

BARGAINS PREVAIL IN U.S. SMALL CAPS

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When I last wrote about U.S. [small caps](#), [valuations had reached historic lows after immense springtime volatility](#). Unfortunately for [bulls](#), small caps have yet to rebound, but attractive valuations remain.

Though recessionary fears are top of mind, we believe those with a contrarian view or the confidence to remain invested amid the volatility can still benefit from small-cap allocations. Their future may be brighter than the grim forecasts suggest.

Historically Low Valuations Remain

U.S. small caps are notoriously a “junky” market, with a preponderance of unprofitable companies that have historically ranged around 20% for the [Russell 2000](#). But even when unprofitable companies are removed from the Index, the [P/E](#) and [forward P/E](#) ratios of the small-cap market are historically discounted.

Both measures are currently trading well below long-term averages and have remained more than two [standard deviations](#) below that average amid the summertime and early fall volatility. Even after a “[dead cat bounce](#)” from June to July, small-cap valuations have fallen two straight months to reach their lowest level since the depths of the [global financial crisis](#).

Historical P/E (ex. Negative Earners) of Russell 2000



Historical Forward P/E (ex. Negative Earners) of Russell 2000



Sources: WisdomTree, FactSet, as of 9/30/22. You cannot invest directly in an index. Past performance is not an indicator of future performance.

In percentage terms, both multiples are about 35%–40% discounted from their long-term average and are nearing single-digit territory.

[Value](#) and [growth](#) styles haven't fared much better, trading roughly 35%–44% (and about two standard deviations) below their long-term averages.

Russell 2000				
Metric	9/30/2022 Value	Long-Term Avg.	Current Discount	Premium/Discount Percentile Rank (Higher = Better)
P/E	10.6x	18.3x	-41.8%	99.6%
Fwd. P/E	10.8x	17.0x	-36.6%	99.6%
P/B	1.7x	2.0x	-14.6%	80.5%
P/S	1.1x	1.1x	1.3%	46.7%

Russell 2000 Value				
Metric	9/30/2022 Value	Long-Term Avg.	Current Discount	Premium/Discount Percentile Rank (Higher = Better)
P/E	8.8x	15.6x	-43.4%	100.0%
Fwd. P/E	9.4x	15.0x	-37.7%	100.0%
P/B	1.1x	1.4x	-20.0%	89.8%
P/S	0.9x	0.8x	4.5%	42.1%

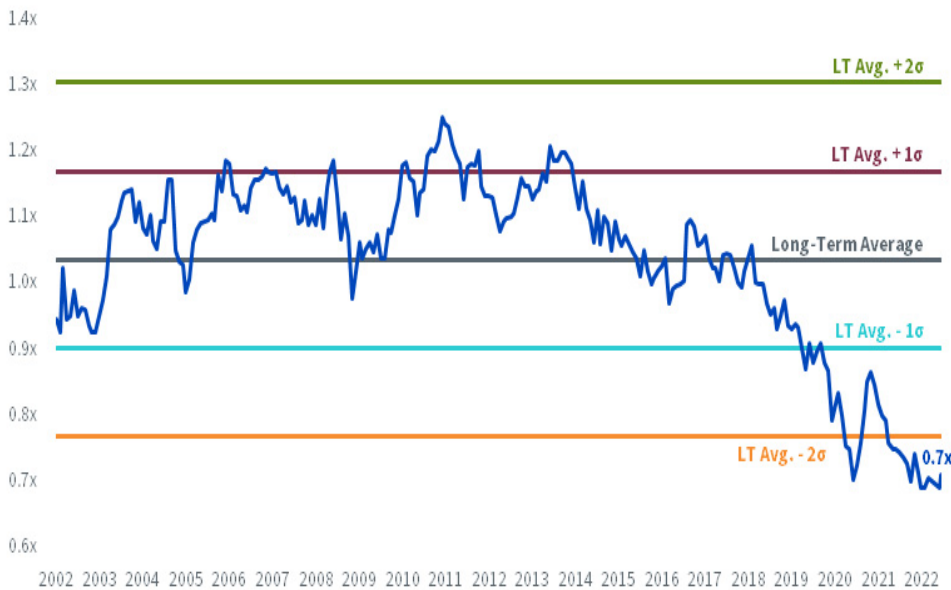
Russell 2000 Growth				
Metric	9/30/2022 Value	Long-Term Avg.	Current Discount	Premium/Discount Percentile Rank (Higher = Better)
P/E	13.7x	22.7x	-39.7%	98.0%
Fwd. P/E	12.7x	19.9x	35.7%	99.2%
P/B	3.5x	3.6x	-4.0%	56.8%
P/S	1.4x	1.5x	-7.2%	62.5%

Sources: WisdomTree, FactSet, as of 9/30/22. You cannot invest directly in an Index.

Recessionary Fears Causing Undue Pain

Historically, small-cap forward P/Es commanded about a 4% [premium](#) to [large caps](#), though this relationship has steadily broken down in the last few years. After the summertime volatility, the forward P/E of the Russell 2000 relative to that of the large-cap-centric [Russell 1000](#) remains more than two standard deviations below its long-term average.

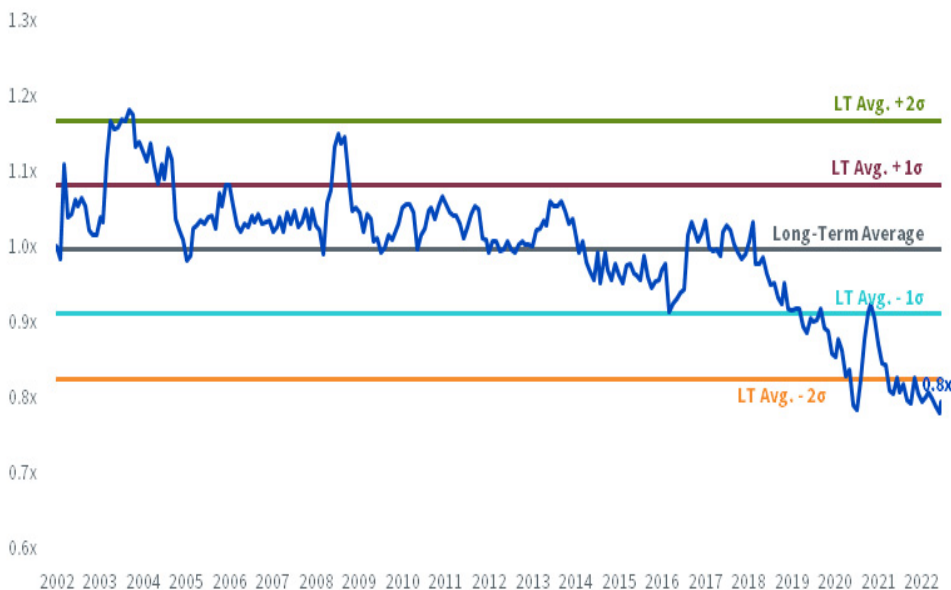
Russell 2000 Fwd. P/E (ex. Negative Earners vs. Russell 1000



Sources: WisdomTree, FactSet, as of 9/30/22. You cannot invest directly in an index.

Their relationship with [mid-caps](#) is similar, reflecting investors' fears that a [recession](#) will disproportionately affect smaller companies heavily dependent on the local economy.

Russell 2000 Fwd. P/E (ex. Negative Earners) vs. Russell Mid Cap



Sources: WisdomTree, FactSet, as of 9/30/22. You cannot invest directly in an index.

History Suggests a Promising Outlook

For those who believe the [Fed](#) may tip the U.S. into a recession with its aggressive [rate hike](#) agenda, it is understandably counterintuitive to dignify an asset class notoriously sensitive to economic growth amid expectations of reduced earnings and profit margins. But for the intrepid small-cap investor, we believe the future has historically looked bright after similar periods.

Over the past two decades, small-cap valuations have breached a 20% discount to their long-term average forward P/E on nine occasions (using monthly data). For eight of these nine observations, small caps subsequently outperformed large caps over a two-year

period by roughly 5% on average.

Forward Returns When Forward P/E Exceeds 20% Discount from LT Average

Date	Discount to LT Avg. Fwd. P/E	2-Year Forward Return of Russell 2000	2-Year Forward Return of Russell 1000	Relative Performance
10/31/2008	24.2%	16.1%	14.4%	1.7%
11/30/2008	34.1%	25.7%	19.2%	6.6%
12/31/2008	22.6%	27.0%	22.1%	4.9%
1/31/2009	31.5%	34.6%	28.9%	5.6%
3/31/2009	38.0%	47.4%	38.5%	8.9%
8/31/2009	25.7%	43.1%	33.0%	10.1%
8/31/2010	20.3%	17.7%	18.2%	-0.5%
9/30/2011	26.0%	31.0%	25.4%	5.6%
3/31/2020	25.8%	35.5%	34.9%	0.6%
4/30/2022	24.8%			
5/31/2022	28.1%	Average Performance		
6/30/2022	33.7%	Russell 2000	Russell 1000	Relative
7/31/2022	27.2%	30.9%	26.1%	4.8%
8/31/2022	30.1%			
9/30/2022	36.6%			

Sources: WisdomTree, Bloomberg, as of 9/30/22. Past performance is not indicative of future results.

Many of these observations occurred in the wake of historical economic disasters, such as the global financial crisis and the onset of the COVID-19 pandemic. Although 2022 has looked similar to those timeframes from a market performance standpoint, history suggests a rosy outlook for small caps in the aftermath of a severe downturn.

Fortune (May) Favor the Bold

WisdomTree has preached the merits of small-cap equities since launching the [WisdomTree U.S. SmallCap Dividend Fund \(DES\)](#) in 2006. Since then, we’ve expanded our U.S. small-cap equity lineup to include the [WisdomTree U.S. SmallCap Fund \(EES\)](#) and the [WisdomTree U.S. SmallCap Quality Dividend Growth Fund \(DGRS\)](#).

We believe all three look attractive in today’s small-cap market, with valuations deeply below long-term averages and [discounts](#) among the lowest since each Fund’s inception.

If small caps behave in accordance with historical patterns in the aftermath of a [downturn](#), these Funds may potentially catch a strong [tailwind](#).



For the most recent SEC standardized performance and month end performance, please click the respective ticker: [EES](#), [DES](#), [DGRS](#).

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DEFINITIONS

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

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.

volatility: A measure of the dispersion of actual returns around a particular average level. nbsp;.

Bullish: a position that benefits when asset prices rise.

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.

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.

Forward P/E ratio: Share price divided by compilation of analyst estimates for earnings-per-share over the coming 12-month period. These are estimates that may be subject to revision or prove to be incorrect over time.

Standard deviation: measure of how widely an investment or investment strategy's returns move relative to its average returns for an observed period. A higher value implies more "risk", in that there is more of a chance the actual return observed is farther away from the average return.

Dead cat bounce: A short-lived recovery of asset prices from a prolonged decline or a bear market that is followed by the continuation of the downtrend.

The Global Financial Crisis: Refers to the period of extreme stress in global financial markets and banking systems between mid 2007 and early 2009.

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.

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.

Premium: When the price of an ETF is higher than its NAV.

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.

Russell 1000 Index: A measure of the performance of the 1,000 largest companies by market capitalization in the Russell 3000 Index.

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.

Recession: two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemployment.

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

Rate Hike: refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Discount: when the price of an ETF is lower than its NAV.

Downturn: A general slowdown in economic activity over a sustained period of time.

Tailwind: Situation that will help growth in a sector/asset class because of some development in another sector/asset class.