

# WITH SMALL CAP VALUATIONS STRETCHED, CAN YOU FIND POCKETS OF VALUE IN SMALL CAPS?

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04/23/2014

Many market watchers are discussing [valuations](#) in [small caps](#), a theme WisdomTree's research team has been writing about since the start of the [year](#). As the most recent example, Josh Brown, also known as "the Reformed Broker," tweeted the following on March 25, 2014: "[Russell 2000's PE ratio](#) now at a 40% premium to the [total market](#), not seen since 1979. [Spread](#) between small and large PE at a 34 year high."<sup>1</sup> I generally agree that small caps have been on an unprecedented run, outperforming [large caps](#) since 2000, and there will come a time, perhaps soon, when large caps take leadership again.<sup>2</sup> But there are also some biases in the Russell 2000 price-to-earnings (P/E) ratio. For instance, over 20% of the Russell 2000 is invested in money-losing companies—that is negative earners—that bias the total P/E ratio upward, as discussed [here](#). **Small-Cap Dividend Growth Offers Better Valuations than Small-Cap Value**<sup>3</sup> With valuations stretched, should one abandon small caps entirely? Small caps have a history of performing well during periods of rising rates and economic recovery<sup>4</sup>—a theme I will discuss in a future research piece—and I don't think it is prudent to abandon small caps entirely because of more expensive valuations, but rather to search for pockets of potential value within small caps. This is an area I will focus on in this blog- small-cap dividend growers<sup>5</sup>. Valuations on this basket look attractive to me, at least as of March 31, 2014. The [U.S. SmallCap Dividend Growth Index \(WTSDG\)](#) focuses on stocks from a broad small-cap dividend index<sup>6</sup> that I believe have potential for dividend growth increases based on a proprietary combination of growth<sup>7</sup> and [quality](#)<sup>8</sup> metrics. What is interesting about valuations on WTSDG:

- **Higher Dividend Yield:** WTSDG, which selects its constituents by high-growth and high-quality criteria, has a higher [dividend yield](#)<sup>9</sup> than the [Russell 2000 Value Index](#), which selects its companies largely on valuation characteristics (i.e. low [price-to-book ratios](#)).
- **Better Growth Potential:** The Russell 2000 Value Index, due to its emphasis on valuation, has lower growth expectations than the Russell 2000 Index by about 2%. Traditionally, firms with inexpensive valuations tend to also have lower growth expectations. This trade-off is less pronounced in WTSDG, as it incorporates long-term earnings growth expectations into its methodology. In fact, WTSDG's long term growth expectation stands at 14%, more than 2% higher than that of the Russell 2000 Value Index.
- **Higher Quality:** The selection methodology for WTSDG focuses on [return on equity \(ROE\)](#) and therefore, the ROE factor for WTSDG is approximately 50% higher than the ROE on both the Russell 2000 Index and the Russell 2000 Value Index. Additionally, WTSDG also boasts higher [return on assets \(ROA\)](#) and lower leverage compared to the Russell 2000 Index, Russell 2000 Value Index and [Russell 2000 Growth Index](#). This makes the quality case for WTSDG even stronger.
- **Lower P/E Ratio:** Neither WTSDG nor the Russell 2000 Value Index uses P/E as a selection factor, but because of the unprofitable company exposure in the Russell 2000 Index and Russell 2000 Value Index, the P/E ratio of WTSDG is significantly lower than the Russell indexes. As we stated earlier, firms with negative earnings can actually cause the overall P/E ratio for an index to look higher.
- **More Attractive Valuations Relative to S&P:** Most importantly, while some say valuations of small caps versus large caps are stretched, WTSDG has both a higher dividend yield and a higher long term growth estimate than the S&P 500. Thus, this renders the small caps as relatively inexpensive compared to large caps.

**Valuations across the Small-Cap Broad, Value, and Growth Cuts**

Data as of 03/31/2014	Small Cap Indexes				Large Cap Index
	WT U.S. SmallCap Dividend Growth	Russell 2000 Value	Russell 2000	Russell 2000 Growth	S&P 500
Price-to-Earnings (P/E) Ratio	18.3x	21.8x	25.8x	31.7x	16.0x
Long-Term Earnings Growth Expectations	14.0%	12.0%	14.0%	15.5%	10.8%
Dividend Yield	2.2%	2.0%	1.3%	0.7%	1.9%
Earnings Yield	5.5%	4.6%	3.9%	3.2%	6.3%
Dividend Yield / Earnings Yield	39.7%	43.4%	34.7%	22.5%	31.1%
Return on Equity	14.8%	7.6%	9.8%	12.6%	18.2%
Return on Assets	7.4%	3.2%	4.3%	5.8%	7.0%
Leverage	2.0x	2.4x	2.3x	2.2x	2.6x

Past performance is not indicative of future results. You cannot invest directly in an index. Index performance is not indicative of fund performance.

*For definitions of terms and indexes in the chart, please visit our [Glossary](#).* **Quite a Powerful Combination** In short, as of March 31, 2014, WTSDG offered what could be a potentially inexpensive valuation compared to other measures of U.S. small-cap equities. Usually, the trade-off for lower valuation is lower growth expectations or lower quality. At least at this time, that is not the case for WTSDG, in that, compared to the other Russell Indexes shown, we see the lowest P/E, highest dividend yield, highest return on equity, highest return on assets, lowest leverage and significant growth expectations (trailing only the Russell 2000 Growth Index). We think that this offers a powerful combination for those interested in considering U.S. small caps in today’s market environment. <sup>1</sup>Source: Josh Brown, author of *The Reformed Broker* and regular contributor to CNBC, Investment News, the Daily Beast and many other outlets for financial news. Josh Brown is not affiliated with WisdomTree or ALPS Distributors, Inc. <sup>2</sup>Sources: Ibbotson, Zephyr, BMO Private Bank. Small caps include listed U.S. equities on the New York Stock Exchange, NASDAQ and American Stock Exchange and include the bottom 50% of the market capitalization. Large caps include listed U.S. equities on these same exchanges and include the top 20% of the market capitalization. <sup>3</sup>Refers to the Russell 2000 Value Index. <sup>4</sup>Source: Joe Light, “How to Invest as Interest Rates Rise,” Wall Street Journal, 1/3/14. <sup>5</sup>Refers to the [WisdomTree U.S. SmallCap Dividend Growth Index](#) <sup>6</sup>Refers to the [WisdomTree SmallCap Dividend Index](#) <sup>7</sup>Refers to long-term earnings growth expectations, which are compilations of analyst estimates of the growth in operating earnings expected to occur over the next full business cycle, typically three to five years. <sup>8</sup>Refers to the combination of three-year average return on equity and three-year average return on assets used in the selection process for the Index. <sup>9</sup>Dividend yield: Refers to the trailing 12-month dividend yield.

**Important Risks Related to this Article**

Dividends are not guaranteed, and a company’s future ability to pay dividends may be limited. A company currently paying dividends may cease paying dividends at any time. Investments focusing 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.

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**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.

**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.

**Total market** : Refers to the Russell 3000 Index universe.

**Spread** : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

**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.

**WisdomTree U.S. SmallCap Dividend Growth Index (WTSDG)** : A fundamentally weighted index designed to track the performance of dividend-paying companies in the U.S. small-cap equity universe that WisdomTree believes have the potential to increase their dividends due to certain factors, which include estimated earnings growth, return on equity and return on assets. Weighting is by indicated cash dividends.

**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.

**Dividend yield** : A financial ratio that shows how much a company pays out in dividends each year relative to its share price.

**Trailing 12-month dividend yield** : Dividends over the prior 12-months are added together and divided by the current share price. Higher values indicate more dividends are being generated per unit of share price.

**Russell 2000 Value Index** : measures the performance of small-cap value segment of the U.S. equity universe. It includes those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values.

**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.

**Russell 2000 Growth Index** : Measures the performance of the small-cap growth segment of the U.S. equity universe. It includes those Russell 2000 Index companies with higher price-to-book ratios and higher forecasted growth values.

**S&P 500 Index** : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

**WisdomTree SmallCap Dividend Index** : A fundamentally weighted index measuring the performance of the small-capitalization segment of the U.S. dividend-paying market. The Index comprises the companies that constitute the bottom 25% of the market capitalization of the WisdomTree Dividend Index after the 300 largest companies have been removed. The Index is dividend weighted annually to reflect the proportionate share of the aggregate cash dividends each component company is projected to pay in the coming year, based on the most recently declared dividend per

share.