can adversely affect performance. Investments focusing on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility.