ACTIVE MANAGEMENT IN SMALL CAP EQUITIES — NO PROOF OF OUTPERFORMANCE?

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I recently had a conversation with Craig Lazzara, Head of Index Investment Strategy at S&P Dow Jones Indices, about his research on dispersion—a factor he believes is very important in explaining the opportunities for active managers. According to Craig, current dispersion readings are quite low, which implies there are fewer opportunities for active managers than usual. Since there generally is higher dispersion in small caps than in large caps, I thought it would be interesting to see how active managers had performed against broad indexes in the small-cap category over the past decade. Did the greater dispersion and increased opportunities for differentiation lead to better performance for active managers? Turns out it did not for the majority of the periods analyzed. **There Are Many Ways to Invest** There are numerous ways to invest, but the decision usually starts with whether to invest in either active mutual funds or passive exchange-traded funds (ETFs). Some argue that active managers are best suited to outperform, especially in small-capitalization stocks, because they think this area tends to be less efficient. Recently, as a result of the broad market rally, these same proponents of active managers have insisted that today's environment is ripe for active managers to outperform, so I want to take a hard look at the numbers. In the table below, I compare how some small-cap indexes have performed against U.S. ETFs and open-end mutual funds in the Morningstar Small-Cap Blend category. **Small-Cap Study (12/31/2003–12/31/2013)**

	Average Annual Return			Calendar Year Return									
Index	3 years	5 years	10 years	2013	2012	2011	2010	2009	2008	2007	2006	2005	2004
WisdomTree SmallCap Earnings	18.32%	25.69%	N/A	45.37%	15.80%	-1.60%	26.60%	49.57%	-32.87%	N/A	N/A	N/A	N/A
S&P SmallCap 600	18.42%	21.37%	10.65%	41.31%	16.33%	1.02%	26.31%	25.57%	-31.07%	-0.30%	15.12%	7.68%	22.65%
Russell 2000	15.67%	20.08%	9.07%	38.82%	16.35%	-4.18%	26.86%	27.17%	-33.79%	-1.57%	18.37%	4.55%	18.33%
Did Managers Outperform the Specified Index?													
WisdomTree SmallCap Earnings	No	No	N/A	No	No	No	No	No	No	N/A	N/A	N/A	N/A
S&P SmallCap 600	No	No	No	No	No	No	No	Yes	No	No	Yes	No	No
Russell 2000	No	Yes	No	No	No	Yes	No	Yes	No	Yes	No	Yes	Yes
Percentage of Managers Beaten by the Specified Index													
	3 years	5 years	10 years	2013	2012	2011	2010	2009	2008	2007	2006	2005	2004
WisdomTree SmallCap Earnings	88.9%	96.4%	N/A	91.7%	58.0%	68.2%	60.8%	90.3%	65.3%	N/A	N/A	N/A	N/A
S&P SmallCap 600	89.6%	70.0%	86.3%	79.9%	66.6%	91.4%	57.3%	26.9%	78.9%	53.3%	45.9%	65.7%	81.6%
Russell 2000	54.8%	48.8%	56.3%	64.0%	67.8%	38.0%	63.1%	39.6%	57.0%	42.4%	78.1%	32.8%	46.5%
Number of Managers	678	654	504	722	735	731	718	706	666	643	604	572	545

Sources: WisdomTree, Zephyr StyleADVISOR, Morningstar; 12/31/2003–12/31/2013. Past performance is not indicative of future results. You cannot invest directly in an index.

• **Majority of Active Managers Underperform** – Over the most recent 10-year period the Russell 2000 Index and the S&P SmallCap 600 Index outperformed 56.3% and 86.3%, respectively, of managers in the Morningstar Small-Cap Blend category. The Russell 2000 also outperformed more than 50% of the Morningstar category in 5 out of the past 10 calendar years, and the S&P SmallCap 600 outperformed more than 50% of the category in 8 out of the past 10 calendar years. Notice the differentiation between the S&P Small Cap 600 and the Russell 2000. I discussed the benefits of including a profitability and quality screen in the S&P methodology in this research piece, and we can see its track record added considerable value by substantially increasing the percentage of active managers it beat. • **WisdomTree SmallCap Earnings Index** – WTSEI has outperformed over 91% of the Morningstar category since its inception.[1] I find it impressive that the Index was able to outperform over 90% of the category during the 2009 and 2013 calendar years, which were some of the best-performing years for the category. It is even more impressive considering the Index also outperformed close to two-thirds of the category in 2008 and 2011, which were among the worst. **Why Indexes?** Like all investors, active managers are susceptible to behavioral biases that can negatively affect their investment decisions. This is illustrated through the table above, which shows that the majority of active managers actually underperformed their respective benchmarks over the most recent 10-year period and over the majority of calendar years. For believers of active management, I think these results are even more alarming given the fact that the Russell and S&P indexes are market cap-weighted. Market cap-weighted indexes typically give the greatest weight to the stocks with the highest prices, without regard to any measure of fundamental value. As a result, the market capitalization-weighted index may tend to over-weight more expensive equities and under-weight those that may be relatively less expensive. **Why Smart Beta?** Although I do not feel active management is necessary to provide compelling long-term returns, I do think it is important to invest with a disciplined focus on valuations. WisdomTree uses a rules-based methodology to weight the companies in its Indexes by their underlying fundamentals, such as dividends or earnings, because at WisdomTree we believe that stock markets are not always efficient. Furthermore, WisdomTree rebalances its Indexes annually to adjust for relative value. As I referenced above, although dispersion levels can't predict active manager performance, the current low dispersion levels imply that there are potentially fewer opportunities for active managers than usual. Given this reading and the historical underperformance of active managers against traditional indexes, I do not think it is time for active management within small-cap equities. [1]Sources: Zephyr StyleADVISOR, Morningstar; Index inception: 02/01/2007.

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DEFINITIONS

Dispersion : A measure of the statistical distribution of portfolio returns.

Active manager : Portfolio managers who run funds that attempt to outperform the market by selecting those securities they believe to be the best.

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

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.

Actively managed mutual funds : Investment strategies that are not designed to track the performance of an underlying index.

Passive exchange-traded funds : Exchange-traded funds that track the performance of an index.

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.

Open-End Mutual Funds : Type of mutual fund that does not have restrictions on the amount of shares the fund will issue, so if demand is high enough the fund will continue to issue shares. These funds buy back shares when investors wish to sell.

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.

WisdomTree SmallCap Earnings Index (WTSEI) : measures the performance of earnings-generating companies within the small-capitalization segment of the U.S. Stock Market. The index is comprised of the companies in the bottom 25% of the market capitalization of the WisdomTree Earnings Index after the 500 largest companies have been removed.

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.

Fundamental value : The value of a firm that is related to a company’s actual operations and production as opposed to changes in share price.

Smart Beta : A term for rules-based investment strategies that don’t use conventional market-cap weightings.

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.

Fundamentals : Attributes related to a company’s actual operations and production as opposed to changes in share price.

Efficient Market Hypothesis : Current share prices correctly reflect all available information about publicly traded firms and continually incorporate the emergence of new information on a nearly instantaneous basis; there are no bubbles, and firms are neither expensive nor inexpensive.

Rebalance : An index is created by applying a certain set of selection and weighting rules at a certain frequency. WisdomTree rebalances, or re-applies its rules based selection and weighting process on an annual basis.