

Small Caps in Focus Following Fed Comments

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In conjunction with Janet Yellen's testimony before Congress on July 15, the Federal Reserve produced a "Monetary Policy Report¹" that provides an update on monetary policy, economic conditions and financial markets. The report referenced equity valuations —perhaps to address claims that Fed policies are causing potential bubbles in asset prices. The statement below generally says that overall markets are fairly priced , but certain pockets among small caps have valuation characteristics that are harder to explain. The report states: *Valuation measures for the overall market in early July were generally at levels not far above their historical averages, suggesting that, in aggregate, investors are not excessively optimistic regarding equities. Nevertheless, valuation metrics in some sectors do appear substantially stretched—particularly those for smaller firms in the social media and biotechnology industries, despite a notable downturn in equity prices for such firms early in the year.*² Additionally, the Fed commented on high-yield bond spreads and the leveraged loan market. This may have been in response to criticism about its monetary policy causing unsustainable behavior among investors looking to generate current income. While there is no question the Fed is pushing people to take some risk to achieve more substantial levels of income, I don't believe all income-producing asset classes are necessarily expensive. I think the small-cap dividend and small-cap dividend growth segments of the market are quite attractively priced compared to their alternative market cap-weighted options. A key differentiator? Biotech. **Small-Cap Dividends and Small-Cap Dividend Growth: Biotech Weight in Small-Cap Indexes (as of 7/15/14)**

Index	% Weight in Biotechnology Sub Industry
WisdomTree SmallCap Dividend Index	0.88%
WisdomTree U.S. SmallCap Dividend Growth Index	0.00%
Russell 2000 Index	4.80%
Russell 2000 Growth Index	8.84%

Source: Bloomberg, with data as of 7/15/14.

Looking at the [price-to-earnings \(P/E\) ratios](#), dividend yields and corresponding price-to-dividend ratios (just 1/dividend yield) of these indexes, I believe the irony is that the more expensive part of the market could be in the non-yield-oriented sectors. And their performance has the potential to hold up better in the

event that the Momentum-led small-cap growth segment starts to sell off. Subject to change. **Performance and Valuation Measures of Small-Cap Indexes (as of 7/15/14)**

Index	P/E Ratio	Dividend Yield	Price-to-Dividend Ratio	Year-to-Date Return
WisdomTree SmallCap Dividend Index	19.7x	3.29%	30.4x	2.75%
WisdomTree U.S. SmallCap Dividend Growth Index	17.9x	2.31%	43.3x	-0.42%
Russell 2000 Index	26.4x	1.28%	78.1x	-0.17%
Russell 2000 Growth Index	33.6x	0.63%	157.5x	-1.76%

Source: Bloomberg, with data as of 7/15/14. Year-to-date returns reference the period from 12/31/13 to 7/15/14. Past performance is not indicative of future results. You cannot invest directly in an index.

I agree with comments from the Fed that parts of the small-cap market—particularly some of these small-cap small-cap growth and momentum stocks—look more stretched than broader equity markets, like the [S&P 500](#) or Russell 3000 Indexes. As a result, within small-cap allocations, I think investors should look to over-weight, or rotate, into the small-cap dividend or small-cap dividend growth segments of the small-cap market to mitigate the risk of exposures that may be more speculatively priced. ¹Board of Governors of the Federal Reserve System, “Monetary Policy Report,” U.S. Federal Reserve, 7/15/14. ²Board of Governors of the Federal Reserve System, “Monetary Policy Report,” U.S. Federal Reserve, 7/15/14.

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