

# THE FUNDAMENTAL DIFFERENCE FOR U.S. LARGE CAPS

Tripp Zimmerman — Director, Research

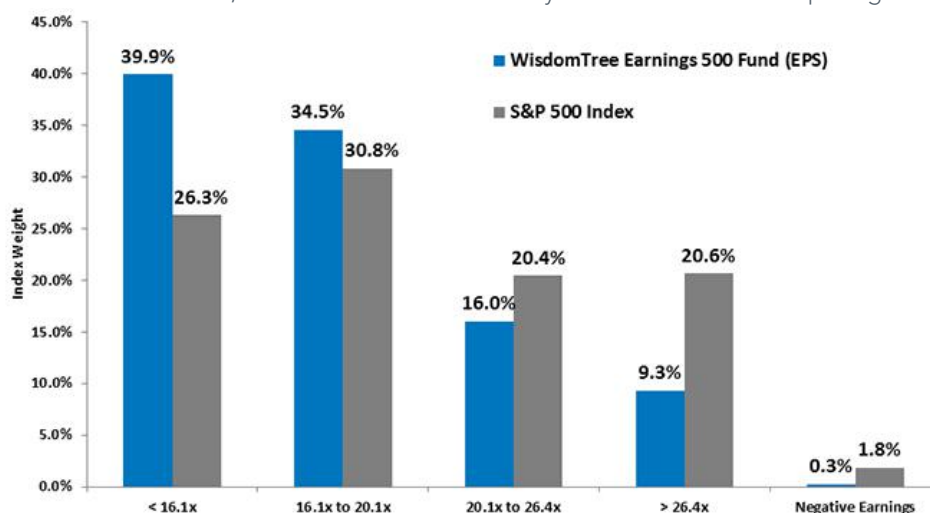
06/18/2015

On May 21, 2015, the [S&P 500 Index](#) closed at a record high. Since the March 2009 lows, the index has appreciated by over 210% on a price basis and, as a result, the [price-to-earnings \(P/E\) ratio](#) has expanded from 11x to 18.8x<sup>1</sup>. Now, six years into this [bull](#) market, many market participants are concerned about both the price appreciation and multiple expansion, actively debating whether the markets are ripe for a pullback. If you are also concerned about [valuations](#), then we think you should look to [fundamentally weighted](#) investment options, which tend to be more sensitive to valuations. WisdomTree feels that weighting by [market capitalization](#), which does not weight, consider or rebalance back to any fundamental value, renders an investment most susceptible to bubbles. We believe that a disciplined strategy of anchoring allocations back to a concept of relative value, based on [fundamentals](#) such as [dividends](#) or earnings, can protect against [valuation risks](#). **The Fundamental Difference** The [WisdomTree Earnings 500 Index \(WTEPS\)](#) seeks to provide exposure to the 500 largest profitable U.S. companies but to do so while maintaining sensitivity to valuation. To help achieve this, the Index weights companies by the profits they generate, rather than their market cap, and rebalances back to profitability on an annual basis. WisdomTree's rebalance process typically is driven by:

- Earnings Growth: Companies increasing profits see their weight increased
- Relative Performance:

- Underperformers typically see their weight increased
- Outperformers often see their weight decreased

**P/E Ratio Weight Distribution** The annual Index rebalance process tends to shift weight to firms with the lowest P/E ratios and away from firms with the highest P/E ratios. The chart below helps visualize the distribution of stocks by their P/E ratios for the [WisdomTree Earnings 500 Fund \(EPS\)](#), which seeks to track WTEPS before fees and expenses, against the S&P 500 Index, one of the most widely followed market cap-weighted indexes. **P/E Distribution**



Sources: WisdomTree, Bloomberg, as of 5/21/15. P/E ranges were selected using quartiles from the S&P 500 Index. Subject to change.

## • More Weight to Lower-

**Priced Stocks** – The WisdomTree Earnings 500 Fund has almost 75% of its weight in the two lowest-priced quartiles, which is over 17% more weight than the S&P 500 Index. There is a natural tendency of earnings-weighted approaches to reduce weight to stocks whose prices have appreciated at a faster rate than their earnings, and concurrently to increase

weight to stocks that have fallen in price despite exhibiting positive earnings growth. • **Less Weight to Higher-Priced Stocks** – WisdomTree's 17% over-weight to lower-priced stocks comes from a 17% under-weight to the higher-priced segment of the market. EPS also has less than half the weight of the S&P 500 to stocks that fall in the highest P/E ratio quartile. • **Negative Earnings and Speculative Stocks** – Although profitability may fluctuate throughout the year, at each annual rebalance WisdomTree requires companies to be profitable before inclusion. This requirement limits the weight to firms we feel tend to be more speculative and of lower quality to zero. Although the weight to unprofitable firms is currently low for the S&P 500 Index as well, the index does not screen for profitability on an annual basis, so that number could potentially rise in times of market stress. <sup>1</sup>Source: Bloomberg, 3/9/09–5/21/15.

#### Important Risks Related to this Article

Funds focusing their investments on certain sectors increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

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](#).

## **IMPORTANT INFORMATION**

**U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.**

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages ([www.msci.com](http://www.msci.com))

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

## **DEFINITIONS**

**S&P 500 Index** : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

**Bullish** : a position that benefits when asset prices rise.

**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.

**Fundamental weighting** : A type of equity index in which components are chosen based on fundamental criteria as opposed to market capitalization. Fundamentally weighted indexes may be based on fundamental metrics such as revenue, dividend rates, earnings or book value.

**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.

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

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

**Valuation risk** : The risk of buying or over-weighting a particular stock that has appreciated significantly in price relative to its dividends, earnings or any other fundamental metric.