

Taking Some Chips Off the Small Cap Table

Published January 2, 2014

Christopher Gannatti, CFA

Global Head of Research

U.S. equity markets¹ performed strongly through much of 2013². And one of the most impressive pockets of performance occurred in the small-cap size segment, with the Russell 2000 Index up more than 36% compared to the [S&P 500 Index](#), which was up slightly less than 30%. WisdomTree's SmallCap Earnings Index (WTSEI) was up even more over this same period, with a return of more than 40%³.

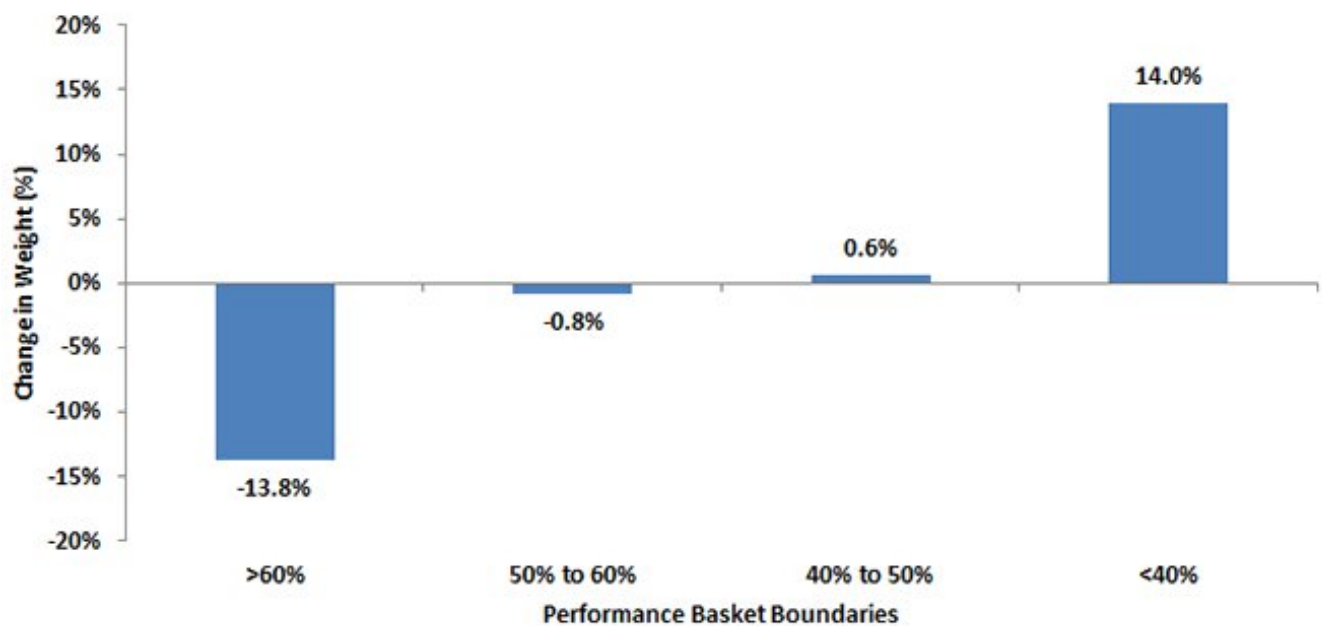
Decision Time Due to the futility of trying to time market tops and bottoms for individual stocks on a consistent basis, we believe that there are benefits to undertaking disciplined practices that take some weight away from particularly well-performing positions and reallocating toward areas that may not have kept up. **WTSEI as a Case Study Mapping the Performance Picture** While the whole Index was up about 50%⁴ between annual rebalance screenings, we know that this is an average and not every stock was up by this amount. If we think broadly in terms of sector performance⁵:

- **Four Sectors Greater Than 50%:** Consumer Discretionary (57.5%), Industrials (55.1%), Information Technology (52.8%) and Telecommunication Services (51.4%).
- **Two Sectors Less Than 30%:** Energy (26.4%) & Utilities (19.3%).

We believe that performance dispersion such as this leads to potential opportunities for a relative value rebalance to go to work. **How Chips Were Taken Off the Table** Shifting to a constituent level, it's important to remember that WTSEI is unique within the U.S. small-cap equity space in that it weights constituent firms by earnings.

- **Greater Earnings = Road to Greater Weight:** The typical firm receiving increased weight in WTSEI will have grown or at least maintained its earnings but have had lackluster price performance. Conversely, the typical firm receiving lower weight will have had stronger price performance but earnings growth that did not keep pace.
- **Losses Lead to Deletion:** Every constituent of WTSEI must prove its cumulative profitability over the four quarters prior to the November 30 screening. Lack of profits leads to lack of representation.

The Chips Coming Off the Small-Cap Table



Performance is measured from 11/30/2012 to 11/30/2013.

Sources: WisdomTree, Standard & Poor's, Bloomberg. Past performance is not indicative of future results. You cannot invest directly in an index.

• **Over 40% of Weight Returned Over 60%:** It was a great year in U.S. small caps, and WTSEI's constituents were no exception. The overall Index returned nearly 50% between annual screening dates. Prior to the November 30, 2013, screening, more than 40% of its weight was in constituents that had returned better than 60%. • **Subtracting from Winners and Adding to Losers:** Regardless of how strong a year it must be to have “losers” defined as those returning less than 40%, we clearly see that weight is taken from those firms with returns greater than 60% over the prior year and redistributed to firms with returns below 40%. • **Accounting for the “Drop-Down” Effect:** Some might correctly point out the possibility for underperforming firms in the WisdomTree MidCap Earnings Index (WTMEI) to decrease in their market capitalizations such that they can become constituents of WTSEI. Approximately 11% of the weight of the new constituents of WTSEI were part of WTMEI prior to the November 30, 2013, rebalance. While WTMEI returned over 40% in aggregate, the average performance for these particular firms was below 5%, meaning that they were in fact some of WTMEI's lower performers. **Effectively Taking the “Decision” Off the Table** WTSEI's relative value rebalance, the mechanics of which are seen above, is helpful in that it attacks the market in a disciplined way each and every year. This is especially important after the phenomenal performance of U.S. small caps this year, in that we believe investors might tend to want to hold on to the stronger performers. In sticking to the investment mantra “buy low, sell high,” a relative value rebalance may aid in accomplishing this notably difficult action—a key feature of how we think investors can become smarter with their beta exposures. 1Refers to the Russell 3000 Index, S&P 500 Index, S&P MidCap 400 Index and Russell 2000 Index. 2Refers to the 12/31/2012 to 11/30/2013 period. 3Source: Bloomberg. 4Refers to the 11/30/2012 to 11/30/2013 period, specifically from the 2012 rebalance screen to the 2013 rebalance screen. 5Each of the following return figures is sourced from Bloomberg for the 11/30/2012 to 11/30/2013 period.

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. This may result in greater share price volatility.