

All Size Indexes Are Not Created Equal

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One of the classic exposure questions in equity investing regards market capitalization size, i.e., whether one should choose large caps, mid caps or small caps. The capitalization size segment decision is an important one, as it sets up the potential for very different performance characteristics over time. **The Devil Is in the Details** How should one approach the decision of *which* small-cap or mid-cap index is best as a benchmark? If they all focus on U.S. equities, wouldn't they all be quite similar? The fact is that there is no universally accepted truth as to what market capitalization boundaries constitute mid-cap stocks or small-cap stocks. As a general descriptor of market capitalization buckets, we tend to think these buckets are useful to describe market capitalization exposure in various indexes: • **Small Caps:** Less than \$2 billion • **Mid Caps:** Between \$2 billion and \$10 billion • **Large Caps:** Greater than \$10 billion

A Quick Size Spectrum Analysis after a Strong Year U.S. equity markets—large caps, mid caps and small caps alike—performed well during 2013. Following that performance, it is interesting to evaluate the size characteristics of traditional market capitalization-weighted indexes using the range of market caps described above. In this piece we take a look at WisdomTree's U.S. earnings family of Indexes, specifically the WisdomTree Earnings Index (WTEI), WisdomTree Earnings 500 Index (WTEPS), WisdomTree MidCap Earnings Index (WTMEI) and WisdomTree SmallCap Earnings Index (WTSEI). **Figure 1a: Surprising Size Dispersion in Small-Cap Indexes**

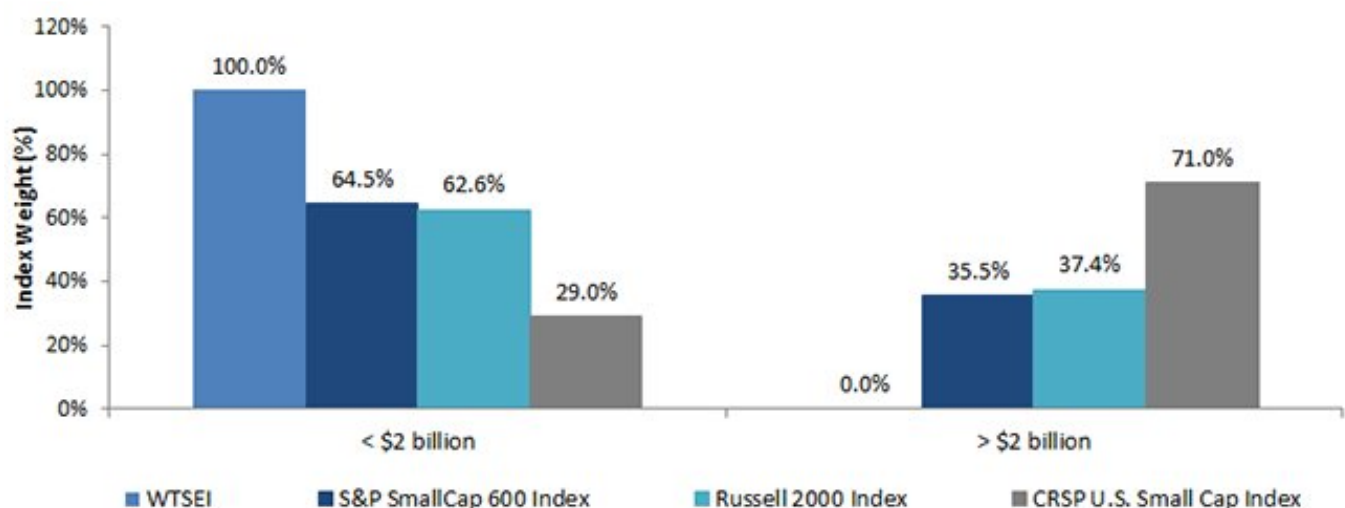
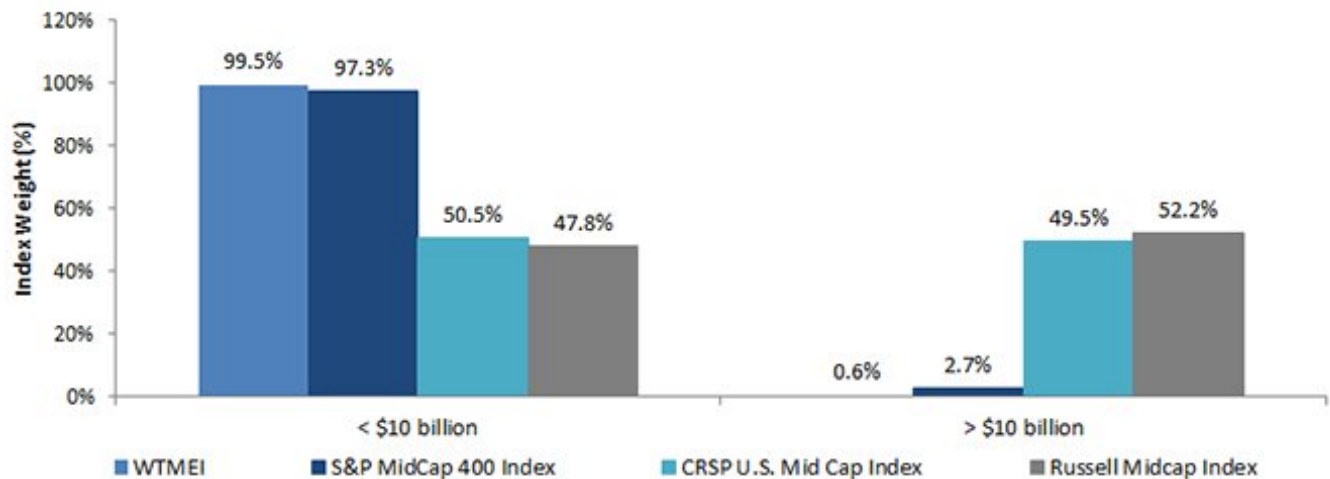


Figure 1b: Surprising Size Dispersion in Mid-Cap Indexes



Source for 1a & 1b: Bloomberg, with data as of 12/31/2013. You cannot invest directly in an index.

Ultimately, the point of this size analysis is to help people understand that index construction and methodology can have the potential to lead to very different sets of index constituents. We find it surprising that Indexes geared toward the same market capitalization size segments can exhibit such significant differences in the sizes of constituents that they include. • **CRSP U.S. Small Cap Index Stands Out:** This is a very inclusive small-cap index. However, since it is market-capitalization weighted, some of its biggest weights—ultimately adding up to more than 70%—are in stocks with market capitalizations above \$2 billion. This leads to a drifting upward along the market capitalization spectrum, with a weighted average market cap of \$3.2 billion as of December 31, 2013. For reference, the Russell 2000 and [S&P SmallCap 600](#) indexes are at approximately \$1.8 billion, and WTSEI is at slightly over \$1 billion by this same metric at this time. • **WTSEI and WTMEI Clearly Different:** Something is clearly going on with these two options, in that WTSEI had 0% of its weight in firms above \$2 billion and WTMEI had 0.6% of its weight in firms above \$10 billion in market capitalization. But before people start jumping to conclusions, it should be noted that *neither* has absolute market cap boundaries included in its selection process. **The Benefit of a Relative Value Rebalance** We've written a [very similar blog post](#) on this concept, focusing purely on WTSEI, and you've read [many blog posts](#) about the potential benefits of a relative value rebalance occurring annually. While those posts addressed the concept from a standpoint of valuation, the process also refocuses the Indexes on constituents that make up what we believe to be mid-cap and small-cap stocks, respectively, as opposed to just holding on to top performers while they potentially migrate from small- to mid- or from mid- to large-cap status. • **WTSEI:** Each year, WTSEI selects the bottom 25% of the market capitalization remaining after the largest 500 firms have been removed from WTEI, WisdomTree's broadest measure of profitable firms in the United States. Doing so this year dropped WTSEI's weighted average market capitalization by almost 10%; and if one factors in the average reduction across all rebalances, it was about 16%.¹ • **WTMEI:** Each year, WTMEI selects the top 75% of the market capitalization remaining after the largest 500 firms have been removed from WTEI. Doing so this year dropped WTMEI's weighted average market capitalization by approximately 9%; and if one factors in the average reduction across all rebalances, it was about 11%.² The other indexes also refocus their size exposures, attempting to zero back in on the market's small-cap or mid-cap size segments, but their market

capitalization weighting process has a tendency to put the most weight in the largest qualifying firms.

The Bottom Line of this Analysis: A number of the market cap-weighted small-cap indexes have been drifting toward having substantial weight in stocks we consider mid-cap stocks. WTSEI looks to us to be a purer form of the small-cap segment. The same can be said for mid-cap stocks' tendency to drift toward larger-cap stocks, while we believe WTMEI is a better representation of the mid-cap segment than many other market cap-weighted indexes. 1Sources: WisdomTree, Bloomberg. Based on annual rebalancing occurring from Index inception (2/1/2007) to 12/31/2013. 2Sources: WisdomTree, Bloomberg. Based on annual rebalancing occurring from Index inception (2/1/2007) to 12/31/2013.

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