

# U.S. VALUATION WATCH: MORE THAN A PRICE STORY

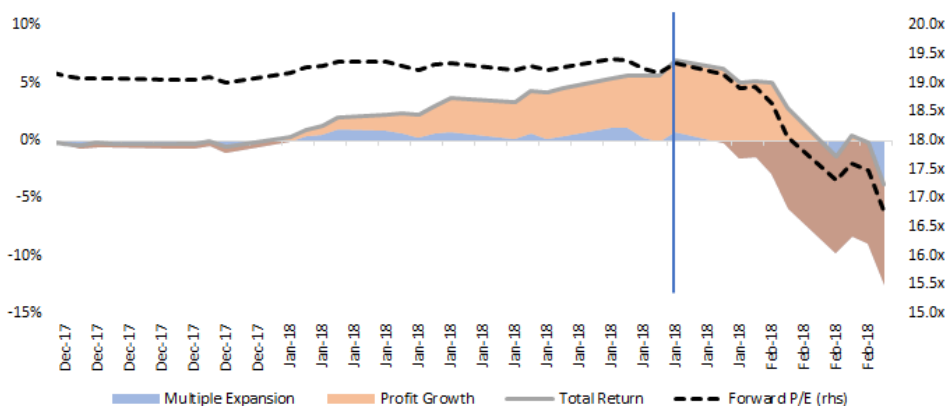
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Throughout 2017, a common theme at the forefront of many discussions about equity markets in the United States were the high [valuations](#) relative to history. It seems, however, that many of the discussions put a great emphasis on the numerator of metrics such as [forward price-to-earnings ratio](#), i.e., the price, rather than giving at least equal consideration to the denominator underpinning the ratio, namely the earnings.

## Price Masking Greater Earnings Expectations

Perhaps one of the main reasons investors focus so much on the numerator is because it is immediate; it is what we see on TV and on our screens all day long. However, it does not tell the whole story and can often distract us from what is going on under the hood. For instance, despite the [S&P 500 Index](#) returning 7.8% between the passage of tax reform on December 19, 2017, and the all-time high on January 26, 2018, there was indeed little multiple expansion in terms of forward P/E ratios.

## S&P 500 Index Profit Growth & Multiple Expansion



Sources: WisdomTree, FactSet, 12/19/17–2/8/18. Past performance is not indicative of future results. You cannot invest directly in an index.

## Implications of Tax Reform on [EPS](#) Estimates

As companies have continued to report their Q4 2017 earnings throughout January and into February, we have seen earnings estimates pick up significantly. A large part of this pickup in earnings estimates is attributable to the positive impact a lower corporate tax rate will have on the profitability of the market constituents. As a result, the denominator of the forward P/E has expanded, thus contracting the overall ratio.

Moreover, during the [correction](#), we saw dramatic forward P/E contraction, while the increases in growth expectations and profitability remained elevated (shown in orange). The result of the drop in prices combined with the boost in

earnings expectations is what led to the forward P/E contraction being as substantial as it was.

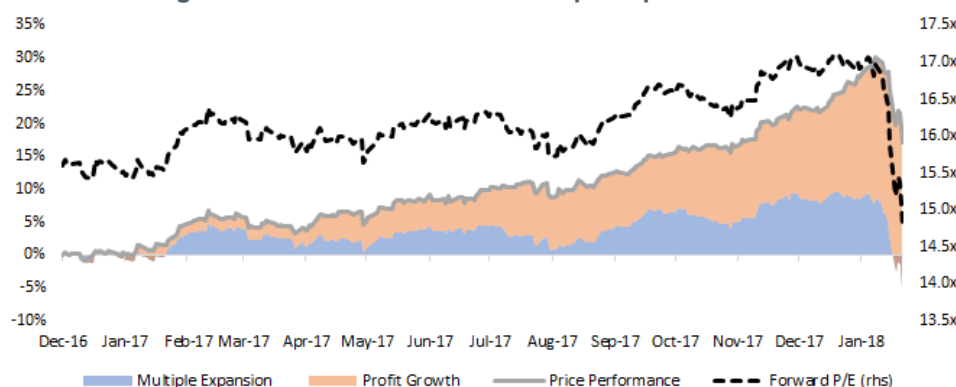
## The Right Tools for Valuation Management

As many investors familiar with WisdomTree may know, not all strategies are created equal. When it comes to valuation sensitivity, the WisdomTree earnings-weighted equity strategies are at the forefront of our toolkit.

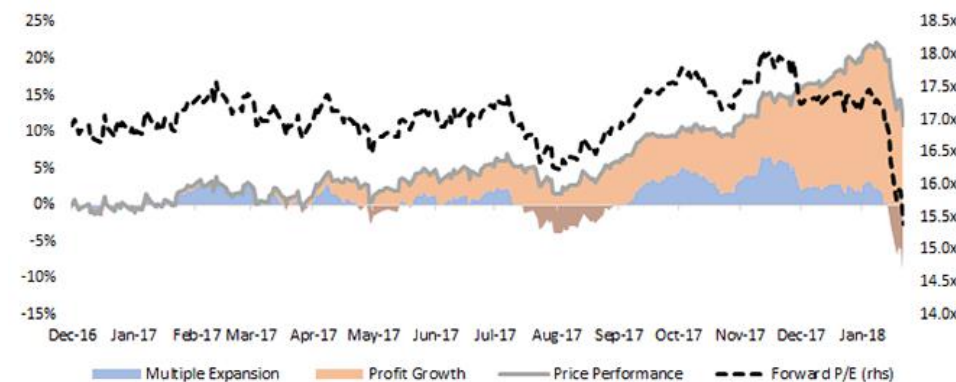
**Annual Rebalance:** Through yearly rebalancing and weighting by core earnings, the WisdomTree earnings strategies maintain a disciplined, fundamentally anchored approach to investing.

**Purge the Negative Earners:** By utilizing core earnings, these strategies remove unprofitable companies. This tends to result in significant valuation discounts versus the broad market—particularly in the small- and mid-cap segments.

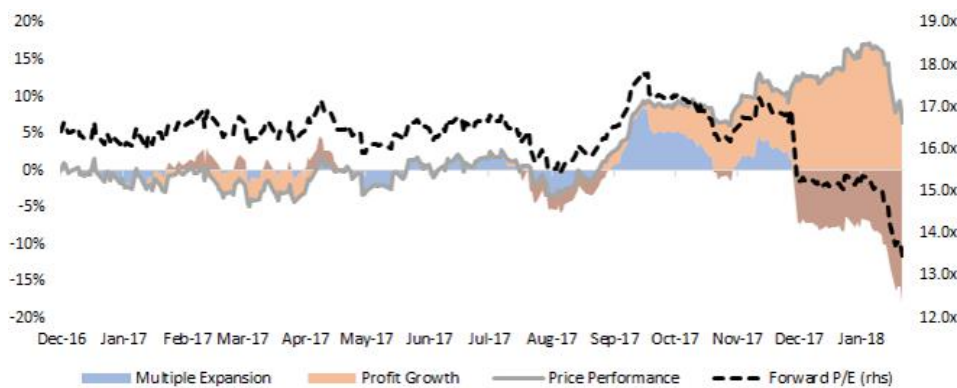
### WT U.S. Earnings 500 Index Profit Growth & Multiple Expansion



### WT U.S. MidCap Earnings Index Profit Growth & Multiple Expansion



### WT U.S. SmallCap Earnings Index Profit Growth & Multiple Expansion



Sources: WisdomTree, FactSet, 12/19/16–2/8/18. Past performance is not indicative of future results.

The charts above seek to show the valuation trip, so to speak, that the [WisdomTree U.S. Earnings 500 Index](#), [WisdomTree U.S. MidCap Earnings Index](#), and [WisdomTree U.S. SmallCap Earnings Index](#) have taken since their 2016 rebalance went into effect on December 19, 2016.

We first note the pronounced effect of the 2017 rebalance on both the MidCap and SmallCap Earnings Indexes as one of the features of this fundamentally weighted approach. Additionally, both strategies have experienced significant forward P/E contraction related to the aforementioned tax and correction effects.

While many investors may be preoccupied with the timing of the correction and whether to “buy the dip,” this analysis shows that the underlying fundamentals continue to improve irrespective of how the top line may be behaving.

For the top 10 holdings of EZM please visit the Fund's fund detail page at <https://www.wisdomtree.com/investments/etfs/equity/ezm>

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.

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You cannot invest directly in an index.

## **DEFINITIONS**

**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.

**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.

**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.

**Earnings per share** : Total earnings divided by the number of shares outstanding. Measured as a percentage change as of the annual Index screening date compared to the prior 12 months. Higher values indicate greater growth orientation.

**Correction** : A drop of 10% or greater in an Index or stock from a recent high.

**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.