

OPPORTUNITIES ABOUND IN U.S. SMALL CAPS

Brian Manby — Senior Analyst, Research
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Recessionary fears may be top of mind these days, but for investors with a contrarian view or the confidence to remain invested amid the [volatility](#), there are attractive opportunities in U.S. [small caps](#).

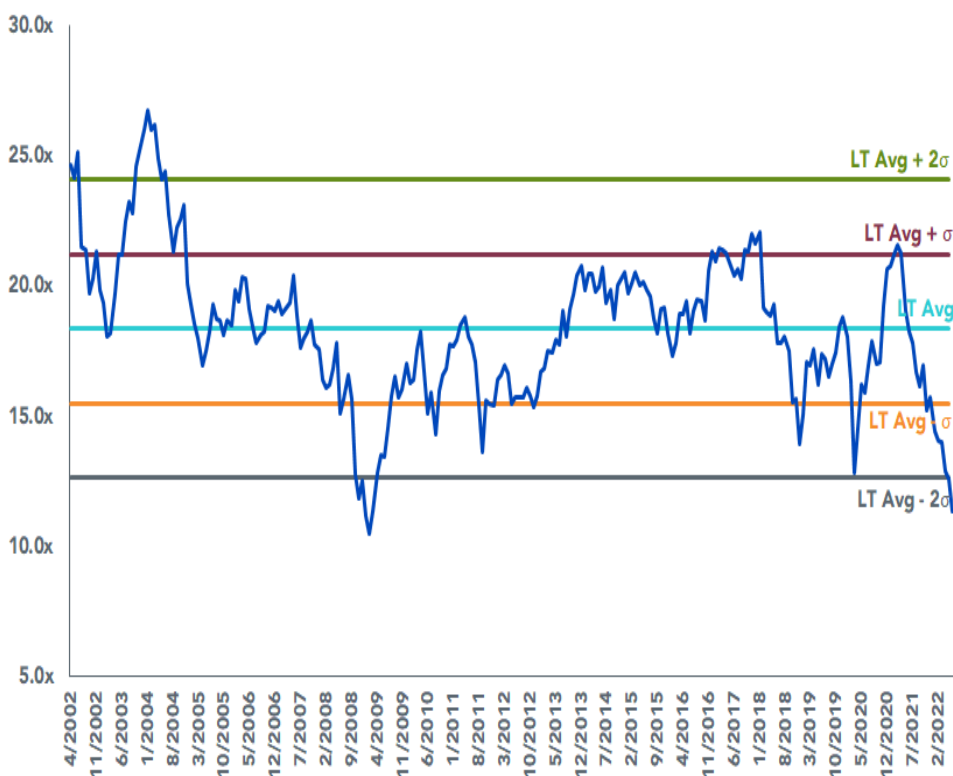
The prospect of a Fed-induced recession to combat historical [inflation](#) has priced in [valuation discounts](#) so steep they're difficult to ignore. If history is any indication, the future for small caps may be brighter than the grim near-term forecasts suggest.

Bargain Hunting

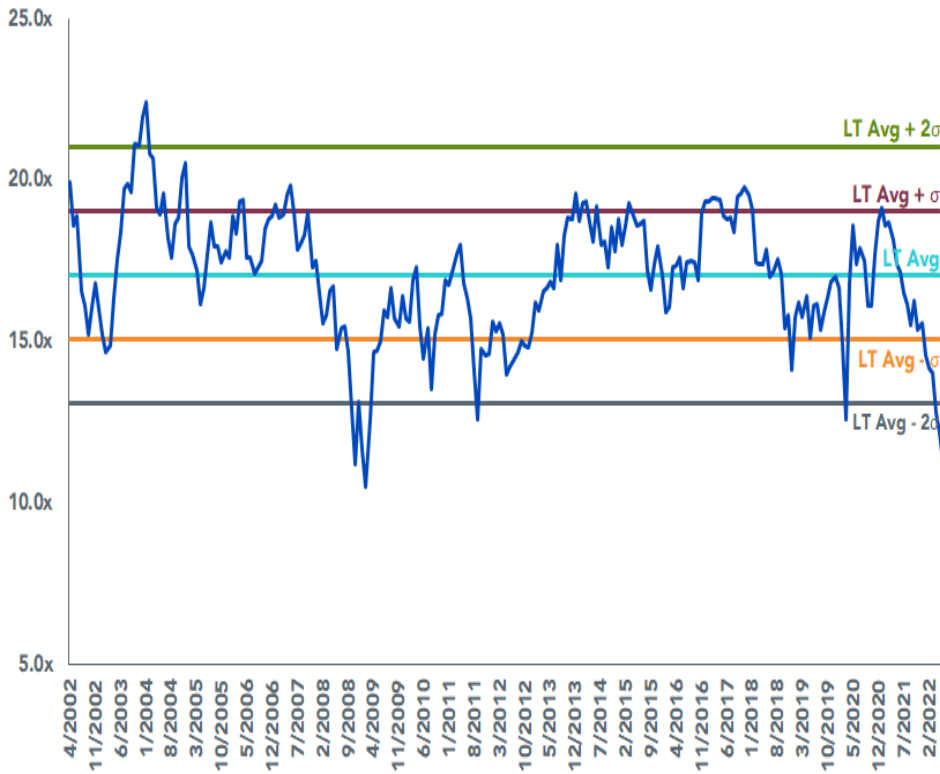
U.S. small caps are notoriously a "junky" market, with a prevalence of unprofitable companies that has historically ranged around 20% for the [Russell 2000](#). But even when unprofitable companies are removed from the Index, the [P/E](#) and [forward P/E ratios](#) of the small-cap market are historically discounted.

Both measures are currently trading below long-term averages and breached a level two [standard deviations](#) below that average after May's severe volatility.

Historical P/E (ex. Negative Earners) of Russell 2000



Historical Forward P/E (ex. Negative Earners) of Russell 2000



Sources: WisdomTree, FactSet, as of 6/30/22. You cannot invest directly in an index.

In percentage terms, both multiples are about 30% discounted from their long-term average and range between 12x and 13x.

[Value](#) and [growth](#) styles haven't fared much better, trading about 25%–30% (and about two standard deviations) below their long-term averages.

Russell 2000				
Metric	6/30/2022 Value	Long-Term Avg.	Current Discount	Premium/Discount Percentile Rank (Higher = Better)
P/E	11.3x	18.4x	-38.2%	98.8%
Fwd. P/E	11.3x	17.0x	-33.9%	99.2%
P/B	1.8x	2.0x	-11.8%	77.3%
P/S	1.1x	1.1x	8.0%	29.0%
PEG	0.7x	1.3x	-44.4%	100.0%

Russell 2000 Value				
Metric	6/30/2022 Value	Long-Term Avg.	Current Discount	Premium/Discount Percentile Rank (Higher = Better)
P/E	9.4x	15.6x	-39.9%	100.0%
Fwd. P/E	9.8x	15.1x	-35.2%	99.6%
P/B	1.2x	1.4x	-15.7%	82.3%
P/S	0.9x	0.8x	14.3%	25.3%
PEG	0.8x	1.5x	-48.5%	99.6%

Russell 2000 Growth				
Metric	6/30/2022 Value	Long-Term Avg.	Current Discount	Premium/Discount Percentile Rank (Higher = Better)
P/E	14.9x	22.8x	-34.8%	97.2%
Fwd. P/E	13.4x	19.9x	-32.4%	98.8%
P/B	3.5x	3.6x	-2.8%	52.5%
P/S	1.5x	1.5x	-3.8%	52.9%
PEG	0.8x	1.3x	-38.5%	97.6%

Sources: WisdomTree, FactSet, as of 6/30/22. You cannot invest directly in an index.

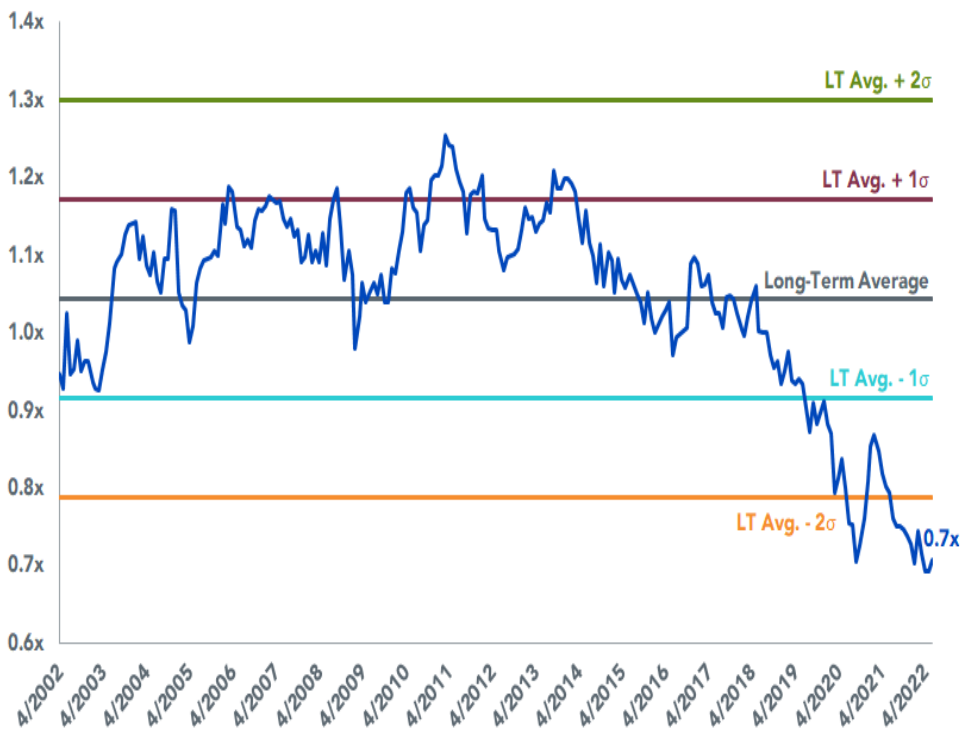
For definitions of terms in the chart above, please visit the [glossary](#).

Recessionary Fears Causing Undue Pain

Although most major equity indexes are near [bear market](#) territory, small caps have suffered a bit more than their counterparts along the [size](#) spectrum, owing to prevailing recession fears and threats to earnings and margins.

Historically, small-cap forward P/Es commanded about a 5% [premium](#) to [large caps](#), though this relationship has steadily broken down in the last few years. After May's market volatility, the forward P/E of the Russell 2000 compared to that of the [Russell 1000](#) (a large-cap proxy) is less than its long-term average and comfortably less than two standard deviations below this average.

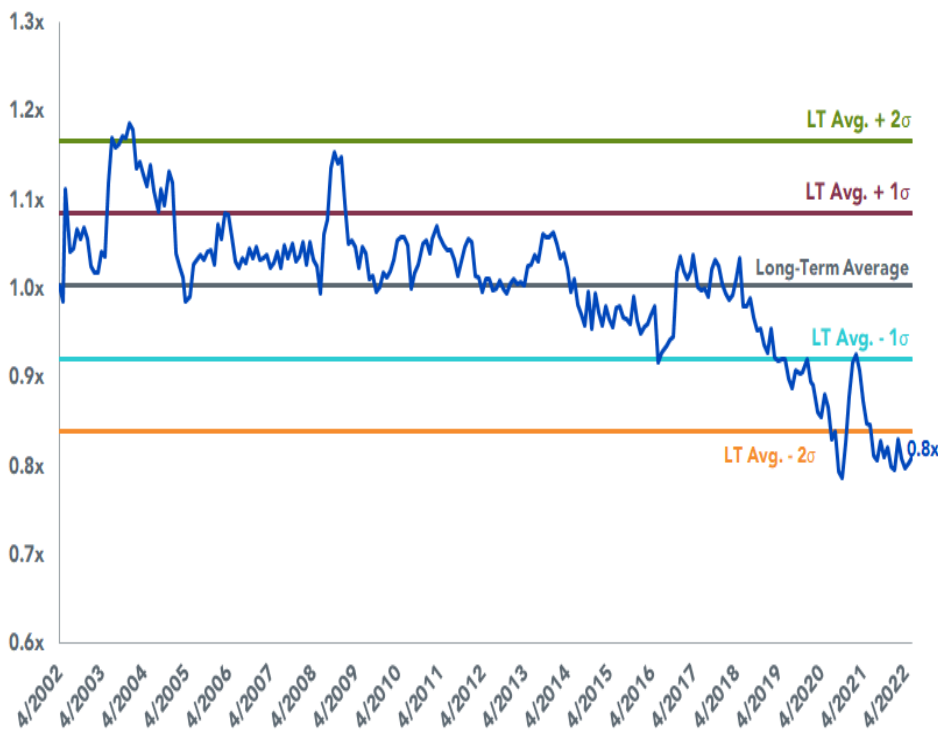
Russell 2000 Fwd. P/E (ex. Negative Earners) vs. Russell 1000



Sources: WisdomTree, FactSet, as of 6/30/22. You cannot invest directly in an index.

Their relationship with [mid-caps](#) is similar, reflecting investors' fears that a recession will disproportionately affect smaller companies heavily dependent on the local economy.

Russell 2000 Fwd. P/E (ex. Negative Earners) vs. Russell Mid Cap



Sources: WisdomTree, FactSet, as of 6/30/22. You cannot invest directly in an index.

Are Better Returns Beyond the Horizon?

For those who believe a recession is imminent, it is understandably counterintuitive to dignify an asset class notoriously

sensitive to economic growth amid rising [interest rates](#) and expectations of reduced earnings and profit margins. But for the intrepid small-cap investor, the future has historically looked bright after similar periods.

Over the past two decades, small-cap valuations have breached a 20% discount to their long-term average forward P/E on nine occasions (using monthly data). Over eight of these nine observations, small caps subsequently outperformed large caps over a two-year period by roughly 5% on average.

Forward Returns when Forward P/E Exceeds 20% Discount from LT Average

Forward Returns When Forward P/E Exceeds 20% Discount from LT Average				
Date	Discount to LT Avg. Fwd. P/E	2-Year Forward Return of Russell 2000	2-Year Forward Return of Russell 1000	Relative Performance
10/31/2008	24.5%	16.1%	14.4%	1.7%
11/30/2008	34.3%	25.7%	19.2%	6.6%
12/31/2008	22.9%	27.0%	22.1%	4.9%
1/31/2009	31.8%	34.6%	28.9%	5.6%
2/28/2009	38.3%	47.4%	38.5%	8.9%
3/31/2009	26.0%	43.1%	33.0%	10.1%
8/31/2010	20.6%	17.7%	18.2%	-0.5%
9/30/2011	26.3%	31.0%	25.4%	5.6%
3/31/2020	26.1%	35.5%	34.9%	0.6%
4/30/2022	25.1%			
5/31/2022	28.4%			
6/30/2022	33.9%			

Sources: WisdomTree, Bloomberg, as of 6/30/22. Past performance is not indicative of future results.

Many of these observations occurred in the wake of historical economic disasters, such as the global financial crisis and the onset of the COVID-19 pandemic. While we’re not anticipating economic calamity to those extents, history suggests a rosy outlook for small caps in the aftermath of a severe downturn.

Buy the Ticket, Take the Ride

WisdomTree has preached the merits of small-cap equities since launching the [WisdomTree U.S. SmallCap Dividend Fund \(DES\)](#) in 2006. Since then, we’ve expanded our U.S. small-cap equity lineup to include the [WisdomTree U.S. SmallCap Fund \(EES\)](#) and the [WisdomTree U.S. SmallCap Quality Dividend Growth Fund \(DGRS\)](#) as well.

All three look attractive in today’s small-cap market, with valuations deeply below long-term averages and discounts among the lowest since each Fund’s inception.

If small caps behave in accordance with historical patterns in the aftermath of a downturn, these Funds may potentially catch a strong tailwind.

Figure 7_Fund Metrics copy



Important Risks Related to this Article

DES: 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. Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

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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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You cannot invest directly in an index.

DEFINITIONS

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

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

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Inflation : Characterized by rising price levels.

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.

Discount : When the price of an ETF is lower than its NAV.

Russell 2000 Index : Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

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.

Forward P/E ratio : Share price divided by compilation of analyst estimates for earnings-per-share over the coming 12-month period. These are estimates that may be subject to revision or prove to be incorrect over time.

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.

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.

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.

Bear market : A sustained downturn in market prices, increasing the chances of negative portfolio returns.

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.

Premium : When the price of an ETF is higher than its NAV.

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.

Russell 1000 Index : A measure of the performance of the 1,000 largest companies by market capitalization in the Russell 3000 Index.

Mid-Cap : Characterized by exposure to the next 20% of market capitalization (after the top 70% have been removed) within the Value, Blend or Growth style zones with the majority of the fund's weight.

Interest rates : The rate at which interest is paid by a borrower for the use of money.