

# YES, IT DOES MATTER

Scott Welch — Chief Investment Officer, Model Portfolios  
11/13/2020

*I'm little, but I'm loud  
I'm poor, but I'm proud  
I'm countrified and I don't care who knows it  
I'm like a banty rooster  
In a big, red rooster crowd  
I'm puny, short and little, but I'm loud  
I'm puny, short and little, but I'm loud...*

(From "I'm Little But I'm Loud" by "Little" Jimmy Dickens and Boudleaux Bryant, 1969, covered by Martina McBride, 1997)

In WisdomTree parlance, "[size](#)" refers to [small-cap](#) stocks, both domestically and internationally. As most advisors probably know, size was identified in the original iconic [French & Fama](#) research as a "risk factor" that could be used to identify promising investment opportunities over reasonable time horizons. The other two original identified factors were value and the excess performance of stocks over the risk-free rate.<sup>1</sup>

This research was instrumental in the creation of WisdomTree, and many of our Indexes and accompanying [ETFs](#) have size and/or [value](#) tilts built into them. In a recent blog post [we focused on the value factor](#); here we will focus on size.

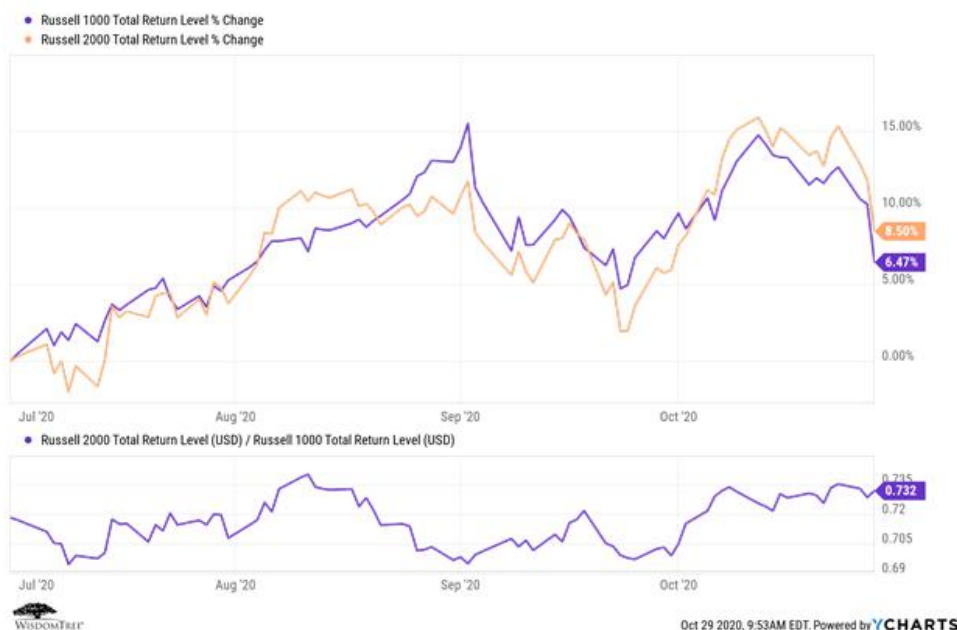
How has the size factor performed over time? The short answer is reasonably well, until the last several years when [large-cap](#) stocks (led by the [mega-cap](#) tech stocks) dominated performance:



Source: YCharts, data as of 10/29/20. You cannot invest in an index, and past performance does not guarantee future results.

But notice something interesting about the above chart—going back to the 1980–1982 recession (U.S. recessions are marked by the grey bars), small-cap stocks (the [Russell 2000 Index](#)) have beaten large-cap stocks (the [Russell 1000 Index](#)) in every economic recovery period coming out of those recessions.

We see this seemingly happening again as we slowly pull ourselves out of the pandemic-induced recession of the first two quarters of 2020. Here is the same graph over only the past four months (i.e., the beginning of the third quarter):



Source: YCharts, data as of 10/29/20. You cannot invest in an index, and past performance does not guarantee future results.

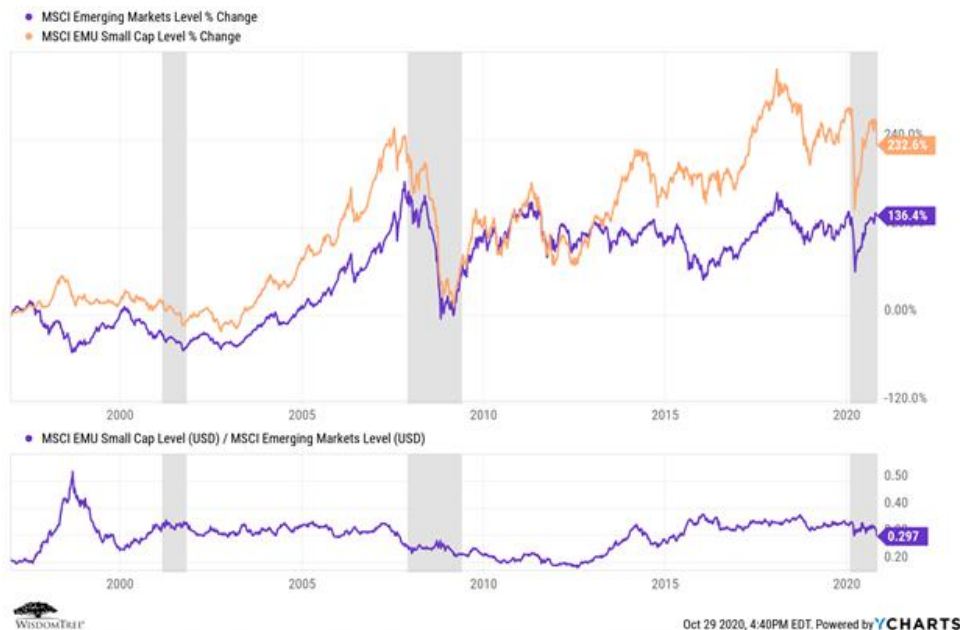
This is not simply a U.S. phenomenon. Here is a comparison of developed international large caps (the [MSCI EAFE Index](#)) versus small caps (the [MSCI EAFE Small Cap Index](#)) since 2000:



Source: YCharts, data as of 10/29/20. You cannot invest in an index, and past performance does not guarantee future results.

Not only have developed international small caps outperformed on an absolute return basis over a 15-year common investment period (a function, we believe, of it being a less efficient asset class and, therefore, offering a better opportunity to generate “[alpha](#)”), but they dramatically outperformed as we exited the 2000–2002, the 2008–2009 and the 2020 U.S. recessions (marked by the gray bars).

We see somewhat similar absolute return results if we compare emerging markets large-cap stocks (MSCI EM Index) to emerging markets small-cap stocks (MSCI EMU Small Cap Index):



There is less correlation between performance and economic recovery in the U.S. (the gray bars indicate U.S. recessions) because EM small-cap stocks generally are more dependent on economic conditions in their home countries—one of the reasons we like them as diversifiers in a global portfolio.

If advisors believe, as we do, that there will eventually be another round of massive fiscal stimulus in the U.S. (the size and shape still to be determined), then we may have the ability to “relaunch” an economic recovery. As we have illustrated in previous blog posts, this has historically been a positive market regime for small-cap (and value) stocks:

### Typical behavior of global business cycle



Source: NASDAQ, 11/18. This chart is for illustration purposes only and may not reflect actual market behavior.

From valuation, market momentum and economic regime perspectives, we believe we might be entering a market phase when small-cap stocks make a long overdue comeback. If you agree, WisdomTree offers several domestic, international and emerging markets ETFs that employ disciplined and explicit size “screens” and tilts.

We also have a variety of ETFs that take on more “implicit” size tilts because they screen for factors such as earnings,

dividends or quality—factors that frequently result in lowering the market cap size of the index that underlies a given ETF. Each of these strategies tends to perform differently under different economic and market regimes, and we encourage readers to visit our website to gather more specific information.

In addition, financial professionals can access a variety of our Model Portfolios by registering on the WisdomTree website. Many of these models employ an explicit small-cap tilt in their asset allocations and portfolio construction (security selection).

It may be time, once again, for small-cap stocks to start singing *"I'm little, but I'm loud."*

<sup>1</sup>Later evolutions of this research added two additional risk factors—momentum and profitability. See, for example: <https://www.sciencedirect.com/science/article/abs/pii/S0304405X14002323>.

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

**Size** : Characterized by smaller companies rather than larger companies by market capitalization. This term is also related to the Size Factor, which associates smaller market-cap stocks with excess returns vs the market over time.

**Small caps** : new or relatively young companies that typically have a market capitalization between \$200 million to \$2 billion.

**Fama-French** : Refers to a factor-based model to describe stock returns developed by Eugene Fama and Kenneth French. Their original three-factor model breaks down the components of stock returns to market risk, company size and book to market ratio, or value. &nbsp;

**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.

**Large-Capitalization (Large-Cap)** : A term used by the investment community to refer to companies with a market capitalization value of more than \$10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

**Mega Cap** : Market Capitalization over \$100 Billion.

**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.

**Russell 1000 Index** : A measure of the performance of the 1,000 largest companies by market capitalization in the Russell 3000 Index.

**MSCI EAFE Index** : is a market cap-weighted index composed of companies representative of the developed market structure of developed countries in Europe, Australasia and Japan.

**MSCI EAFE Small Cap Index** : A free float-adjusted market capitalization equity index that captures small-cap representation across developed market countries around the world, excluding the U.S. and Canada.

**Alpha** : Can be discussed as both risk-adjusted excess return relative to a specific benchmark, or absolute excess return relative to a benchmark. It is sometimes more generally referred to as excess returns in general.