

Target Your Emerging Markets Exposure with Small Caps

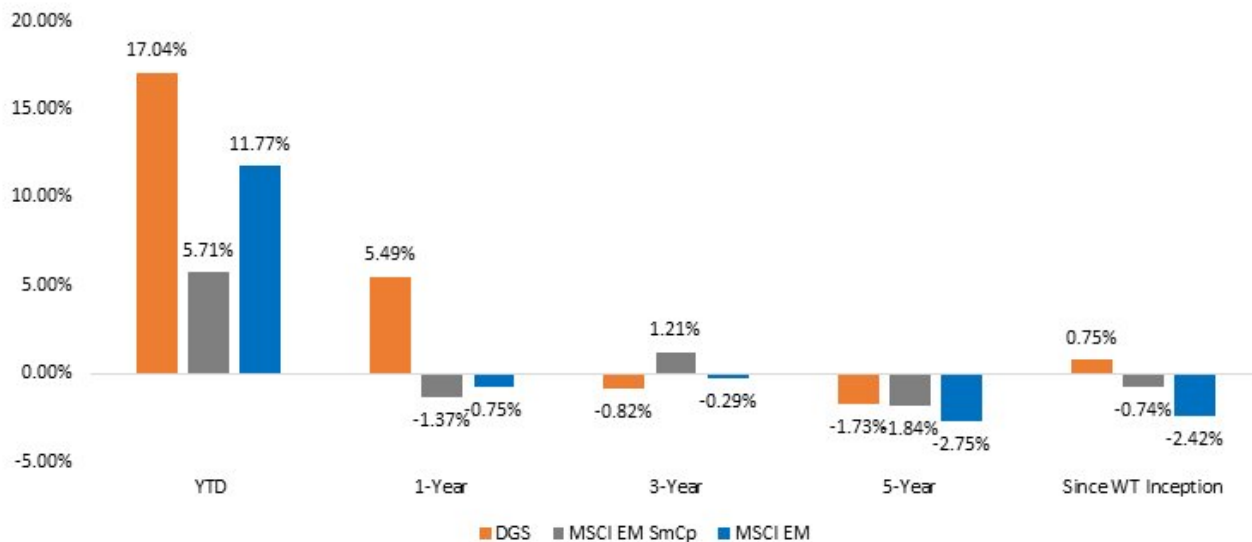
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Emerging markets (EM) are seeing a resurgence of interest and performance in 2016. After five years of disappointing results—when broad emerging market indexes lost 20% cumulatively on a total return basis for the period ending December 31, 2015, while the [S&P 500 Index](#) returned over 80% over the period—we are seeing emerging markets outperforming again in 2016 through July 31.¹ There tends to be a correlation in sentiment between emerging markets and commodities, and this year is no different—across most regional indexes, the best-performing segments of the market have tended to be energy and materials exposures. However, some of the best returns within the emerging markets are coming from segments that receive little exposure in traditional market benchmarks. And the type of strong returns being shown this year also highlights one of the reasons why rebalancing toward underlying fundamental metrics can help manage valuation risk. **Small-Cap Dividend Stocks: Outperforming in 2016 and Over the Long Run** Small-cap stocks with a dividend focus, represented by the [WisdomTree Emerging Markets SmallCap Dividend Fund \(DGS\)](#),² have seen returns of greater than 17% through July 31, while a broad index of emerging markets small caps from MSCI, the MSCI Emerging Markets Small Cap Index, was up less than 6%, and the large-cap MSCI Emerging Markets Index was up 11.8%. This is not a new phenomenon, either. DGS has outperformed both the cap-weighted MSCI Emerging Markets Small Cap Index and the broader MSCI Emerging Markets Index by over 1.5% per year for nearly the last nine years as of July 31.

Emerging Market Performance



Sources: WisdomTree, Bloomberg as of 7/31/16. WT Inception refers to 10/30/07, the inception of the WisdomTree Emerging Markets SmallCap Dividend Fund. 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.

Attribution: What Is Driving This Year's Outperformance? The table below shows the top five countries (classified by currency exposure) adding to the returns of DGS compared to the traditional MSCI benchmarks. Some of the key stories for the strongest returns in DGS are out of Brazil, South Africa and Thailand.

- Brazil has been a great performer, partly with its currency but also the stock selection within the small-cap side of the market. Brazil small caps in DGS are up over 80% in 2016 and averaged over 9% weight in the DGS. The MSCI EM Small Cap Index had less than 3% weight to Brazil small caps, and this led to 450 basis point (bps) of outperformance over the MSCI Emerging Markets Small Cap Index. Taiwan small-cap dividend payers, over-weight in DGS, also had better performance than cap-weighted Taiwan small caps, and that led to positive attribution.
- Hong Kong exposure—representing China stocks—was another place where the dividend-weighted approach added value from a stock selection basis, as Hong Kong stocks in DGS returned over 6% higher returns than China stocks in the MSCI Emerging Markets Small Cap Index.
- South African small- cap dividend payers were up 43%, with approximately 15% coming from currency gains.

	Weight			Return USD		Return Local		Attribution	Currency Impact DGS
	DGS	MSCI EM Small Cap Index	+/-	DGS	MSCI EM Small Cap Index	DGS	MSCI EM Small Cap Index		
Total	100	100	0	18.42	6.77	12.75	3.59	11.65	5.67
Brazilian real	9.45	2.66	6.79	82.36	67.08	50.44	37.83	4.52	31.92
Taiwan dollar	27.54	17.54	10	14.73	9.68	10.5	5.64	2.15	4.23
Hong Kong dollar	21.45	19.17	2.28	-0.88	-7.32	-0.75	-7.2	1.13	-0.13
Thai baht	8.59	3.79	4.8	24.1	22.58	19.91	18.44	1.07	4.19
S. African rand	7.64	4.9	2.74	43.48	43.63	28.67	28.81	0.95	14.81
U.S. dollar	0.58	3.57	-2.99	-3.02	-15.94	-3.02	-15.94	0.85	0
Indonesian rupiah	3.28	2.38	0.9	41.87	32.19	34.52	25.34	0.53	7.35
South Korean won	6.72	19.96	-13.24	6.22	2.79	0.38	-2.87	0.35	5.84
Malaysian ringgit	5.01	3.62	1.39	9.05	4.8	2.24	-1.75	0.24	6.81
New Turkish lira	3.2	1.29	1.91	8.51	6.23	11.19	8.86	0.17	-2.68
Chilean peso	1.32	0.94	0.38	38.18	34.44	28.22	24.76	0.15	9.96
Mexican peso	1.29	3.36	-2.07	10.42	1.86	20.54	11.2	0.15	-10.12
Egyptian pound	0	0.6	-0.6		-5.77		6.86	0.07	

Sources: WisdomTree, MSCI, Bloomberg Portfolio attribution 12/31/15–8/1/2016.

Given some of these large gains in countries such as Brazil, Indonesia and South Africa—returns of greater than 40% when average returns were closer to 18% across the region—investors may start to worry about those stocks running too much. Managing valuation risk is a key element of the WisdomTree Index family that incorporates a relative value rebalance. We are coming up on the annual emerging markets rebalance in October, which will look at stocks becoming more expensive relative to their dividends. The WisdomTree Index process is designed to reduce weight in those stocks that have become more expensive (whose prices are appreciating more than dividends) while adding to weight in stocks that are becoming relatively less expensive (whose prices are falling more than dividends or whose dividends are growing relative to prices). This process has added value in terms of higher returns over the long run compared to traditional indexes, and years like 2016 with sharp moves higher are classic cases of why we like to rebalance back to underlying fundamentals of companies. Also, for those investors who think that small-cap companies are more volatile than large caps and that it sounds especially volatile to allocate to emerging market small caps, it may be surprising that since the inception of DGS, the beta of this Index relative to the MSCI Emerging Markets Index of large caps was .89 and the volatility was 1.13% lower.³ Given that traditional benchmarks have very little exposure to emerging market small caps, we'd encourage investors to look at emerging market small-cap dividend payers as a diversifier for their emerging market allocations.

¹Sources: WisdomTree, Bloomberg. ²Designed to track the [WisdomTree Emerging Markets SmallCap Dividend Index](#) after fees and expenses. ³Sources: WisdomTree, StyleAdvisor as of 6/30/16. Refers to three-year period ending 6/30/16.

Important Risks Related to this Article

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.