U.S. SMALL CAPS: LURKING VULNERABILITIES

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The Federal Reserve (Fed) released its inaugural financial stability report on November 28. In the report, the Fed highlighted two of the main vulnerabilities in the financial system[1]:

1. Elevated asset valuations
2. Historically high corporate leverage accompanied by a lowering of credit standards

We touched on both risks over the course of this year, in How to Avoid Leverage Risks in Small Caps and How to Manage Valuation Risk in U.S. Equities.

Coming into the year, elevated equity valuations in the U.S. were a major concern. At such high valuations, forward return estimates had become increasingly unattractive.

As a result of the December 2017 corporate tax reform, which bolstered profit growth in 2018, as well as the negative returns for U.S. equities thus far, valuations have become much more modest. This point was also conceded by the Fed in their report.

While there seems to have been improvement on vulnerability number one, the second point has been a vulnerability we have been closely watching, particularly as it relates to small caps.

Zombie Companies

Only time will tell the ultimate impacts of the Fed's extraordinary easy money policies, which were initiated in the aftermath of the financial crisis. Amid the longest bull market in history, many investors would say the Fed has done an exceptional job.

A legitimate lingering concern, however, is the significant build-up in debt among U.S. corporations. Just as the monetary stimulus was intended to do, corporations have tapped the capital markets for cheap debt financing while rates have been at historically low levels.

Of utmost importance for equity investors is the ability of these corporations to repay their obligations. The increasing attention on identifying firms unable to pay debt servicing costs has resulted in a name for this distained class of profligate companies: zombies.

In the chart below, we plot the percentage of the constituents of the S&P 500 Index and the Russell 2000 Index that are classified as zombie companies. We define zombies as those with current trailing 12-month interest expenses that exceed the average of the past three years of earnings before interest and taxes (EBIT).

While the number of companies in the S&P 500 that have insufficient profits to cover their interest expenses is a negligible 2%, **nearly 25% of Russell 2000 constituents have unsustainable debt burdens.** This level of zombie companies is near an all-time high for the Russell index.

Percentage of Zombie Companies

Sources: WisdomTree, FactSet, data 1/1/04—11/30/18. Past performance is not indicative of future results. You cannot invest directly in an index.

Different Measures of U.S. Small Caps

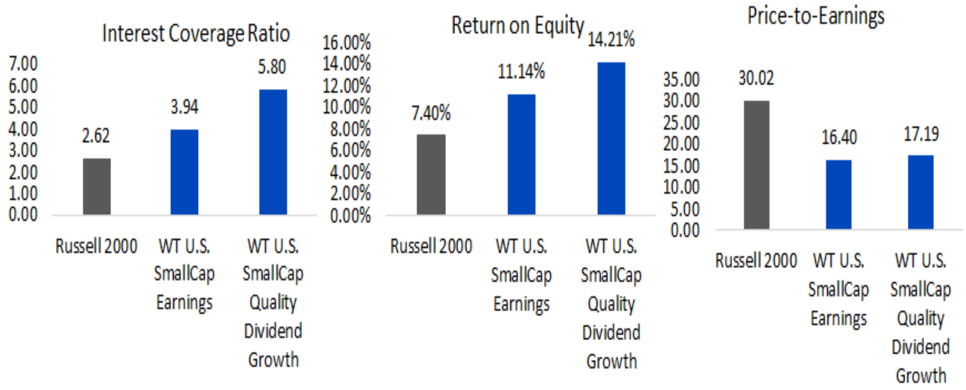
The Russell 2000 Index is one of the broadest indexes of small-cap stocks. As a by-product of its inclusivity, it has about 21% of its weight in companies with negative earnings.

The WisdomTree U.S. SmallCap Earnings Index is similarly broad, currently containing 811 constituents. The one major differentiator from the Russell 2000 universe is the requirement of positive core earnings over the four quarters prior to the Index's annual reconstitution each December.

The WisdomTree U.S. SmallCap Quality Dividend Growth Index is a more selective cut of small caps, containing 272 constituents. The Index screens for companies with attractive growth and profitability characteristics on an annual basis, also in December.

By slicing the universe of U.S. small caps in these different ways, the fundamental exposures that result for these Indexes are considerably different from the Russell 2000. The WisdomTree U.S. SmallCap Quality Dividend Growth Index offers an interest-coverage ratio of over twice that of the Russell 2000, while at a significant valuation discount based on price-to-earnings.

Typically, investors would be required to pay a significant premium to own more stable, quality companies. Uniquely for both the WisdomTree Indexes, higher quality metrics are offered at a significant discount to the Russell 2000.



Sources: WisdomTree, FactSet. Data as of 11/30/18. Past performance is not indicative of future results. You cannot invest directly in an index.

Unless otherwise noted, all data from WisdomTree, FactSet as of November 30, 2018.

[1]https://www.federalreserve.gov/publications/files/financial-stability-report-201811.pdf

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

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You cannot invest directly in an index.

DEFINITIONS

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

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.

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

Easy money policies : Policies that have the goal of stimulating economic activity.

Bullish : a position that benefits when asset prices rise.

Monetary stimulus : refers to attempts to use monetary policy like lowering interest rates or quantitative easing to stimulate the economy.

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.

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.

Earnings before interest and taxes (EBIT) : A measure of a firm's profit that includes all expenses except interest and income tax expenses.

Interest Coverage : A measure of a firms earnings before interest and taxes divided by interest expense.

Price-to-earnings (P/E) ratio : Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over tim.