WHY IT'S IMPORTANT TO FOCUS ON U.S. EQUITY VALUATIONS

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U.S. equity market participants find themselves adjusting to somewhat of a different reality as we approach the end of 2016. Price-to-earnings (P/E) ratios are elevated, in some cases above 20.0x.[1] 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 for overvaluation becomes less clear.

Higher Valuations = Higher Hurdles for Future Returns

While it is tough to know if the U.S. equity market is expensive or inexpensive in real time, there is little doubt that higher valuations today mean a more challenging environment for future returns. Why is this? In our view, investors simply 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.

WisdomTree's Earnings Strategies Are Designed to Mitigate This Risk

We recently wrote about how each of our earnings strategies incorporate an annual rebalancing mechanism that functions to lower P/E ratios in a disciplined manner. Because our strategies have a historical track record extending nearly 10 years, one can look at the WisdomTree Earnings, Earnings 500, MidCap Earnings and SmallCap Earnings Indexes and see P/E reductions occurring each year as a result of the following:

- **Eliminating Firms with Negative Earnings:** This is most important within the WisdomTree SmallCap Earnings Index, as this is the area of the market where profitability tends to be less stable over time. In general, constituents with negative earnings drag down the earnings per share of the overall index, at times causing the P/E ratio to rise not because of prices are rising but rather due to the denominator, earnings per share, falling.
- **Tying Increased Weight to Increasing Earnings:** Over the course of a given year, we know that share prices can rise and fall. Top-performing stocks see their weights increase relative to other index constituents, whereas bottom-performing stocks see their weights decrease. If there is no rebalancing mechanism that ties exposures back to fundamentals, the index will tend to hold more and more of the outperformers and fewer and fewer of the underperformers regardless of underlying company fundamentals. WisdomTree's process breaks this cycle—strong share price performance but earnings growth that isn't commensurate typically leads to decreased Index weights. Strong earnings growth but weak share price performance typically leads to increased index weight.

Measuring Importance of This Process over Time

It makes sense that this rebalancing process has tended to lead to a lower P/E ratio relative to market capitalization-weighted approaches. We wanted to measure this discount over time and, more importantly, find out if at present—when we know that the U.S. equity market has become more expensive—the valuation discount has increased.

WisdomTree Earnings 500 Index: Close to The Largest Discount That We've Seen Since Inception

WT Earnings 50 Index

For definitions of indexes in the chart, visit our glossary.

- **Market P/E Ratio Approaching Highs:** The WisdomTree Earnings 500 Index began its live calculation on February 1, 2007. Since that point, the highest trailing 12-month P/E ratio that we saw (on a month-end basis) for the MSCI USA Index was 22.2x, as of December 31, 2009. As of September 30, 2016, we were at 21.6x, fairly close. What's interesting is that the December 31, 2009, spike upward in the trailing 12-month P/E ratio was less related to an upward trend in prices and more related to a tough earnings environment beginning its recovery. At present, the situation is less about sharp declines in earnings and more about rising price levels that have persisted for multiple years.
- **P/E Ratio Discount at or Near Greatest Levels:** From February 1, 2007, to September 30, 2016, the average discount of the WisdomTree Earnings 500 Index to the MSCI USA Index was 16.7%, meaning that the WT Index tended to be 16.7% less expensive, on average. As of September 30, 2016, the WT Index was 27.3% less expensive—a figure that

is nearly twice the average discount. This level was only approached in December 2009 and indicates to us that the WisdomTree Earnings 500 Index is seeing its methodology add as great a relative value discipline as we have seen over its history relative to the MSCI USA Index, which is market capitalization-weighted and therefore does not have a relative value discipline baked into its methodology.

[1]Source: Bloomberg, as of 11/4/16.

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.

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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.

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

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.

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.

Relative value : The relationship between a particular attribute, e.g., a dividend, and the firm's share price compared to that of another firm.