

Are You Ready for a Cyclical Reversion?

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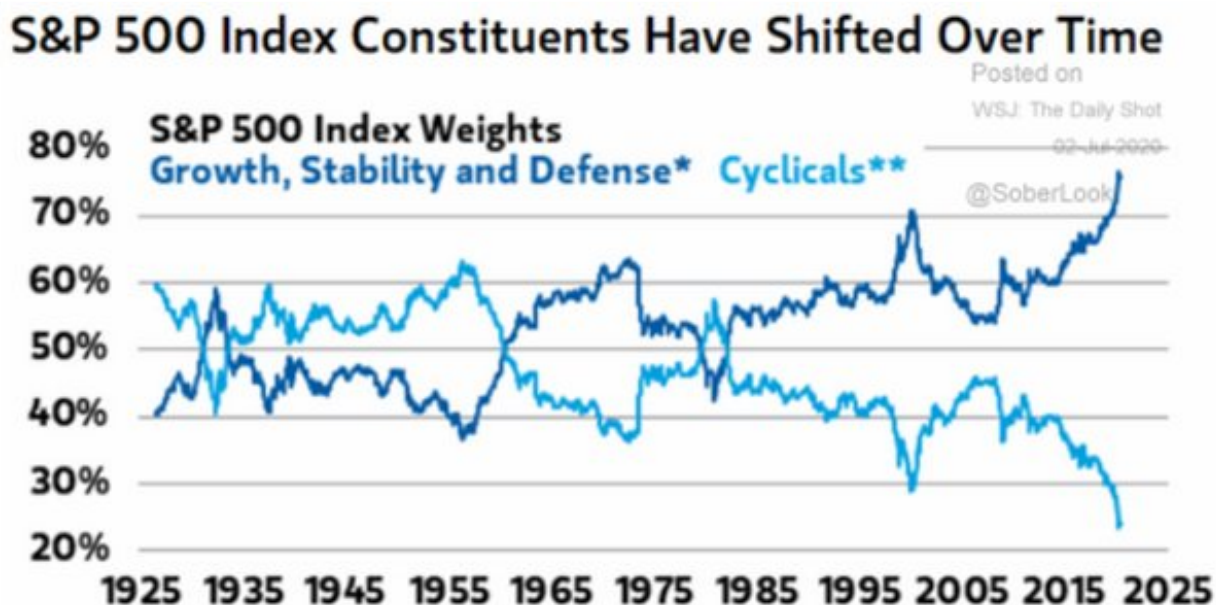
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Things have changed.

Looking at 100 years of data, the below chart from Morgan Stanley shows that cyclical sectors have never had a lower weight in the S&P 500.

Growth, stability and defense sectors have never had a greater weight—now more than three-quarters of the Index.¹



*Information technology, communications, health care, consumer staples, consumer discretionary, utilities, real estate **Financials, industrials, materials, energy

Source: Bloomberg as of June 22, 2020

Cyclical sectors are Financials, Industrials, Energy and Materials.

Growth, stability and defense sectors are Tech, Communications, Health Care, the Consumer sectors, Utilities and Real Estate.

So much of market performance can be attributed to this sector classification.

The growth, stability and defense sectors have fared particularly well during the 2020 pandemic. Tech-enabled growth company employees were able to work effectively from home. The counter-cyclicality of defense sectors shined through as people stayed at home, stocked up on staples and streamed movies from the couch.

Cyclicals had their revenue wiped out directly by, or as a close byproduct of, the economic shutdown.

- The airlines and airplane manufacturers within the Industrials sector had their businesses grind to a halt.
- Banks had to provision losses for soured loans.
- Energy companies had to write down asset values from plunging oil prices.
- Materials businesses were impaired by a standstill in construction activity.

So, a question: If we emerge from the pandemic shutdown with a more cyclical rebound and better economic environment heading into 2021, how can we get cyclical sector exposure when the traditional indexes keep lowering their weight to these sectors?

One idea with sector exposures that's almost the opposite of the S&P 500 is our [U.S. SmallCap Quality Dividend Growth Fund \(DGRS\)](#).

First, small caps have historically tended to be more cyclical than large caps by their nature. Because they have less diversified businesses, they are often more tied to economic fluctuations.

But, from sector categorization, this cyclicity is ultimately reinforced and accentuated.

Instead of having less than 24% in cyclical sectors, DGRS has 65%, with more than double the Financials sector weight, three times the Industrials sector weight and more than six times the Materials sector weight. Energy is the only sector that didn't qualify for an over-weight within the cyclical category.

SECTOR EXPOSURE				
Category	Sector	DGRS	S&P 500 Index	Russell 2000 Index
Cyclicals	Energy	0.2%	2.8%	2.3%
Cyclicals	Financials	22.7%	10.1%	16.3%
Cyclicals	Industrials	25.2%	8.0%	14.5%
Cyclicals	Materials	16.9%	2.5%	4.0%
Growth Stability and Defensives	Communication Services	2.3%	10.8%	2.5%
Growth Stability and Defensives	Consumer Discretionary	9.8%	10.8%	11.8%
Growth Stability and Defensives	Consumer Staples	3.9%	7.0%	3.3%
Growth Stability and Defensives	Health Care	3.6%	14.6%	20.6%
Growth Stability and Defensives	Information Technology	5.9%	27.5%	13.9%
Growth Stability and Defensives	Real Estate	2.7%	2.8%	7.1%
Growth Stability and Defensives	Utilities	6.8%	3.1%	3.6%
Cyclicals		65.0%	23.4%	37.2%
Growth Stability and Defensives		35.0%	76.6%	62.8%

Sources: WisdomTree, FactSet, 6/30/20. You cannot invest directly in an index. Weights subject to change.

On a pure valuation basis, people often think of small caps as being particularly expensive—more than 30% of the Russell 2000 is currently unprofitable, after all. That's up from about 20% pre-pandemic.

But as of June 30, only about 6% of DGRS was unprofitable. More companies will become unprofitable as earnings come in. Even including these negative earnings, the trailing 12-month price-to-earnings (P/E) ratio was six multiple points below that of the S&P 500.

People tend to not think of small caps for dividends, because 50% of the Russell 2000 is non-dividend payers. But this basket of lower-multiple small caps does have a considerably higher dividend yield than the S&P 500.

These dividends were also not coming at the expense of buybacks, as the trailing 12-month net buyback yield was similar to that of the S&P 500. For a small-cap basket this is fairly unique as small-cap indices generally tend to issue shares and see negative net buyback ratios.

Characteristic	DGRS	S&P 500 Index	Russell 2000 Index
Dividend Yield	3.34%	1.92%	1.84%
Net Buyback Yield	1.83%	2.08%	-1.16%
Gross Buyback Yield	2.85%	2.64%	2.12%
Shareholder Yield	5.17%	4.00%	0.68%
Price/Earnings (P/E)	16.11	22.36	85.05
Price/Earnings (P/E) Excl. Negative	14.34	21.51	15.87
Percent Negative Earn	5.89%	1.49%	30.66%
Price-Cash Flow (P/CF)	7.64	12.60	10.96
Price/Book (P/B)	1.73	3.54	1.75
Wgt Ave. Est. Long-Term Growth	9.58%	10.14%	8.76%

Sources: WisdomTree, FactSet, 6/30/20. Past performance is not indicative of future results. You cannot invest directly in an index.

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

For definitions of terms in the table, please visit our [glossary](#).

We have been hosting [weekly conference calls with Professor Jeremy Siegel](#) where he outlines a view for a strong economy in 2021, supported by very robust growth in the M1 money supply measures and all the pandemic relief efforts. Siegel believes that, as we regain confidence to open the economy in 2021, all this liquidity pumped into the system will likely support higher inflation and potentially a cyclical rebound.

The big market cap indexes keep lowering exposure to these sectors, per the chart above. For investors seeking to add exposure to that cyclical growth story, DGRS could be a very good option to reflect this growth rebound.

For advisors who use model portfolios in their practice, DGRS is also the small-cap strategy that WisdomTree includes in model portfolios we created with Professor Siegel.

¹The Wall Street Journal's Daily Shot email series recently featured this chart.

Important Risks Related to this Article

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