

With Small Cap Valuations Stretched, Can You Find Pockets of Value in Small Caps?

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Many market watchers are discussing valuations in small caps, a theme WisdomTree's research team has been writing about since the start of the [year](#). As the most recent example, Josh Brown, also known as "the Reformed Broker," tweeted the following on March 25, 2014: "*Russell 2000's [PE ratio](#) now at a 40% premium to the total market, not seen since 1979. Spread between small and large PE at a 34 year high.*"¹ I generally agree that small caps have been on an unprecedented run, outperforming large caps since 2000, and there will come a time, perhaps soon, when large caps take leadership again.² But there are also some biases in the Russell 2000 price-to-earnings (P/E) ratio. For instance, over 20% of the Russell 2000 is invested in money-losing companies—that is negative earners—that bias the total P/E ratio upward, as discussed [here](#). **Small-Cap Dividend Growth Offers Better Valuations than Small-Cap Value**³ With valuations stretched, should one abandon small caps entirely? Small caps have a history of performing well during periods of rising rates and economic recovery⁴—a theme I will discuss in a future research piece—and I don't think it is prudent to abandon small caps entirely because of more expensive valuations, but rather to search for pockets of potential value within small caps. This is an area I will focus on in this blog- small-cap dividend growers⁵. Valuations on this basket look attractive to me, at least as of March 31, 2014. The U.S. SmallCap Dividend Growth Index (WTSDG) focuses on stocks from a broad small-cap dividend index⁶ that I believe have potential for dividend growth increases based on a proprietary combination of growth⁷ and quality⁸ metrics. What is interesting about valuations on WTSDG:

- **Higher Dividend Yield:** WTSDG, which selects its constituents by high-growth and high-quality criteria, has a higher dividend yield⁹ than the Russell 2000 Value Index, which selects its companies largely on valuation characteristics (i.e. low [price-to-book ratios](#)).
- **Better Growth Potential:** The Russell 2000 Value Index, due to its emphasis on valuation, has lower growth expectations than the Russell 2000 Index by about 2%. Traditionally, firms with inexpensive valuations tend to also have lower growth expectations. This trade-off is less pronounced in WTSDG, as it incorporates long-term earnings growth expectations into its methodology. In fact, WTSDG's long term growth expectation stands at 14%, more than 2% higher than that of the Russell 2000 Value Index.
- **Higher Quality:** The selection methodology for WTSDG focuses on return on equity (ROE), and therefore, the ROE factor for WTSDG is approximately 50% higher than the ROE on both the Russell 2000 Index and the Russell 2000 Value Index. Additionally, WTSDG also boasts higher return on assets (ROA) and lower leverage compared to the Russell 2000 Index, Russell 2000 Value Index and Russell 2000 Growth Index. This makes the quality case for WTSDG even stonger.
- **Lower P/E Ratio:** Neither WTSDG nor the Russell 2000 Value Index uses P/E as a selection factor, but because of the unprofitable company exposure in the Russell 2000 Index and Russell 2000 Value Index,

the P/E ratio of WTSDG is significantly lower than the Russell indexes. As we stated earlier, firms with negative earnings can actually cause the overall P/E ratio for an index to look higher. • **More Attractive Valuations Relative to S&P:** Most importantly, while some say valuations of small caps versus large caps are stretched, WTSDG has both a higher dividend yield and a higher long term growth estimate than the S&P 500. Thus, this renders the small caps as relatively inexpensive compared to large caps. **Valuations across the Small-Cap Broad, Value, and Growth Cuts**

Data as of 03/31/2014	Small Cap Indexes				Large Cap Index
	WT U.S. SmallCap Dividend Growth	Russell 2000 Value	Russell 2000	Russell 2000 Growth	S&P 500
Price-to-Earnings (P/E) Ratio	18.3x	21.8x	25.8x	31.7x	16.0x
Long-Term Earnings Growth Expectations	14.0%	12.0%	14.0%	15.5%	10.8%
Dividend Yield	2.2%	2.0%	1.3%	0.7%	1.9%
Earnings Yield	5.5%	4.6%	3.9%	3.2%	6.3%
Dividend Yield / Earnings Yield	39.7%	43.4%	34.7%	22.5%	31.1%
Return on Equity	14.8%	7.6%	9.8%	12.6%	18.2%
Return on Assets	7.4%	3.2%	4.3%	5.8%	7.0%
Leverage	2.0x	2.4x	2.3x	2.2x	2.6x

Past performance is not indicative of future results. You cannot invest directly in an index. Index performance is not indicative of fund performance.

For definitions of terms and indexes in the chart, please visit our [Glossary](#). **Quite a Powerful Combination**

In short, as of March 31, 2014, WTSDG offered what could be a potentially inexpensive valuation compared to other measures of U.S. small-cap equities. Usually, the trade-off for lower valuation is lower growth expectations or lower quality. At least at this time, that is not the case for WTSDG, in that, compared to the other Russell Indexes shown, we see the lowest P/E, highest dividend yield, highest return on equity, highest return on assets, lowest leverage and significant growth expectations (trailing only the Russell 2000 Growth Index). We think that this offers a powerful combination for those interested in considering U.S. small caps in today's market environment. 1Source: Josh Brown, author of The Reformed Broker and regular contributor to CNBC, Investment News, the Daily Beast and many other outlets for financial news. Josh Brown is not affiliated with WisdomTree or ALPS Distributors, Inc. 2Sources: Ibbotson, Zephyr, BMO Private Bank. Small caps include listed U.S. equities on the New York Stock Exchange, NASDAQ and American Stock Exchange and include the bottom 50% of the market capitalization. Large caps include listed U.S. equities on these same exchanges and include the top 20% of the market capitalization. 3Refers to the Russell 2000 Value Index. 4Source: Joe Light, "How to Invest as Interest Rates Rise," Wall Street Journal, 1/3/14. 5Refers to the [WisdomTree U.S. SmallCap Dividend Growth Index](#). 6Refers to the WisdomTree SmallCap Dividend Index. 7Refers to long-term earnings growth expectations, which are compilations of analyst estimates of the growth in operating earnings expected to occur over the next full business cycle, typically three to five years. 8Refers to the combination of three-year average return on equity and three-year average return on assets used in the selection process for the Index. 9Dividend yield: Refers to the trailing 12-month dividend yield.

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