

MULTIPLE FACTORS FOR DIFFERENT MARKETS

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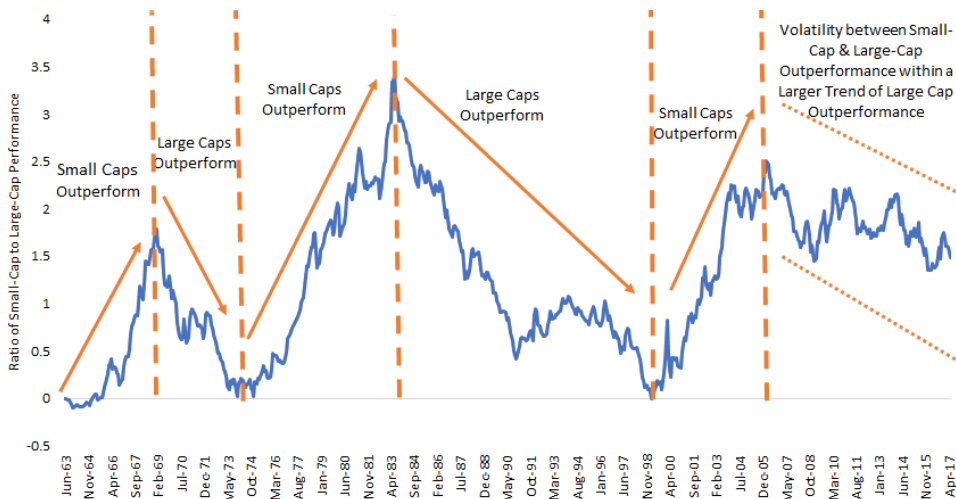
Despite all of the noise reverberating within investment discussions today, the bottom line is that strong risk-adjusted performance drives people toward investment goals. Thinking about [factors](#) is one way to accomplish this objective.

[Small Caps](#): A Classic Factor

If there is one factor that has become so ubiquitous that many people don't even think of it in the factor context, it is size. Investors may not think of it in this context, but the amount of assets that follow indexes like the [Russell 2000](#), [S&P SmallCap 600](#) and [CRSP U.S. Small Cap Indexes](#) tell us that following the returns of U.S. small-cap stocks is popular.

Unfortunately, broad small caps don't always outperform [large caps](#)—many of the studies that show their popularity and the pervasive intuition that “small outperforms large” are based on very long periods.

Cycles of Small-Cap and Large-Cap Outperformance in U.S. Equities



Sources: WisdomTree, Kenneth French Data Library, with data from 6/30/1963 to 5/31/2017. Past performance is not indicative of future results. Small Caps refer to those publicly listed U.S. stocks within the smallest 20% of total market capitalization. Large Caps refer to those publicly listed U.S. stocks within the largest 20% of total market capitalization. Past performance is not indicative of future results.

The swings between large-cap and small-cap equity performance during some of these cycles have been truly staggering:

- From December 1974 to July 1983, small caps delivered 36% per year while large caps delivered 14.7% per year.
- From July 1983 to March 1999—almost a full 16 years—large caps delivered 18.2% per year while small caps delivered 7.5% per year.

The period from 2006 onward has tended toward a greater degree of [volatility](#). The longer-run cyclical trend appears to be large caps outperforming small caps, but within that trend there have been periods in which small caps have delivered strongly relative to large caps—just not strongly enough to break the bigger trend.

Increasing Your Odds within Small Caps—Using the Factors

Sophisticated investors utilize the factors to attempt to improve their chances of generating better risk-adjusted returns within a particular asset class. For multidecade periods, history has tended to show a strong potential for outperformance coming from a factor focus. However, in any given calendar year (or shorter) period, it can become very, very difficult to know which factor to tilt toward.

Small-Cap Factors: A Calendar Year Study from 2000 to 2016

Factor Focus	2000	2001	2002	2003	2004	2005	2006	2007	2008
Small Caps-Value	24.08%	23.66%	-9.02%	66.64%	20.28%	8.78%	24.46%	-11.03%	-32.72%
Small Caps-High Quality	9.40%	21.31%	-5.83%	47.63%	27.60%	8.08%	19.08%	-2.88%	-31.18%
Small Caps-High Momentum	8.48%	20.00%	-7.04%	54.82%	17.63%	12.84%	13.56%	4.82%	-36.92%
Broad Small Caps	-5.30%	23.33%	-15.54%	66.22%	17.48%	5.05%	19.25%	-6.47%	-37.86%
Broad Market	-11.71%	-11.37%	-21.12%	31.78%	11.93%	6.06%	15.42%	5.68%	-36.75%
Best Small-Cap Strategy	Value	Value	Quality	Value	Quality	Momentum	Value	Momentum	Quality
Factor Focus	2009	2010	2011	2012	2013	2014	2015	2016	
Small Caps-Value	31.45%	26.86%	-8.55%	20.02%	41.75%	4.01%	-9.40%	37.13%	
Small Caps-High Quality	46.86%	28.13%	-4.47%	16.74%	47.22%	4.75%	-7.18%	22.06%	
Small Caps-High Momentum	10.83%	33.19%	-2.20%	22.36%	50.97%	2.43%	1.26%	12.56%	
Broad Small Caps	36.23%	29.18%	-9.50%	17.86%	47.18%	3.61%	-5.75%	24.10%	
Broad Market	28.36%	17.48%	0.46%	16.32%	35.17%	11.71%	0.07%	13.52%	
Best Small-Cap Strategy	Quality	Momentum	Momentum	Momentum	Momentum	Quality	Momentum	Value	

Sources: WisdomTree, Kenneth French Data Library. Period is from 12/31/1999 to 12/31/2016. Small Cap-Value refers to publicly listed U.S. firms below the median market capitalization level in the top 30% when ranked by book-to-market value ratios. Small Cap-High Quality refers to publicly listed U.S. firms below the median market capitalization level in the top 30% when ranked by operating profitability. Small Cap-High Momentum refers to publicly listed U.S. firms below the median market capitalization level in the top 30% when ranked by recent price momentum. Broad Small Caps refer to publicly listed U.S. firms in the smallest 30% ranked by market capitalization. Broad Market refers to all U.S. listed stocks for which pricing data was available. Best Small-Cap Strategy refers to value, quality or momentum and is limited to each respective calendar year. Past performance is not indicative of future results.

- 2014, 2015 and 2016 demonstrate an important point. It would have been very difficult to—ahead of time—call out quality, [momentum](#) and then value as the top small-cap factor strategies. This was made even more challenging because one would have just seen momentum outperform for four calendar years in a row (2010–2013).
- For these 17 years, momentum was the top strategy for seven years, and value and quality each delivered as the top strategy in five years.

We believe that different factors will continue to shift in and out of favor across time.

Enter Multifactor Strategies to Deliver a More-Versatile Approach

For those not confident in their ability to switch between factors, multifactor approaches can deliver a much greater degree of potential versatility. It’s important to note that, even if an index doesn’t have the word “multifactor” in its name, it’s absolutely possible that it still taps into multiple factors. In fact, it’s fairly difficult for a strategy to solely touch a single factor and not be influenced by any others.

WisdomTree U.S. SmallCap Quality Dividend Growth Index: Size & Quality with Value & a Touch of Momentum

Small-Cap Focus	Mkt-Rf	SMB	HML	RMW	MOM
WT U.S. SmallCap Quality Dividend Growth Index	0.97	0.92	0.32	0.51	0.08
S&P SmallCap 600 Index	0.99	0.84	0.25	0.23	0.14
S&P SmallCap 600 Value Index	0.99	0.82	0.33	0.26	0.05
S&P SmallCap 600 Growth Index	0.98	0.85	0.16	0.20	0.24
Russell 2000 Index	1.04	0.84	0.09	-0.03	0.11
Russell 2000 Value Index	0.98	0.83	0.40	0.18	0.11
Russell 2000 Growth Index	1.09	0.84	-0.23	-0.24	0.09

Sources: WisdomTree, Kenneth French Data Library, with period using monthly data from 5/1/13 to 5/31/17. You cannot invest directly within an index. Mkt-Rf refers to market sensitivity, with higher values indicating greater potential for larger movements in relation to the market's returns. SMB refers to size sensitivity, with higher numbers indicating greater loading to small caps. HML refers to value sensitivity, with higher numbers indicating greater loading to value stocks. RMW refers to operating profitability sensitivity, with higher numbers indicating greater loading to quality stocks. MOM refers to momentum sensitivity, with higher numbers indicating greater loading to stocks with high price momentum. You cannot invest directly in an index.

- We started this discussion with size, and the WisdomTree U.S. SmallCap Quality Dividend Growth Index tapped into this factor very strongly. With its focus on three-year average [return on equity \(ROE\)](#) and [return on assets \(ROA\)](#), it also delivered nearly twice the loading-to-operating profitability as the next highest loaded index to this factor. Notably, the growth indexes shown here do not offer all that great of a proxy for quality.
- Value in this context references “high book-to-market value minus low book-to-market value.” Since this is predominantly how the S&P SmallCap 600 Value Index and the [Russell 2000 Value Index](#) define value, they load well to this factor. The WisdomTree strategy doesn't focus on book-to-market value at all, but it still loads fairly strongly to this factor.
- Over this particular period, all of the small-cap indexes we show did have a positive loading toward momentum. The [S&P SmallCap 600 Growth Index](#) was most strongly loaded to this factor. WisdomTree's rebalance, focused on relative valuation, may not tend toward the best capture of exposure to momentum, but the quality and growth focus employed by the WisdomTree U.S. SmallCap Quality Dividend Growth Index coincided with some momentum tilts over this period.

When Do You Say “No” to Quality and Dividend Growth?

Quality and dividend growth are two concepts that resonate strongly with investors. Many investors who like to select individual stocks do so with these attributes affecting their selection criteria. What we think most investors may not realize is that you don't need to focus solely on large-cap stocks to achieve this objective.

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DEFINITIONS

Factor: Attributes that based on its fundamentals or share price behavior, are associated with higher return.

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

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.

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

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.

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

Momentum Factor: Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

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.

Russell 2000 Value Index: measures the performance of small-cap value segment of the U.S. equity universe. It includes those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values.

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