

FACTOR TIMING OR FACTORS ALL THE TIME?

Matt Wagner — Associate Director, Research

10/01/2019

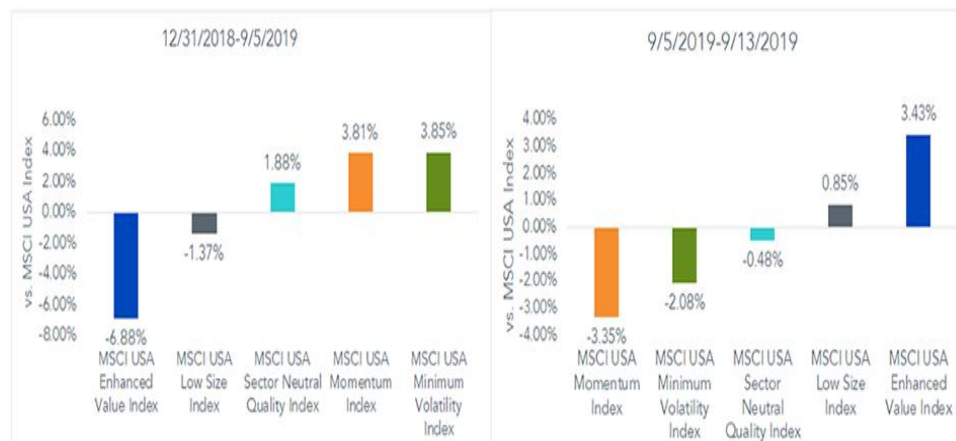
[Factor](#) timing is an appealing concept. But as with any [active](#) strategy, the right decision tends to look much more obvious in hindsight.

Most investors were caught off guard by the sudden reversal of factor performance at the beginning of September. It was hard to even pinpoint the exact reason for the reversal in factor leadership after the fact—some rosier-than-expected economic data and a possible thaw in the U.S.-China trade war are the most likely explanations.

The [MSCI USA Enhanced Value Index](#) (factor: [value](#)) lagged the broader MSCI USA Index by 688 [basis points \(bps\)](#) to start the year through September 5. This was followed by a remarkable 343 bps of outperformance over just a handful of trading sessions.

A similar reversal was seen with smaller stocks (factor: [size](#)) that lagged earlier this year.

Relative Index Performance



Sources: WisdomTree, Bloomberg. Past performance is not indicative of future results. You cannot invest directly in an index.

Time for [Small Caps](#)?

Many investors have been asking whether this rally really has legs and if now is the time to tilt into value or small caps.

Focusing on small caps—those stocks most sensitive to economic growth—exchange-traded fund (ETF) flows have shown some investor conviction: the largest small-cap ETF took in \$1.3 billion on September 16, its largest daily inflow since September 2018.

For tactical investors, perhaps small caps have been oversold for the past 12 months on overly pessimistic expectations for a global [recession](#), and this performance reversal and these flows could indicate a good entry opportunity.

But strategic asset allocators with a longer time horizon are right to be more measured in response to catalysts like a few days of good performance and inflows. We have to dig deeper to find a compelling investment opportunity.

Relative [Valuations](#) Provide a Cushion

Many market participants (WisdomTree included) have commented that since we are “late cycle” in the [bull market](#) in U.S. equities, [now is the time to favor factors](#) such as [momentum](#) and [quality](#), and dial down exposure to those like value and size. This call has by and large been spot on.

But most investors would be best suited to take the advice of AQR’s Cliff Asness on such market-timing: “Sin a little.”¹ It is very difficult to know what stage of the market cycle we are in until after the fact—history tells us that 10 years without a recession makes the economy due for one soon, but that’s no guarantee.

For investors with long-term goals and return objectives in mind, elevated valuations and above-average returns of [large-cap](#) U.S. equities over the past decade make valuation contraction and lower returns ahead more likely.

And for investors using single-factor strategies to be over-weight in more richly valued defensive factors such as [minimum volatility](#), achieving return objectives may be even more difficult.

Attractive relative valuations for small caps are giving investors a nice cushion relative to large caps. This is the type of valuation opportunity to which investors want to pay attention, particularly for those more reluctant to be over-weight in discounted international equities.

Relative Valuation: Small Caps vs. Large Caps

S&P 600 vs. S&P 500 Index Price-to-Earnings



Sources: WisdomTree, FactSet. Price-to-earnings based on forward price-to-earnings excluding negative earners. Past performance is not indicative of future results. You cannot invest directly in an index.

Conclusion: The Small-Cap Value Opportunity

As earnings have turned negative for small caps in the first half of 2019 and recession probabilities have risen, small-cap value suffered dearly relative to [growth](#). This trend has been a drag on the performance of more value-tilted small-cap indexes, such as the [WisdomTree U.S. SmallCap Index](#).

For investors who can withstand the short-term fluctuations of small caps and have a long time horizon, the discounted valuations of small-cap value are attractive.

Some say the worst-case scenario has not yet been priced in for small caps. But consider the alternative: perhaps the best case is still priced in for large caps, which sit near all-time highs, and explains why small caps are priced at the least-expensive relative valuation since the mid-2000s.

When looking at WisdomTree's earnings-weighted Indexes, the [price-to-earnings \(P/E\)](#) discount of small caps is even more pronounced. The WisdomTree U.S. SmallCap Index has a P/E of 11.0x, which puts it at a 22% discount to its historical median and in the bottom decile of its range of historical valuations.

Compare this with the S&P 500 Index P/E of 17.5x, which puts that index's valuation in the top quintile of observations back to 2007, and a nearly 60% premium to WisdomTree's small-cap Index.

Valuation Comparison

Index	Forward P/E Ratio	Median Since 2007	Discount vs. Median	Percentile vs. History
WisdomTree U.S. LargeCap Index	14.8x	14.2x	4.6%	71.3%
S&P 500 Index	17.5x	15.6x	12.3%	86.8%
WisdomTree U.S. MidCap Index	13.3x	15.1x	-12.3%	20.0%
S&P MidCap 400 Index	17.0x	17.2x	-0.9%	47.7%
WisdomTree U.S. SmallCap Index	11.0x	14.2x	-22.4%	6.0%
S&P SmallCap 600 Index	16.9x	17.5x	-3.7%	38.4%

Sources: WisdomTree, FactSet. Data from 2/28/07–8/31/19. Data using monthly observations. Past performance is not indicative of future results. You cannot invest directly in an index.

¹Clifford Asness, Antti Ilmanen and Thomas Maloney, "Back in the Hunt," Institutional Investor, 11/11/15.

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

Factor : Attributes that based on its fundamentals or share price behavior, are associated with higher return.

Active : Funds that attempt to outperform the market by selecting securities a portfolio manager believe to be the best.

MSCI USA Enhanced Value Index : Large and Mid-cap stocks exhibiting higher value characteristics relative to peers within their respective GICS sector. Value measured by Price-to-Book Value, Price-to-Forward Earnings and Enterprise Value-to-Cash flow from Operation.

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 time.

Basis point : 1/100th of 1 percent.

Size : Characterized by smaller companies rather than larger companies by market capitalization. This term is also related to the Size Factor, which associates smaller market-cap stocks with excess returns vs the market over time.

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

Recession : two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemployment.

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.

Bullish : a position that benefits when asset prices rise.

Momentum : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over time.

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.

Low Volatility : Characterized by lower standard deviation of price over time. This term is also associated with the Low Volatility Factor, which associates lower volatility stocks with better risk-adjusted returns vs the market over time.

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.

Price-to-earnings (P/E) ratio : Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.