

SMALL CAPS IN FOCUS FOLLOWING FED COMMENTS

Jeremy Schwartz — Global Head of Research
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In conjunction with Janet Yellen’s testimony before Congress on July 15, the Federal Reserve produced a [Monetary Policy Report](#)¹ that provides an update on monetary policy, economic conditions and financial markets. The report referenced equity [valuations](#) —perhaps to address claims that Fed policies are causing potential bubbles in asset prices. The statement below generally says that overall markets are fairly priced, but certain pockets among small caps have valuation characteristics that are harder to explain. The report states: *Valuation measures for the overall market in early July were generally at levels not far above their historical averages, suggesting that, in aggregate, investors are not excessively optimistic regarding equities. Nevertheless, valuation metrics in some sectors do appear substantially stretched—particularly those for smaller firms in the social media and biotechnology industries, despite a notable downturn in equity prices for such firms early in the year.*² Additionally, the Fed commented on [high-yield bond spreads](#) and the [leveraged loan market](#). This may have been in response to criticism about its monetary policy causing unsustainable behavior among investors looking to generate current income. While there is no question the Fed is pushing people to take some risk to achieve more substantial levels of income, I don’t believe all income-producing asset classes are necessarily expensive. I think the small-cap dividend and small-cap dividend growth segments of the market are quite attractively priced compared to their alternative [market cap-weighted](#) options. A key differentiator? Biotech. **Small-Cap Dividends and Small-Cap Dividend Growth: Biotech Weight in Small-Cap Indexes (as of 7/15/14)**

Index	% Weight in Biotechnology Sub Industry
WisdomTree SmallCap Dividend Index	0.88%
WisdomTree U.S. SmallCap Dividend Growth Index	0.00%
Russell 2000 Index	4.80%
Russell 2000 Growth Index	8.84%

Source: Bloomberg, with data as of 7/15/14.

Looking at the [price-to-earnings \(P/E\) ratios, dividend yields](#) and corresponding price-to-dividend ratios (just 1/dividend yield) of these indexes, I believe the irony is that the more expensive part of the market could be in the non-yield-oriented sectors. And their performance has the potential to hold up better in the event that the [Momentum](#)-led small-cap growth segment starts to sell off. Subject to change. **Performance and Valuation Measures of Small-Cap Indexes (as of 7/15/14)**

Index	P/E Ratio	Dividend Yield	Price-to-Dividend Ratio	Year-to-Date Return
WisdomTree SmallCap Dividend Index	19.7x	3.29%	30.4x	2.75%
WisdomTree U.S. SmallCap Dividend Growth Index	17.9x	2.31%	43.3x	-0.42%
Russell 2000 Index	26.4x	1.28%	78.1x	-0.17%
Russell 2000 Growth Index	33.6x	0.63%	157.5x	-1.76%

Source: Bloomberg, with data as of 7/15/14. Year-to-date returns reference the period from 12/31/13 to 7/15/14. Past performance is not indicative of future results. You cannot invest directly in an index.

I agree with comments from the Fed that parts of the small-cap market—particularly some of these small-cap [small-cap growth](#) and momentum stocks—look more stretched than broader equity markets, like the [S&P 500](#) or [Russell 3000 Indexes](#). As a result, within small-cap allocations, I think investors should look to over-weight, or rotate, into the small-cap dividend or small-cap dividend growth segments of the small-cap market to mitigate the risk of exposures that may be more speculatively priced.¹ Board of Governors of the Federal Reserve System, “Monetary Policy Report,” U.S. Federal Reserve, 7/15/14.² Board of Governors of the Federal Reserve System, “Monetary Policy Report,” U.S. Federal Reserve, 7/15/14.

Important Risks Related to this Article

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Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

High-yield bond spread : The amount of incremental income a bondholder receives for assuming credit risk, specifically that of companies rated below investment grade credit.

Leveraged loan market : Loans extended to companies or individuals that already have undertaken considerable amounts of debt, thereby increasing their risk of potential default.

Weighted average market cap : Measure of the average market capitalization that takes into account how constituents are weighted—weighting large market capitalization firms more heavily will tend to increase this figure.

Dividend yields : Refers to the trailing 12-month dividend yield. Dividends over the prior 12 months are added together and divided by the current share price. Higher values indicate more dividends are being generated per unit of share price.

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.

Small-cap growth : Refers to the Russell 2000 Growth Index universe.

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.

Russell 3000 Index : Measures the performance of the 3,000 largest U.S. companies based on total market capitalization.