

# GROWTH IS IN THE EYE OF THE INDEX PROVIDER

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10/05/2017

Many clients have been asking us this year about U.S. [mid-caps](#). Over WisdomTree's live history extending back to 2006 for mid-cap [dividends](#) and 2007 for mid-cap earnings, the performance of U.S. mid-caps has been robust, as discussed below. However, for those looking at 2017, the picture hasn't been nearly as strong.

What, if anything, has changed?

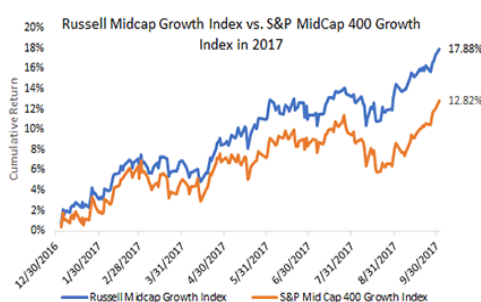
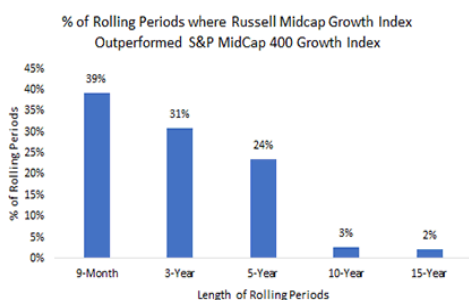
## [Growth](#) Style Comes into Favor—Heavily

"Growth" has been the way to go in the first nine months of 2017.

[WisdomTree's U.S. MidCap Dividend Index](#), though broad-based, won't include any companies that don't pay regular dividends, thereby biasing away from the growth style. [WisdomTree's U.S. MidCap Earnings Index](#), though broader, won't include speculative firms that have not yet generated positive core earnings. In other words, both of these Indexes have somewhat of a [quality](#) bias.

But also among growth style, there were some interesting factors at play in 2017.

## Outperformance of Mid-Cap Growth—Specifically Russell Midcap Growth



Sources: WisdomTree, Bloomberg. Data for "% of Rolling Periods where Russell Midcap Growth Index Outperformed S&P MidCap 400 Growth Index" from 6/30/1995 to 9/29/2017, the longest common period of live history with data in Bloomberg. Data for "Russell Midcap Growth Index vs. S&P MidCap 400 Growth Index in 2017" from 12/31/16 to 10/2/17. You cannot invest directly in an index.

Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns.

- Through September 29, 2017, the [Russell Midcap Growth Index](#) outperformed the [S&P MidCap 400 Growth Index](#) by 5.29%. Given that they are both U.S. mid-cap Indexes focused on the growth style, this is a large performance gap. To find another nine-month period where Russell outperformed to a similar or greater extent, we had to go back to the summer of 2003—about 14 years ago!
- Beyond that, we looked at rolling periods back to June 1995 to figure out how unusual outperformance of the Russell Midcap Growth Index over the S&P MidCap 400 Growth Index actually was. The Russell Index won only about 39% of the time in the analysis of rolling nine-month periods. As the rolling periods lengthened, it became less and less likely to see the Russell Index outperforming the S&P Index.

### Russell Midcap Growth vs. S&P MidCap 400 Growth—Critical Differences

We dug further into the differences between these two Indexes. A theme that came up was that the S&P MidCap 400 Growth Index did bias a bit more toward higher quality and away from the more speculative firms that could qualify for the Russell Midcap Growth Index. That showed up in a few different ways:

- The average weight in the first nine months of 2017 to unprofitable companies was about 7.8% in the Russell Midcap Growth Index, but only about 3.6% in the S&P MidCap 400 Growth Index.<sup>1</sup> This largely comes back to methodology, in that for initial inclusion, Standard & Poor's does require proof that a firm has generated positive [generally accepted accounting principles \(GAAP\)](#) net income over the prior four quarters.<sup>2</sup>
- The sector picture was also quite different. For instance, in the Consumer Discretionary sector, the Russell Midcap Growth Index had more than four times the exposure to retailing (7.8% vs. 1.6%) than the S&P MidCap 400 Growth Index, and we know that the earnings environment has been very challenging for this sector. In Health Care, the Russell Index had more than twice the exposure to biotech as did the S&P Index.<sup>3</sup>
- Factor regression analysis going back to June 1995 also confirmed this result, as the Russell Midcap Growth Index had a -0.26 loading to operating profitability, whereas the S&P MidCap 400 Growth Index had a loading of 0.08.<sup>4</sup>

### Unlocking the Key to the Difference between Growth Indexes

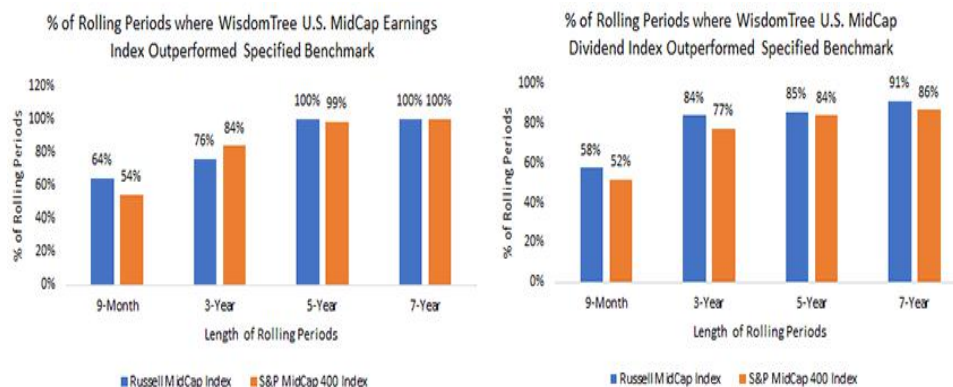
Differences like this can hold important keys to how the market—in this case, U.S. mid-caps—is behaving. If the Russell Index has opened up a cumulative performance gap over the S&P Index, the likes of which we haven't seen for 14 years, that's telling us that U.S. mid-caps are behaving in a much more speculative manner than usual.

*Bottom line: What's tended to work over the long term in U.S. mid-caps (quality and sensitivity to [relative value](#), to name a couple) has not been working in 2017.*

### WisdomTree's Mid-Cap Indexes Tilt Away from More Speculative Stocks

While the broader and more widely followed [Russell Midcap](#) and [S&P MidCap 400 Indexes](#) seek to include an array of both value and growth stocks—some of which may very well be more speculative in nature—WisdomTree's mid-cap Indexes are attempting to deliver [risk-adjusted](#) outperformance over time. If the Russell Midcap Growth Index is outperforming the S&P MidCap 400 Growth Index (as we've seen this year), it signals that the market has become more speculative in nature, and we'd expect that WisdomTree's approach might be at more of a disadvantage. Fortunately, these more speculative swings haven't tended to characterize three-year, five-year or seven-year more strategically oriented periods—but they very well could have been great tactical trades.

### Long-Term Performance Wasn't Achieved during Speculative Upswings in U.S. Mid-Caps



Sources: WisdomTree, Bloomberg, with data from 2/1/07, the earliest common inception period for the WisdomTree U.S. MidCap Earnings Index, through 9/29/17. You cannot invest directly in an index.

### Speculative Outperformance Is Nothing New, and It's Not Supported by Longer-Term Studies

With everyone looking at factor research these days, it's important to note that there is not yet any long-term data supporting the longer-term potential of more expensive or more speculative stocks. It's important to understand that the first eight months of 2017 represent something we've seen before (and likely will again), but WisdomTree's longer-term track record in U.S. mid-caps was still strong enough to deliver compelling performance over its full historical record.

<sup>1</sup>Sources: WisdomTree, Bloomberg, with period analyzed from 12/31/16 to 9/29/17.

<sup>2</sup>Sources: "S&P U.S. Indices Methodology," S&P Dow Jones Indices, 8/17, and "S&P U.S. Style Indices Methodology," S&P Dow Jones Indices, 7/17.

<sup>3</sup>Sources: WisdomTree, Bloomberg, with period analyzed from 12/31/16 to 9/29/17.

<sup>4</sup>Sources: WisdomTree, Bloomberg, Kenneth French Data Library, with regression analysis run on monthly data from 6/30/1995 to 6/30/2017.

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

**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.

**Dividend** : A portion of corporate profits paid out to shareholders.

**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.

**Quality** : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over time.

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

**S&P MidCap 400 Growth Index** : Provides investors with a measure of the performance of the growth segment of the S&P MidCap 400 Index.

**Generally Accepted Accounting Principles (GAAP)** : Principles of accounting utilized in the U.S. that deal with different aspects and assumptions that are deemed acceptable in calculating the earnings of a firm.

**Relative value** : The relationship between a particular attribute, e.g., a dividend, and the firm's share price compared to that of another firm.

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

**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.

**Risk-adjusted returns** : Returns measured in relation to their own variability. High returns with a high level of risk indicate a lower probability that actual returns were close to average returns. High returns with a low level of risk would be more desirable, as they indicate a higher probability that actual returns were close to average returns.