50 SHADES OF VALUE: SMALLER

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In Part I of this blog series, we wrote that there are many ways of accessing value, and investors should be aware of those definitions because they will impact a strategy's exposures and returns.

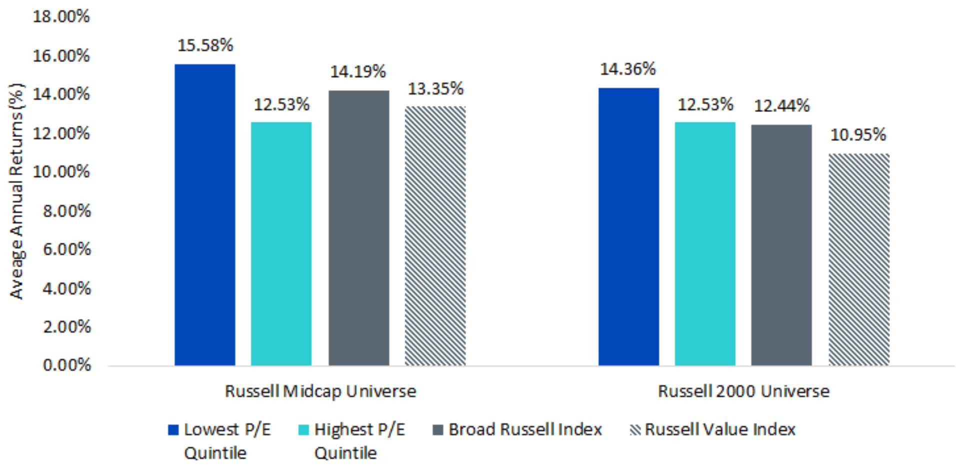
We showed how the earnings-weighted methodology of the WisdomTree U.S. Earnings 500 Index (WTEPS) implicitly tilts toward the value factor and results in characteristics that have contributed positively to performance over the last decade. In this post, we'll show how the definition of value matters just as much when going down the market cap (size) spectrum.

Below, we can see that over the last 10 years, the least-expensive companies as measured by the price-to-earnings (P/E) ratio have outperformed their respective broad Russell Midcap and Russell 2000 indexes. The magnitude of this outperformance in the mid- and small-cap universe is significantly greater than in the large-cap universe because factor exposures are magnified in less-efficient markets. During this period, there has also been a positive spread in the performance of the lowest P/E quintile (undervalued constituents) and highest P/E quintile (overvalued constituents). However, we can see that the value versions of these Russell indexes, which are built by over-weighting companies with low price-to-book value (P/B) ratios, have lagged the broad indexes over the same period.

The definition of value matters, and low P/B has lagged low P/E over the last 10 years.

Trailing 10-Year Returns: Russell MidCap and 2000 Indexes

Low P/E Outperformed But Value Indexes Lagged?



Sources: WisdomTree, FactSet, for the 10-year period 10/31/08–10/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

WisdomTree U.S. Earnings Family

Since their inception in January 2007, the WisdomTree U.S. MidCap Earnings Index (WTMEI) and the WisdomTree SmallCap Earnings Index (WTSEI) have outperformed 98% and 92%, respectively, of their peers in their Morningstar Categories while tilting to the value factor. These Indexes are rebalanced annually by weighting constituents with positive trailing 12-month core earnings in their respective universe by their proportionate share of total aggregate earnings. Their methodology results in a lower aggregate valuation as measured by their P/E, higher profitability and stronger characteristics than their Russell value benchmarks, whose methodology over-weights low P/B stocks. It is this combination of factor exposures, value and quality, that has led WTMEI and WTSEI to outperform their broad and value Russell benchmarks.

Portfolio Characteristics						
Index	Dividend Yield (%)	Price to Earnings (P/E)	Price to Book (P/B)	Price to Sales (P/S)	Return on Assets	Return on Equity
WT U.S. MidCap Earnings	1.62	16.34	2.42	1.10	3.18	13.88
Russell Midcap Value	2.14	23.12	1.94	1.43	1.94	8.23
WT U.S. SmallCap Earnings	1.36	16.33	2.05	0.80	2.67	11.00
Russell 2000 Value	1.94	29.73	1.55	0.92	1.01	4.78

Sources: WisdomTree, FactSet. For the period 10/31/15–10/31/18. Characteristics shown are median values using monthly data.

Mid-Caps

Since its inception almost 12 years ago, WTMEI has outperformed the Russell Midcap Value Index by 2.29% annually. Below, we highlight how the methodology of WisdomTree's Index is responsible for the stronger performance by showing performance attribution on P/E and P/B quintiles. The teal bar shows whether WTMEI is over- or under-weight in a given quintile group, while the blue bar shows the contribution to alpha stemming from the given quintile group. As expected, WTMEI is over-weight in the lowest P/E quintiles and significantly under-weight in the highest P/E quintile and the group of negative earners. These allocations have been the main contributors to alpha, shown in the blue bars. In the second chart, we can see that the difference in methodology between WTMEI and the Russell Midcap Value Index results in significant active weight deviations from a P/B perspective. These deviations, under-weight lowest P/B, have been contributors to alpha as the two lowest P/B quintiles have trailed the market since January of 2007.

P/E Quintile Attribution: WTMEI vs. Russell Midcap Value Index

Quintile Attributions_MidCaps

Small Caps

WTSEI has narrative similar to WTMEI's, and the benefits of its methodology are very noticeable. Since its inception in January 2007, WTSEI outperformed the Russell 2000 Value Index by 2.91% annually. From a P/E perspective, we can see that WTSEI is significantly over-weight in the lowest P/E quintile, which has beaten the broad market, thus contributing close to one-third of the alpha. At the same time, WTSEI has been significantly under-weight in the overvalued or highest P/E quintile and companies with negative earnings, which has further contributed to alpha. Similarly, through a P/B lens, we can see how the alpha is evenly distributed among the quintiles.

P/E Quintile Attribution: WTSEI vs. Russell 2000 Value Index

Quintile Attributions_small caps

It is academically-accepted that factor exposures are magnified when going down the market cap spectrum because inefficiencies tend to persist. Therefore, it is important for investors to know how factors are defined and what type of factor exposures result from their investment decisions. It is especially important to know what shade of value you're getting when going smaller.

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

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You cannot invest directly in an index.

DEFINITIONS

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 tim.

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.

Size : Characterized by smaller companies rather than larger companies by market capitalization. This term is also related to the Size Factor, which associates smaller market-cap stocks with excess returns vs the market over time.

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.

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

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.

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.

Quintile : One of the class of values of a variate which divides the members of and batch or sample into equal-sized subgroups of adjacent values or a probability distribution into distributions of equal probability.

Price-to-book ratio : Share price divided by book value per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

Alpha : Can be discussed as both risk-adjusted excess return relative to a specific benchmark, or absolute excess return relative to a benchmark. It is sometimes more generally referred to as excess returns in general.