

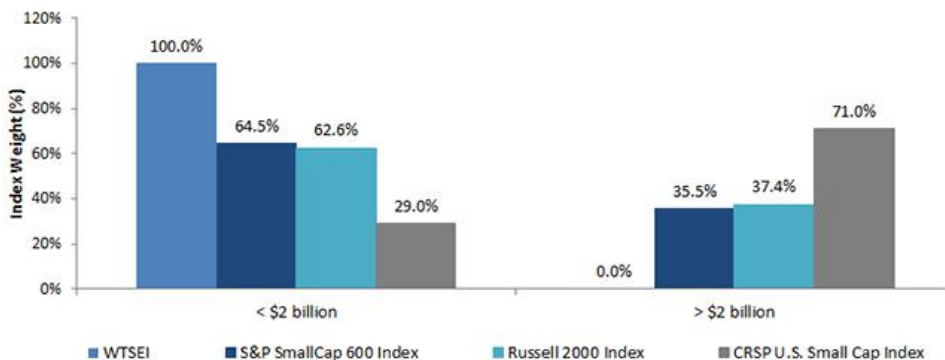
ALL SIZE INDEXES ARE NOT CREATED EQUAL

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One of the classic exposure questions in equity investing regards [market capitalization](#) size, i.e., whether one should choose [large caps](#), [mid caps](#) or [small caps](#). The capitalization size segment decision is an important one, as it sets up the potential for very different performance characteristics over time. **The Devil Is in the Details** How should one approach the decision of *which* small-cap or mid-cap index is best as a benchmark? If they all focus on U.S. equities, wouldn't they all be quite similar? The fact is that there is no universally accepted truth as to what market capitalization boundaries constitute mid-cap stocks or small-cap stocks. As a general descriptor of market capitalization buckets, we tend to think these buckets are useful to describe market capitalization exposure in various indexes:

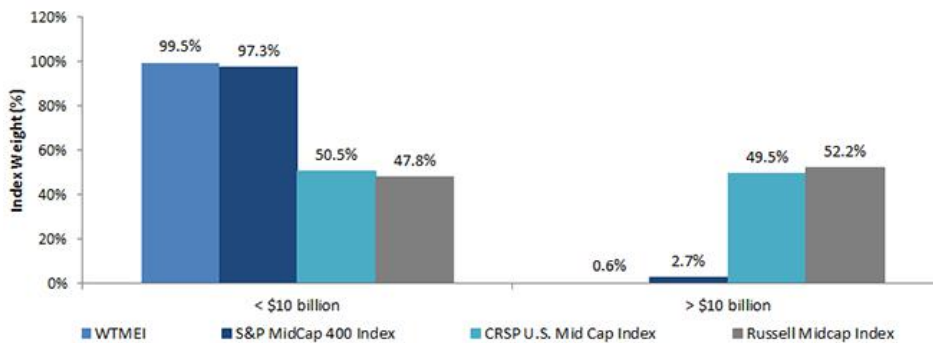
- **Small Caps:** Less than \$2 billion
- **Mid Caps:** Between \$2 billion and \$10 billion
- **Large Caps:** Greater than \$10 billion

A Quick Size Spectrum Analysis after a Strong Year U.S. equity markets—large caps, mid caps and small caps alike—performed well during 2013. Following that performance, it is interesting to evaluate the size characteristics of traditional [market capitalization-weighted](#) indexes using the range of market caps described above. In this piece we take a look at wisdomTree's U.S. earnings family of Indexes, specifically the [WisdomTree Earnings Index \(WTEI\)](#), [WisdomTree Earnings 500 Index \(WTEPS\)](#), [WisdomTree MidCap Earnings Index \(WTMEI\)](#) and [WisdomTree SmallCap Earnings Index \(WTSEI\)](#). **Figure 1a: Surprising Size Dispersion in Small-Cap Indexes**



Surprising Size Dispersion in Mid-Cap Indexes

Figure 1b: Indexes



Source for 1a & 1b: Bloomberg, with data as of 12/31/2013. You cannot invest directly in an index.

Ultimately, the point of this size analysis is to help people understand that index construction and methodology can have the potential to lead to very different sets of index constituents. We find it surprising that Indexes geared toward the same market capitalization size segments can exhibit such significant differences in the sizes of constituents that they include.

- **CRSP U.S. Small Cap Index Stands Out:** This is a very inclusive small-cap index. However, since it is market-capitalization weighted, some of its biggest weights—ultimately adding up to more than 70%—are in stocks with market capitalizations above \$2 billion. This leads to a drifting upward along the market capitalization spectrum, with a weighted average market cap of \$3.2 billion as of December 31, 2013. For reference, the [Russell 2000](#) and [S&P SmallCap 600](#) indexes are at approximately \$1.8 billion, and WTSEI is at slightly over \$1 billion by this same metric at this time.
- **WTSEI and WTMEI Clearly Different:** Something is clearly going on with these two options, in that WTSEI had 0% of its weight in firms above \$2 billion and WTMEI had 0.6% of its weight in firms above \$10 billion in market capitalization. But before people start jumping to conclusions, it should be noted that *neither* has absolute market cap boundaries included in its selection process.
- **The Benefit of a Relative Value Rebalance** We've written a [very similar blog post](#) on this concept, focusing purely on WTSEI, and you've read [many blog posts](#) about the potential benefits of a [relative value](#) rebalance occurring annually. While those posts addressed the concept from a standpoint of [valuation](#), the process also refocuses the Indexes on constituents that make up what we believe to be mid-cap and small-cap stocks, respectively, as opposed to just holding on to top performers while they potentially migrate from small- to mid- or from mid- to large-cap status.
- **WTSEI:** Each year, WTSEI selects the bottom 25% of the market capitalization remaining after the largest 500 firms have been removed from WTEI, WisdomTree's broadest measure of profitable firms in the United States. Doing so this year dropped WTSEI's weighted average market capitalization by almost 10%; and if one factors in the average reduction across all rebalances, it was about 16%.¹
- **WTMEI:** Each year, WTMEI selects the top 75% of the market capitalization remaining after the largest 500 firms have been removed from WTEI. Doing so this year dropped WTMEI's weighted average market capitalization by approximately 9%; and if one factors in the average reduction across all rebalances, it was about 11%.²

The other indexes also refocus their size exposures, attempting to zero back in on the market's small-cap or mid-cap size segments, but their market capitalization weighting process has a tendency to put the most weight in the largest qualifying firms. **The Bottom Line of this Analysis:** A number of the market cap-weighted small-cap indexes have been drifting toward having substantial weight in stocks we consider mid-cap stocks. WTSEI looks to us to be a purer form of the small-cap segment. The same can be said for mid-cap stocks' tendency to drift toward larger-cap stocks, while we believe WTMEI is a better representation of the mid-cap segment than many other market cap-weighted indexes. ¹Sources: WisdomTree, Bloomberg. Based on annual rebalancing occurring from Index inception (2/1/2007) to 12/31/2013. ²Sources: WisdomTree, Bloomberg. Based on annual rebalancing occurring from Index inception (2/1/2007) to 12/31/2013.

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DEFINITIONS

Market Capitalization: Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

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.

Mid-Cap: Characterized by exposure to the next 20% of market capitalization (after the top 70% have been removed) within the Value, Blend or Growth style zones with the majority of the fund’s weight.

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

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

WisdomTree Earnings Index: Fundamentally-weighted index that measures the performance of earnings-generating companies within the broad U.S. stock market.

WisdomTree Earnings 500 Index: A fundamentally weighted index that measures the performance of earnings-generating companies within the large-capitalization segment of the U.S. Stock Market. Companies in the index are incorporated and listed in the U.S and have generated positive cumulative earnings over their most recent four fiscal quarters prior to the index measurement date. The index is comprised of the 500 largest companies ranked by market capitalization in the WisdomTree Earnings Index.

WisdomTree MidCap Earnings Index: Fundamentally-weighted index that measures the performance of the top 75% of the market capitalization of the WisdomTree Earnings Index after the 500 largest companies have been removed.

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.

CRSP U.S. Small Cap Index: Market capitalization-weighted measure of the performance of small cap equities within the United States.

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.

S&P SmallCap 600 Index: Market capitalization-weighted measure of the performance of small cap equities within the United States, with constituents required to demonstrate profitability prior to gaining initial inclusion.

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

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.