
HOW TO INVEST IN SMALL CAPS TODAY

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A big story thus far in 2018 has been U.S. [small-cap](#) stocks, which have emerged as one of the best performing major asset classes. Normally this would come as a surprise so late in the economic cycle, but this year is different. 2018 may well produce the fastest economic growth the country has seen in the last 10 years. It's also been a year when threats by the Trump administration have morphed into actual tariffs on imports. In this environment, it makes sense that small caps should outperform large-company stocks, as they typically are more insulated from a rising dollar and the complexity of global supply chains.

But what has driven small-cap performance? And will current [valuations](#) give investors pause before putting new money to work?

The answers may depend on which barometer one uses to evaluate the small-cap segment.

In the first six months of 2018, the [Russell 2000 Index](#), for example, outpaced the [S&P 500 Index](#) by roughly 500 [basis points \(bps\)](#), returning 7.7%. When this happens, it's always good to drill down into one of the largest sectors in the Russell 2000, health care, and examine how the biotech stocks performed. For much of the year, biotech, one of the most speculative portions of the small-cap universe, represented 7% to 9% of the weight of the Russell 2000 and was a major contributor to overall returns. Small-cap biotechs, as measured by the [Russell 2000 Biotech Index](#), returned 13.5% through June.

If small-cap biotechs continue to outperform, the Russell 2000 Index may be a difficult benchmark to beat, because many of these constituents are “story stocks” trading on hopes of future growth. If we drill down into those health care and biotech companies, we notice that roughly 62% of them generate no profits, so betting on the Russell 2000 requires that investors assume this embedded speculative bet. For those looking for an alternative, WisdomTree believes you can increase quality and reduce [valuation risk](#) by limiting your small-cap exposure to only companies that generated profits in the prior fiscal year. WisdomTree created an Index that does this. The [WisdomTree U.S. SmallCap Earnings Index](#), which actually beat the Russell 2000, returning 7.9% through the first half of the year. Yet, it did so without relying on small-cap biotechs to lead the advance. On June 30, the WisdomTree Index was 7.5 percentage points under-weight health care compared to the Russell 2000, and it concentrated just 1.3% of its weight in biotech companies.

Put another way, during a six-month span when companies with very high [price-to-earnings \(P/E\) ratios](#) or negative earnings posted some of the highest returns in the small-cap space, the WisdomTree index still outperformed this “[beta](#)” benchmark, even though it tilted index weights toward lower P/E stocks. This table, derived from [WisdomTree's index attribution tool available on our website](#), illustrates this point.

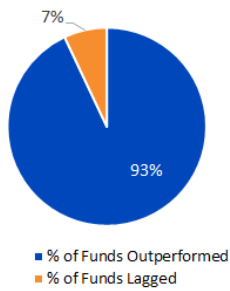
WTSEI - WisdomTree U.S. SmallCap Earnings Index				VS. RU2000 - Russell 2000® Index						
Earnings Yield Attribution		As of: 6/30/2018		<input type="checkbox"/> MTD <input type="checkbox"/> QTD <input checked="" type="checkbox"/> YTD <input type="checkbox"/> 1Y <input type="checkbox"/> 3Y <input type="checkbox"/> 5Y <input type="checkbox"/> 10Y <input type="checkbox"/> Since Inception						
Category	Attribution Component			Total Attribution	Average Category Weight			Category Performance		
	Allocation	Stock Selection	Interaction		Index Weight	Benchmark Weight	+/- Wgt	WT Index Return	Benchmark Return	
1st Quintile (Lowest P/E)	-1.02%	0.60%	0.87%	0.45%	31.92%	12.54%	19.38%	7.30%	2.06%	
2nd Quintile	-0.17%	0.53%	0.20%	0.56%	21.39%	15.43%	5.96%	8.31%	4.50%	
3rd Quintile	-0.05%	0.38%	0.04%	0.37%	17.89%	16.99%	0.90%	6.80%	4.28%	
4th Quintile	0.03%	-0.10%	-0.06%	0.00%	15.42%	16.96%	-1.54%	7.07%	7.48%	
5th Quintile (Highest P/E)	-0.23%	-0.28%	0.16%	-0.36%	7.57%	16.38%	-8.81%	8.67%	10.75%	
Negative Earners	-0.94%	1.01%	-0.73%	-0.66%	5.45%	21.57%	-16.13%	20.00%	14.08%	
N/A	-0.05%	-0.03%	-0.06%	-0.14%	0.36%	0.12%	0.23%	3.14%	-26.94%	
Total	-2.42%	2.11%	0.54%	0.23%	-	-	-	7.89%	7.66%	

Sources: WisdomTree, FactSet, for the period 12/31/17–6/30/18. Past performance is not indicative of future results. You cannot invest directly in an index.

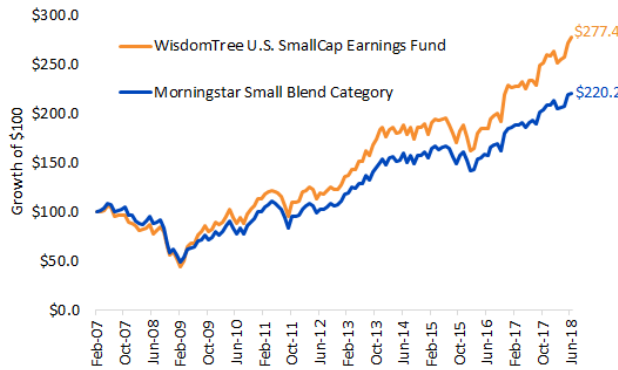
The table shows that during the first half of the year, 21.57% of the Russell 2000’s weight was in companies that posted losses (Negative Earners). Yet, as a category, those stocks returned 14.08% year-to-date through June 30. WisdomTree’s Index, weighted by core earnings, had about 5% of its weight in constituents that either became unprofitable during this period or had negative noncore earnings, and so was roughly 15 percentage points under-weight the best performing category for this period. By contrast, WisdomTree was nearly 20 percentage points over-weight the stocks with the lowest P/E ratios. As a category, this group of stocks returned 7.30% for WisdomTree—generally in line with the market—but significantly better than the cheapest stocks in the Russell 2000, which on average returned only 2% for the period.

In fact, by being over-weight the two [quintiles](#) with the lowest P/E stocks, the WisdomTree Index generated 100 bps of excess return compared to the Russell 2000, more than making up for the 66 bps drag in performance by being under-weight the Negative Earners. Our research has shown that over longer holding periods, investors actually get a greater reward by tilting toward profitable companies and away from the speculative small caps that have no profits. So being permanently under-weight the Negative Earners is an “embedded bet” we believe investors should be systemically making in the small-cap segment. Avoiding them also helps lower the overall P/E ratio on the Index. On June 30, for example, the Russell 2000 was trading at 25 times forward earnings, whereas the WisdomTree U.S. SmallCap Earnings Index exhibited a [forward P/E](#) of 14.5. Perhaps most importantly for investors, [earnings weighting](#) this starting universe of profitable small-cap companies has the potential to create [alpha](#) compared to traditional [cap-weighted](#) indexes.

EES Percentage of Peers Outperformed
(3/1/07–6/30/18)



WisdomTree and Median Peer Performance
(3/1/07–6/30/18)



Fund/Index/Category	Average Annual Total Returns as of 6/30/18												
	Fund Information			NAV Returns (%)					Market Price Returns (%)				
	Ticker	Exp. Ratio	Inception Date	1-Year	3-Year	5-Year	10-Year	Common Period	1-Year	3-Year	5-Year	10-Year	Common Period
WisdomTree U.S. SmallCap Earnings Fund	EES	0.38%	2/23/2007	18.9%	12.5%	12.9%	13.7%	9.4%	19.2%	12.5%	13.1%	13.7%	9.4%
Russell 2000 Index				17.6%	11.0%	12.5%	10.6%	8.1%	17.6%	11.0%	12.5%	10.6%	8.1%
Morningstar Small Blend Category				15.5%	9.8%	11.4%	9.6%	7.2%	15.5%	9.8%	11.4%	9.6%	7.2%

Sources: Morningstar, WisdomTree, for the period 3/1/07–6/30/18. "Common period" refers to 3/1/07–6/30/18 due to data availability. 2/23/07 represents the EES inception date. 197 investments included in peer group for Morningstar Small Blend Category. For the 1-, 5- and 10-year periods, the Fund outperformed 88%, 84% and 99%, respectively, out of 778, 541 and 395 funds.

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Conclusion: Earnings Are Not a Small Matter with Small Caps

As we can see from this table, even after deducting for Fund fees and expenses, the [WisdomTree U.S. SmallCap Earnings Fund \(EES\)](#) which tracks the wisdomTree U.S. SmallCap Earnings Index, has consistently outperformed both the Russell 2000 Index and its peer group. It has done so over not just the last year, but over the last three years, the last five years and the last 10 years. Over the 10-year time frame, it has generated returns that have surpassed the Russell 2000 by approximately 300 bps on an annualized basis. If we include mutual funds, the excess return of EES over its category stretched to 400 bps per year. That ranked EES in the top 1% of the Small Blend Category monitored by Morningstar over that period. And all this from an index fund!

Now that's modern alpha.

All data as of June 30, 2018, and sourced from wisdomTree, FactSet.

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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.

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 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 Biotech Index: Market capitalization-weighted measure of performance of the smallest biotech companies in the Russell 3000 Index.

Valuation risk: The risk of buying or over-weighting a particular stock that has appreciated significantly in price relative to its dividends, earnings or any other fundamental metric.

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.

Beta: A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

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.

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.

Earnings-weighted: Earnings for all constituents in an index are added together, and individual constituents are subsequently weighted by their proportional contribution to that total.

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.

Market capitalization-weighting: 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.