SMALL CAPS SURGE: WHAT NOW IN 2021?

Jeremy Schwartz — Global Chief Investment Officer
12/14/2020

One of the market implications of the COVID-19 pandemic has been the remarkable performance of large-cap growth and technology names, particularly those impacted by the work-from-home trend and cloud computing, and the underperformance of small-cap stocks that were more or less shut down during the economic lockdowns.

Positive vaccine news boosted hopes for an economic reopening in 2021, which flipped market signals, and small caps and value stocks rallied strongly in November. The Russell 2000 Index, a gauge of U.S. small-cap equity performance, delivered some of the strongest gains in its history.

Ben Carlson, author of the blog "A Wealth of Common Sense," has evaluated what happened in the aftermath of past small-cap surges, like the one we saw in November.

- The forward returns over one-, three- and five-year intervals were, on average, quite compelling, especially for the five years following the small-cap surges that Carlson studied. The average five-year cumulative return was almost 80%. Notably, the minimum return was 17.7%, following the peak of the market in Feburary 2000.
- The shorter time periods had more risk of negative subsequent returns. But even in the three-year analysis, only two periods had negative returns: around the 1999–2000 peak and into 2002–2003 market trough.
- The average one-year return of 15% is quite positive for a forward-looking one-year interval.

While the future is always uncertain, the data makes a strong case that we had an inflection point for small-cap stocks—and that while investors will inevitably feel they 'missed' this large turn, this past analysis indicates there's reason to believe more is to come.

Figure 1: Small Caps Have a Compelling Track Record after Rallies

Month	Return	Russell 2000 Forward Total Returns		
		One Year	Three Years	Five Years
Feb-2000	16.5%	-16.8%	-35.0%	17.1%
Apr-2009	15.5%	49.0%	74.3%	147.2%
Oct-2011	15.1%	12.1%	65.1%	72.4%
Oct-1982	14.4%	38.3%	55.0%	63.5%
Apr-2020	13.7%	???	???	???
Jan-1985	13.2%	17.5%	16.4%	47.9%
Sep-2010	12.5%	-3.5%	65.5%	74.1%
Aug-1984	11.8%	15.7%	74.7%	85.4%
Jan-1987	11.6%	-14.7%	8.4%	51.0%
Dec-1999	11.3%	-3.0%	-21.0%	37.7%
Jan-2019	11.3%	9.2%	???	???
Jul-1980	11.2%	30.3%	107.9%	120.0%
Feb-1991	11.2%	34.1%	74.3%	120.3%
Nov-2016	11.2%	18.3%	28.0%	???
May-1997	11.1%	21.2%	29.7%	36.4%
May-2003	10.7%	30.3%	69.2%	80.0%
Mar-1979	10.1%	6.7%	57.0%	160.6%
Averages		**15.3%**	**44.6%**	**79.5%**

Source: "A Wealth of Common Sense," Ben Carlson, as of 11/24/20. Past performance is not indicative of future results. You cannot invest directly in an index.

There is also research that suggests January is a particularly strong time for the performance of small-cap stocks. This "January Effect" does not work every year, and small caps generally have faced a tough stretch for quite an extended period.

But some of the arguments for why small caps perform well in January may be relevant this year. In years with large drawdowns, there can be some sharp tax loss selling. This drives prices down even further and below their fair value, resulting in them snapping back in January to correct for that selling as investors reestablish positions.

WisdomTree rebalances its fundamentally weighted indexes in late December to capitalize on similar trends of selling unrelated to corporate fundamentals creating noise and opportunities to pick up value trades.

Small-cap dividend-payers were particularly impacted during the 2020 pandemic and faced some of the strongest selling pressures all year. We believe small caps are ripe for Christmas shopping lists, particularly to get ahead of the January Effect in small caps.

Consider:

- WisdomTree SmallCap Dividend Fund (DES)
- WisdomTree SmallCap Quality Dividend Growth Fund (DGRS)

Important Risks Related to this Article

There are risks associated with investing, including the possible loss of principal. Funds focusing their investments 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. Please read each Fund's prospectus for specific details regarding the Fund's risk profile.

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.

For more investing insights, check out our Economic & Market Outlook

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Large-Capitalization (Large-Cap) : A term used by the investment community to refer to companies with a market capitalization value of more than $10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

Growth : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

Cloud computing : computing capabilities deployed via internet connection in form of applications, platform services, or infrastructure.

Small caps : new or relatively young companies that typically have a market capitalization between $200 million to $2 billion.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

12-month forward return : Returns for the 12-month period following an observed trailing 12-month dividend yield.

January Effect : Refers to market gains that may take place in during the month of January, as investors establish new positions for the year after selling losing positions in December to engage in tax-loss harvesting.

Tax Loss Harvesting : Selling securities at a loss to offset a capital gains tax liability. Tax gain/loss harvesting is typically used to limit the recognition of short-term capital gains, which are normally taxed at higher federal income tax rates than long-term capital gains.

Rebalance : An index is created by applying a certain set of selection and weighting rules at a certain frequency. WisdomTree rebalances, or re-applies its rules based selection and weighting process on an annual basis.

Fundamental weighting : A type of equity index in which components are chosen based on fundamental criteria as opposed to market capitalization. Fundamentally weighted indexes may be based on fundamental metrics such as revenue, dividend rates, earnings or book value.