

2017: Anatomy of a Small-Cap Junk Rally

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Many clients have been asking us, “What happened to U.S. small caps in 2017?” Also, they’ve been asking us what has happened to quality-focused small-cap strategies.

2016 saw incredible performance. In 2017, the trend has completely reversed.

The U.S. Dollar, Interest Rates and Momentum (or Lack Thereof) of the Trump Agenda

To say the least, 2017 has been surprising thus far. Since the November 8, 2016, election of President Trump, the U.S. 10-Year Treasury note has hit 2.60% twice.¹ As of this writing, it is below 2.35%. Many would have thought that the momentum of and excitement about President Trump’s plans would have led to higher interest rates, not lower ones. Small caps historically have responded well to a rising rate environment.

The U.S. dollar also has been weakening. A weaker U.S. dollar—don’t get us wrong—is (and has been) a boon to the earnings of U.S. large-cap multinationals. In 2017, one of the most exciting trends has involved the earnings of the [S&P 500 Index](#), and we believe that a critical causal factor is the weakening of the U.S. dollar. Unfortunately, U.S. small caps do the majority of their business inside the United States, so their relative performance when measured against large caps is actually helped by a stronger, not weaker, U.S. dollar.

Finally, U.S. small-cap stocks tend to pay higher effective corporate taxes than do U.S. large-cap multinationals, which may leave a portion of their earnings outside of the United States to avoid paying taxes. After President Trump’s 2016 election, small-cap stocks went on a massive rally—the Russell 2000 Index was positive 15 days in a row.² As the momentum behind corporate tax reform has seemed to wane for most of the year, small caps have underperformed large caps in the U.S.

Of course, these three factors have been discussed for the last nine months.

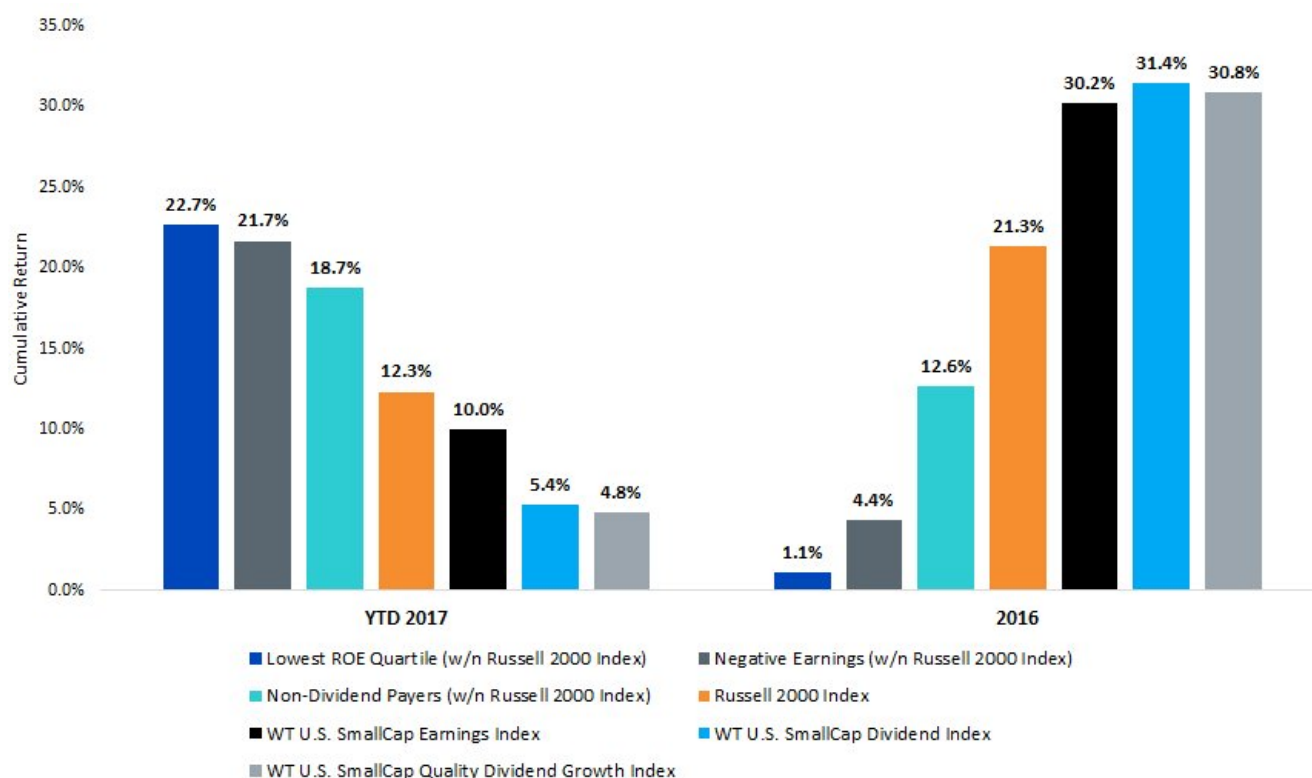
WisdomTree Focuses on Specific Small-Cap Stocks

Where an index like the Russell 2000 seeks to include a very broad spectrum of small caps, WisdomTree’s small-cap Indexes seek to include small caps with very specific fundamental characteristics.

- **WisdomTree U.S. SmallCap Dividend Index:** This Index focuses solely on dividend-paying companies, to the exclusion of any non-dividend payers. Notably, almost 50% of the Russell 2000 Index market capitalization is in stocks that do not pay dividends,³ so in U.S. small caps this is an important selection criterion to consider.

- **WisdomTree U.S. SmallCap Earnings Index:** This Index focuses solely on companies with positive core earnings. Firms with negative earnings would therefore be excluded, and for context, the Russell 2000 Index has approximately 20% of its market capitalization in firms with negative earnings over the prior 12-month period.⁴
- **WisdomTree U.S. SmallCap Quality Dividend Growth Index:** This Index focuses on small-cap firms with higher earnings growth expectations, three-year average return on equity (ROE) and three-year average return on assets (ROA). Every firm has to pay dividends. The bias, of course, is toward higher-quality small-cap firms.

2017: Strong Performance in Non-Dividend Payers, Negative Earners and Low-ROE Small Caps



Sources: WisdomTree, FTSE Russell, Bloomberg, with data for YTD 2017 from 12/31/16 to 10/2/17 and data for 2016 from 12/31/15 to 12/31/16. You cannot invest directly within an Index.

For definitions of indexes in the chart, visit our [glossary](#).

- **2016:** WisdomTree's U.S. small-cap strategies delivered approximately 900 to 1,000 basis points (bps) of cumulative outperformance over the Russell 2000 Index. It was a great year. We screened the Russell 2000 Index and found that non-dividend payers returned about 12.6%, almost 9% below that of the broad benchmark. Firms within the Russell 2000 Index with negative earnings did even worse, returning 4.4%. Finally, the lowest ROE quartile within the Russell 2000 Index returned only 1.1% in 2016. These lower-quality segments of the Russell 2000 Index didn't do well in 2016, and we think this makes sense, because if corporate tax reform potential was a performance-driver, then these firms would have been less likely to be generating strong earnings and therefore paying higher effective tax rates.
- **YTD 2017:** All three of WisdomTree's U.S. small-cap strategies underperformed the Russell 2000 Index over the first nine months of 2017. We ran the same screens, and we found that 1) the non-dividend payers returned 18.7% (more than 600 bps better than the Russell 2000 Index), 2) the firms with negative earnings returned 21.7% and 3) the firms within the lowest ROE quartile returned 22.7% (almost two times that of the Russell 2000 Index).

Junk May Outperform in the Short Term, but Quality Has Persisted in the Long Term

The three WisdomTree U.S. small-cap strategies shown here all aim to do the same thing, albeit in different ways: outperform the Russell 2000 Index. They all tilt away from the more speculative components of the Russell 2000 Index, and their methodologies have put them at a disadvantage during the first nine months of 2017 because their focuses are tilting away from where the stronger performance within U.S. small caps has been. Because over the long haul there isn't yet a known premium to non-dividend payers, negative earners or low ROEs, we are confident that the tide will turn back, and people should be ready to position for any positive surprises in President Trump's tax agenda that may occur in the fourth quarter of 2017 or even in early 2018.

1Source: Bloomberg. Periods include 12/15/16 and 3/9/17–3/13/17.

2Source: "Ah Heck! Russell 2000 Win Streak Is Over at 15 Days," Associated Press, 11/28/16.

3 Source: Bloomberg, with data as of 10/2/17.

4Source: Bloomberg, with data as of 9/1/17.

Important Risks Related to this Article

Investments focusing on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development.