

EYES ON EARNINGS IN U.S. SMALL CAPS

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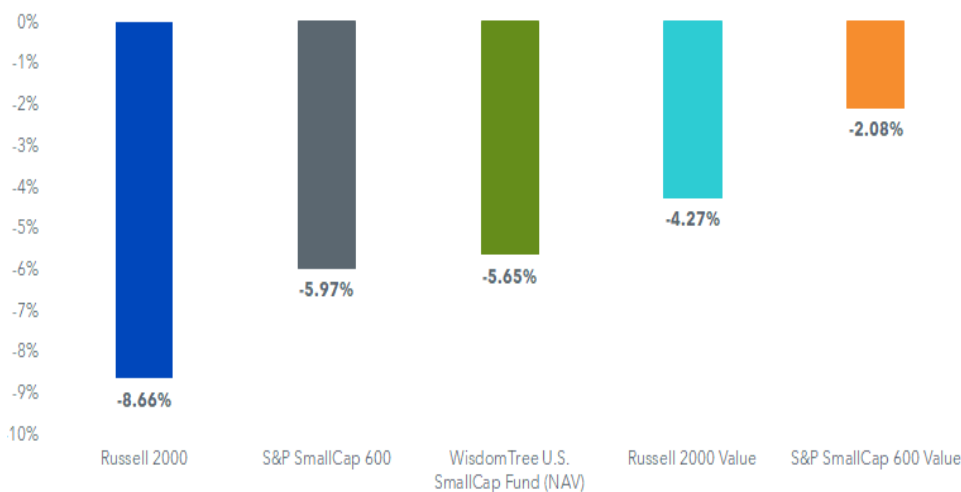
The beginning of 2022 has presented a challenging investment environment for U.S. investors, who are now forced to contend with an equity landscape vastly different from the secular [bull](#) market they enjoyed since the onset of the pandemic.

In an environment distinguished by persistent [inflation](#), geopolitical conflicts, supply chain disruption, and the tacit understanding that the [Federal Reserve](#) will soon begin [monetary tightening](#), investors are beginning to scrutinize equity positions more closely than before. Increasingly, they are opting for profitable companies with healthier fundamentals versus the profitless, growth-oriented winners of yesteryear.

Checking the Health of Small Caps

This effect is already apparent in the U.S. [small-cap](#) market. Although small caps have suffered in tandem with the broader market, there was notable outperformance to begin the year among small-cap indexes with an explicit focus on profitability and an implicit focus on modest valuations.

Performance through February 2022



Source: WisdomTree, as of 2/28/22. Past performance is not indicative of future results. You cannot invest directly in an index. Subject to change.

The [Russell 2000](#), an approximate gauge of the U.S. small-cap market, neared correction territory in by the end of February, as [risk-off](#) appetite finally disciplined the speculative fervor that distinguished the last two years. But the [S&P S mallCap 600](#), and the corresponding value segments of both these indexes, didn't suffer the same fate.

Are Investors Finally Rewarding Earnings?

One reason for this outperformance may be related to profitability. The S&P indices explicitly focus more on profitable companies with healthier [balance sheets](#) than the Russell 2000, which also includes a broad swath of unprofitable companies.

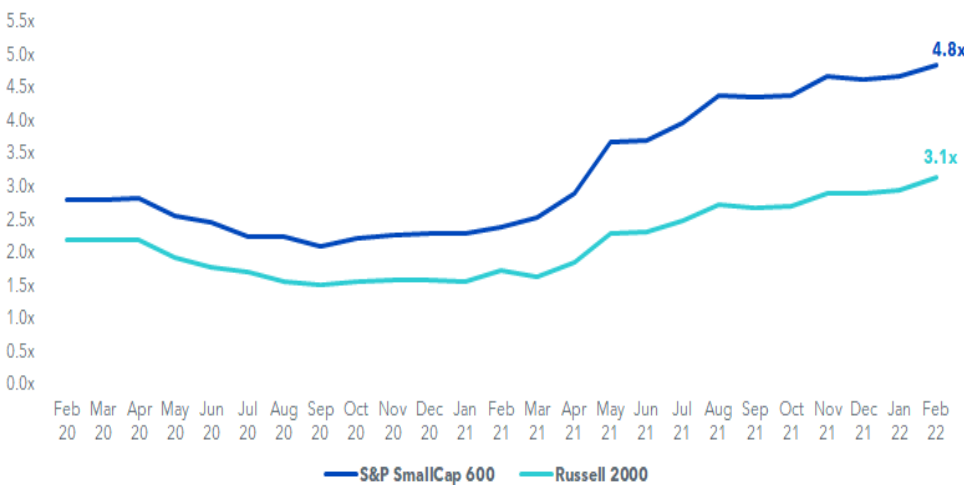
Index	Weight in Companies w/ Negative EPS	Weight in Companies w/ Negative 3-Year EPS
S&P SmallCap 600	6.35%	15.73%
Russell 2000	17.02%	27.47%
S&P SmallCap 600 Value	7.23%	16.09%
Russell 2000 Value	11.45%	21.30%

Sources: WisdomTree, FactSet, as of 2/28/22. You cannot invest directly in an index. Subject to change.

Over 17% of the weight in the Russell 2000 is comprised of unprofitable companies, compared to only 6% for the S&P SmallCap 600. On a three-year basis, the Russell 2000 inches even higher toward a 30% weight in companies with negative [earnings per share \(EPS\)](#).

The health differential between these indexes is also evident when you look at interest coverage ratios, which signal the extent to which a business can service interest obligations on its debt using [earnings before interest and taxes \(EBIT\)](#). Higher multiples indicate a better ability to pay debt.

Interest Coverage during COVID-19 Pandemic



Sources: WisdomTree, FactSet, as of 2/28/22. You cannot invest directly in an index. Subject to change.

The S&P index is fundamentally stronger by design when looking at this measure relative to the Russell 2000.

Is it Valuations?

Another reason for the outperformance may be related to valuations. After all, investors enthusiastically dumped shares of richly-valued growth and technology names to start the year, leading many growth indexes near, or past, correction territory.

The small-cap market performed in sympathy with this trend: high-valuation indexes fell further than their lower-valuation counterparts. The Russell 2000, with [price-to-earnings \(P/E\)](#) and estimated P/E ([forward P/E](#)) ratios of 32x35 times and 23x27 times, respectively, suffered more than the S&P SmallCap 600, with its strong profitability, lower [valuation](#) and focus on healthy balance sheets.

Index	Price-to-Earnings (P/E)	Forward P/E
S&P SmallCap 600	18.1x	14.7x
Russell 2000	32.3x	23.5x
S&P SmallCap 600 Value	18.6x	14.8x
Russell 2000 Value	20.3x	16.8x

Sources: WisdomTree, FactSet, as of 2/28/22. You cannot invest directly in an index. Subject to change.

The reason for this may also be related to the S&P indexes' focus on healthy balance sheets and operational efficiency. Higher earnings, and the potential for higher earnings in future periods, are a direct result of maintaining efficient and productive operations, complete with sound and sustainable business models. Better profits thereby reduce valuation ratios, so that investors are not inherently paying more per dollar of earnings than they would for lower quality

businesses.

An Earnings-Weighted Small-Cap Solution

Launched in 2007, the [WisdomTree U.S. SmallCap Fund \(EES\)](#) can potentially address the pitfalls that impacted the small-cap market to start the year. As an earnings-weighted Fund, it directly addresses profitability and valuations by explicitly targeting profitable companies over the unprofitable ones that afflict the greater market. A by-product of that is potentially lower valuations, since higher earnings would result in reduced P/E and forward P/E ratios, all else being equal.

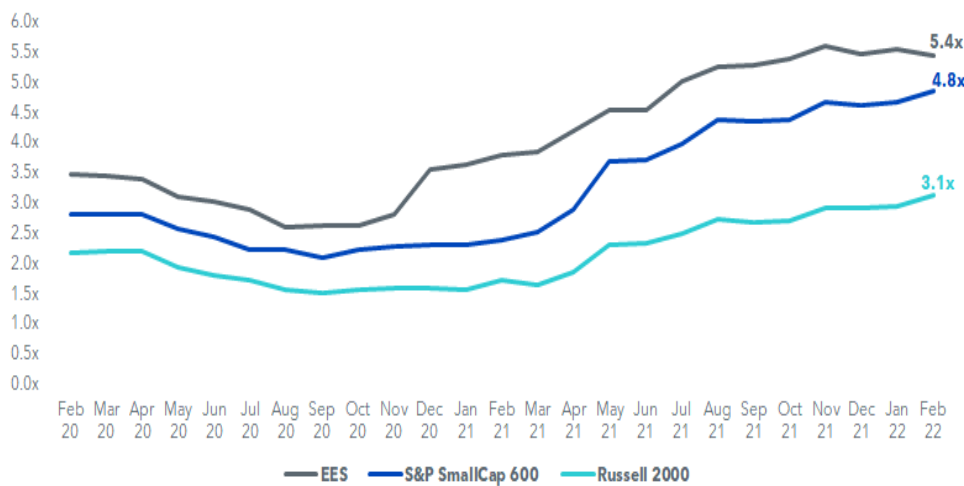
Index	Weight in Companies w/ Negative EPS	Weight in Companies w/ Negative 3-Year EPS
EES	3.92%	11.30%
S&P SmallCap 600	6.35%	15.73%
Russell 2000	17.02%	27.47%
S&P SmallCap 600 Value	7.23%	16.09%
Russell 2000 Value	11.45%	21.30%

Index	Price-to-Earnings (P/E)	Forward P/E
EES	10.9x	11.0x
S&P SmallCap 600	18.1x	14.7x
Russell 2000	32.3x	23.5x
S&P SmallCap 600 Value	18.6x	14.8x
Russell 2000 Value	20.3x	16.8x

Sources: WisdomTree, FactSet, as of 2/28/22. You cannot invest directly in an index. Subject to change.

There’s potential for improved balance sheet health as well since weighting by earnings naturally skews toward companies with higher profits that may be more likely to service their debt. The interest coverage ability of [EES](#) surpasses that of both the Russell and S&P indexes.

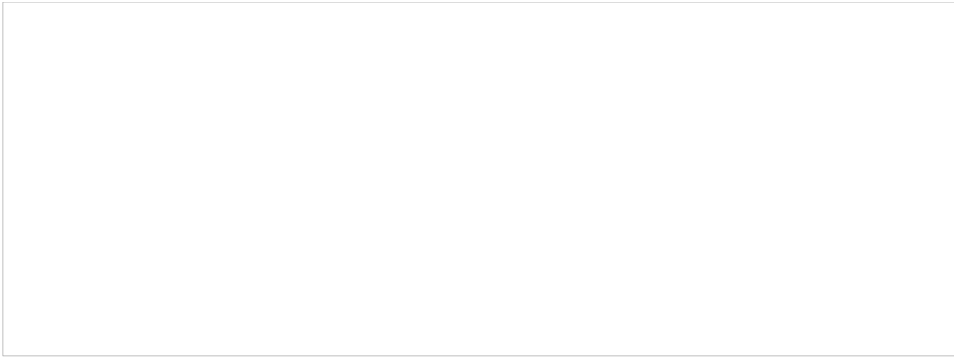
Interest Coverage during COVID-19 Pandemic



Sources: WisdomTree, FactSet, as of 2/28/22. You cannot invest directly in an index. Subject to change.

One final point relates to sector weights. The winning trades of the last two years often involved Information Technology stocks, which have been clobbered to begin 2022. [EES](#) may have remained a bit more immune to the selling pressure because of its relative under-weight allocation in tech names versus these two indexes.

Likewise, [EES](#) is established more in the Financials and Consumer Discretionary sectors, both of which are more cyclical in nature and tend to be leveraged to economic growth. These positions may be additive in today’s market. For example, rising [interest rates](#), which we’ve already seen to begin the year, may provide a tailwind to financial stocks.



Overall, the market's reversal from last year's trends is already underway, but still in early stages. We think there is an opportunity to reassess small-cap allocations in favor of a position that will emphasize earnings, balance sheet health and lower valuations relative to the broader market.

Important Risks Related to this Article

There are risks associated with investing, including the possible loss of principal. Funds focusing their investments on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

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.

Related Funds

+ [WisdomTree U.S. SmallCap Fund](#)

View the online version of this article [here](#).

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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.

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You cannot invest directly in an index.

DEFINITIONS

Bullish : a position that benefits when asset prices rise.

Inflation : Characterized by rising price levels.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Monetary tightening : A course of action undertaken by the Federal Reserve to constrict spending in an economy that is seen to be growing too quickly or to curb inflation when it is rising too fast.

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

Risk-on/risk-off : refers to changes in investment activity in response to perceived risk. During periods when risk is perceived as low, investors tend to engage in higher-risk investments. When risk is perceived as high, investors tend to gravitate toward lower-risk investments.

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.

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firm's balance sheet and cash available for purchasing new position.

Earnings per share : Total earnings divided by the number of shares outstanding. Measured as a percentage change as of the annual Index screening date compared to the prior 12 months. Higher values indicate greater growth orientation.

Earnings before interest and taxes (EBIT) : A measure of a firm's profit that includes all expenses except interest and income tax expenses.

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.

Forward P/E ratio : Share price divided by compilation of analyst estimates for earnings-per-share over the coming 12-month period. These are estimates that may be subject to revision or prove to be incorrect over time.

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.

Interest rates : The rate at which interest is paid by a borrower for the use of money.