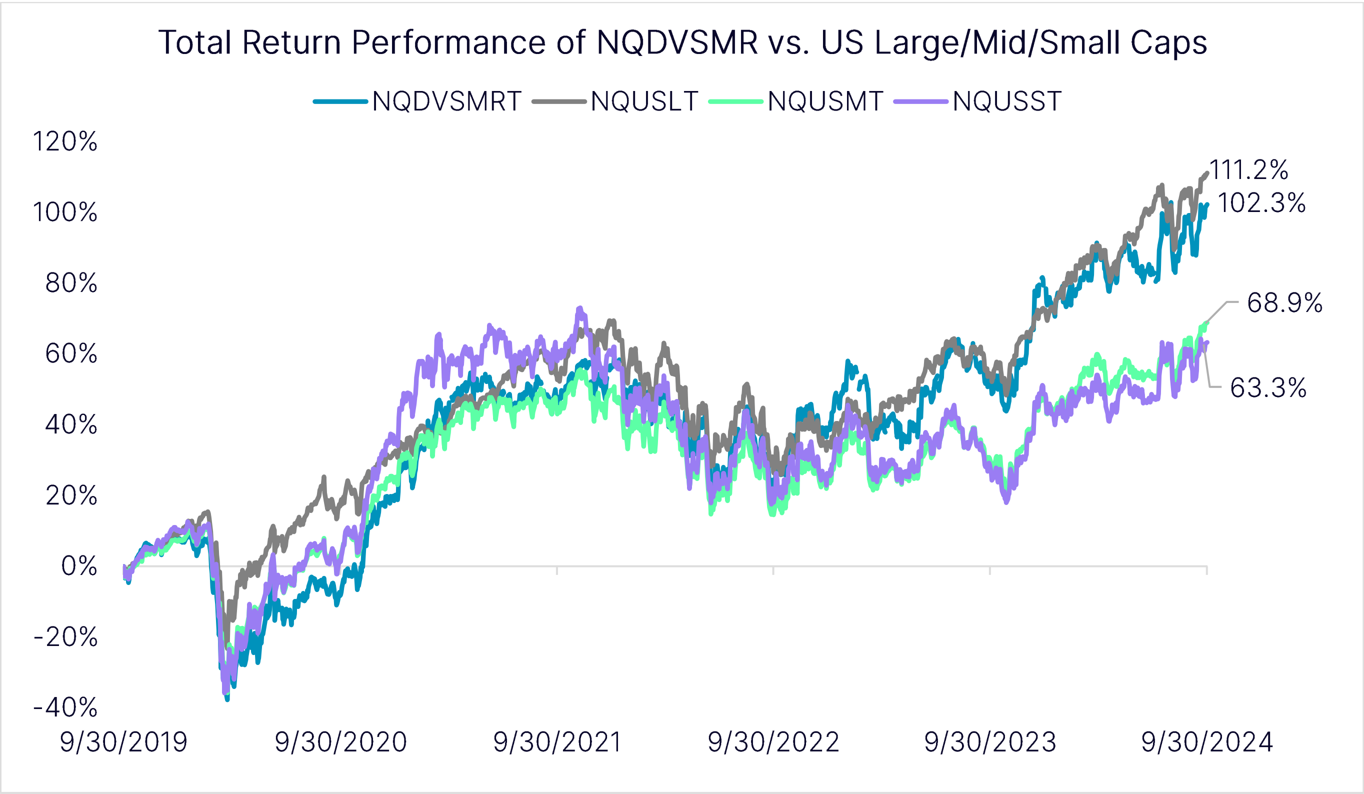
High-Quality Small & Mid-Cap Exposure with the Benefit of Rising Dividends

Small and mid-caps have lagged the rest of the US equity market in recent years, in large part due to a period of aggressive monetary tightening that began in March 2022. In 2023, there continued to be a performance differential between large caps and small/mid-caps, with the former benefitting from the emergence of AI as a new secular growth driver. As the year 2024 progressed, investor sentiment towards small and mid-caps occasionally improved, most notably in July as the likelihood of rate cuts in the second half of the year increased. The Fed delivered its first rate cuts in September, prompting another leg up and strengthening the outlook towards small and mid-caps into 2025. Most recently, in the wake of Trump's election victory, small caps rallied due to the anticipation of tax cuts, less regulation and higher M&A activity. With the equity rally broadening beyond large caps in recent months, small and mid-caps have already begun to play catch-up, aided by lower valuations than exist in the overextended, highly concentrated large cap space. Given the much lower concentration of market capitalization across the small and mid-cap spectrums, the much larger playing field in terms of number of companies vs. large cap, and the wide variation in the quality of business models, investors may want to consider a more intentional approach to tracking these types of companies, such as via the Nasdaq US Small Mid Cap Rising Dividend Achievers™ Index (NQDVSMR™).

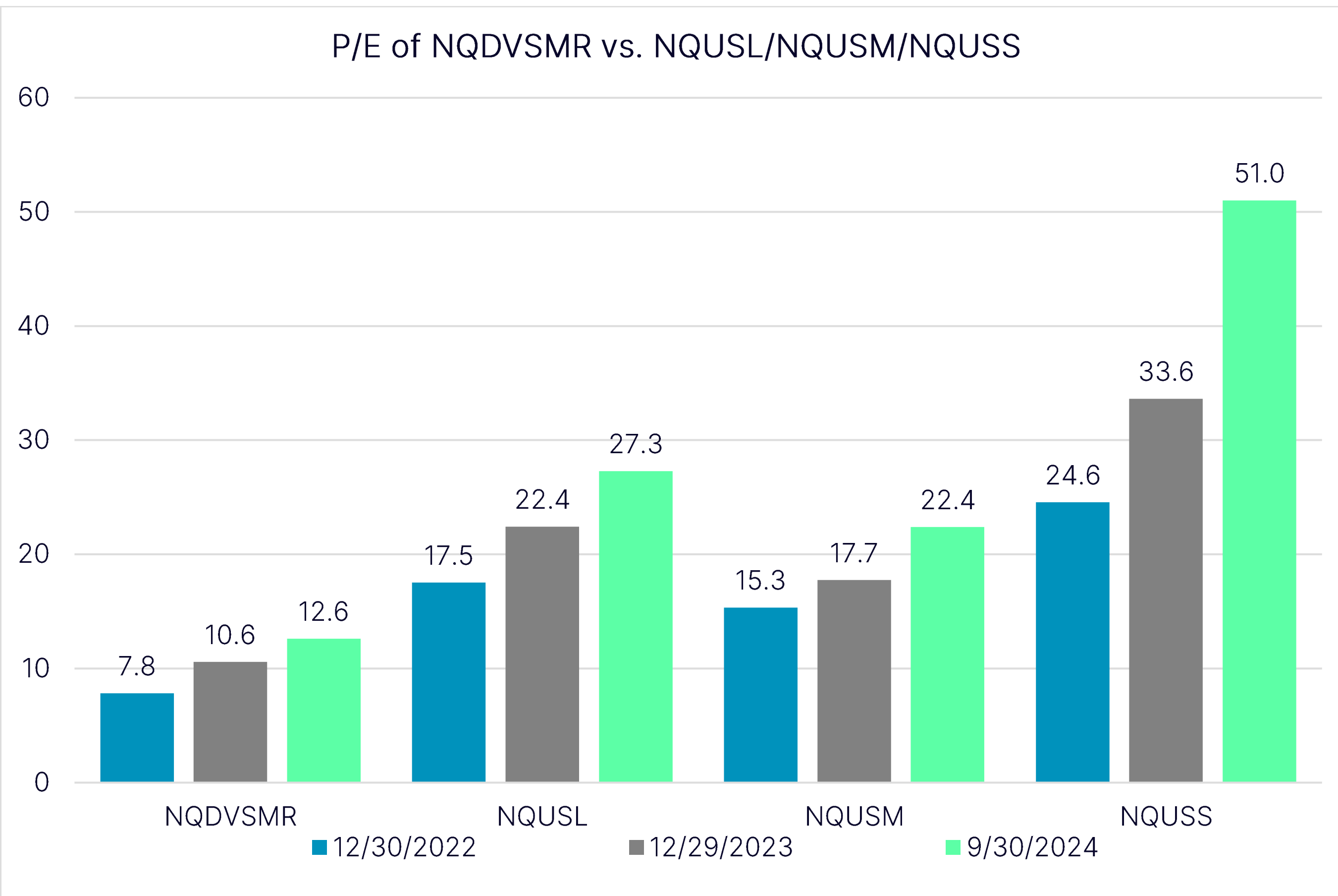


Source: Bloomberg

As seen in the five-year performance chart above, the Nasdaq US Small Mid Cap Rising Dividend Achievers Total Return™ Index (NQDVSMRT™) has generated impressive returns of 102.3%, easily outperforming both the Nasdaq US Mid Cap Total Return™ Index (NQUSMT™) and Nasdaq US Small Cap Total Return™ Index (NQUSST™), which generated returns of 68.9% and 63.3%, respectively. It underperformed the Nasdaq US Large Cap Total Return™ Index (NQUSLT™), however, by about nine percentage points – almost fully narrowing the recent gap between large and small/mid-cap performance. The performance differential between large and small/mid-caps widened in 2023 and into 2024 as the large-cap space disproportionately benefitted from the AI growth driver, while seeing lesser impacts from rising rates. Prior to 2023, the cumulative performance differential was at most around 20 percentage points. Since mid-2023, the performance differential has broadened to as much as 50 percentage points. This wide performance differential suggests that there is a strong possibility for a catch-up rally in small and mid-caps.

NQDVSMR's Lower Valuations vs. Nasdaq Large/Mid/Small Benchmarks

As seen in the chart below, NQDVSMR has consistently traded at a discount to Nasdaq's broad benchmark indexes tracking US large caps, as well as small/mid-caps, over the past couple of years. Additionally, large caps are overvalued relative to history and their mid/small cap peers. This also suggests that there is a strong likelihood for a catch-up rally in mid and small caps as valuations begin to trade more in line with historical averages.



Source: Bloomberg

Investors encouraged by the improving outlook for small and mid-caps are likely to benefit from concentrating their exposure to companies with an effective dividend strategy and other fundamental characteristics that signal higher quality. These companies are likely to offer a comparative advantage over their non-dividend paying counterparts, many of which may be unprofitable; in fact, a recent study by Apollo flagged 42% of the Russell 2000 as generating negative earnings[1]. The Nasdaq US Small Mid Cap Rising Dividend Achievers Index (NQDVSMR) is comprised of securities in the small and mid-cap space, determined by Nasdaq to have increased their dividend value over the previous three-year and five-year annual periods, while also generating positive earnings in recent years and maintaining reasonable leverage ratios.

Index Eligibility

To be eligible for inclusion in the Nasdaq US Small Mid Cap Rising Dividend Achievers Index, a security must meet the following criteria:

- Be a member of the Nasdaq US Mid Cap™ Index (NQUSM™) or Nasdaq US Small Cap™ Index (NQUSS™);
- Must not be classified as a Mortgage Real Estate Investment Trust or Real Estate Investment Trust according to the Industry Classification Benchmark (ICB);
- A minimum three-month average daily dollar trading volume (ADDTV) of $2 million;
- A minimum free float market cap of $1 billion;
- Paid a dividend in the trailing twelve-month period greater than the dividend paid in the trailing twelve-month period three and five years prior;
- Positive earnings per share in the most recent fiscal year greater than the earnings per share three fiscal years prior;
- Cash to debt ratio greater than 25%;
- Trailing twelve-month period payout ratio no greater than 65%; and
- One security per issuer is permitted.

Index Construction

The Nasdaq US Small Mid Cap Rising Dividend Achievers Index is an equal-weighted index. Eligible securities receive 3 ranks: by five-year dollar dividend increase, in descending order; by current dividend yield, in descending order; and by payout ratio, in ascending order. These three ranks are summed to obtain a single combined rank and the 100 securities with the lowest combined ranks are selected.

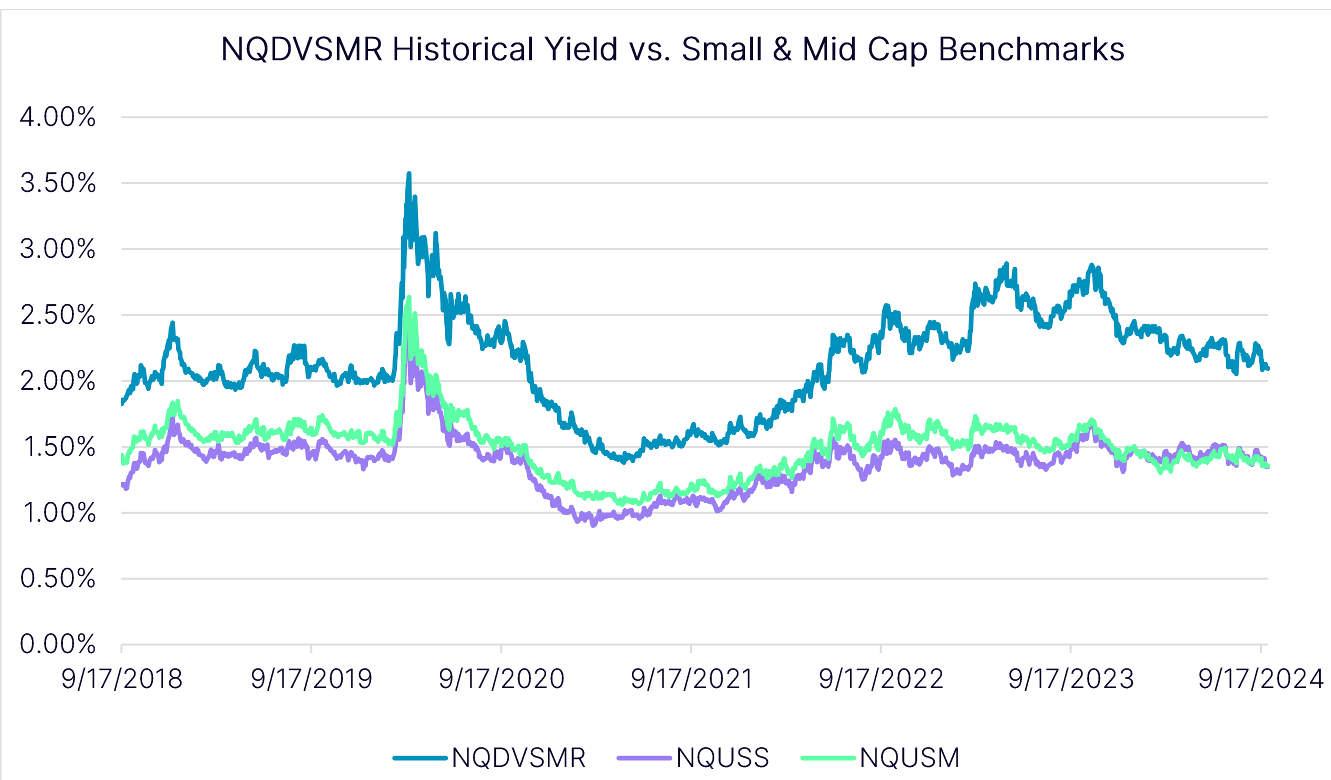
After the top 100 securities are selected, they are reviewed to determine if an ICB Industry is represented by more than 30 securities, and to ensure mid cap (or small cap) exposure does not exceed 75 securities. If an Industry is represented by more than 30 securities, the highest-ranking component within the Industry is removed and replaced with the next eligible security (e.g. the 101st ranked in the evaluation) from a different Industry. The same process is repeated with mid/small cap if either has more than 75 eligible securities. This process is repeated until no Industry has more than 30 securities and neither mid/small cap has a count greater than 75 securities. After the final list of 100 securities (or fewer, if less than 100 are

[1] https://www.apolloacademy.com/the-share-of-companies-with-negative-earnings/

eligible with all criteria and caps are employed) is selected, each security's Index market value is rebalanced quarterly to an equal-dollar value corresponding to an equal percent weight of the Index's aggregate market value. Should an Index Security fail to meet either the market capitalization or liquidity criteria, it will be removed from the Index on the Rebalance Effective Date. If an Index Security is removed from the Index outside of an Index reconstitution, it will be replaced at the next Quarterly Rebalance. The security being added to the Index cannot be a member of the ICB Industry which was previously capped unless this security does not push the capped industry to a cumulative weight greater than 30% (e.g., if the removed security was from a capped sector and the next eligible security is from the capped sector, it will get added back in). A Special Rebalance may be conducted anytime if it is determined to be necessary to maintain the integrity of the Index.

Historical Yield Comparison

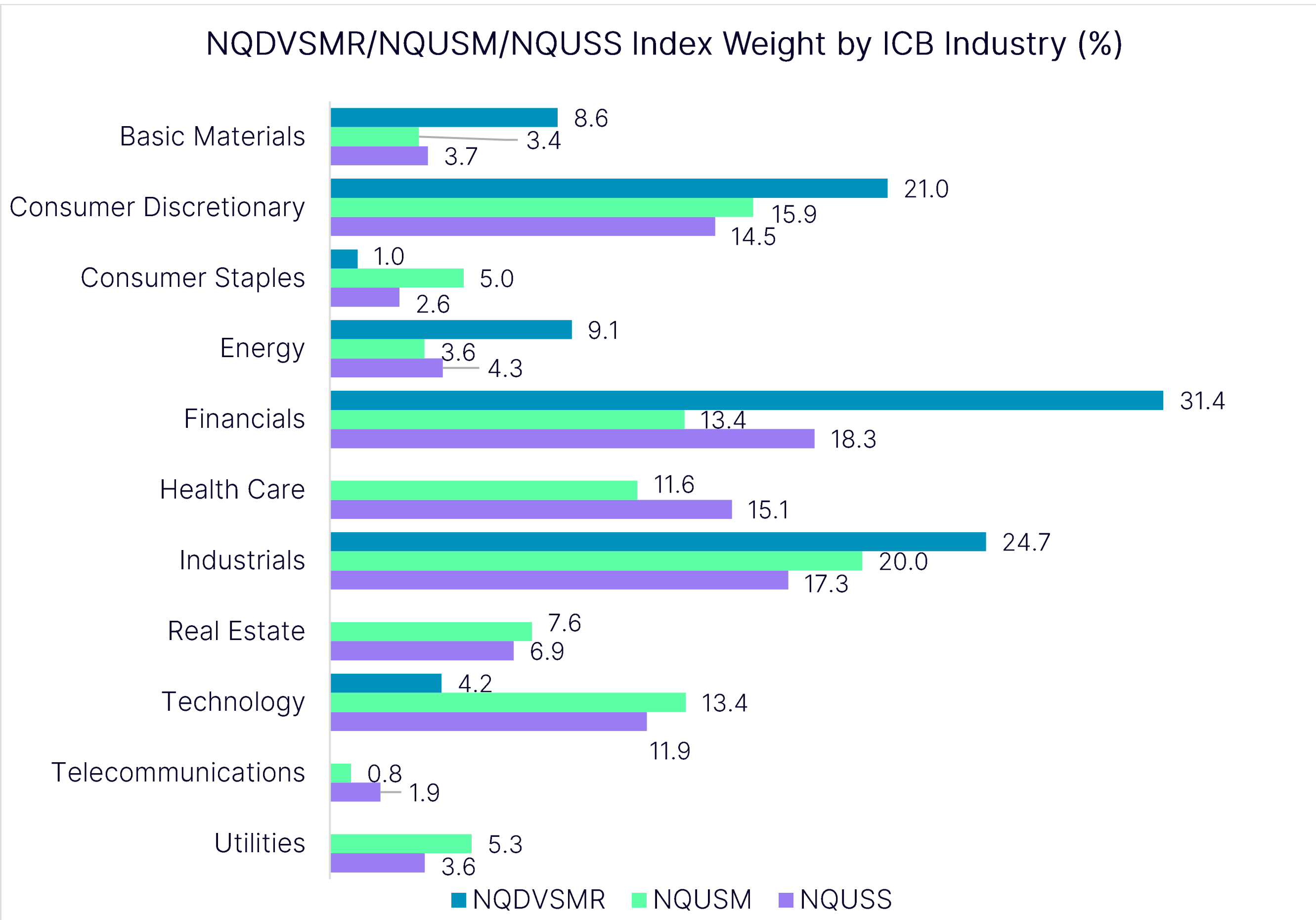
During the time period studied beginning one year after index launch (September 18, 2018 – September 30, 2024), the Nasdaq US Small Mid Cap Rising Dividend Achievers Total Return Index saw a 12-month rolling dividend yield in the range of 1.38% to 3.57%, with an average of 2.14%. The peak yield was observed in March 2020, around the start of the Covid-19 pandemic. The chart below compares the yield of the Nasdaq US Small Mid Cap Rising Dividend Achievers Index (NQDVSMR) with both the Nasdaq US Mid Cap Index (NQUSM) and Nasdaq US Small Cap Index (NQUSS). Both benchmark yields are consistently lower than NQDVSMR. Over the same time period, NQUSS generated an average 12-month rolling dividend of only 1.38%, while NQUSM averaged a yield of 1.50%, both approximately one-third lower than the average yield of NQDVSMR. This demonstrates what the index methodology is designed to achieve: stronger and more consistent dividend yield than the broader benchmarks that comprise the starting universe.



Source: Nasdaq Global Indexes

Industry Exposure

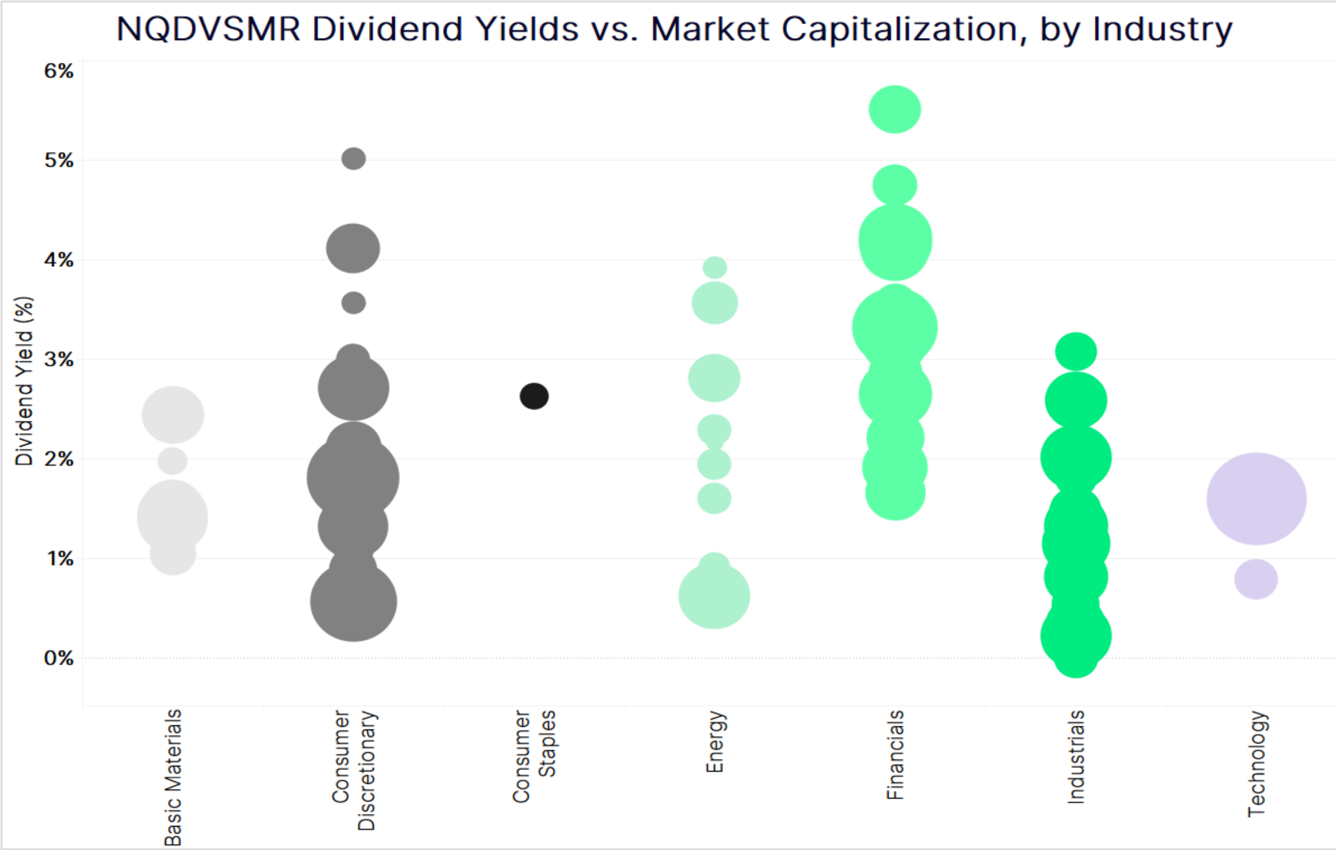
Below are the ICB Industry weights of the Nasdaq US Small Mid Cap Rising Dividend Achievers Index (NQDVSMR), the Nasdaq US Mid Cap Index (NQUSM) and the Nasdaq US Small Cap Index (NQUSS) as of September 30, 2024. NQDVSMR's largest industry allocations and overweights are towards Financials (31.4%), Industrials (24.7%) and Consumer Discretionary (21.0%), with sizable overweights also in Basic Materials and Energy. The smallest industry allocations are towards Consumer Staples (1.0%) and Technology (4.2%), with no allocations towards Health Care, Real Estate, Telecommunications, or Utilities. What is particularly impressive about NQDVSMR's recent outperformance is its substantial underweight in the top-performing sector of Technology, while overweighting Financials which has seen turbulence in recent years from the regional banking crisis that began in March 2023.



Source: Nasdaq Global Indexes, Bloomberg

Yield Analysis by Industry

Below is a scatter plot of the index holdings with trailing 12-month dividend yields on the y-axis and the dots sized by their relative market caps, as of September 30, 2024. As seen below, securities that make up Basic Materials, Consumer Staples, Technology and Industrials have dividend yields almost exclusively around or below 3%, while Financials, Consumer Discretionary and Energy have numerous securities with dividend yields above 3% - broadly consistent with the spread in sector weightings.



Source: Nasdaq Global Indexes, FactSet

Conclusion

This research piece provides a deep dive into the Nasdaq US Small Mid Cap Rising Dividend Achievers Index **(NQDVSMR),** including the index methodology, recent performance, valuations, and dividend yield history, along with current industry allocations. With rate cuts underway, investor sentiment towards small and mid-caps may improve as their debt burdens lessen. Additionally, the return of animal spirits as the US transitions to a more business-friendly political environment may especially favor smaller companies that have recently underperformed, as large cap valuations have swelled to historical highs. With the added benefit of the index being built around sustainably increasing dividends and screening for higher quality fundamental characteristics, NQDVSMR is designed to provide a smoother path to capital appreciation with higher and more consistent yield than broader US small and mid-cap index benchmarks. Market participants looking to gain exposure to the Nasdaq US Small Mid Cap Rising Dividend Achievers Index can do so through the First Trust SMID Cap Rising Dividend Achievers ETF (Nasdaq: SDVY) and the First Trust SMID Rising Dividend Achievers UCITS ETF (London: SDVY).

Sources: Nasdaq Global Indexes, Bloomberg, Factset

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