

SOME SMALL CAPS ARE LARGER THAN OTHERS

Christopher Gannatti – Global Head of Research
10/31/2013

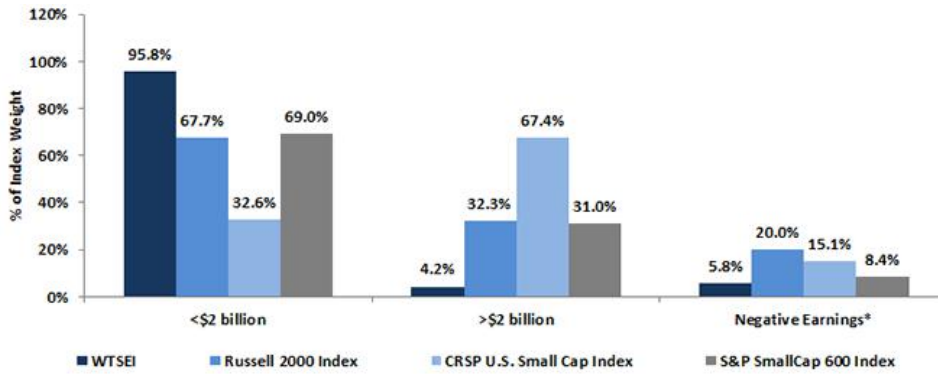
What exact [market capitalization](#) boundaries constitute large-, mid- or small-capitalization stocks? The truth of the matter is that there really is no one, absolute answer—various index providers define small caps differently. The [Russell 2000 Index](#) is ingrained in the U.S. equity investor DNA as the performance benchmark for U.S. small-cap stocks. But there are new indexes that are gaining traction, such as the CRSP indexes that Vanguard chose as the benchmarks for its U.S. equity funds, and there are WisdomTrees Indexes that weight by fundamentals but determine size allocations based on market cap characteristics. As the universe of indexes expands, we believe it becomes ever more important to question the types of exposure being generated. Let’s take a look at the small-cap indexes to see how truly small each of them may be—and the answer of which is actually the smallest may surprise you. A Look at [Weighted Average Market Capitalization](#) One way to judge the size exposure of an index is through a look at its weighted average market cap. This combines the impact of both its stock selection and constituent weighting. In essence, if an index gives larger weights to larger companies, this number will be higher. In this case, the new [CRSP U.S. Small Cap Index](#) has a weighted average market cap that is nearly three times the size of the [WisdomTree SmallCap Earnings Index \(WTSEI\)](#), and the Russell 2000 Index has a weighted average market cap that is more than 60% larger than that of WTSEI. If one is looking for an index tilted to the smaller of the small-cap companies, WTSEI seems to fit that bill well. **Weighted Average Market Capitalization of U.S. Small-Cap Indexes (as of**



Source: Bloomberg. Past performance is not indicative of future results. You cannot directly invest in an index. Subject to change.

9/30/2013)

A Look at Exposure to Firms with Less Than \$2 Billion in Market Capitalization Another way to judge the size exposure of an index is through a look at the percentage of its market capitalization in firms below a certain market capitalization level. In our analysis, we choose \$2 billion; in other words, we’re determining that firms with a market capitalization below \$2 billion are considered small-cap companies.¹ **Percentage of Index Weight Above/Below \$2 Billion and Percentage of Index Weight in Unprofitable Firms (as of 9/30/2013)**



*Negative earnings: Refers to the percentage of index weight in firms generating negative earnings over the prior 12-month period.
 Source: Bloomberg. Past performance is not indicative of future results. You cannot directly invest in an index. Subject to change.

• **WTSEI with Nearly**

96% of weight in Stocks Below \$2 Billion in Market Cap: At each year’s rebalance, WTSEI refocuses on the small-cap segment of the U.S. equity market. Other indexes (such as the [S&P SmallCap 600](#)) may include set numbers of companies or include mid-/large-cap firms that have fallen in price, or continue to hold small-cap firms that have appreciated in price.

• **Majority of the CRSP U.S. Small Cap Index Are Above \$2 Billion in Market Cap:** It is interesting to us that almost 70% of the weight of the CRSP U.S. Small Cap Index is above \$2 billion in market cap. It is notable that both the Russell 2000 and the S&P SmallCap 600 indexes are at about 30% by this metric. The three indexes beside WTSEI are weighted by market capitalization, so it is notable that the disparity is so large.

• **Ongoing Profitability as an Inclusion Requirement:** Each year, WTSEI’s rebalancing process includes a screen for those firms that have demonstrated profitability over the prior four quarters on a cumulative basis. The Russell 2000 Index has no such requirement. True, as the year progresses, firms may come in and out of profitability, but the fact that the Russell 2000 Index has approximately 20% of its market capitalization in firms that have not demonstrated profitability over the prior year is worth noting. To complete the picture, the S&P SmallCap 600 Index requires profitability for initial inclusion, whereas the CRSP U.S. Small Cap Index has no such requirement. We’ve written multiple pieces discussing the fact that U.S. small-cap stocks have performed strongly for the first three quarters of 2013. We believe that this makes it ever more important to pay some attention to the [relative valuations](#) of these stocks. The fact of the matter is that while some sectors within U.S. small caps may have performed well, not every sector did so to the same degree. With wisdomTree, and especially with WTSEI, this creates the potential for more of an opportunity for the annual rebalance—which occurs every year in December—to add value. Specifically:

- Stocks whose earnings have increased but whose prices have remained constant or fallen may tend to see increased weights.
- Stocks whose earnings have fallen or remained constant but whose prices have risen may tend to see decreased weights.

Conclusion In essence, a strategy of adherence to relative value rebalancing, we believe, has a greater potential to continue on a path of strong performance. No one ever knows what future performance will be, but refocusing on stocks whose [fundamentals](#) have done well but whose prices have yet to respond could be a positive. ¹Ultimately, there is no one boundary universally used today in determining what separates a small-cap stock from a mid-cap stock—we used this as a useful illustration of what we believe is a common cutoff.

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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.

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.

Weighted average market cap: Measure of the average market capitalization that takes into account how constituents are weighted—weighting large market capitalization firms more heavily will tend to increase this figure.

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

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.

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.

Fundamentals: Attributes related to a company's actual operations and production as opposed to changes in share price.