

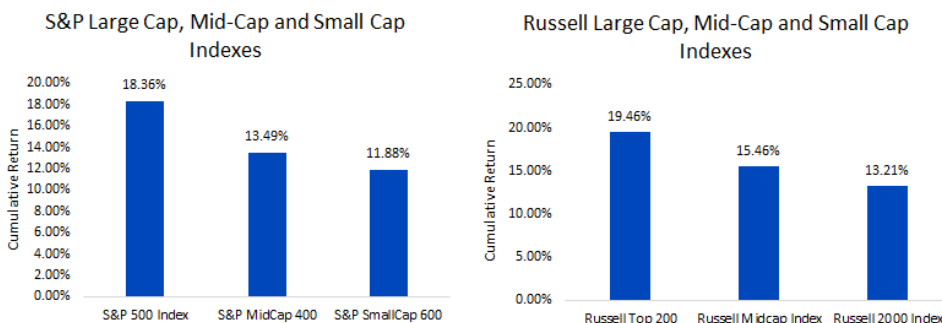
# MANAGING VALUATION RISKS AS MARKET MULTIPLES RISE IN MID- & SMALL CAPS

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On February 1, 2007, WisdomTree launched its U.S. Earnings family of Indexes. Over the course of this nearly 11-year live track record, many clients have asked us why we chose to weight these Indexes by earnings.

What’s happening in U.S. equities today provides an environment for a better answer than any we have been able to provide thus far. I have recently addressed the topic of [managing valuation risk in large caps](#). Below I focus on the mid- and small-cap segments of the U.S. market.

2017 has seen the [Bloomberg Dollar Spot Index](#) drop by 8.53%,<sup>1</sup> creating a positive tailwind to the earnings of U.S. multinationals—predominantly larger companies. We see below that this has manifested in [large caps](#) outperforming both [mid-caps](#) and [small caps](#) in 2017.



Sources: WisdomTree, Bloomberg, with data from 12/31/16 to 11/24/17. You cannot invest directly in an index. Past performance is not indicative of future results.

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

Even though large caps have been outperforming in 2017, if we instead focus on [valuation](#), a similar step-wise progression exists in the opposite direction. The two large-cap Indexes (the [S&P 500 Index](#) and the [Russell Top 200 Index](#)) have [trailing 12-month price-to-earnings \(P/E\)](#) ratios of slightly below 22.0x. Both the [S&P MidCap 400](#) and the [Russell Midcap Indexes](#) had P/E ratios of between 24.0 and 25.0x. The small caps were the most expensive, with the [S&P SmallCap 600 Index](#) trading at about 29.0x and the [Russell 2000 Index](#) trading slightly below 50.0x.<sup>2</sup>

## The Difference of Negative Earnings

A P/E ratio of close to 50.0x stands out and probably leaves many thinking that there may be some sort of mistake or miscalculation. However, this draws out an important distinction between the Russell 2000 and the [S&P SmallCap 600 Index](#)

[dexes](#). In the case of the S&P Index, there is a requirement for positive [generally accepted accounting principles \(GAAP\)](#) net income prior to companies gaining initial inclusion.<sup>3</sup> The Russell 2000 Index has no such requirement<sup>4</sup>, and on a trailing 12-month basis, we've tended to see approximately 20% of the weight of the Russell Index in firms with negative earnings.<sup>5</sup>

Firms with negative earnings bring down the earnings per share of the full index, and this is the denominator of the P/E ratio formula. The price, or numerator, is not impacted, and so the result leads to a higher P/E ratio. Lower-[quality](#) small-cap indexes may therefore tend to have very high P/E ratios on the basis of their trailing earnings per share.

### How Valuation Has Been Important

While valuation alone hasn't been the best predictor of future market corrections (something many seem to be thinking about these days in this low-[volatility](#) environment), we have found it to be important over longer time frames in helping to set expectations for [real returns](#) from equities. Over a variety of long-term periods, work by Professor Jeremy Siegel in his book *The Future for Investors* has indicated that the after-inflation returns of equities have held a very close relationship to their [earnings yield](#)—the reciprocal of the P/E ratio. In short:

- Higher earnings yields (or lower P/E ratios) have been associated with stronger real returns.
- Lower earnings yields (or higher P/E ratios) have been associated with weaker real returns.

So if, for instance, we're looking at the S&P SmallCap 600 Index with a trailing 12-month P/E ratio of 28.9x as of November 24, 2017, that is associated with a 3.5% earnings yield, and it becomes more challenging to see real, after-inflation returns to U.S. equities that are too different from this 3.5% level—at least if history is any guide.<sup>6</sup>

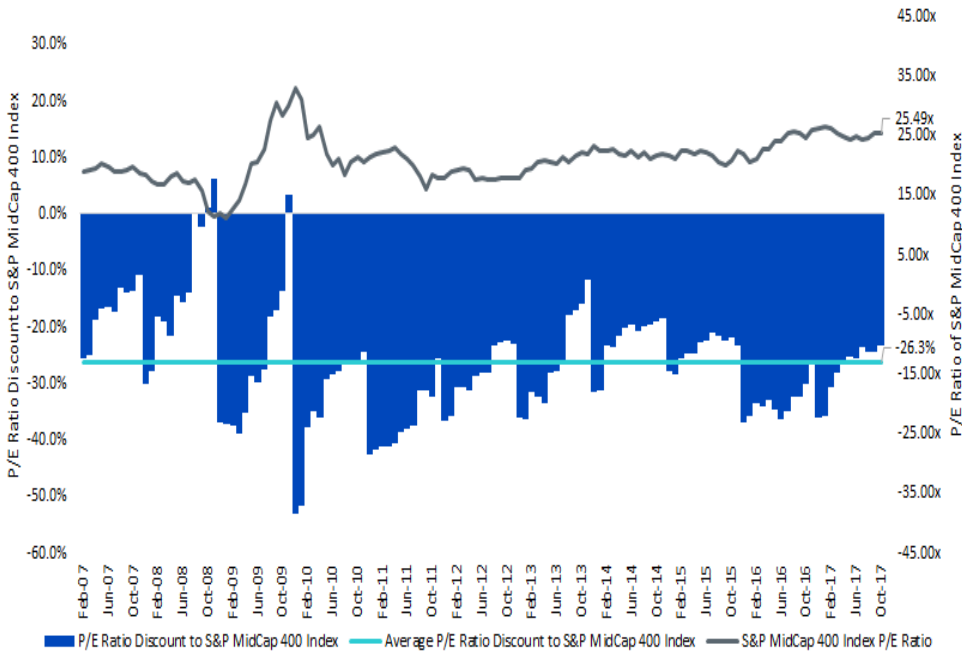
### Where WisdomTree's U.S. Earnings Indexes Can Help

WisdomTree's U.S. Earnings Indexes follow two big-picture steps at their [annual rebalance](#), screened on November 30 of each year:

- Include only profitable companies
- Weight companies by their [core earnings](#)

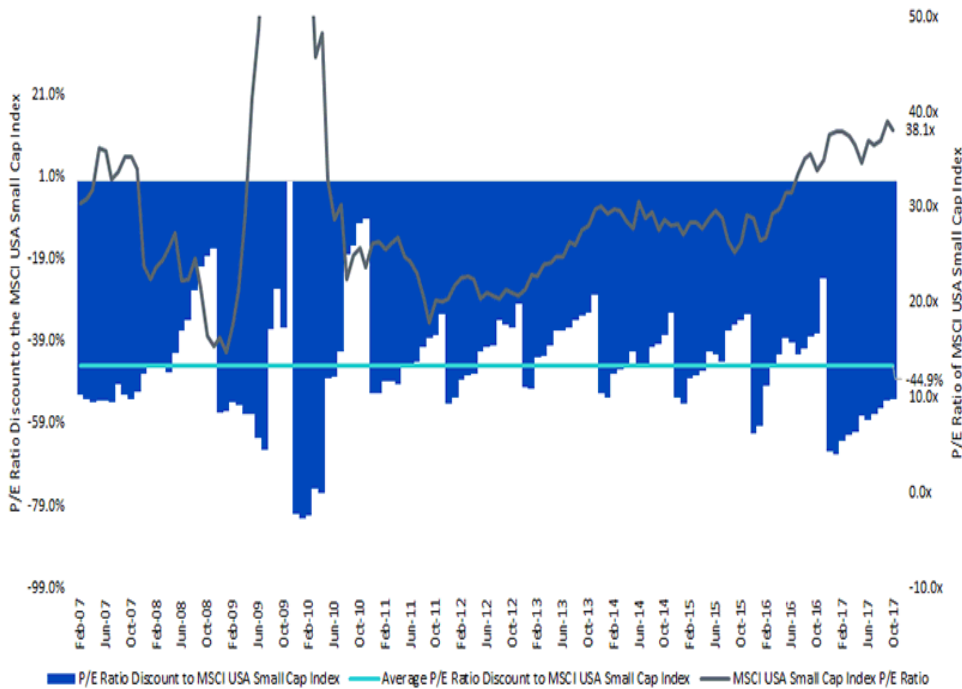
This process has tended to raise earnings yields (same thing said a different way: lower P/E ratios) compared to [market capitalization-weighted](#) universes of similar stocks. Below, we focus on the [WisdomTree U.S. MidCap Earnings Index](#), which is highly comparable to the S&P MidCap 400 Index, and the [WisdomTree U.S. SmallCap Earnings Index](#), which is highly comparable to the [MSCI USA Small Cap Index](#).<sup>7</sup>

### The WisdomTree U.S. MidCap Earnings Index Has Had a 26.3% Average P/E Ratio Discount Compared to the S&P MidCap 400 Index over Its Live History



Sources: WisdomTree, FactSet, with data from 2/1/07 inception date of WisdomTree U.S. MidCap Earnings Index to 10/31/17. You cannot invest directly in an index.

**The WisdomTree U.S. SmallCap Earnings Index Has Had a 44.9% Average P/E Ratio Discount Compared to the MSCI USA Small Cap Index over Its Live History**



Sources: WisdomTree, FactSet, with data from 2/1/07 inception date of WisdomTree U.S. SmallCap Earnings Index to 10/31/17. You cannot invest directly in an index.

**Conclusion: Why Does WisdomTree Have a U.S. Earnings Family of Indexes?**

The bottom-line answer: This methodology has provided a capability to raise the earnings yield (or lower the P/E ratio) compared to a similar market capitalization-weighted universe of stocks. When searching for a strategy in an

environment where the markets are experiencing overall lower earnings yields (or higher P/E ratios), this approach could be even more important when considering longer-run returns.

The current P/E ratios of 19.6x for the WisdomTree U.S. MidCap Earnings Index and 17.9x for the WisdomTree U.S. SmallCap Earnings Index, while elevated, represent discounts to the market to help investors manage the valuation risks of rising multiples.<sup>8</sup> The higher the market multiples go, the more important we believe this methodology could become.

<sup>1</sup>Source: Bloomberg, with data from 12/31/16 to 11/24/17.

<sup>2</sup>Source for all P/E ratio data in No. 2 is Bloomberg, with trailing 12-month P/E ratios cited as of 11/24/17.

<sup>3</sup>Source: "S&P U.S. Indices Methodology," S&P Dow Jones Indices, 8/17.

<sup>4</sup>Source: "Russell U.S. Equity Indexes v2.9," FTSE Russell Construction & Methodology, 10/17.

<sup>5</sup>Sources: WisdomTree, Bloomberg, with most recent month-end data as of 10/31/17.

<sup>6</sup>Sources: WisdomTree, FactSet.

<sup>7</sup>For the purposes of this analysis, we do not utilize the S&P SmallCap 600 Index because it tends not to have more than 10% of its weight in firms with negative earnings over the prior 12 months, and we are unable to utilize the Russell 2000 Index as of this writing due to data constraints. As of 10/31/17, the MSCI USA Small Cap Index had 15% to 16% of its weight in firms with negative trailing 12-month earnings per share.

<sup>8</sup>Sources: WisdomTree, FactSet, with data as of 11/3/17.

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**

**Bloomberg Dollar Spot Index (BBDXY)** : Tracks the performance of a basket of ten leading global currencies versus the U.S. dollar. Each currency in the basket and their weight is determined annually based on their share of international trade and FX liquidity.

**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.

**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.

**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.

**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.

**Russell Top 200 Index** : Measures the performance of the 200 largest companies in the Russell 1000 index.

**Trailing Price-to-earnings (P/E) ratio** : Trailing Price-to-earnings (P/E) ratio: Share price divided by trailing 12-month earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

**S&P MidCap 400 Index** : provides investors with a benchmark for mid-sized companies. The index covers over 7% of the U.S. equity market, and seeks to remain an accurate measure of mid-sized companies, reflecting the risk and return characteristics of the broader mid-cap universe on an on-going basis.

**Russell Midcap Index** : The Russell Midcap Index measures the performance of the mid-cap segment of the U.S. equity universe. The Russell Midcap is a subset of the Russell 1000 Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership.

**S&P SmallCap 600 Index** : Market capitalization-weighted measure of the performance of small cap equities within the United States, with constituents required to demonstrate profitability prior to gaining initial inclusion.

**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.

**Generally Accepted Accounting Principles (GAAP)** : Principles of accounting utilized in the U.S. that deal with different aspects and assumptions that are deemed acceptable in calculating the earnings of a firm.

**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.

**Volatility** : A measure of the dispersion of actual returns around a particular average level.

**Ex post real return** : ex post refers to actual results rather than forecasts. Real return refers to return after inflation. So in total, this is the return after inflation that actually happen.

**Earnings yield** : The earnings per share for the most recent 12-month period divided by the current market price per share. The earnings yield (which is the inverse of the P/E ratio) shows the percentage of each dollar invested in the stock that was earned by the company.

**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.

**Core Earnings** : Income generated by the company's daily operations rather than one-time events or market fluctuations.

**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.

**MSCI USA Small Caps Index** : a small-cap US equity index aiming to capture the performance of the securities within this size segment.&nbsp;