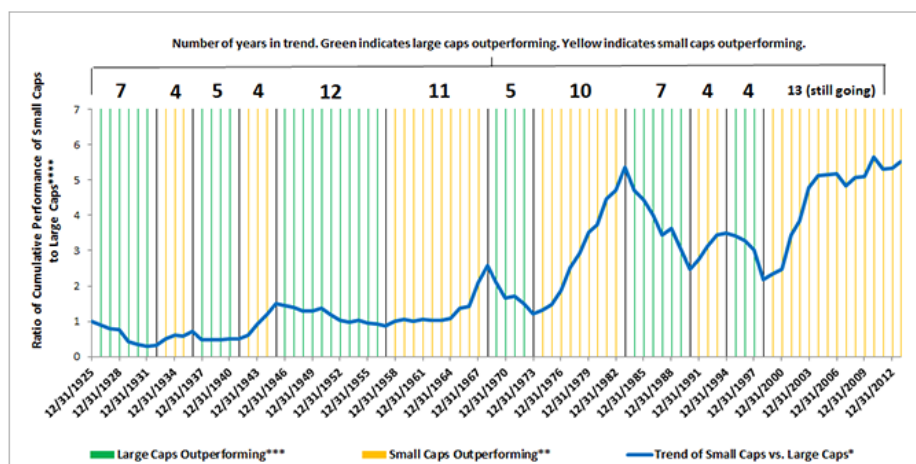


U.S. EQUITIES: HISTORICAL TRENDS OF LARGE CAPS VS. SMALL CAPS

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For the first three quarters of 2013, U.S. equity markets performed strongly—the [S&P 500 Index](#) was up nearly 20%. However, [small caps](#) did even better, with the [Russell 2000 Index](#) being up almost 28% through September 30, 2013. This current outperformance of small caps over [large caps](#) continues a performance run that is largely unprecedented in the last 80-plus years of historical data.¹ In this blog, we discuss strategies that one might want to consider in the small-cap segment in light of this current outperformance period. **Examining the Historical Record** I saw the chart below on the performance of small caps versus large caps in an asset allocation strategy report prepared by BMO Private Bank strategists Jack Ablin and Jeff Weniger (CFA, Senior Investment Analyst). Given the current unprecedented performance run of small caps over large caps that has lasted 13 years so far, Jeff and Jack ask whether it is time for a leadership change to large caps. I believe that this is a very worthwhile question.

Ratio of Cumulative Performance of Small Caps to Large Caps (12/31/1925–9/30/2013)



*Trend of Small Caps vs. Large Caps. Utilizes data compiled by Ibbotson for listed small-cap and large-cap equities in the United States, beginning 12/31/1925. An upward trend indicates that small-cap stocks are outperforming large-cap stocks, whereas a downward trend indicates the opposite. 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 encompass the top 20% of the market capitalization.

**Small caps outperforming: Each yellow bar indicates the performance of small caps outpacing that of large caps.

***Large caps outperforming: Each green bar indicates the performance of large caps outpacing that of small caps.

****Ratio of cumulative performance of small caps to large caps. Ratio meant to gauge the performance of small caps relative to large caps. An increasing slope indicates small cap outperformance, and a decreasing slope indicates large cap outperformance.

Sources: Ibbotson, Zephyr, BMO Private Bank

Past performance is not indicative of future results.

Based on this historical picture, we see: • **Six Periods of Sustained Small-Cap Outperformance:** There have been six sustained periods (in yellow) when small caps outperformed large caps. On average, these periods lasted slightly more than seven years. The current period has lasted approximately 13 years—nearly twice as long as the average going back about 88 years. One conclusion resulting from analyzing this chart would be to shift U.S. equity allocations from small caps to large caps. But many will not want to eliminate small-cap exposure entirely, so I believe it is important to consider strategies that incorporate a process to manage the [valuation](#) risks building up in this asset class. **Dispersions in Sector Performance** The [WisdomTree SmallCap Earnings Index](#) was up more than 34% for the prior year,² and the [WisdomTree SmallCap Dividend Index](#) was up nearly 28% for the same period. Both small-cap Indexes have therefore delivered large returns this year. Driving those returns: • **For the WisdomTree SmallCap Earnings Index:** Consumer Discretionary and Industrials were the leading sectors, with returns of greater than 40% over the period. Health Care and Utilities, on the other hand,

delivered returns of below 20%. • **For the WisdomTree SmallCap Dividend Index:** Consumer Discretionary and Industrials were also the leading sectors for this Index, each with returns above 40% over the same period. However, the group of sectors with returns below 20% over the period was a bit broader, and in addition to Utilities included both Materials and Energy. There was quite a dispersion in small-cap equity returns on a sector basis over this period—something could indicate an opportunity for a [relative value](#) rebalancing process to add value and take some chips off the table in sectors that have really run the most. *Past performance is not indicative of future results.* **A Disciplined Focus on Relative Value** With [market capitalization-weighted](#) indexes, when constituents increase in price, there is no mechanism to subtract weight based on the idea of valuations becoming overly extended. I see this as a potential risk building up in market cap-weighted small-cap indexes. One solution could be to look for small-cap indexes that have lower valuations. [Value](#)-oriented indexes are one way to focus on small-cap stocks with relatively lower prices. At WisdomTree, we have two small-cap Indexes that utilize a rigorous, rules-based approach to focus on relative-value rebalancing. WisdomTree focuses on dividends (WisdomTree SmallCap Dividend Index) and earnings (WisdomTree SmallCap Earnings Index). During the rebalancing process, which occurs once per year in December, the relationship between share price performance and either dividend growth or earnings growth is measured. • Firms whose prices have increased more than their relative earnings or dividend growth will see their weight decline at the rebalance. • Firms whose prices have lagged behind their relative earnings or dividend growth will see their weight increase at the rebalance. **Conclusion** Without question, small-cap stocks have been outperforming large-cap stocks in the United States. We believe that the application of a process to focus on relative valuations is becoming increasingly important in this arena as this small-cap stretch carries on. We thank the BMO Private Bank strategy team for sharing their great chart with us. ¹Sources: Ibbotson, Zephyr, BMO Private Bank ²From 9/30/2012 to 9/30/2013.

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DEFINITIONS

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Small caps : new or relatively young companies that typically have a market capitalization between \$200 million to \$2 billion.

Russell 2000 Index : Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

Large-Capitalization (Large-Cap) : A term used by the investment community to refer to companies with a market capitalization value of more than \$10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

WisdomTree SmallCap Earnings Index (WTSEI) : measures the performance of earnings-generating companies within the small-capitalization segment of the U.S. Stock Market. The index is comprised of the companies in the bottom 25% of the market capitalization of the WisdomTree Earnings Index after the 500 largest companies have been removed.

WisdomTree SmallCap Dividend Index : A fundamentally weighted index measuring the performance of the small-capitalization segment of the U.S. dividend-paying market. The Index comprises the companies that constitute the bottom 25% of the market capitalization of the WisdomTree Dividend Index after the 300 largest companies have been removed. The Index is dividend weighted annually to reflect the proportionate share of the aggregate cash dividends each component company is projected to pay in the coming year, based on the most recently declared dividend per share.

Relative value : The relationship between a particular attribute, e.g., a dividend, and the firm's share price compared to that of another firm.

Market capitalization-weighting : $\text{Market cap} = \text{share prices} \times \text{number of shares outstanding}$. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over time.