

ARE YOU READY FOR A CYCLICAL REVERSION?

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Things have changed.

Looking at 100 years of data, the below chart from Morgan Stanley shows that cyclical sectors have never had a lower weight in the [S&P 500](#).

Growth, stability and defense sectors have never had a greater weight—now more than three-quarters of the Index.¹

S&P 500 Index Constituents Have Shifted Over Time



*Information technology, communications, health care, consumer staples, consumer discretionary, utilities, real estate **Financials, industrials, materials, energy

Source: Bloomberg as of June 22, 2020

Cyclical sectors are Financials, Industrials, Energy and Materials.

Growth, stability and defense sectors are Tech, Communications, Health Care, the Consumer sectors, Utilities and Real Estate.

So much of market performance can be attributed to this sector classification.

The growth, stability and defense sectors have fared particularly well during the 2020 pandemic. Tech-enabled growth company employees were able to work effectively from home. The counter-cyclicality of defense sectors shined through as people stayed at home, stocked up on staples and streamed movies from the couch.

Cyclicals had their revenue wiped out directly by, or as a close byproduct of, the economic shutdown.

- The airlines and airplane manufacturers within the Industrials sector had their businesses grind to a halt.
- Banks had to provision losses for soured loans.

- Energy companies had to write down asset values from plunging oil prices.
- Materials businesses were impaired by a standstill in construction activity.

So, a question: If we emerge from the pandemic shutdown with a more cyclical rebound and better economic environment heading into 2021, how can we get cyclical sector exposure when the traditional indexes keep lowering their weight to these sectors?

One idea with sector exposures that's almost the opposite of the S&P 500 is our [U.S. SmallCap Quality Dividend Growth Fund \(DGRS\)](#).

First, [small caps](#) have historically tended to be more cyclical than [large caps](#) by their nature. Because they have less [diversified](#) businesses, they are often more tied to economic fluctuations.

But, from sector categorization, this cyclicity is ultimately reinforced and accentuated.

Instead of having less than 24% in cyclical sectors, DGRS has 65%, with more than double the Financials sector weight, three times the Industrials sector weight and more than six times the Materials sector weight. Energy is the only sector that didn't qualify for an over-weight within the cyclical category.

SECTOR EXPOSURE				
Category	Sector	DGRS	S&P 500 Index	Russell 2000 Index
Cyclicals	Energy	0.2%	2.8%	2.3%
Cyclicals	Financials	22.7%	10.1%	16.3%
Cyclicals	Industrials	25.2%	8.0%	14.5%
Cyclicals	Materials	16.9%	2.5%	4.0%
Growth Stability and Defensives	Communication Services	2.3%	10.8%	2.5%
Growth Stability and Defensives	Consumer Discretionary	9.8%	10.8%	11.8%
Growth Stability and Defensives	Consumer Staples	3.9%	7.0%	3.3%
Growth Stability and Defensives	Health Care	3.6%	14.6%	20.6%
Growth Stability and Defensives	Information Technology	5.9%	27.5%	13.9%
Growth Stability and Defensives	Real Estate	2.7%	2.8%	7.1%
Growth Stability and Defensives	Utilities	6.8%	3.1%	3.6%
Cyclicals		65.0%	23.4%	37.2%
Growth Stability and Defensives		35.0%	76.6%	62.8%

Sources: WisdomTree, FactSet, 6/30/20. You cannot invest directly in an index. Weights subject to change.

On a pure [valuation](#) basis, people often think of small caps as being particularly expensive—more than 30% of the [Russell 2000](#) is currently unprofitable, after all. That's up from about 20% pre-pandemic.

But as of June 30, only about 6% of DGRS was unprofitable. More companies will become unprofitable as earnings come in. Even including these negative earnings, the [trailing 12-month price-to-earnings \(P/E\) ratio](#) was six multiple points below that of the S&P 500.

People tend to not think of small caps for [dividends](#), because 50% of the Russell 2000 is non-dividend payers. But this basket of lower-multiple small caps does have a considerably higher dividend yield than the S&P 500.

These dividends were also not coming at the expense of [buybacks](#), as the trailing 12-month net buyback yield was similar to that of the S&P 500. For a small-cap basket this is fairly unique as small-cap indices generally tend to issue shares and see negative net buyback ratios.

Characteristic	DGRS	S&P 500 Index	Russell 2000 Index
Dividend Yield	3.34%	1.92%	1.84%
Net Buyback Yield	1.83%	2.08%	-1.16%
Gross Buyback Yield	2.85%	2.64%	2.12%
Shareholder Yield	5.17%	4.00%	0.68%
Price/Earnings (P/E)	16.11	22.36	85.05
Price/Earnings (P/E) Excl. Negative	14.34	21.51	15.87
Percent Negative Earn	5.89%	1.49%	30.66%
Price-Cash Flow (P/CF)	7.64	12.60	10.96
Price/Book (P/B)	1.73	3.54	1.75
Wgt Ave. Est. Long-Term Growth	9.58%	10.14%	8.76%

Sources: WisdomTree, FactSet, 6/30/20. Past performance is not indicative of future results. You cannot invest directly in an index.

For standardized performance of DGRS, please click [here](#).

For definitions of terms in the table, please visit our [glossary](#).

We have been hosting [weekly conference calls with Professor Jeremy Siegel](#) where he outlines a view for a strong economy in 2021, supported by very robust growth in the [M1](#) money supply measures and all the pandemic relief efforts. Siegel believes that, as we regain confidence to open the economy in 2021, all this [liquidity](#) pumped into the system will likely support higher [inflation](#) and potentially a cyclical rebound.

The big [market cap](#) indexes keep lowering exposure to these sectors, per the chart above. For investors seeking to add exposure to that cyclical growth story, DGRS could be a very good option to reflect this growth rebound.

For advisors who use model portfolios in their practice, DGRS is also the small-cap strategy that WisdomTree includes in model portfolios we created with Professor Siegel.

¹The Wall Street Journal's Daily Shot email series recently featured this chart.

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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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DEFINITIONS

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.

Diversification: A risk management strategy that mixes a wide variety of investments within a portfolio.

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.

Trailing 12-month earnings: is the sum of a company’s earnings for the previous 12 month.

Dividend: A portion of corporate profits paid out to shareholders.

Buyback: When a company uses its own cash to purchase its own outstanding shares; may positively impact the share price.

M1: refers to the M1 money supply that includes physical money, such as coins and currency, as well as demand deposits, checking accounts, and Negotiable Order of Withdrawal accounts.

Liquidity: The degree to which an asset or security can be bought or sold in the market without affecting the asset’s price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

Inflation: Characterized by rising price levels.

Market Capitalization: $\text{Market cap} = \text{share prices} \times \text{number of shares outstanding}$. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.