Why Small Caps and Quality Can Be a Powerful Combination

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In January 2015, Cliff Asness and his colleagues published a paper titled "Size Matters, if You Control Your Junk."1 The big-picture concept of focusing on a fundamental attribute—in this case, quality—within small caps is something that we believe is quite powerful and something that WisdomTree has been doing when constructing its Indexes since 2006.

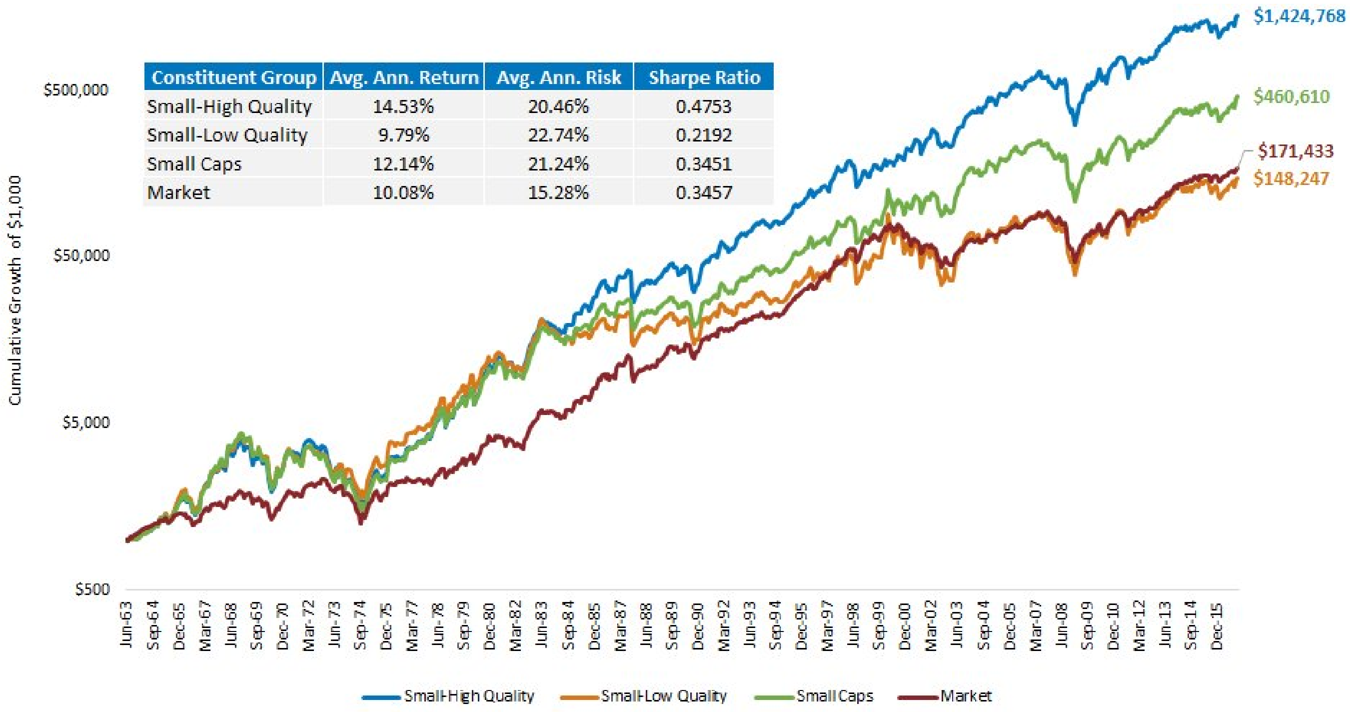
Quality: Long-Term Outperformance with Lower Risk

The "size effect" has been well documented, leading many investors to believe that holding shares of small companies for long periods of time could be a successful strategy. However, it's important to question whether these greater returns over long periods are simply a function of greater risk.2

- **Small caps vs. the market:** Small caps did beat the market by slightly more than 2% per year from June 30, 1963, to December 31, 2016, but this was with about 6% per year in incremental additional volatility. It's notable that small caps had a lower Sharpe ratio than the market over this period by .0006—meaning that in risk-adjusted terms it would be difficult to say that small caps outperformed the market over this period.
- **Not all small caps are equal:** In investing, what's avoided is at times equally (or more) important than what is focused upon. Clearly, there are small-cap, lower-quality firms—specifically with lower operating profitability—that had lower returns and higher risk over this period.
- **Small quality:** By avoiding the small caps with lower operating profitability and focusing on those with higher profitability, there was a return advantage over simply focusing on small caps alone. However, there was also a risk advantage, leading to a significant increase in the Sharpe ratio.

Conclusion: *When investing in small caps, filtering out lower-quality, more speculative companies could be beneficial.*

Cumulative Growth of $1,000 (6/30/1963–12/31/16)



Constituent Group	Avg. Ann. Return	Avg. Ann. Risk	Sharpe Ratio
Small-High Quality	14.53%	20.46%	0.4753
Small-Low Quality	9.79%	22.74%	0.2192
Small Caps	12.14%	21.24%	0.3451
Market	10.08%	15.28%	0.3457

Sources: WisdomTree, Kenneth French Data Library. "Small-High Quality" refers to firms below the median market capitalization size for listed U.S. companies, with operating profitability in the top 30% of these firms. "Small-Low Quality" refers to firms below the median market capitalization size for listed U.S. companies, with operating profitability in the bottom 30% of these firms. "Small Caps" refers to firms in the bottom 30% of market capitalization of all listed U.S. firms. "Market" includes all U.S.-listed companies. Past performance is not indicative of future results.

How WisdomTree has Avoided Speculative Small-Cap Firms

WisdomTree now has two U.S. small-cap strategies with 10 years of live performance history.

- **WisdomTree SmallCap Dividend Index:** This is a very broad approach, meant to capture U.S. small-cap companies that pay regular dividends.
- **WisdomTree SmallCap Earnings Index:** This is also a very broad approach, meant to capture U.S. small cap companies that have generated positive earnings over the four quarters leading up to the annual screening date.

Critical ingredient: *Rather than including all small-cap firms, WisdomTree requires that firms must do something deemed to be fundamentally valuable (such as pay a regular dividend or have positive profits) prior to gaining inclusion.*

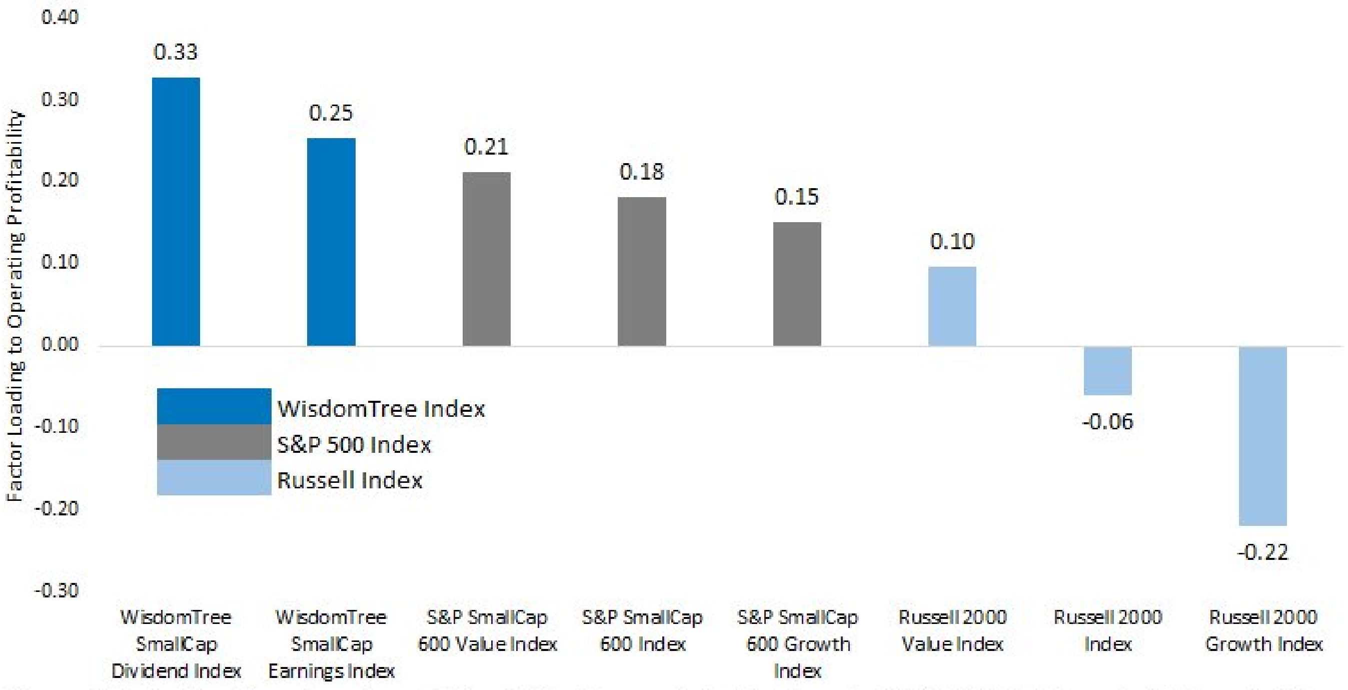
Why Does the Russell 2000 Index Receive So Much Attention?

We wrote recently about the continuum of index construction from Russell to S&P to WisdomTree. In short:

- Russell's methodology tends to be the most broadly focused.
- One of S&P's standards for companies to gain initial inclusion is the generation of positive profits.
- WisdomTree's Earnings family of Indexes requires ongoing profitability—a step further than S&P. Similarly, WisdomTree's Dividend family of Indexes requires the ongoing payment of regular cash dividends.

Intuitively, the requirement of paying ongoing dividends or generating positive profits could lead to a focus on higher quality, predominantly by avoiding the more speculative firms that may not meet these criteria. Now, instead of simply stopping there, we tested the factor loading to operating profitability over the live performance history. In a word, the indexes exhibited the exact positioning along the continuum that intuition would predict:

- Russell had the lowest loading to operating profitability.
- S&P had a higher loading to operating profitability than Russell.
- WisdomTree had the highest loading to operating profitability.



Sources: WisdomTree, Bloomberg, Kenneth French Data Library, with data for the period 2/1/07–1/31/17, the period of live calculation for the WisdomTree SmallCap Earnings Index. You cannot invest directly within an index.

Conclusion

If small-cap exposure is desired, we believe that focusing on fundamentals adds an important layer. Both dividend and earnings weighting helped introduce a quality bias to the portfolios. Notably, even within market cap-weighted small-cap indexes there was a big quality differential, so it pays to look deeper at what is driving your index exposure in small caps.

1Cliff Asness, et al., “Size Matters, if You Control Your Junk,” SSRN, first draft 1/23/15.
2Source for data within bullets is Kenneth French Data Library, with data from the period 6/30/1963–12/31/2016.

Important Risks Related to this Article

Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time.

Investments focusing on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development.