

# ARE STOCK PRICES DISCONNECTED FROM EARNINGS?

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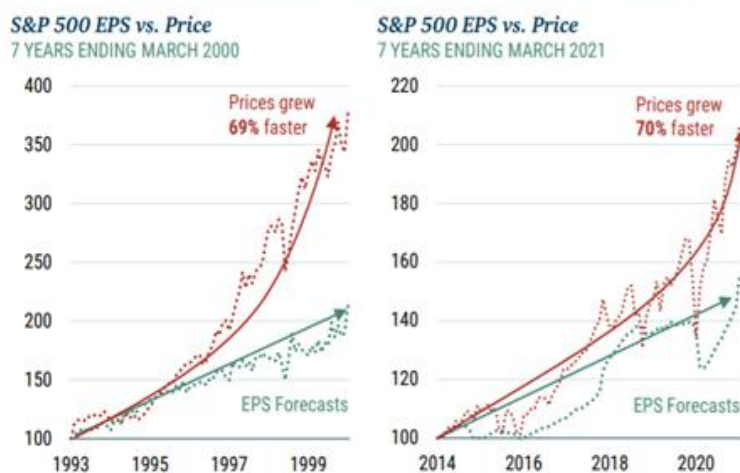
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The team at GMO recently came out with their mid-year investor letter and one chart raised some alarm bells.

In the chart below, we see that in the seven years ending March 2000, earnings forecasts were growing at a very healthy clip—over 11% per year. The issue was that excitement for technology stocks was so high that prices grew 69% faster.

In the seven years ending March 2021, prices have now grown 70% more than earnings forecasts.

REMINDER: THERE ARE NO BAD ASSETS...JUST BAD PRICES



Source: GMO, I/B/E/S

EPS forecasts are 2-year forecasts. In the first chart, EPS forecasts grew at an annualized rate of 11.1%; in the second chart, EPS forecasts grew at an annualized rate of 6.4%.

EPS stands for earnings per share.

These rising price levels are symbolic of more elevated market [valuations](#)—which gets magnified in [market capitalization-weighted](#) indexes that lean heavier into stocks that are already rising the most.

## Reconnecting Stocks with their Earnings

In February 2007, WisdomTree launched a suite of [earnings-weighted](#) stock indexes that reconnects stock allocations to their underlying earnings. The valuation discounts we see today in this earnings-weighted family are some of the widest gaps compared to their market cap-weighted counterparts that we've seen since inception.

Using trailing earnings, which makes the market look more expensive, the valuation gaps for WisdomTree's earnings-weighted strategies compared to the S&P family of market cap-weighted benchmarks, ranges from 31% for [large caps](#) to 57% for [small caps](#).

Using estimated earnings for 2021, the valuations look more reasonable for the cap-weighted market: around 23 times for [S&P 500](#) and 20–21 times for [mid](#) and small caps.

The discount for WisdomTree's earnings-weighted strategies using forward-looking earnings ranges from 19% for large caps to 36% for small caps.

Often, one assumes you sacrifice [quality](#) and profitability and get 'junkier' stocks when you look for valuation discounts.

But the earnings-weighted approach and additional risk screens we added to our Indexes have led to profitability premiums across all size segments. You can see this in profit margins ([return on sales](#)), [ROE](#) or [ROA](#) metrics.

In the below tables, we compare the [WisdomTree U.S. LargeCap Fund \(EPS\)](#), [WisdomTree U.S. MidCap Fund \(EZM\)](#), and [WisdomTree U.S. SmallCap Fund \(EES\)](#) relative to their corresponding market cap-weighted Indexes, based on size.

	Large Caps			Mid Caps			Small Caps		
Valuation Characteristic	EPS	S&P 500	% Discount	EZM	S&P 400	% Discount	EES	S&P 600	% Discount
Trailing 12m Price-to-Earnings	22.9x	31.9x	-31%	15.9x	29.9x	-46%	14.9x	32.9x	-57%
Trailing 12m Price-to-Earnings ex. Negative	21.9x	27.9x	-23%	15.9x	22.9x	-31%	12.9x	18.9x	-34%
Percent Negative Earnings	1.3%	5.0%		1.7%	10.0%		5.7%	20.1%	
Estimated Price-to-Earnings	18.9x	22.9x	-19%	14.9x	19.9x	-25%	13.9x	20.9x	-36%
Profitability Characteristic	EPS	S&P 500	% Premium	EZM	S&P 400	% Premium	EES	S&P 600	% Premium
Return on Assets	3.3%	3.1%	7%	3.1%	2.1%	45%	2.5%	1.7%	50%
Return on Equity	17.3%	14.6%	18%	14.5%	9.5%	53%	13.4%	7.4%	80%
Return on Sales	14.8%	14.0%	6%	12.9%	9.6%	34%	9.6%	7.6%	27%

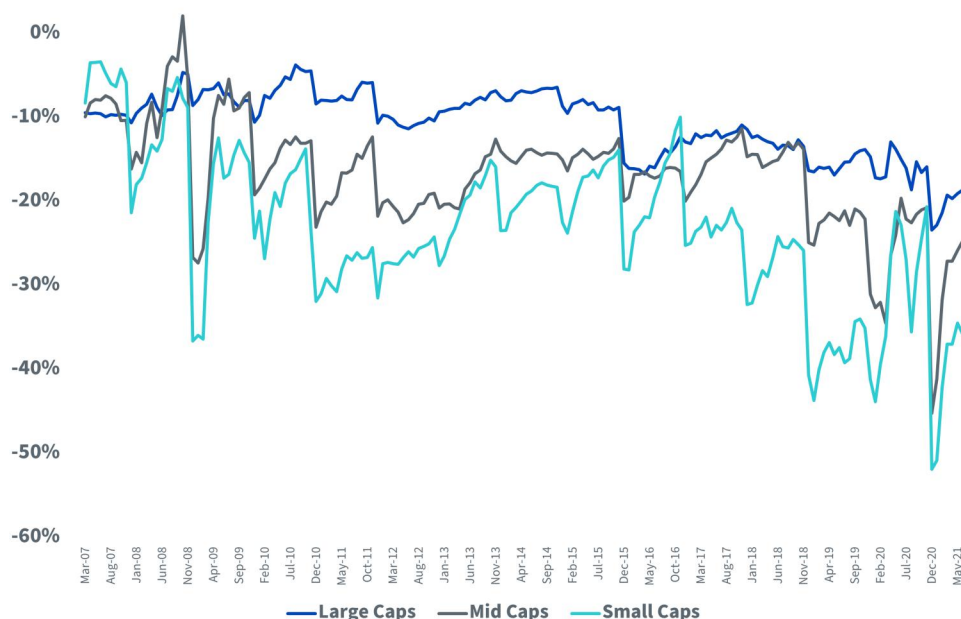
Source: WisdomTree. Data as of 6/30/21. Past performance is not indicative of future results. You cannot invest directly in an index. Please see the Important Information and Details tabs for standardized performance and other fund information.

For standardized performance of the Funds in the table, please click their respective ticker: [EPS](#), [EZM](#), [EES](#).

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

#### Forward P/E Ratios: The Earnings-Weighted Discounts

10%



WisdomTree Fund Comparison Tool, as of 6/30.

The more market valuations rise, the more important we believe it is to reconnect stock weights with their underlying earnings. As investors talk more about the [value](#) rotation, WisdomTree's family provides very broad-based diversified exposure to these size segments, without having specific valuation cutoffs to sort the market and only select a subset of the market.

These Indexes start with all profitable companies in their universes, and then weight those companies by their core earnings streams and make adjustments for the most risky stocks in their universe. Now could be a particularly good time for both elements of this lower valuation and risk-controlled process.

**Important Risks Related to this Article**

There are risks associated with investing, including the possible loss of principal. Funds focusing their investments on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Please read each 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.

**Related Funds**

+ [WisdomTree U.S. SmallCap Fund](#)

+ [WisdomTree U.S. MidCap Fund](#)

+ [WisdomTree U.S. LargeCap Fund](#)

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

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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.

**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-weighted** : Earnings for all constituents in an index are added together, and individual constituents are subsequently weighted by their proportional contribution to that total.

**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.

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

**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.

**Mid-Cap** : Characterized by exposure to the next 20% of market capitalization (after the top 70% have been removed) within the Value, Blend or Growth style zones with the majority of the fund's weight.

**Quality** : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over time.

**Junk Bond** : A high-yield or non-investment grade bond. Junk bonds are fixed-income instruments that carry a rating of 'BB' or lower by Standard & Poor's, or 'Ba' or below by Moody's. Junk bonds are so called because of their higher default risk in relation to investment-grade bonds.

**Return on Sales (ROS)** : A measurement of operational efficiency which relates how much profit is generated from one dollar of sales.

**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.

**Value** : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over time.