11 CONSECUTIVE YEARS OF LOWERING P/E RATIOS … AND COUNTING!

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Most of our discussions these days start with some level of concern—odd with U.S. equity markets at or near record highs. Yet, because U.S. equities have done so well and the perceived risk within them has been so low, there is a feeling that this party simply cannot go on forever.

We Focus on What We Know

None of us knows exactly when a correction will come—we hear a lot of investors directly telling us that they have cash to deploy into the market when such a correction comes to pass. But certain statistics, like price-to-earnings (P/E) ratios, are much easier to find. Commonly, we'll hear that the U.S. equity market has become or is becoming expensive, and for that reason, price levels will have to drop. Those with experience have learned—sometimes the hard way—that:

- An equity market can remain more expensive than recent history might suggest it should for an extended period. Additionally, factors such as interest rates or inflation can undergo regime shifts, changing the levels of what might be perceived as "fair" valuations. People will likely always love the concept of the single-digit P/E ratio, but rarely do they connect it with the fact that—when this occurred on the S&P 500 Index—U.S. interest rates were in double-digit territory. In fact, on March 9, 2009, the recent global financial crisis low, the P/E ratio on that Index was 11.2x.[1]

Valuation really isn't a great predictor of how equity markets might behave in the short term, but for those interested in the longer term, we believe it can have major implications.

The Relationship between the Earnings Yield and the Potential Real Returns

In his book *The Future for Investors*, Professor Jeremy Siegel focused on equities as real assets and indicated that, over a variety of long time frames, the earnings yield on an equity market was very close to the long-term, after-inflation return that market generated over time. Simply put, this tells us the following:

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

The bottom line: If new dollars are being invested in U.S. equities in an environment where the S&P 500 Index has a P/E ratio of slightly more than 22.0x, that is associated with an earnings yield of approximately 4.5%. U.S. mid-caps, with their P/E ratio of nearly 25.0x, would have an earnings yield of around 4.0%, and U.S. small caps, with a P/E around 29.0x, would have an earnings yield of about 3.4%. The next 10-year period—at least if history is any guide—may look MUCH different from the last one.[2]

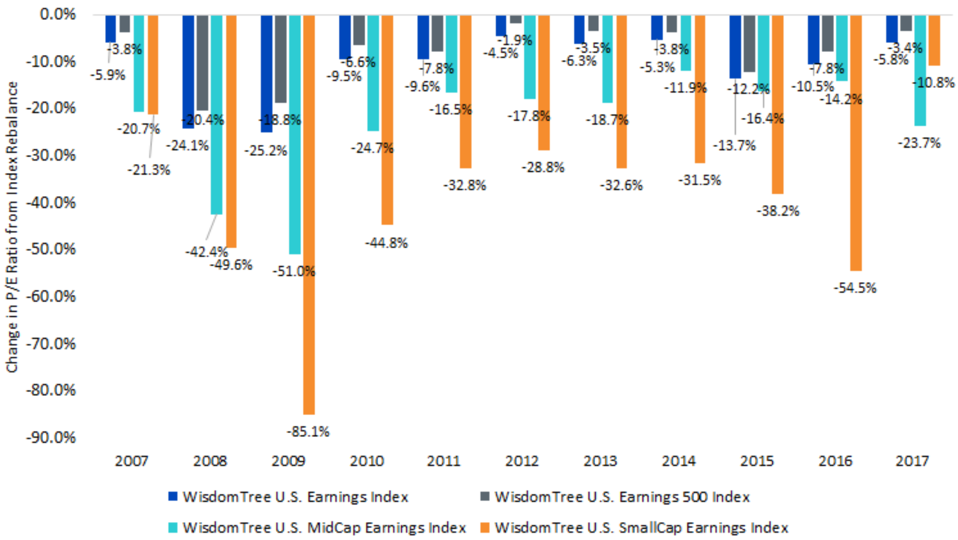
If we've paid attention, history has shown us this principle before. On March 23, 2000, the S&P 500 Index had a P/E ratio of 30.6x, and over the subsequent 10 years, its average annual total return was down almost 1% per year. The 10 years leading up to March 23, 2000, saw returns of more than 18.2% per year.

How WisdomTree's Earnings Indexes Embody the Principle of "Modern Alpha"

WisdomTree launched its U.S. earnings family of Indexes on February 1, 2007, nearly 11 years ago. Over that period, the approach has been termed "fundamental weighting," "smart beta" or even "modern-alpha," but the overarching goal has been the same all along: to unshackle the investor from needing to invest at whatever the market's earnings yield is by rebalancing annually with a process aimed at actually raising the earnings yield compared to a similar market cap-weighted Index.

- Market capitalization-weighted indexes are "valuation takers" in that they do not employ any techniques that might tilt weight away from more expensive stocks.
- WisdomTree's Earnings Indexes are "valuation makers" in that they employ a relative value rebalance annually, tilting away from stocks whose share prices have outperformed their earnings growth.

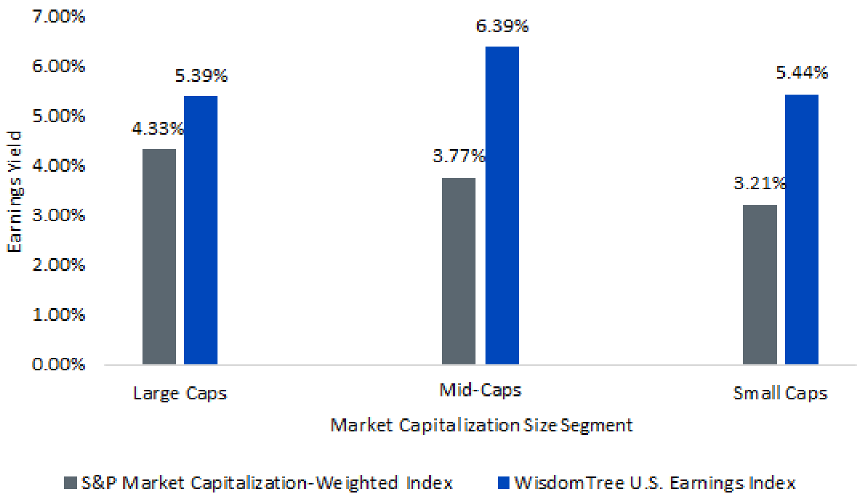
The 11 Consecutive Rebalances of Lower P/E Ratios Across Broad, Large, Mid- and Small Size Segments



Sources: WisdomTree, FactSet, with data measured as of each annual respective rebalance date to indicate the change in the trailing 12-month P/E ratio in cumulative percentage terms. You cannot invest directly in an index. Past performance is not indicative of future results.

- Each of the WisdomTree U.S. Earnings Indexes weights stocks on the basis of core earnings, a process that has seen 44 (4 Indexes x 11 annual rebalances) P/E ratio reductions over the live track record.
- Within the WisdomTree U.S. MidCap Earnings and SmallCap Earnings Indexes, there have tended to be some rather large reductions in P/E ratios, driven predominantly by the elimination of exposure to firms with negative earnings. We've written before about how negative earnings for an index may in fact raise the P/E ratio by lowering the trailing 12-month earnings per share, and this tends to be a larger issue for mid-caps and small caps than for large caps.

Earnings Yields: Earnings Family vs. Market Cap-Weighted Benchmarks



Sources: WisdomTree, FactSet, with data as of the 11/30/17 index screening date.

While by no means does a higher earnings yield ensure outperformance, we believe that it can be one important factor that may lead to a chance of improved returns over the long haul.

Conclusion: WisdomTree's U.S. Earnings Indexes Answer One of the Biggest Concerns Today

On the subject of U.S. equity market valuation, no investors are telling us that they'd prefer to invest at ever-higher multiples, but by the same token, most U.S. investors are heavily exposed to U.S. equities in various ways. WisdomTree's U.S. Earnings Indexes are interesting in that they provide U.S. equity exposure while looking to mitigate the risk of the seemingly ever-rising P/E ratios to which we've become accustomed.

[1]Source: Bloomberg.

[2]Source for paragraph: Bloomberg, with data as of 12/7/17.

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You cannot invest directly in an index.

DEFINITIONS

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.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Inflation : Characterized by rising price levels.

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.

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.

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.

Real assets : Assets that have their own value independent of their price, typically used to mitigate the potential impact of inflation lessening the purchasing power of an investor's home currency.

Modern Alpha : Modern Alpha® combines the outperformance potential of active with the benefits of passive—to offer investor strategies that are built for performance.

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.

Smart Beta : A term for rules-based investment strategies that don't use conventional market-cap weightings.

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.

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