

A SMALL (CAP) COMEBACK

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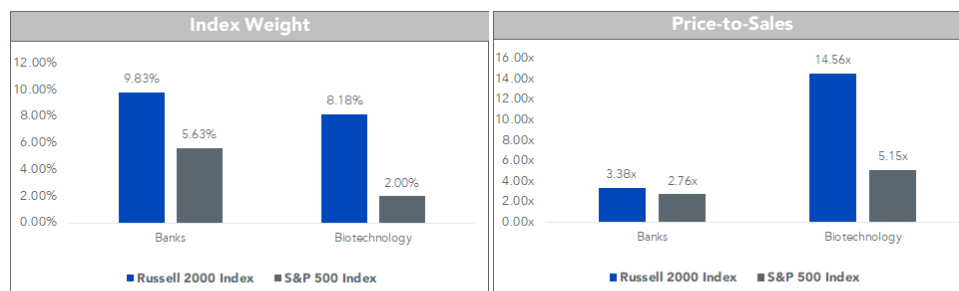
U.S. [small caps](#) are mounting a comeback. Just a little, at least.

After lagging the [S&P 500 Index](#) by almost 650 [basis points \(bps\)](#) from January through August, the [Russell 2000 Index](#) surged into the year-end, outperforming by 112 bps for the last four months of the year.

The outlook for small caps has been turning up from sell-side research analysts too, despite some lagging performance to start the year. The main reason for [bullishness](#): a potential reacceleration in global growth after months of anxiety over an [inverted yield curve](#) and global trade wars—both major factors favoring [large-cap](#), [quality](#) companies in 2019.

But, as a recent *Barron's* cover story pointed out, the broad Russell benchmark emphasizes “money-losing biotech stocks” and regional banks.¹ That’s an unattractive bet for some investors. And, after a stretch of recent outperformance for biotechnology, [price-to-sales](#) multiples look rich at over 14 times.

While some investors look for [active managers](#) to navigate such risks in this more inefficient market, there are [passive](#) indexes worth consideration.



Sources: WisdomTree, FactSet. Data as of 12/31/19. Past performance is not indicative of future results. You cannot invest directly in an index. Weights subject to change.

For definitions of the indexes in the chart, please visit our [glossary](#).

Small Cap Quality

The [WisdomTree U.S. SmallCap Quality Dividend Growth Index \(WTSQG\)](#) completed its annual [rebalance](#) in December.

Its current exposure to unprofitable biotech companies? 0%.

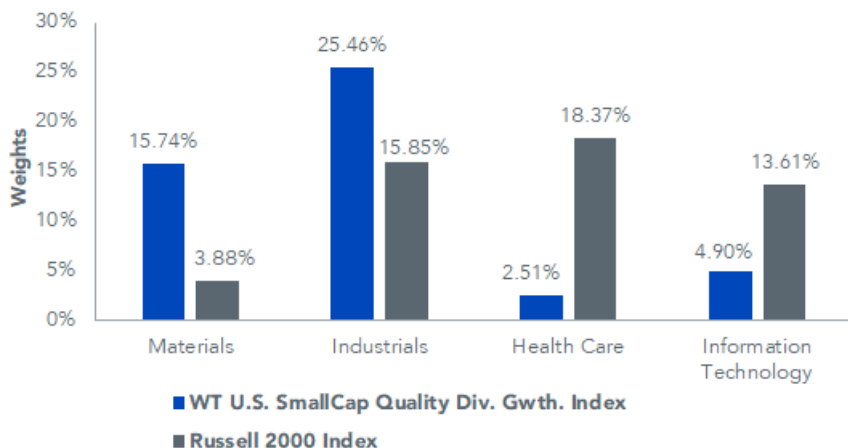
WTSQG is constructed with a combined focus on growth and quality. Companies from the small-cap universe of dividend-paying stocks are ranked through a combination of their long-term earnings growth expectations and their [return on equity \(ROE\)](#) and [return on assets \(ROA\)](#). The top 50% of companies with the most favorable [fundamental](#) scores are selected for inclusion and then weighted by their indicated cash dividends.

From a sector perspective, the Index is overweight cyclicals like Materials and Industrials, and underweight sectors with low profitability and low dividend payments like Health Care and Information Technology.

Despite its screen on long-term earnings growth expectations, the Index’s methodology favors companies with current profitability over the lottery-ticket type companies with

low or no profits that tend not to pay dividends (about half of Russell 2000 constituents do not pay dividends).

Top Two Sector Overweights & Underweights



Sources: WisdomTree, FactSet. Data as of 12/23/19, the date of Index reconstitution. Past performance is not indicative of future results. You cannot invest directly in an index. Weights subject to change.

The overweight to cyclical sectors results in lower [valuations](#) on [price-to-earnings](#) and price-to-sales, and [dividend weighting](#) produced a yield advantage of over 140 bps, as of the December rebalance. The screen on quality can be seen in higher profitability ratios (ROE and ROA), as well as a significant improvement in WTSDG’s [interest coverage ratio](#).

	WT U.S. SmallCap Quality Div. Gwth. Index	Russell 2000 Index
Forward Price-to-Earnings (P/E) Ratio	14.07x	16.96x
Price-to-Sales	0.85x	1.17x
Dividend Yield	2.80%	1.36%
Return on Equity (ROE)	14.08%	4.70%
Return on Assets (ROA)	2.80%	0.98%
Assets/Equity	5.03x	4.79x
Interest Coverage Ratio (ex. Financials)	4.41x	1.92x

Sources: WisdomTree, FactSet. Data as of 12/23/19, the date of Index reconstitution. You cannot invest directly in an index. Past performance is not indicative of future returns.

Conclusion

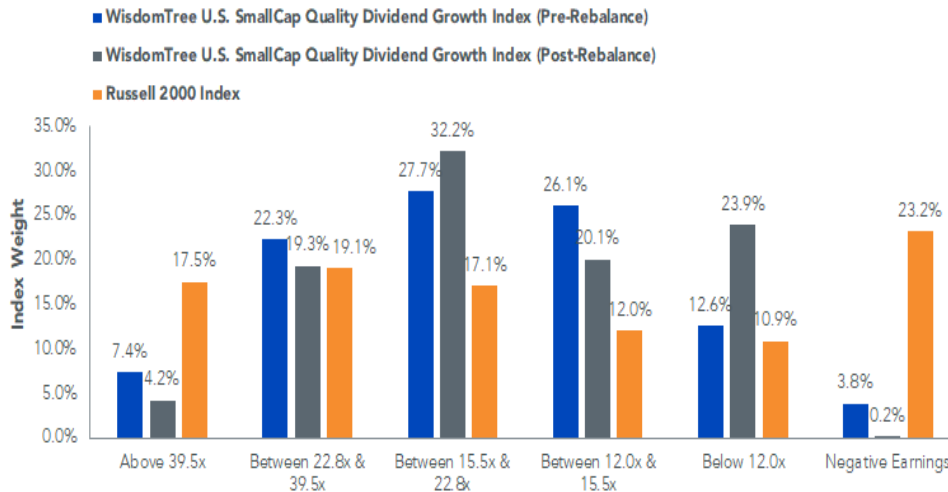
Small caps can help investors capitalize on a potential global growth reacceleration, while a screen on quality can protect from some of the riskiest companies should a [volatile](#) late-stage environment reappear.

After a gain of more than 25% for the broad small-cap index, we think now is as good a time as any for investors to consider the benefits of a fundamentals-based rebalancing process.

Comparing the grey and blue bars below, we can see the tilt toward lower P/E companies and away from negative earners at the annual rebalance for the wisdomTree U.S. SmallCap Quality Dividend Growth Index.

Despite the passive nature of the rules-based annual rebalance, the significant differences in fundamental exposures for WTSDG relative to the Russell 2000 Index and its 85% [active share](#) suggest this may present an attractive Modern Alpha® alternative to a traditional active manager or the market cap-weighted index.

Price-to-Earnings Quintiles



Sources: WisdomTree, FactSet. Pre-rebalance data as of 12/20/19. Post-rebalance data and Russell 2000 Index data as of 12/23/19. Past performance is not indicative of future results. You cannot invest directly in an index.

¹Avi Salzman and John Coumarianos, “Small-Cap Stocks Are Breaking Out. Here Are 10 Investments Poised to Win.” *Barron’s*, Dec. 6, 2019.

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.

For more investing insights, check out our [Economic & Market Outlook](#)

view the online version of this article [here](#).

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DEFINITIONS

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

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.

Basis point: 1/100th of 1 percent.

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.

Bullish: a position that benefits when asset prices rise.

Inverted Yield Curve: An interest rate environment in which long-term debt instruments have a lower yield than short-term debt instruments of the same credit quality.

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.

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 time.

Price-to-sales (P/S) ratio: share price divided by per share revenue.

Active manager: Portfolio managers who run funds that attempt to outperform the market by selecting those securities they believe to be the best.

Passive: Indexes that take a rules-based approach with regular rebalancing schedules that are not changed due to market conditions.

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.

Return on Equity (ROE): Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

Return on assets (ROA): Firm profits (after accounting for all expenses) divided by the firm's total assets. Higher numbers indicate greater profits relative to the level of assets utilized to generate them.

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

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.

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.

Dividend weighted : Constituent securities represented within the Index in proportion to their contribution to the dividend stream of the Index.

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

Volatility : A measure of the dispersion of actual returns around a particular average level.

Active Share : Active share is a measure of the percentage of holdings in a fund's portfolio that differs from the benchmark index.