

BEWARE OF ZOMBIES IN U.S. SMALL CAPS

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By now, many investors can probably recite most investment strategists’ expectations for 2021 in their sleep. The common theme is an anticipated economic recovery.

Although forecasts are inherently limited, after a tumultuous 2020, this sanguine consensus is certainly encouraging. One sector on many investors’ minds is U.S. [small caps](#). However, we think there’s a prevalent risk that is dangerously overlooked: historically high [valuations](#) and deteriorating fundamentals.

- The [Russell 2000 Index](#) is currently trading at a [P/E ratio](#) of 496x earnings, a multiple so high it’s practically meaningless. Its [forward P/E](#) multiple is more mundane by its own standard (clocking in at 53x estimated earnings), but still nearly twice its historical average.
- Moreover, the health of the small-cap market, as measured by Russell 2000, has continued to deteriorate, all while investors have become comfortable throwing money at it with little regard for price.

We think WisdomTree has a compelling alternative that can provide small-cap access without paying astronomical valuations or sacrificing the quality of its underlying company exposures: the [WisdomTree U.S. SmallCap Fund \(EES\)](#).

It’s Simple: Profitability

Launched in 2007, EES uses an [earnings-weighted](#) methodology to access small-cap U.S. equities. It’s a key differentiator from [market cap-weighted](#) alternatives. Selecting and weighting by a company’s contribution to the overall [Earnings Stream](#)[®] (using trailing 12-month earnings) gives the Fund an inherent emphasis: profitability.

The profitability focus is significant, and its value is evident. **The weight of unprofitable companies in the Russell 2000 is nearing 40%, more than twice its average weight since EES’s inception in early 2007.** This percentage has also been above its average since mid-2017, signaling that while valuations have gone stratospheric, so has the junk that investors are unknowingly paying for.

On the other hand, the weight of unprofitable companies in EES is sitting right at its long-term average of 6%. Moreover, at the Fund’s annual rebalance, the earnings-weighted methodology systematically reduces the weight to unprofitable companies so that valuations and junk don’t grow unabated.

Fund / Index	% of Negative Earners Over Time			
	Range (2/2007 - 1/2021)	Weight as of 1/31/21	Average (since EES Inception)	% Above / Below Avg.
EES	0.6% - 28%	6.3%	6.1%	3.75%
Russell 2000	12.3% - 38.9%	38.9%	19.0%	104.33%

Source: WisdomTree, FactSet as of 1/31/2021. You cannot invest directly in an index. Subject to change.

But How Bad Is *Bad*?

Despite this, negative earnings are not always an irrefutable sign of a bad investment.

For small companies, especially those in their infancy or in nascent markets, it's common to have negative earnings as the industry grows, operations improve, and consumer recognition and demand for their product or service increases.

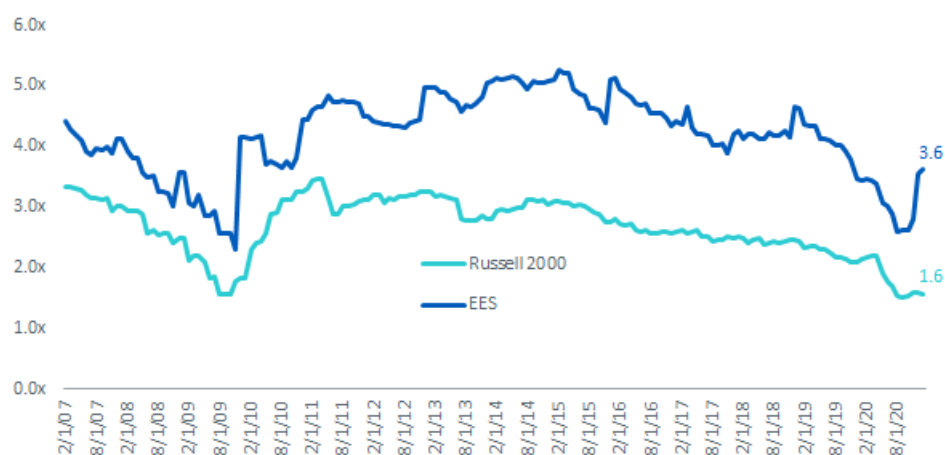
That means it's prudent to examine another metric to discern the health of the small-cap market. We think [interest coverage ratios](#) are informative and especially helpful in identifying "[zombie companies](#)."

While there are varying definitions for zombies, the essence is the same: zombie companies barely generate enough cash to service the interest on their debt, instead relying on loans from creditors and external sources to stay afloat.

There's cause for concern since the interest coverage ratio for the Russell 2000 is a measly 1.5x interest expense, meaning operating earnings (measured by [EBIT](#)) are barely enough to service their debts. Furthermore, interest coverage has been on a steady downtrend since about 2011, save for a few brief periods of improvement. The current multiplier is also more than a full point less than its long-term average of 2.7x interest expense.

The underlying companies in EES have much more breathing room, another benefit of the emphasis on positive [trailing earnings](#). Despite the pandemic's afflictions in 2020, interest coverage has steadily recovered since economic activity cratered, settling in at 3.6x interest expense as of January. This is still slightly below the long-term average of 4.2x interest expense, but the upward trend is encouraging.

Interest Coverage Ratios



Source: WisdomTree, FactSet as of 1/31/2021. You cannot invest directly in an index. Past performance is not indicative of future results.

Back to the Basics

Now that we know what to be concerned by, we can recognize the attractive opportunities as well. Once again, the story for EES is compelling.

P/E and forward P/E valuations are not even on the same planet, which is reassuring. But profitability measurements such as [return-on-equity \(ROE\)](#) and [return-on-assets \(ROA\)](#) are intriguing as well. EES delivers 10x more ROE and 2% ROA, compared to virtually none for the Russell 2000. That results in about half as much [leverage](#) the broader index as well.

Fund/Index	Fundamental Comparison as of 1/31/2021				
	P/E	Forward P/E	ROE	ROA	Leverage
WisdomTree U.S. SmallCap Fund (EES)	14.9	13.7	11.04%	2.01%	5.5
Russell 2000 Index	496.1	55.9	1.09%	0.12%	9.2

Source: WisdomTree, FactSet as of 1/31/2021. You cannot invest directly in an index. Past performance is not indicative of future results. Favorable fund metrics do not guarantee favorable fund performance.

Time to Reassess Small-Cap Allocations

Small caps are in a precarious position. Market cap-weighted approaches are forcing

investors to pay more than ever for lower quality and inefficient companies.

We believe in the benefits of a long-term allocation to small caps, but *what* you own is more important than just owning an allocation.

EES has historically delivered healthy underlying companies with controlled valuations, and can be a beneficial way to access an otherwise speculative market.

Important Risks Related to this Article

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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.

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.

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.

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.

Earnings Stream[®]: Earnings per share x the number of shares outstanding. For an index, these totals are added for all constituents.

Coverage ratio: Also referred to as interest coverage ratio, which compares earnings before interest and taxes to interest expense.

Zombie Companies: A term used for companies that are operating in debt, near bankruptcy.

Earnings before interest and taxes (EBIT): A measure of a firm's profit that includes all expenses except interest and income tax expenses.

Trailing Earnings: The amount of profit that a company produces during prior fiscal year.

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.

Leverage: Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.