FILTERING OUT THE NOISE IN MID-CAPS

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U.S. mid-caps have outperformed large caps over the past decade.[1]

According to the efficient market hypothesis (EMH), this should tend to be the case over the long run. EMH says market prices reflect all available information, and any excess returns are simply a by-product of greater risk.

Let's run with this theory of higher risk being behind higher returns: How have riskier mid-caps done relative to less-risky mid-caps?

Mid-Cap Inefficiency?

The most straightforward way we can measure risk is by volatility, or standard deviation of returns. The least-volatile quintile of mid-caps outperformed the most volatile quintile by *over 300 basis points (bps) annually*. For proponents of efficient markets, this performance could be puzzling.

But we can also look at "value" stocks. If prices reflect all available information, then riskier stocks must be discounted to compensate investors for taking that risk. The first quintile of stocks sorted by book-to-price (B/P)—the most inexpensive, riskiest stocks—underperformed the fifth quintile by 183 bps.

Lastly, sorting the market on profitability—or return-on-equity (ROE)—the most profitable companies can be viewed as less risky than the least profitable. The least profitable are more likely to be distressed businesses. Here, the top three quintiles handily outperformed the bottom two quintiles on profitability.

Russell Midcap Index: Average Annual Returns			
Category	**Volatility**	**B/P**	**ROE**
1st Quintile	15.72%	14.23%	14.70%
2nd Quintile	14.50%	13.50%	15.72%
3rd Quintile	13.98%	13.03%	15.12%
4th Quintile	13.66%	14.37%	12.28%
5th Quintile	12.60%	16.05%	13.19%
Total	**14.43%**	**14.43%**	**14.43%**

Sources: WisdomTree, FactSet. Returns for the period 5/31/09–5/31/19. 1st Quintile = Lowest volatility, highest book-to-price, highest ROE. 5th Quintile = Highest volatility, lowest book-to-price, lowest ROE. Book-to-price quintiles exclude companies with negative book value. ROE quintiles exclude companies with negative earnings or negative equity. Past performance is not indicative of future returns. You cannot invest directly in an index.

Why did we run through the performance of these different cuts of the market? To show that over this relatively long time frame of 10 years, it doesn't seem that the EMH of higher risk leading to higher returns held up. The lower-risk stocks as measured by volatility, valuations and profitability all outperformed.

Of course, you should take this 10-year exhibit with a grain of salt when comparing it with research conducted with sometimes 100 years or more of market returns. But asset allocators tend to make decisions based off performance over the last 3, 5 or 10 years.

And this past decade of performance seems to enforce WisdomTree's core belief in an alternative to the EMH.

The Noisy Market Hypothesis

When WisdomTree was doing its original research on fundamental indexing in the early 2000s, it was clear to us that markets are not always perfectly efficient. Nothing showed this more clearly than the triple-digit P/E ratios of some tech stocks during the tech bubble.[2]

That's why we believe stock price movements are better explained by the noisy market hypothesis. Markets are generally efficient, but stocks may be bought, sold or held for any number of reasons unrelated to the fundamental value of the firm—liquidity, taxes, animal spirits or any other common investor behavioral biases.

Because market prices can deviate from fundamentals at any given time, indexes that rebalance back to a measure of fundamentals other than price *may offer better returns without necessarily having to increase risk*.

Within WisdomTree's suite of dividend-weighted Funds launched in 2006, the more inefficient markets outside of large caps have provided the greatest relative value.

Take, for example, the performance of the WisdomTree U.S. MidCap Dividend Fund (DON) over the past decade.

This fund weights mid-cap dividend payers by their regular annual cash dividends, which always tethers weights back to a fundamental metric and away from price.

DON added excess return relative to its market cap-weighted S&P MidCap 400 Index benchmark without adding excess risk—as measured by its lower standard deviation, smaller maximum drawdown, down capture of 79% and beta of 0.86.

Click here for standardized performance of DON.

As of this writing, DON is currently trading at 15.2 times forward earnings, which is an 11% discount to the S&P MidCap 400 Index.[3] Before 2019, the last time investors saw valuations this inexpensive for DON was in the mini economic slowdown of 2011–2012. Since the end of 2012, the fund has returned just over 12% annualized, about 100 bps higher than the S&P MidCap 400 Index.[4]

Conclusion

We're almost 10 years into this economic cycle. But bull markets don't die of old age.

This current soft patch in the economy—which has many investors convinced the Federal Reserve is going to cut rates multiple times this year—seems fully reflected in the valuations for DON. In our view, this bodes favorably for investors who have been waiting for years for more attractive valuations.

[1]Sources: Zephyr StyleADVISOR. Returns for the period 5/31/09–5/31/19. Mid-caps measured by the Russell Midcap Index; large caps measured by the S&P 500 Index.

[2]Jeremy J. Siegel, "Big-Cap Tech Stocks Are a Sucker Bet," The Wall Street Journal, 3/14/00.

[3]Source: WisdomTree, FactSet. Data as of 6/18/19.

[4]Source: Zephyr StyleADVISOR. Returns for the return 12/31/12–5/31/19.

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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.

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.

Efficient Market Hypothesis : Current share prices correctly reflect all available information about publicly traded firms and continually incorporate the emergence of new information on a nearly instantaneous basis; there are no bubbles, and firms are neither expensive nor inexpensive.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Standard deviation : measure of how widely an investment or investment strategy's returns move relative to its average returns for an observed period. A higher value implies more "risk", in that there is more of a chance the actual return observed is farther away from the average return.

Basis point : 1/100th of 1 percent.

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 tim.

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.

Return on Equity (ROE) : Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

Noisy Market Hypothesis : A hypothesis that the prices of securities are not always the best estimate of the true underlying value of a firm. Prices may be subject to temporary shocks that may be "noise" obscuring a security's true fundamental value.

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.

Bubble : when market participants drive stock prices above their "fair value" in relation to some system of stock valuation.

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

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.

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

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.

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.

Drawdowns : Periods of sustained negative trends of return.

Down Capture : Measure of the performance of an investment relative to a benchmark index during a down market.

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

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.

Bullish : a position that benefits when asset prices rise.