

IT'S TIME TO GET EXCITED ABOUT U.S. SMALL CAPS

Christopher Gannatti — Global Head of Research

02/25/2019

When the [VIX](#) hit 36 at the end of December 2018, the last thing we would have thought would be that risk-on strategies might have a strong month in January 2019. It would have represented a strong trend reversal.

But it's exactly what happened.

Late-Cycle Rallies Are Not Unusual

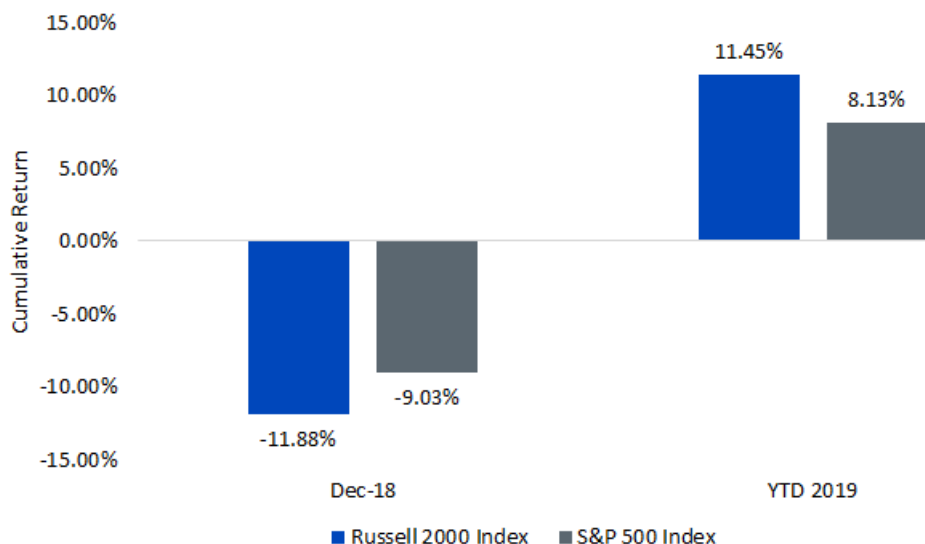
2018 was a [volatile](#) year—and it felt even more volatile than it was because the risk that had manifested in 2017 was so low. There is also no question that the U.S. economy is late in the current cycle. The current expansion by the National Bureau of Economic Research (NBER), measured during the summer of this year, indicated that we may see the longest expansion on record in the post-World War II period.

Growth is slowing as the strong stimulus provided by the 2017 tax cuts wears off. But it's important to recognize that corporate earnings growth is still alive and in double-digit territory as we begin 2019. Importantly:

- Policy remains the “X” factor. The final outcomes of the U.S. government shutdown, the U.S. vs. China trade discussions and the [Brexit](#) situation are all very difficult to predict. All we can do is try to bring discussions back to [fundamentals](#), such as earnings, in order to better deal with short-term factors that have a higher likelihood of certain negative impacts.
- Figure 1 shows that in December 2018, when perceptions and sentiment were stressed and in [risk-off](#) mode, the Russell 2000 Index dropped farther than the S&P 500 Index. During the risk-on period in January 2019, the [Russell 2000 Index](#) outperformed the [S&P 500 Index](#), showcasing the capability of [small caps](#) to respond quickly in a positive direction as conditions change.

There is no way to be certain that negative sentiment won't rear its head again in 2019. But we believe in the diversification potential of having some allocation in small caps to respond quickly during those times when markets recover and sentiment shifts back into the risk-on mode.

Figure 1: Small Caps Respond Quickly to Changing Market Sentiment



Source: Bloomberg. December 2018 data is 11/30/18–12/31/18. Data for YTD 2019 is 12/31/18–2/1/19. Past performance is not indicative of future results. You cannot invest directly in an index.

So Many Choices...

Clearly, investors can simply focus on the Russell 2000 Index. But is it the best option? It's an interesting question. The Russell 2000 Index also has [value](#) and [growth](#) options, not to mention the other quantitative, rules-based, small-cap strategies we have designed. From figure 2, it's apparent that:

- The S&P 500 Index has been strong when measured on a calendar-year basis against these indexes, coming out ahead in many of the years shown.
- The [Russell 2000 Growth Index](#), at least among the other small-cap indexes shown, has done well. It's clear that this period was characterized by growth outperforming value. The [Russell 2000 Value Index](#), consequently, had a more difficult period.
- There are two WisdomTree Indexes shown. They are both quantitative, rules-based strategies for U.S. small-cap equities. From a performance perspective, like any strategy, they show some strong years, some poor years and many years somewhere in the middle.

Figure 2: What Has and What Hasn't Worked in U.S. Small Caps

Calendar Year	WisdomTree U.S. SmallCap Dividend Index	WisdomTree U.S. SmallCap Earnings Index	Russell 2000 Index	Russell 2000 Value Index	Russell 2000 Growth Index	S&P 500 Index
2007	-14.36%	N/A	-1.57%	-9.78%	7.05%	5.49%
2008	-26.85%	-32.87%	-33.79%	-28.92%	-38.54%	-37.00%
2009	22.01%	49.57%	27.17%	20.58%	34.47%	26.46%
2010	27.23%	26.60%	26.85%	24.50%	29.09%	15.06%
2011	-1.64%	-1.60%	-4.18%	-5.50%	-2.91%	2.11%
2012	18.83%	15.80%	16.35%	18.05%	14.59%	16.00%
2013	36.16%	45.37%	38.82%	34.52%	43.30%	32.39%
2014	7.79%	2.42%	4.89%	4.22%	5.60%	13.69%
2015	-5.47%	-6.95%	-4.41%	-7.47%	-1.38%	1.38%
2016	31.40%	30.17%	21.31%	31.74%	11.32%	11.96%
2017	9.03%	12.77%	14.65%	7.84%	22.17%	21.83%
2018	-12.54%	-9.75%	-11.01%	-12.86%	-9.31%	-4.38%
YTD 2019	10.97%	12.65%	11.45%	11.13%	11.75%	8.13%

Source: Bloomberg, 12/31/06–2/1/19. Returns are shown only for indexes with live calculation history during the full calendar years shown. Past performance is not indicative of future results. You cannot invest directly in an index.

WisdomTree's Indexes—So What?

No matter how we look at it, U.S. small-cap equities have significant risks. Sometimes these risks compensate investors with strong returns—but sometimes risk is just risk.

WisdomTree's strategies seek to mitigate risks in different ways. And that is why they diverge from the [market cap-weighted](#) positioning of the Russell 2000 Index (as well as its value and growth cuts).

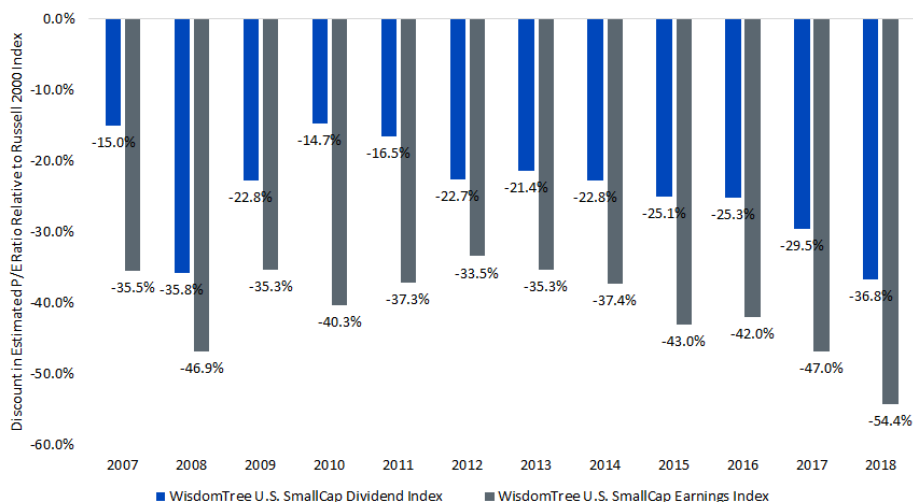
- The [WisdomTree U.S. SmallCap Dividend Index](#) includes only dividend-paying companies and weights those firms on the cash dividends they pay. [Valuation](#) risk is mitigated, as companies with more established businesses tend to commit to paying regular dividends.
- The [WisdomTree U.S. SmallCap Earnings Index](#) only includes companies with proven profitability, weighted by the earnings that they've generated. Valuation risk is also mitigated here, but the approach is broader and more core-oriented, capturing growth companies that may not pay dividends but that do have positive profits.

Before underestimating these risk-mitigation techniques, remember that the Russell 2000 Index tends to have approximately 20% of its weight in companies that have had negative earnings over the prior year.

Which of These Strategies Looks Strong NOW?

While the stories sound good, we believe that data is necessary to figure out which of the strategies might be the most strongly positioned for 2019. In figure 3, we measured the difference in [forward P/E ratio](#) between each WisdomTree Index and the Russell 2000 Index at the end of each specified year, as of December 31.

Figure 3: Massive Discounts to Start 2019 for WisdomTree Strategies



Sources: WisdomTree, FactSet. Data as of December 31 of each year. Past performance is not indicative of future results. You cannot invest directly in an index.

Conclusion: Be Ready for Late Cycle Rallies

At the end of 2018, the WisdomTree U.S. SmallCap Earnings Index indicated a forward P/E ratio that was more than 54% less expensive than the Russell 2000 Index. The WisdomTree U.S. SmallCap Earnings Index has been in live calculation since February 1, 2007, and has never ended a year with a discount like it has now. This tells us that, if there are to be late-cycle rallies and a bit of multiple expansion in U.S. small caps, this strategy may have the potential to capitalize.

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

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

Brexit : an abbreviation of “British exit” that mirrors the term Grexit. It refers to the possibility that Britain will withdraw from the European Union.

Fundamentals : Attributes related to a company’s actual operations and production as opposed to changes in share price.

Risk-on/risk-off : refers to changes in investment activity in response to perceived risk. During periods when risk is perceived as low, investors tend to engage in higher-risk investments. When risk is perceived as high, investors tend to gravitate toward lower-risk investments.

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.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor’s Index Committee designed to represent the performance of the leading industries in the United States economy.

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 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.

Russell 2000 Growth Index : Measures the performance of the small-cap growth segment of the U.S. equity universe. It includes those Russell 2000 Index companies with higher price-to-book ratios and higher forecasted growth values.

Russell 2000 Value Index : measures the performance of small-cap value segment of the U.S. equity universe. It includes those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values.

Market capitalization-weighting : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

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.

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.