

# DON'T PAY LARGE FOR SMALL CAPS

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Black Friday is long behind us, but the importance of finding a bang-for-your-buck is a year-round endeavor. While it's human nature to want to pay as little as possible for the best products, that's often easier said than done, and the best deals can be elusive.

When investing, [valuation](#) ratios can serve as your "bargain hunter," as they indicate how much you're paying to access the fundamental health of the underlying investment. At WisdomTree, we pay special attention to valuations, since many of our strategies are implicitly designed to keep them in check.

## How Can Earnings Help?

WisdomTree's core family of funds manages valuations by weighting their underlying companies by earnings per share. Those with greater earnings over the previous 12 months receive greater weight than those with less, rewarding businesses with impressive financial health and efficient operations.

An important byproduct of this method is that the Funds' valuations remain subdued, especially after rebalancing each December.

The benefit has been especially apparent in U.S. small caps, which is traditionally one of the more speculative asset classes due to investors' desire for small companies with exciting business prospects. As a result, small caps typically have expensive [price-to-earnings \(P/E\)](#) valuations.

Look no further than the [Russell 2000 Index](#) for proof. As of 2019, its 10-year median P/E ratio is 35, and it's currently trading even higher at 46. By comparison, the [earnings-weighted WisdomTree U.S. SmallCap Fund \(EES\)](#) has a median P/E of only 14, and it's currently trading at a 15% *discount* to its median after rebalancing in December.

**Figure 1: U.S. Small Cap Valuation Performance Comparison**

Fund/Index	Historical Valuation Comparison			
	Current P/E	10-Year Median P/E	Discount/Premium	Percentile
WisdomTree U.S. SmallCap Fund (EES)	12.4x	14.7x	-15.13%	21.67%
Russell 2000 Index	46.9x	35.7x	31.67%	89.17%

Sources: WisdomTree, FactSet, as of 12/31/19. Past performance is not indicative of future results. 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. Negative numbers in the Discount/Premium column indicate that the Fund's current valuation is trading at a discount to its historical median. Positive numbers in the Discount/Premium column indicate that the Fund's current valuation is trading at a premium to its historical median. Percentile columns indicate a Fund's valuation relative to the 10 years ending December 31, 2019.

For standardized performance of EES, please click [here](#).

But if both EES and the Russell 2000 Index provide exposure to the same market, what's causing the valuation gap?

There are two answers.

First, we must remember that small caps are often the subject of immense speculation.

With a [market cap-weighted](#) index like the Russell 2000, investors bid up the share price of small companies they believe have potential.

Meanwhile, valuations climb higher without any guarantee that these companies will ever be able to back it up. In fact, about 20% of the Russell 2000 Index is currently comprised of companies with *negative* earnings, adding unprofitability into the valuation recipe as well.

Second, WisdomTree’s approach reduces the speculative element of small-cap investing by its earnings-weighted methodology. By emphasizing profitability, the Fund targets companies that already have a track record of financial health, which provides less-expensive access to an otherwise often expensive asset class.

**Quality Can Reward with Lower Valuations**

An earnings methodology is not the only way to keep valuations under control. A focus on quality and income can help as well, and the [WisdomTree U.S. SmallCap Quality Dividend Growth Fund \(DGRS\)](#) illustrates this example.

By screening for companies with the best three-year averages for [return on equity \(ROE\)](#) and [return on assets \(ROA\)](#), while prioritizing long-term earnings growth expectations, we implicitly filter out much of the unprofitable junk in the small-cap space.

The fund is then weighted by [dividends](#), which means each company receives a new weight each December commensurate with the dividends they contribute to the total amount of dividends paid in the starting universe.

When all is said and done, the emphasis on operational health is illustrated with healthy earnings and rewarded via lowered valuations. After the rebalance this past December, the Fund is trading at a 19% discount to its 10-year median P/E.

Meanwhile, broader U.S. small caps, represented below by the Russell 2000 Index, are trading at a 32% premium and about 10% off their 10-year high, while DGRS finds itself in the opposite position, offering access to the small-cap market without breaking the bank.

**Figure 2: Quality Filters Can Also Reduce Valuations**

Fund/Index	Historical Valuation Comparison			
	Current P/E	10-Year Median P/E	Discount/Premium	Percentile
WisdomTree U.S. SmallCap Quality Dividend Growth Fund (DGRS)	14.9x	18.3x	-19.05%	11.69%
Russell 2000 Index	46.9x	35.7x	31.67%	89.17%

Sources: WisdomTree, FactSet, as of 12/31/19. Past performance is not indicative of future results. You cannot invest directly in an index. Negative numbers in the Discount/Premium column indicate that the Fund’s current valuation is trading at a discount to its historical median. Positive numbers in the Discount/Premium column indicate that the Fund’s current valuation is trading at a premium to its historical median. Percentile columns indicate a Fund’s valuation relative to the 10 years ending December 31, 2019.

For standardized performance of DGRS, please click [here](#).

**Pay Small for Small Caps**

While most U.S. investors are wondering whether equities will continue to climb higher in 2020, we feel they’re only doing themselves a disservice by piling into the small-cap market when it’s most expensive.

We agree that small caps have impressive potential, but that potential is best realized when you’re only paying for those companies that already have something to show for themselves.

Both the EES and DGRS target these companies and are currently trading at considerable valuation discounts after their recent rebalance, which could provide a favorable opportunity for small-cap market access.

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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**

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You cannot invest directly in an index.

## DEFINITIONS

**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.

**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.

**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.

**Earnings-weighted** : Earnings for all constituents in an index are added together, and individual constituents are subsequently weighted by their proportional contribution to that total.

**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.

**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.

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

**Return on assets (ROA)** : Firm profits (after accounting for all expenses) divided by the firm's total assets. Higher numbers indicate greater profits relative to the level of assets utilized to generate them.

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