

Momentum Stocks Falter in 2014

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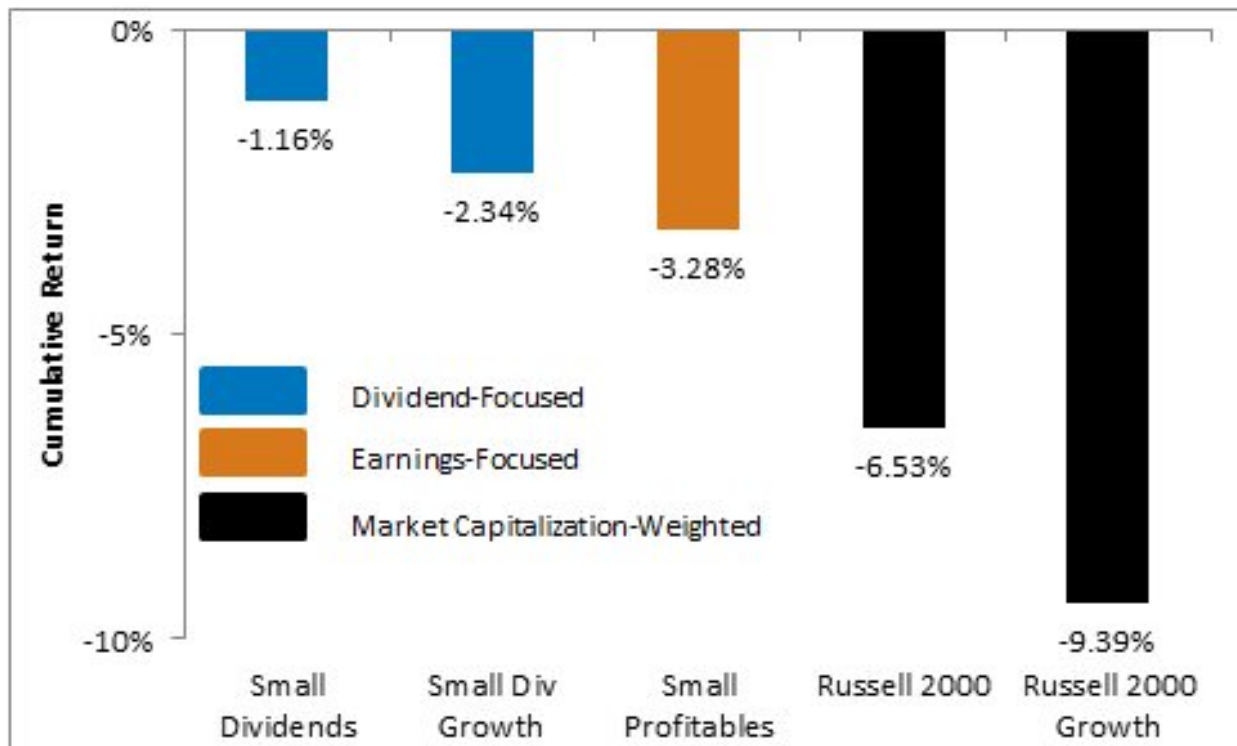
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Within equities, few things capture the excitement and imagination of investors as well as a good growth story. Frequently, these are the stories of companies involved in cutting-edge technologies that could very well change how we live our lives—with the caveat, of course, that they are successful. In 2013, a year of equity performance driven by multiple expansion, we saw very strong performance from these types of stocks. **Sentiment Can Shift on a Dime** Usually, there comes a time when the “good story” is no longer enough, and a stock stops trading based on possibilities and potential and starts trading based on the actual business operations. It’s possible that we saw such a shift around March 4, 2014, as discussion around U.S. equities began to note that high-growth-potential momentum stocks have gone from outperforming broad U.S. equities (represented here by the Russell 3000 Index) to underperforming them by a significant margin. **Studying the Case of Small Caps** If one were to ask where many of these “story stocks” reside, we’d point to the small-cap growth segment of the market, whose performance is well captured by the Russell 2000 Growth Index. These can be new businesses, yet to generate profits but high on potential—and also high on risk. One of the biggest elements of risk involves the fact that, in many cases, the more exciting the story, the less attention potential investors pay to valuation. Ultimately, we believe that small-cap stocks in general represent an important part of an equity portfolio, and history shows their potential to greatly outperform large caps over long periods. However, we find it important to remind investors that, historically speaking, the small-value style has significantly outperformed the small-growth style, even though the most exciting stock stories typically would not be found within the “value” style.

WisdomTree Uses Fundamental Discipline to Mitigate Risk in Small-Cap Stocks At WisdomTree, we have nothing against riding the wave of the next awesomely successful small-cap company, but we recognize that selecting it ahead of time without a crystal ball is extremely difficult. Instead, we focus on two key principles: *Fundamentals* and *Valuation*. We do this using the following three Indexes, as we attempt to more effectively manage the risks inherent in small-cap stocks:

- **WisdomTree SmallCap Dividend Index (Small Dividends):** This Index includes only dividend payers, weighted by the cash dividends they pay, thereby avoiding more speculative non-dividend-paying companies.
- **WisdomTree SmallCap Earnings Index (Small Profitables):** This Index includes only firms that have demonstrated their ability to make money, weighted by the earnings they generate, thereby avoiding more speculative firms that have yet to prove their profitability.
- **WisdomTree U.S. SmallCap Dividend Growth Index (Small Div Growth):** This Index selects firms that pay dividends but also demonstrate relatively high long-term earnings growth expectations and measures of quality¹, weighted by the dividends they pay. The methodology is therefore sensitive to growth potential but able to steer around firms that tend to use high degrees of leverage to support growth. Each of these Indexes also has an annual rebalance that is sensitive to changes in relative valuation. Simply put, this process tends to shift weight from some of the top-performing stocks by share

price and move it toward those better able to improve and grow their fundamentals. In a sense, it's almost a built-in discipline to be "anti-momentum," and we believe it plays a role in risk mitigation, since the very stocks that exhibit big upward movements can often exhibit downward volatility as they come back down to earth. **Navigating the Shifting Sentiment across Small Cap Stocks (3/4/2014 to 5/23/2014)**



Source: Bloomberg. Past performance is not indicative of future results.

• **Common Thread—Avoiding Speculative Names:** What we saw across the brief Index descriptions above was that each WisdomTree Index requires something of its small-cap constituents. In each case, the “story stocks” that may not have actually made any money would have been excluded. The Russell 2000 Index—the broadest shown—would tend to include all small caps. The Russell 2000 Growth Index, as we mentioned earlier, would focus on the growth segment of the small-cap market, a segment that can be prone to higher valuations as well as speculative companies. • **Small Dividends Leads the Way:** For those concerned about the prospects of small-cap stocks in the U.S., we believe that Small Dividends deserves particular focus. The focus solely on dividend payers and the broad diversification combine to form what we’d categorize as WisdomTree’s most defensive way to maintain small-cap equity exposure. Small Div Growth and Small Profitables would both creep more toward the growth side of the style box compared to Small Dividends. **Conclusion: All Small Cap Indexes Are NOT Created Equal** After 2013, a year where many segments of the U.S. equity markets performed particularly well, we believe that attentiveness to risk mitigation has become more important, especially in small-cap stocks. While we wrote about potential [pockets of value within small caps](#) earlier this year, here we emphasize Index methodologies, and those that purposefully avoid the more speculative companies can be beneficial. One may never fully eliminate the risk of investing in small-cap stocks, but we believe that a few simple rules have the potential to make

a noticeable difference—especially during periods where markets become a bit choppy. 1 Measures of quality refer to three-year average return on equity (ROE) and three-year average return on assets (ROA)

Important Risks Related to this Article

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