

ANALYSIS OF THE 2016 EARNINGS INDEX FAMILY REBALANCE

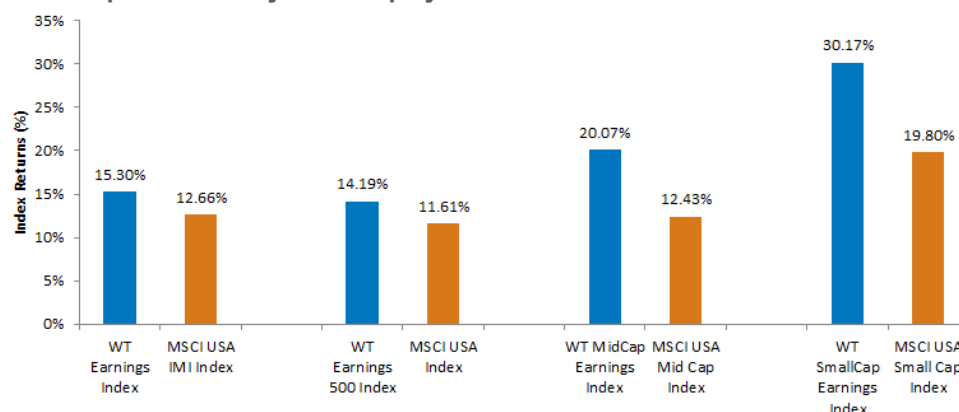
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At WisdomTree, we believe strongly in relative value [rebalancing](#). The act of rebalancing constituents of an Index to their fundamental values is important, given our belief that stocks often overshoot their underlying [fundamentals](#). Consequently, investors run the risk of paying too much for stocks that have become more expensive. A disciplined strategy of reweighting allocations back to more attractively valued stocks, through the annual rebalance process, is an important element in managing market valuation risks. Typically, this results in the following:

- Companies whose share prices appreciated at a faster rate than their fundamental improvement would typically see a reduction in their constituent weight during the rebalancing process.
- Companies whose share prices did not appreciate or even dropped, but whose fundamentals were maintained or improved, would typically see an increase in their constituent weight during the rebalancing process.

In the figure below, we analyze the 2016 calendar year for the WisdomTree Earnings Indexes and compare each to a comparable [market capitalization-weighted](#) benchmark.

Small Caps Led the Way in U.S. Equity Markets for 2016



Sources: WisdomTree, Bloomberg, MSCI, for the period 12/31/15–12/31/16. Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of indexes in the chart, visit our [glossary](#).

• **WisdomTree Earnings Indexes Led Their Market Capitalization-Weighted Counterparts across the Size Spectrum:** The WisdomTree Indexes beat their respective market capitalization-weighted benchmarks, represented by the relevant MSCI USA indexes, for the period displayed above. Similar to what we have seen over the past 10 years for the earnings indexes, outperformance for the small and mid-caps was the largest.

• **Small Caps Led the Way with over 30% Returns:** The [WisdomTree SmallCap Earnings Index](#) had a particularly successful year, up over 30%. This double-digit performance marks a good time to rebalance and take chips away from some of the really big winners and add weight to the stocks at lower multiples, the underperformers.

How Expensive Are the U.S. Equity Markets?

U.S. equity market participants find themselves adjusting to somewhat of a different reality as we enter 2017. [Price-to-earnings \(P/E\)](#) ratios are elevated, in some cases above 20x. When viewed through the longer lens of history, this appears high, but when viewed in the context of interest rates being extremely low, the case becomes less clear.

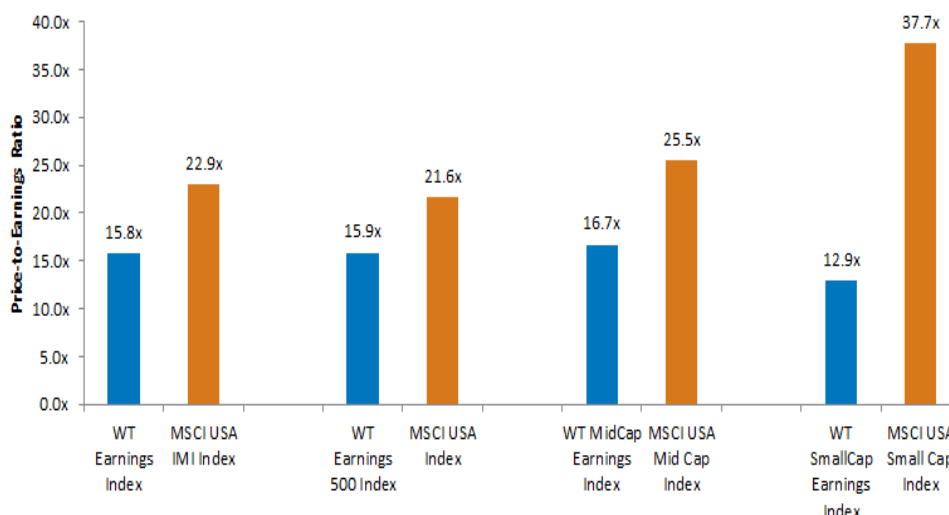
Higher [valuations](#) today mean a more challenging environment for future returns. Investors will not continue to pay ever-

greater amounts for each dollar of earnings, and it becomes harder and harder for that P/E ratio to continue to rise. Stated differently, the market needs more positive earnings growth to continue gains. In this environment, we believe there are rewards for focusing on lower-valued parts of the market.

WisdomTree's Earnings Strategies Are Designed to Mitigate Valuation Risk

As mentioned earlier, each one of our WisdomTree Earnings Indexes incorporates an annual rebalancing mechanism that functions to lower P/E ratios in a disciplined manner. This rebalancing process typically leads to a lower P/E ratio relative to market capitalization-weighted approaches.

Lowering P/E Ratio Relative to Cap-Weighted Benchmarks



Sources: WisdomTree, Bloomberg, MSCI, as of 12/31/16. Subject to change. Past performance is not indicative of future results. You cannot invest directly in an index.

With rising equity prices, coupled with a slight contraction in the aggregate earnings of the market, it is critical to be mindful of valuations like P/E ratios. Of all the Indexes WisdomTree calculates, the lowest relative P/E ratios tend to be found in the WisdomTree Earnings Indexes. Following this rebalance, we saw these portfolio characteristics reinforced.

Certainly, some of President-elect Trump's focus on cutting corporate tax rates and allowing companies to repatriate offshore cash might cause a positive impetus and stimulus for earnings growth in 2017. But after a surge in prices after the election, we believe this rebalance back to valuations comes at a perfect time and can help manage valuation risk if future earnings growth falls short of expectations.

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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You cannot invest directly in an index.

DEFINITIONS

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.

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

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.

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.

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.