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# HOW TO ACCESS SMALL-CAP VALUE

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Over a long period of time, many studies have come to a similar conclusion: Small-cap stocks, screened in some manner for reasonable [valuation](#), have been very strong performers.

## What Does Small-Cap [Value](#) Mean?

“Value” is a term that is used in different ways in the financial industry. First of all, how do you define “value”? Low [price-to-earnings \(P/E\) ratio](#)? Low [price-to-book value ratio](#)? A low price relative to a mix of different [fundamentals](#)? Not to mention how the allocation should be divided among different-value stocks—should the company with the most “value” get the most weight or should the biggest company by [market capitalization](#)?<sup>1</sup>

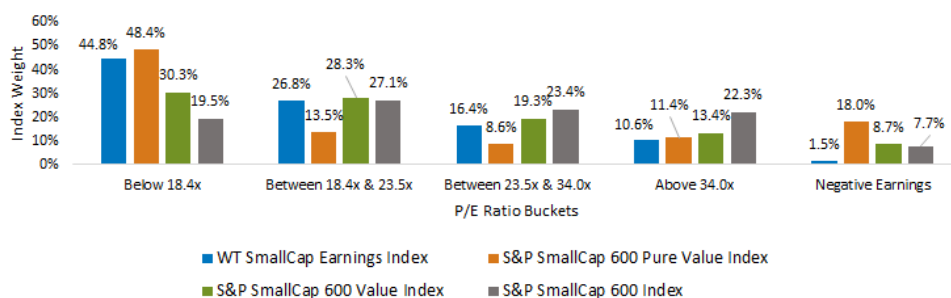
- The [S&P SmallCap 600 Value Index](#) focuses on selecting stocks with low prices relative to three metrics: book value, earnings and sales. It’s notable that, as of December 31, 2016, there were 181 stocks included in this index that were also included within the [S&P SmallCap 600 Growth Index](#). This happens because, although approximately one-third of the [S&P SmallCap 600 Index](#) universe is clearly value and one-third is clearly growth, there is a segment in the middle where weights of stocks are split between value and growth.
- On the other hand, while the [S&P SmallCap 600 Pure Value Index](#) focuses on stocks with low prices relative to the same fundamentals, there is 0% overlap with the [S&P SmallCap 600 Pure Growth Index](#). Instead of weight being proportional to market capitalization, another interesting element is that constituents are weighted in accordance with their attractiveness. In other words, lower prices relative to the defined fundamentals receive higher weights.

## What Is WisdomTree’s SmallCap Earnings Approach?

Instead of directly placing the word “value” in the name of the Index or indicating that the concept of value is the primary focus, WisdomTree instead focuses on earnings. Within U.S. small caps, this leads to the following:

1. **Elimination of unprofitable companies:** Every company within the [WisdomTree SmallCap Earnings Index](#) has generated positive, cumulative earnings<sup>2</sup> over the prior four quarters leading up to the [annual screening date](#), November 30 of each year.
2. **Weighting by profits, not market capitalization:** Companies in the WisdomTree SmallCap Earnings Index are weighted based on the profits that they generate, therefore delinking a rising share price from a greater index exposure.
  - In practice, this creates a situation where companies whose share prices rise but earnings stagnate will tend to see weights decreased. Conversely, if company earnings thrive and growth but share prices stagnate, then weight would be added. In a way, the process adds to areas where earnings have become less expensive and takes away from areas where earnings have become more expensive.

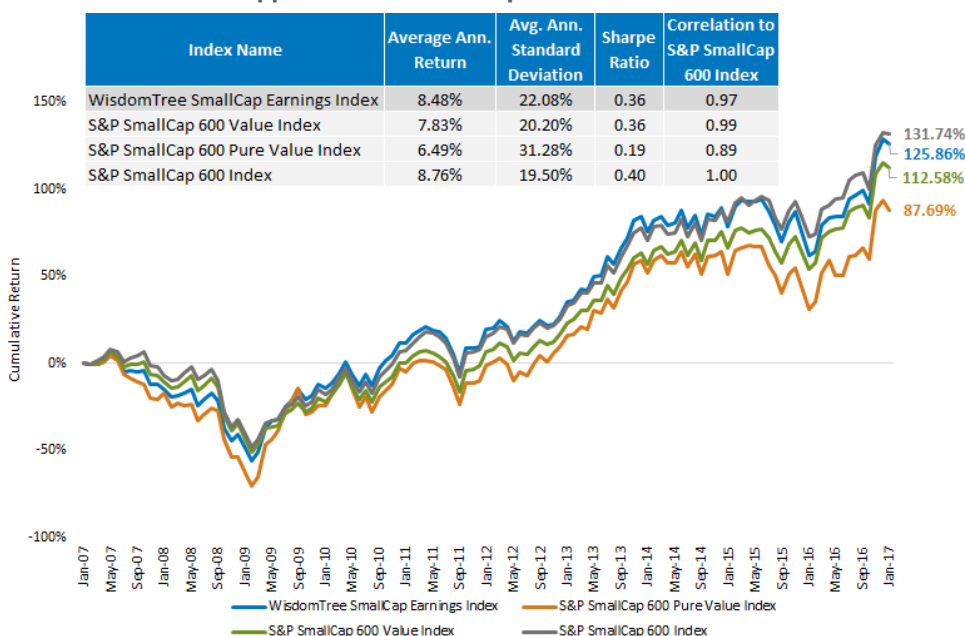
## How to think about "Value" for the S&P SmallCap 600 Starting Universe & the WisdomTree SmallCap Earnings Index



Sources: WisdomTree, Standard & Poor's, Bloomberg. Data is as of 12/31/16. You cannot invest directly in an index. The WisdomTree SmallCap Earnings Index is screened on the basis of S&P core earnings, whereas the P/E ratios in this chart are calculated on the basis of trailing 12-month earnings. It is possible that a small number of firms would have positive core earnings but negative trailing 12-month earnings.

- Pushing weight to lower P/E stocks:** Both the WisdomTree SmallCap Earnings Index and the S&P SmallCap 600 Pure Value Index are not market capitalization-weighted and are clearly pushing more exposure into stocks in the lowest P/E quartile, specifically those stocks with P/E ratios below 18.4x. It is notable that the WisdomTree SmallCap Earnings Index had 71.6% of its weight in stocks below the median S&P SmallCap 600 Index P/E ratio of 23.5x, whereas the S&P SmallCap 600 Pure Value Index only had 61.9% of its weight in stocks with P/E ratios below this level.
- How negative earnings are dealt with:** It's interesting that the S&P SmallCap 600 Pure Value Index had 18% of its weight in stocks with negative earnings over the prior 12-month period. The WisdomTree SmallCap Earnings Index—with earnings measured in equivalent manner—only had 1.5% exposure to these firms, which is a big difference.

## The Risk of "Value" Approaches to Small-Cap Stocks



Sources: WisdomTree, Bloomberg, with data from 2/1/07, start of live calculation for the WisdomTree SmallCap Earnings Index, to 1/31/17. You cannot invest directly within an index.

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

- **The value style can fall out of favor:** For the first 10-year period of its live calculation, the WisdomTree SmallCap Earnings Index saw a period where the growth style dramatically outperformed the value style in U.S. equities. Choosing the value style over this period would therefore lead to underperformance.
- **WisdomTree SmallCap Earnings is more than value:** Since we never know which style would outperform ahead of time (it would be quite nice if we did), a key focus could be on mitigating the risk of making the wrong choice. The WisdomTree Index takes an extremely broad approach—the key being eliminating firms with negative core earnings. This, combined with weighting by earnings, did tend to lower the P/E ratio, but there is nothing that would say profitable growth companies could not also gain inclusion.

### **Rebalancing Has Been about More than Valuation**

A critical focus of the annual rebalance has been lowering P/E ratios, but we also would note the following:<sup>3</sup>

- [Weighted average market capitalization](#) exposure of the Index has tended to fall, therefore refocusing on the appropriate small-cap size segment.
- [Return on equity \(ROE\)](#) or [return on assets \(ROA\)](#) has tended to rise, especially since firms with negative earnings have been eliminated.

Tapping into what many would call the “[size](#)” or “[quality](#)” factors therefore diversifies the set of environments where the WisdomTree SmallCap Earnings Index can thrive, as opposed to purely focusing on “value.”

<sup>1</sup>Sources for information below bullets: S&P Index Methodology Document, Bloomberg.

<sup>2</sup>Earnings represent S&P's measure of core earnings, different from the trailing 12-month earnings that may have greater potential to be impacted by one-time or extraordinary events.

<sup>3</sup>Sources: WisdomTree, Standard & Poor's, with annual index rebalances measured based on screening dates from 11/30/07 to 11/30/16.

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

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You cannot invest directly in an index.

## DEFINITIONS

**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.

**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.

**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.

**Price-to-book ratio** : Share price divided by book value per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

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

**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.

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

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

**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.

**S&P SmallCap 600 Pure Value Index** : Measures value stocks using three factors: the ratios of book value, earnings, and sales to price. S&P Pure Value Indices include only those components of the parent index that exhibit strong value characteristics, and weights them by value score. Constituents are drawn from the S&P SmallCap 600®.

**S&P SmallCap 600 Pure Growth Index** : Measures growth stocks using three factors: sales growth, the ratio of earnings change to price, and momentum. S&P Pure Growth Indices includes only those components of the parent index that exhibit strong growth characteristics, and weights them by growth score. Constituents are drawn from the S&P SmallCap 600®.

**Annual screening date** : The screening date refers to the date upon which characteristics of eligible constituent firms are measured, whereas the rebalance refers to when the results from the screening date are implemented by way of Index weights and constituents.

**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.

**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.

**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.

**Size Factor** : the average returns of small portfolios minus the average returns of the large portfolios after adjusting for

growth or value tendencies.

**Quality Factor** : Excess returns achieved by companies exhibiting higher quality or profitability vs the market. Typically measured using operating profitability, return on equity and/or return on assets.&nbsp;