
SMALL CAPS SURGE: WHAT NOW IN 2021?

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One of the market implications of the COVID-19 pandemic has been the remarkable performance of [large-cap growth](#) and technology names, particularly those impacted by the work-from-home trend and [cloud computing](#), and the underperformance of [small-cap](#) stocks that were more or less shut down during the economic lockdowns.

Positive vaccine news boosted hopes for an economic reopening in 2021, which flipped market signals, and small caps and [value](#) stocks rallied strongly in November. The [Russell 2000 Index](#), a gauge of U.S. small-cap equity performance, delivered some of the strongest gains in its history.

Ben Carlson, author of the blog “A Wealth of Common Sense,” has evaluated what happened in the aftermath of past small-cap surges, like the one we saw in November.

- The [forward returns](#) over one-, three- and five-year intervals were, on average, quite compelling, especially for the five years following the small-cap surges that Carlson studied. The average five-year cumulative return was almost 80%. Notably, the minimum return was 17.7%, following the peak of the market in February 2000.
- The shorter time periods had more risk of negative subsequent returns. But even in the three-year analysis, only two periods had negative returns: around the 1999–2000 peak and into 2002–2003 market trough.
- The average one-year return of 15% is quite positive for a forward-looking one-year interval.

While the future is always uncertain, the data makes a strong case that we had an inflection point for small-cap stocks—and that while investors will inevitably feel they ‘missed’ this large turn, this past analysis indicates there’s reason to believe more is to come.

Figure 1: Small Caps Have a Compelling Track Record after Rallies

Month	Return	Russell 2000 Forward Total Returns		
		One Year	Three Years	Five Years
Feb-2000	16.5%	-16.8%	-35.0%	17.1%
Apr-2009	15.5%	49.0%	74.3%	147.2%
Oct-2011	15.1%	12.1%	65.1%	72.4%
Oct-1982	14.4%	38.3%	55.0%	63.5%
Apr-2020	13.7%	???	???	???
Jan-1985	13.2%	17.5%	16.4%	47.9%
Sep-2010	12.5%	-3.5%	65.5%	74.1%
Aug-1984	11.8%	15.7%	74.7%	85.4%
Jan-1987	11.6%	-14.7%	8.4%	51.0%
Dec-1999	11.3%	-3.0%	-21.0%	37.7%
Jan-2019	11.3%	9.2%	???	???
Jul-1980	11.2%	30.3%	107.9%	120.0%
Feb-1991	11.2%	34.1%	74.3%	120.3%
Nov-2016	11.2%	18.3%	28.0%	???
May-1997	11.1%	21.2%	29.7%	36.4%
May-2003	10.7%	30.3%	69.2%	80.0%
Mar-1979	10.1%	6.7%	57.0%	160.6%
Averages		15.3%	44.6%	79.5%

Source: "A Wealth of Common Sense," Ben Carlson, as of 11/24/20. Past performance is not indicative of future results. You cannot invest directly in an index.

There is also research that suggests January is a particularly strong time for the performance of small-cap stocks. This ["January Effect"](#) does not work every year, and small caps generally have faced a tough stretch for quite an extended period.

But some of the arguments for why small caps perform well in January may be relevant this year. In years with large drawdowns, there can be some sharp [tax loss selling](#). This drives prices down even further and below their fair value, resulting in them snapping back in January to correct for that selling as investors reestablish positions.

WisdomTree [rebalances](#) its [fundamentally weighted](#) indexes in late December to capitalize on similar trends of selling unrelated to corporate fundamentals creating noise and opportunities to pick up value trades.

Small-cap dividend-payers were particularly impacted during the 2020 pandemic and faced some of the strongest selling pressures all year. We believe small caps are ripe for Christmas shopping lists, particularly to get ahead of the January Effect in small caps.

Consider:

- [WisdomTree SmallCap Dividend Fund \(DES\)](#)
- [WisdomTree SmallCap Quality Dividend Growth Fund \(DGRS\)](#)

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DEFINITIONS

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.

Growth: Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

Cloud computing: computing capabilities deployed via internet connection in form of applications, platform services, or infrastructure.

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

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.

12-month forward return: Returns for the 12-month period following an observed trailing 12-month dividend yield.

January Effect: Refers to market gains that may take place in during the month of January, as investors establish new positions for the year after selling losing positions in December to engage in tax-loss harvesting.

Tax Loss Harvesting: Selling securities at a loss to offset a capital gains tax liability. Tax gain/loss harvesting is typically used to limit the recognition of short-term capital gains, which are normally taxed at higher federal income tax rates than long-term capital gains.

Rebalance: An index is created by applying a certain set of selection and weighting rules at a certain frequency. WisdomTree rebalances, or re-applies its rules based selection and weighting process on an annual basis.

Fundamental weighting: A type of equity index in which components are chosen based on fundamental criteria as opposed to market capitalization. Fundamentally weighted indexes may be based on fundamental metrics such as revenue, dividend rates, earnings or book value.