

# SOLVING TODAY'S BIGGEST ISSUE WITH U.S. SMALL CAPS

Christopher Gannatti — Global Head of Research

08/02/2017

Let's be honest—we live in a world that is dominated by home bias. Almost 100% of clients that we have spoken to over the past few years agree that the U.S. market is approaching the upper end of the valuation spectrum. There can be debates over whether the [fundamentals](#) support the [valuations](#) and discussions about whether the U.S. is that much less [ri sky](#) than all other global markets, but the fact is that very few, if any, clients have been telling us that the U.S. represents a valuation opportunity.

## Small Caps—Even More Expensive

We can use the S&P U.S. indexes to illustrate this point<sup>1</sup>:

- The [S&P 500 Index](#) had a [trailing 12-month price/earnings \(P/E\) ratio](#) of 21.7x.
- The [S&P MidCap 400 Index](#) had a trailing 12-month P/E ratio of 24.5x.
- The [S&P SmallCap 600 Index](#) had a trailing 12-month P/E ratio of 26.4x.

As one dips down the [market capitalization](#) spectrum, the [P/E ratios](#) seen today tend to rise. One reason for this is that as one dips down the market capitalization spectrum, the percentage weight in speculative companies that may have had negative earnings over the prior 12 months also rises, pushing up the P/E ratio.

## Quality in U.S. Small Caps—A Distinct Opportunity

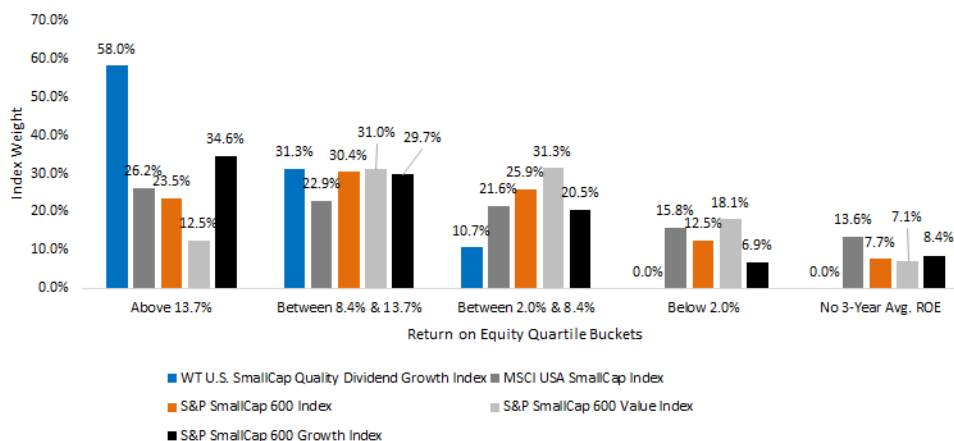
We think this creates a unique opportunity: small-cap strategies that are focused on quality. Many assume that there are two ways to go about U.S. small caps: 1) Own them all, typically with a market capitalization-weighted index, or 2) use an [active manager](#) to screen out the less-than-desirable companies.

This is where WisdomTree entered the picture in 2013 with its quality dividend growth methodology.

## WisdomTree's Quality Focus

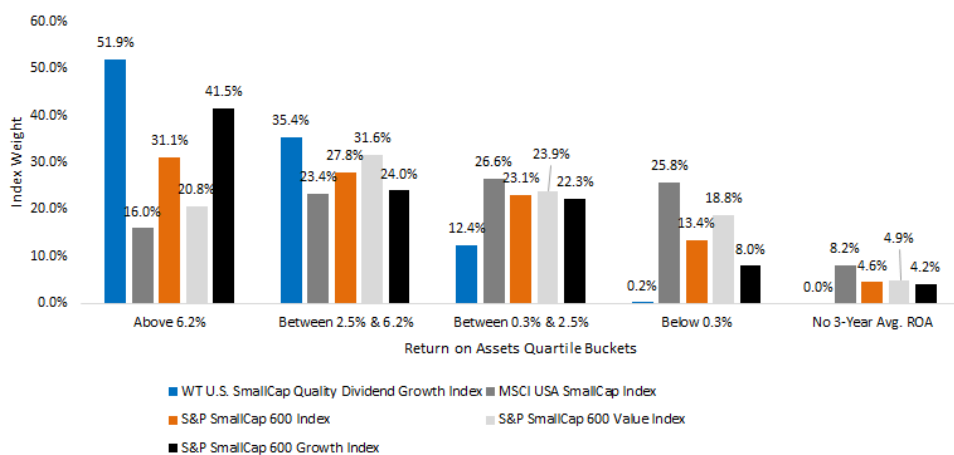
Quality is one of those investment terms that can mean many different things depending on who is saying it. At WisdomTree, we focus on three-year average [return on equity \(ROE\)](#) and three-year average [return on assets \(ROA\)](#). By breaking the very broad [MSCI USA Small Cap Index](#) into quartiles based on these metrics, we can see what this means in terms of a holistic quality exposure.

**The WisdomTree U.S. SmallCap Quality Dividend Growth Index: Nearly 60% in Firms with ROE above 13.7%**



Sources: WisdomTree, Bloomberg, with data as of 11/30/16, the most recent screening data for the WisdomTree U.S. SmallCap Quality Dividend Growth Index. You cannot invest directly in an index.

### The WisdomTree U.S. SmallCap Quality Dividend Growth Index: More than Half of Exposure to Firms with ROA above 6.2%



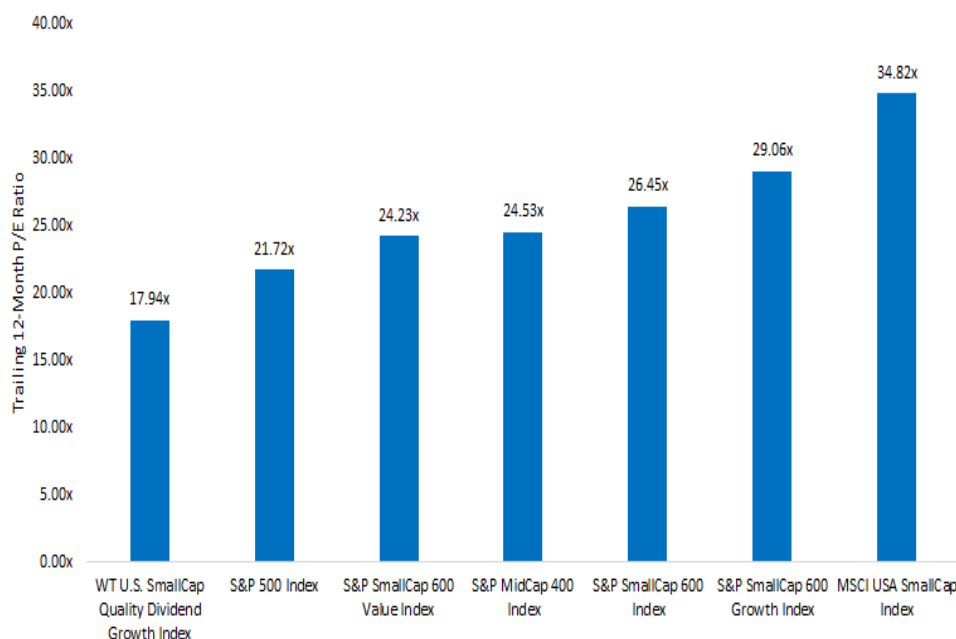
Sources: WisdomTree, Bloomberg, with data as of 11/30/16, the most recent screening data for the WisdomTree U.S. SmallCap Quality Dividend Growth Index. You cannot invest directly in an index.

- It's important to note how WisdomTree combines average three-year ROE and ROA for its quality focus. This leads to firms utilizing high [leverage](#) to achieve high returns on equity to not actually qualify for the Index. None of the other indexes shown has such a focus on quality, and while they may include more companies, the [WisdomTree U.S. SmallCap Quality Dividend Growth Index](#) is straddling between what a [passive, beta](#) index and a small-cap active manager could deliver.

### But Quality at What Price?

OK, so usually if someone is getting more of something desirable, it costs more. Think of typical, traditional active managers. For the perception of expertise, there tends to be a greater cost than what is associated with a passive index-tracking strategy. It's the same with quality—if higher quality is thought to be better than lower quality, the stocks should typically, in some fashion, cost more. Let's check the trailing 12-month P/E ratios.

### Highest Quality and Lowest P/E Ratio



Sources: WisdomTree, Bloomberg, with data as of 7/14/17. You cannot invest directly in an index.

- We saw how WisdomTree's approach tilts weight to higher-quality stocks—both from a perspective of ROE and ROA. That was achieved with a trailing 12-month P/E ratio below that of the S&P 500 Index.

### Ongoing Focus on Quality and Valuation

Another thing that people tend to like about small-cap active managers is that there is ongoing monitoring of the positions. If market conditions change, there can be a response. Market capitalization-weighted indexes focus on one thing: market capitalization.

WisdomTree is different in that it incorporates a systematic, disciplined rebalancing process. This refreshes both the quality attributes and the valuation attributes. As market conditions change, the rebalance brings the focus back to the fundamentals. We have seen in WisdomTree's strategies that have been around for more than 10 years that this has been very tough to beat within U.S. markets.

<sup>1</sup>Source for all bullets: Bloomberg, with data as of 7/14/17.

#### Important Risks Related to this Article

Investments focusing on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development.

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](http://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

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

**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.

**Risk** : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

**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.

**Trailing Price-to-earnings (P/E) ratio** : Trailing Price-to-earnings (P/E) ratio: Share price divided by trailing 12-month earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

**S&P MidCap 400 Index** : provides investors with a benchmark for mid-sized companies. The index covers over 7% of the U.S. equity market, and seeks to remain an accurate measure of mid-sized companies, reflecting the risk and return characteristics of the broader mid-cap universe on an on-going basis.

**S&P SmallCap 600 Index** : Market capitalization-weighted measure of the performance of small cap equities within the United States, with constituents required to demonstrate profitability prior to gaining initial inclusion.

**Market Capitalization** : 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.

**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.

**Active manager** : Portfolio managers who run funds that attempt to outperform the market by selecting those securities they believe to be the best.

**Return on Equity (ROE)** : Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

**Return on assets (ROA)** : Firm profits (after accounting for all expenses) divided by the firm's total assets. Higher numbers indicate greater profits relative to the level of assets utilized to generate them.

**Leverage** : Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.

**Passive** : Indexes that take a rules-based approach with regular rebalancing schedules that are not changed due to market conditions.

**Beta** : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.