

# VALUE IS IN THE EYE OF THE BEHOLDER

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With equity markets near all-time highs, many pundits are eager to claim that [valuations](#) are stretched and the market is ripe for a pullback. One particular segment of the market that always seems to get the most pessimism is the U.S. [small-cap](#) market, and everyone seems to highlight the [Russell 2000 Index price-to-earnings \(P/E\) ratio](#) as the example for all small caps. Stocks do often move more than is justified by changes in their underlying fundamentals, especially small caps, and as a result, investors run the risk of paying too much for stocks that have become more expensive relative to their fundamentals. But there are also some biases in the Russell 2000 P/E ratio. For instance, almost 20% of the Russell 2000 is invested in money-losing companies—that is, negative earners—that bias the total P/E ratio upward.<sup>1</sup> Not all small caps are created equal, so the Russell 2000 Index should not be used as an indicator for all small caps. We think there are still pockets of value in small caps if investors focus on the higher-quality [dividend-growth](#) subset.

- The [WisdomTree U.S. SmallCap Dividend Growth Index \(WTSDG\)](#) focuses on stocks that WisdomTree believes have the potential for dividend growth increases, based on a proprietary combination of growth and quality metrics.
- Figure 1 compares WTSDG to the [Russell 2000 Value Index](#), which screens for value through the [price-to-book \(P/B\) ratio](#).

Quality Growth More Attractively Priced What is important here is that the Russell 2000 Value attempts to identify the lowest-priced basket of stocks. What is particularly intriguing is that WTSDG, an Index focusing on high-quality dividend payers—with better profitability metrics and growth characteristics—has a lower starting valuation point. This could make for a powerful combination in driving returns. **Figure 1: Small-Cap Dividend Growth Offers Better**

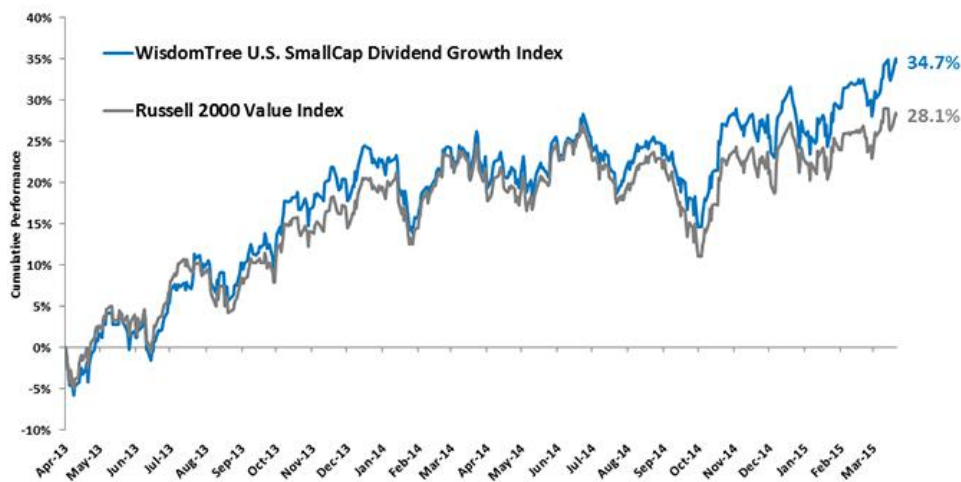
Index	Price-to-Earnings (P/E) Ratio	Long-Term Earnings Growth Expectations	Dividend Yield	Earnings Yield	Dividend Yield / Earnings Yield	Return on Equity	Return on Assets	ROE x Earnings Retention
WT U.S. SmallCap Dividend Growth	16.9x	10.5%	2.8%	5.9%	47.5%	11.2%	3.8%	5.9%
Russell 2000 Value	22.1x	7.5%	2.1%	4.5%	45.3%	3.1%	0.8%	1.7%

Sources: WisdomTree, Bloomberg, as of 3/31/15. Past performance is not indicative of future results. You cannot invest directly in an index.

## Valuations

- **Lower P/E Ratio:** Neither WTSDG nor the Russell 2000 Value Index uses P/E as a selection factor, but because of the unprofitable company exposure in the Russell 2000 Value Index, the P/E ratio of WTSDG is significantly lower. On the other hand, WTSDG does screen based on profitability, so it will typically exclude more of the unprofitable and speculative small caps.
- **Better Growth Potential:** Typically, firms with higher growth expectations tend to trade at higher valuations, but this is not the case when comparing WTSDG to the Russell 2000 value. WTSDG incorporates [long-term earnings growth expectations](#) into its screening process, which helps explain the 3% advantage.
- **Higher Dividend Yield:** WTSDG selects its constituents by growth and quality and then weights these eligible companies based on their dividends, which typically increases the Index dividend yield.
- **Higher Quality:** The selection methodology for WTSDG focuses on quality factors like [return on equity \(ROE\)](#) and [return on assets \(ROA\)](#), and therefore, these numbers are significantly higher for WTSDG compared to the Russell 2000

Value Index. It is important to note that the market often demands a higher price (i.e., higher multiple) for quality companies. **Figure 2: Index Performance**



Sources: WisdomTree, Bloomberg, 4/12/13–3/31/15.

Performance date was chosen to reflect the index inception date of the WisdomTree U.S. SmallCap Dividend Growth Index.

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**• Higher Cumulative Return:** we feel that WTSDG’s ability to offer lower valuations, higher growth expectations and higher quality characteristics is even more impressive considering the performance record. As we mentioned above, people usually equate higher prices with higher valuations, but that isn’t always the case. We feel that the fundamental characteristics of WTSDG are still very attractive across many statistics compared to the Russell 2000 value, even given the strong outperformance since Index inception.

<sup>1</sup>Source: Bloomberg, as of 3/31/15.

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.

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## DEFINITIONS

**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.

**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.

**Dividend growth**: The growth in trailing 12-month dividends for the specified universe.

**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.

**Long-Term Earnings Growth Expectations**: Compilation of analyst estimates of the growth in operating earnings expected to occur over the next full business cycle, typically 3 to 5 years, sourced from Bloomberg.

**Dividend yield**: A financial ratio that shows how much a company pays out in dividends each year relative to its share price.

**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.