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# PROFITABILITY AND PRUDENCE IN SMALL-CAP EQUITIES

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[Small-cap](#) equities have captivated investors for decades, as the allure of exceptional returns and pursuit of diamonds in the rough have been the subject of extensive research and speculation.

[The evidence of small caps outperforming larger companies over time](#), known as the [size factor](#), was first documented in the seminal research of Eugene Fama and Kenneth French, and it has intrigued investors ever since.

But for every diamond in the U.S. small-cap market, there are dozens more that may be better off avoided.

The [Russell 2000 Index](#) is a broad benchmark for U.S. small-cap companies and has averaged about 18% of its weight in companies with *negative* earnings since early 2007. This trend is consistent across investment styles as well, with the [Russell 2000 Value Index](#) and [Russell 2000 Growth Index](#) maintaining 16% and 20% exposure, respectively.

What that means, is that no matter how you segment the market, nearly one in every five small-cap companies in the U.S. is currently unprofitable. That's a harrowing thought.

But what if there was a way to access the U.S. small-cap market that steered investors away from unprofitable companies, whose [valuations](#) and business prospects are based largely on speculation?

## Weighting by Earnings vs. Waiting for Earnings

In 2007, wisdomTree introduced a unique way to analyze small-cap equities that focused objectively on healthy businesses with robust operations and consistent profitability. Since then, the [WisdomTree U.S. SmallCap Index](#) and its earnings-weighted methodology have provided a track record of long-term outperformance with an emphasis on higher-quality companies.

Since its inception, wisdomTree's methodology has maintained an average 12% under-weight in companies with negative earnings compared with the Russell 2000 Index. The emphasis on profitable companies has been beneficial over the long term as well because wisdomTree's methodology has outperformed the Russell 2000 Index by almost 90 [basis points \(bps\)](#). Likewise, the systematic under-weight in unprofitable companies has accounted for over 25% of this outperformance, making it the second-greatest contributor when analyzing performance by [earnings yield](#).

Figure 1: Since Inception Attribution by Earnings Yield

Category	Attribution Component				Average Category Weight			Category Performance	
	Allocation	Selection	Interaction	Total	WisdomTree U.S. SmallCap Index	Russell 2000 Index	Active Weight	WisdomTree U.S. SmallCap Index	Russell 2000 Index
1st Quintile (Lowest P/E)	0.08%	0.18%	0.10%	0.36%	29.52%	12.72%	16.79%	7.63%	6.47%
2nd Quintile	0.04%	-0.02%	0.00%	0.02%	22.10%	15.97%	6.13%	6.47%	6.75%
3rd Quintile	0.00%	0.17%	0.01%	0.18%	18.32%	16.92%	1.41%	8.06%	6.94%
4th Quintile	0.04%	0.04%	0.01%	0.09%	14.66%	17.45%	-2.79%	7.07%	6.85%
5th Quintile (Highest P/E)	0.01%	0.24%	-0.11%	0.15%	8.50%	17.53%	-9.03%	8.37%	6.81%
Negative Earners	-0.01%	0.03%	0.22%	0.26%	5.45%	17.55%	-12.10%	3.07%	5.21%
N/A	-0.01%	-0.15%	0.00%	-0.16%	1.45%	1.86%	-0.41%	-2.03%	-2.50%
<b>Total</b>	<b>0.16%</b>	<b>0.49%</b>	<b>0.24%</b>	<b>0.89%</b>	<b>100.00%</b>	<b>100.00%</b>	<b>0.00%</b>	<b>7.44%</b>	<b>6.55%</b>

Source: WisdomTree, FactSet as of 8/31/19. Analysis period: 2/1/07 – 8/31/19. Subject to change. Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns. WisdomTree, its affiliates and their independent providers are not liable for any informational errors, incompleteness or delays or for any actions taken in reliance on information contained herein.

For definitions in this chart, please visit our [glossary](#).

An earnings-weighted approach to small-cap equities can also help protect on the downside during periods of heightened volatility because high-quality companies can simultaneously provide a defensive allocation. During the painful fourth quarter of 2018, wisdomTree’s method managed to outperform the Russell 2000 Index by 115 bps, with its 13% under-weight in negative earners providing more than two-thirds of the advantage.

Figure 2: Earnings Yield Attribution During the Fourth Quarter of 2018

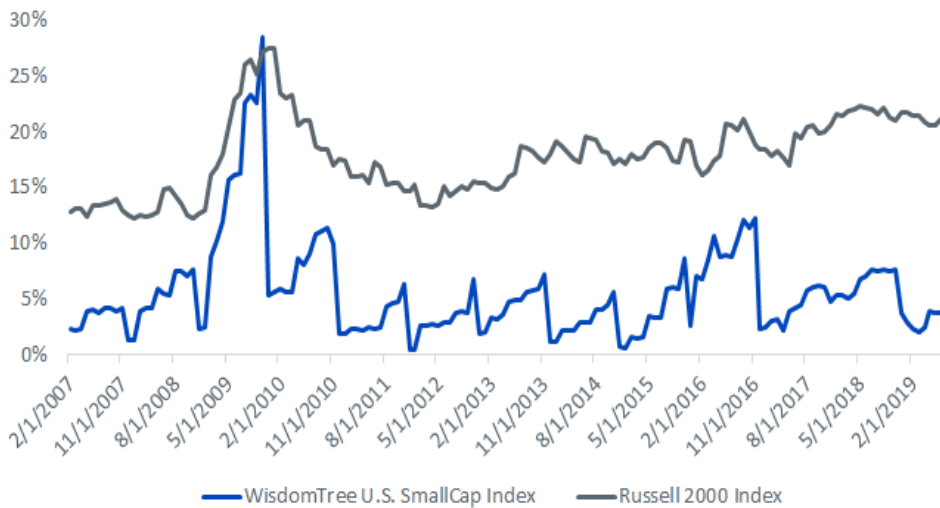
Category	Attribution Component				Average Category Weight			Category Performance	
	Allocation	Selection	Interaction	Total	WisdomTree U.S. SmallCap Index	Russell 2000 Index	Active Weight	WisdomTree U.S. SmallCap Index	Russell 2000 Index
1st Quintile (Lowest P/E)	-0.13%	0.29%	0.22%	0.38%	23.41%	13.17%	10.24%	-19.41%	-21.36%
2nd Quintile	0.09%	-0.14%	-0.02%	-0.07%	19.55%	14.33%	5.22%	-19.05%	-18.54%
3rd Quintile	0.11%	-0.08%	0.01%	0.04%	20.09%	16.65%	3.44%	-18.02%	-17.79%
4th Quintile	0.08%	0.07%	0.02%	0.17%	18.71%	16.61%	2.10%	-15.92%	-16.53%
5th Quintile (Highest P/E)	-0.05%	0.34%	-0.15%	0.13%	9.70%	17.32%	-7.62%	-17.98%	-19.64%
Negative Earners	0.88%	-0.21%	0.11%	0.79%	7.55%	21.39%	-13.84%	-25.89%	-25.31%
N/A	-0.06%	-0.12%	-0.11%	-0.29%	0.99%	0.53%	0.46%	-49.29%	-35.05%
<b>Total</b>	<b>0.91%</b>	<b>0.16%</b>	<b>0.08%</b>	<b>1.15%</b>	<b>100.00%</b>	<b>100.00%</b>	<b>0.00%</b>	<b>-19.05%</b>	<b>-20.20%</b>

Sources: WisdomTree, FactSet, as of 8/31/19. Analysis period: 9/30/18–12/31/18. Subject to change. Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns. WisdomTree, its affiliates and their independent providers are not liable for any informational errors, incompleteness or delays or for any actions taken in reliance on information contained herein.

### Seeking More than Just Profitability

WisdomTree’s tendency to avoid unprofitable companies isn’t an anomaly or a by-product of the methodology; it’s an objective. When we screen for companies with positive earnings each November, ahead of the Index’s formal rebalance in December, we’re selecting the healthiest and most operationally efficient companies. As a result, we also eliminate a majority of those with negative earnings. Since inception, our methodology has managed to eliminate an average weight of 7% in unprofitable companies during every rebalance.

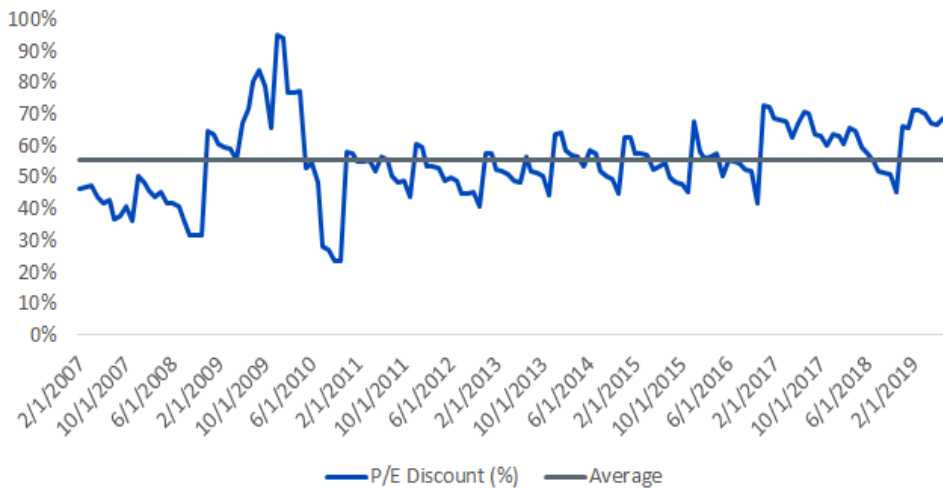
Figure 3: Percent Weight in Companies with Negative Earnings



Source: WisdomTree, as of August 31st, 2019. Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns. WisdomTree, its affiliates and their independent providers are not liable for any informational errors, incompleteness or delays or for any actions taken in reliance on information contained herein.

The reduction in unprofitable companies is especially valuable when you compare WisdomTree’s fundamentals against the Russell 2000 Index. The emphasis on companies with larger earnings directly reduces the Index’s [price-to-earnings ratio](#), offering it at a 70% discount to the broader small-cap market. This is also consistent over time. Since inception, the Index has maintained a 55% [valuation](#) discount relative to the small-cap market.

Figure 4: WisdomTree Index P/E Ratio Discount (%) Relative to Russell 2000 Index



Source: WisdomTree, as of August 31st, 2019. Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns. WisdomTree, its affiliates and their independent providers are not liable for any informational errors, incompleteness or delays or for any actions taken in reliance on information contained herein.

But the Index still has more to offer beyond attractive valuations in an expensive market.

The earnings-weighted methodology systematically improves the profitability profile of the Index as well. Both [return on equity](#) and [return on assets](#) are doubled relative to the Russell 2000, illustrating exactly how the strategy delivers higher-quality companies because of its earnings focus. Couple this with less expensive valuations, and WisdomTree’s methodology is capable of providing more than just profitable companies.

**An Enhanced Approach to U.S. Small Caps**

WisdomTree’s small-cap approach is systematically designed to avoid mediocre companies in favor of higher-quality ones, and the benefits of this approach are evident. In our view, financial markets will be ripe with uncertainty for the remainder of 2019, and that may extend well into 2020. We think now is an appropriate time to emphasize quality companies that can provide upside potential over the long term and downside protection during intermittent periods of volatility. Fortunately for investors looking to invest in small caps, the [WisdomTree U.S. SmallCap Fund \(EES\)](#), which seeks to track our Index, may be able to provide both.

*Unless otherwise stated, all data is sourced from WisdomTree and FactSet as of 8/31/2019.*

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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](#)

View the online version of this article [here](#).

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## DEFINITIONS

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

**Size Factor**: the average returns of small portfolios minus the average returns of the large portfolios after adjusting for growth or value tendencies.

**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.

**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.

**Russell 2000 Growth Index**: Measures the performance of the small-cap growth segment of the U.S. equity universe. It includes those Russell 2000 Index companies with higher price-to-book ratios and higher forecasted growth values.

**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.

**Basis point**: 1/100th of 1 percent.

**Earnings yield**: The earnings per share for the most recent 12-month period divided by the current market price per share. The earnings yield (which is the inverse of the P/E ratio) shows the percentage of each dollar invested in the stock that was earned by the company.

**Volatility**: A measure of the dispersion of actual returns around a particular average level.

**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.

**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.