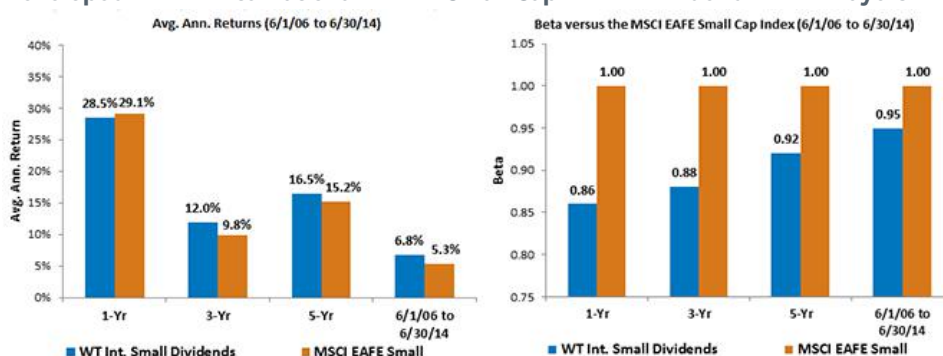


CONCERNED ABOUT U.S. SMALL CAP VALUATIONS? THINK INTERNATIONALLY!

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2013 was a very strong year for U.S. small-cap stocks. However, as is often the case, with great performance comes concern about [valuation](#). Instead of being concerned with valuations in U.S. small caps, we encourage investors to consider diversifying their small-cap allocations around the world. We believe that important valuation opportunities still abound, and we are particularly excited about what we see in developed international equities. **Why Allocate to Small-Cap Stocks?** Stepping back, it's critical to address why people should think about small-cap stocks in the first place. Ultimately, small caps are able to be the most sensitive to incremental changes in economic growth expectations. One reason for this regards their weight in what we call "[cyclical sectors](#)."¹ • The [WisdomTree International SmallCap Dividend Index](#) (WT Int. Small Dividends) had more than 84% of its weight in cyclical sectors as of July 25, 2014. • As a point of reference, the [WisdomTree International LargeCap Dividend Index](#) had only about 61% of its weight in cyclical sectors at that time. • The same phenomenon occurs when looking at the [MSCI EAFE Index](#), predominantly a large-cap exposure (70% exposure to cyclical sectors), versus the [MSCI EAFE Small-Cap Index](#) (84% exposure to cyclical sectors). Exposure to incremental increases in economic growth expectations is therefore an important element when considering small-cap stocks. **Mitigating Risk in Small-Cap Stock Exposures** Where the discussion gets interesting is when determining how to generate attractive [risk-adjusted performance](#) within small-cap stocks, as the economic sensitivity that makes small caps attractive can also at times lead to [volatility](#). From our perspective, focusing on dividends is of particular interest. As of July 25, 2014, approximately 85% of the weight of the MSCI EAFE Small Cap Index was in stocks that had paid at least one dividend over the prior 12 months, telling us that the landscape of small-cap dividend payers provides a rich hunting ground.² Has a dividend-focused approach to developed international small caps actually helped to balance the growth sensitivity of small-cap stocks with their potential for increased volatility? **Putting**

Developed International Small-Cap Dividend Payers to the Test



Source: Zephyr StyleADVISOR, with data from 6/1/06 to 6/30/14. Past performance is not indicative of future results.

• **Dividend Payers**

Outperform: Over the three-year, five-year and since-inception periods, WT Int. Small Dividends outperformed the MSCI EAFE Small Cap Index. In a strong market during the one-year time frame, the dividend payers definitely kept pace—a feat we believe impressive because dividend-focused strategies frequently do not capture the full upward moves of bull markets. • **Dividend Payers Lower Risk across All Periods:** One way to consider risk is through the [beta](#) statistic, a measure of the relative volatility between two indexes. The MSCI EAFE Small Cap Index, serving as the benchmark in this case, will therefore have a beta of 1.00 in every period. Since WT Int. Small Dividends is less than 1.00 over every

period shown, this indicates that risk was reduced over these periods. For those thinking in more absolute terms, WT Int. Small Dividends also had a lower [standard deviation](#) than MSCI EAFE Small Cap Index over each of the periods shown.³ While we believe the historical track record is impressive, past performance is just that—in the past. To really put these results in context, it's important to understand that the single most important element of WT Int. Small Dividends is its annual rebalance. Simply put:

- **Firms Rewarded with Greater Weight:** Typically, these are firms where share-price performance has been lackluster, but dividends have remained stable or grown.
- **Firms Punished with Lower Weight:** Typically, these are firms where share-price performance has been very strong, but dividends—in other words, fundamentals—have not appreciated commensurately. The fact is that the top-performing stocks of today may not be poised to become the key drivers of performance tomorrow—especially after the strong year that we've just seen.

Historically, WT Int. Small Dividends has undergone eight rebalances.⁴

- **Dividend Yield Has Tended to Increase:** On average, the Index dividend yield has increased nearly 23%. In essence, this is a natural consequence of the dividend-focused methodology.
- **Price-to-Earnings (P/E) Ratio Has Tended to Decrease:** On average, the Index P/E ratio has tended to decrease by about 12%.

¹Sources for the three bullets: WisdomTree, Bloomberg, Standard & Poor's, with data as of 7/25/14. ²Source: Bloomberg, as of 7/25/14. ³Source: Zephyr StyleADVISOR, with standard deviation measured over the one-year, three-year, five-year and 6/1/06–6/30/14 periods, as of 6/30/14. ⁴Each rebalance has coincided with an annual Index screening occurring on May 31, the earliest being 5/31/07 and the latest being 5/31/14.

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. Diversification does not eliminate the risk of experiencing investment losses. Dividends are not guaranteed and a company's future ability to pay dividends may be limited. A company currently paying dividends may cease paying dividends at any time.

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.

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DEFINITIONS

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Cyclical sectors : Consumer Discretionary, Energy, Industrials, Materials, Financials and Information Technology sectors.

MSCI EAFE Index : is a market cap-weighted index composed of companies representative of the developed market structure of developed countries in Europe, Australasia and Japan.

MSCI EAFE Small Cap Index : A free float-adjusted market capitalization equity index that captures small-cap representation across developed market countries around the world, excluding the U.S. and Canada.

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.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

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.

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.

Dividend yield : A financial ratio that shows how much a company pays out in dividends each year relative to its share price.