

THE FUNDAMENTAL DIFFERENCE: THROUGH A LENS OF NET BUYBACKS

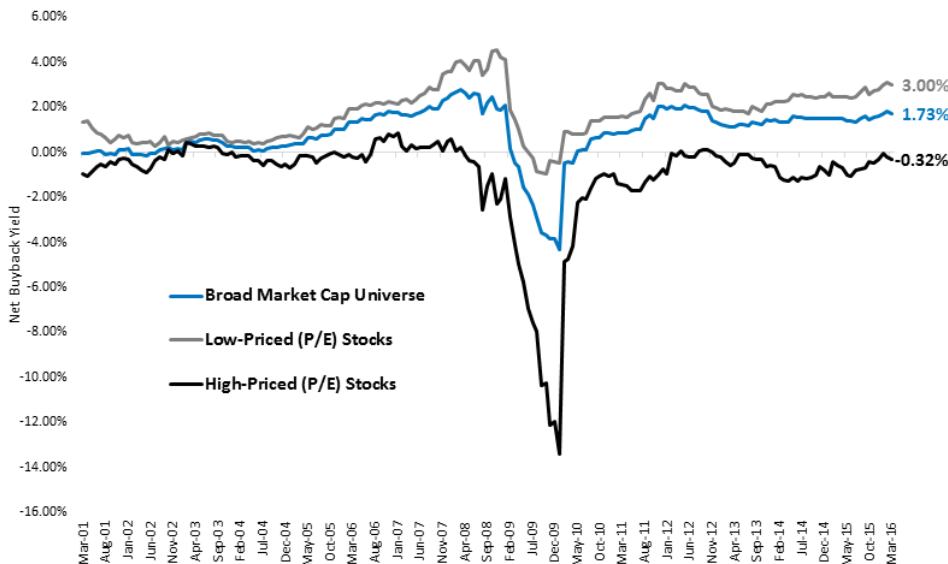
Jeremy Schwartz — Global Head of Research
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At WisdomTree, we believe that screening and weighting equity markets based on [fundamentals](#) such as [dividends](#) or earnings can potentially help produce higher total and [risk-adjusted returns](#) over a complete market cycle. One of the most important elements of a fundamentally weighted index is the annual [rebalance](#) process, where the index screens the eligible universe and then weights those securities based on their fundamentals. In essence, the process takes a detailed look at the relationship between the underlying fundamentals and price performance and tilts weight to lower-priced segments of the market. One way to illustrate the benefits of this approach for our earnings-weighted family is to compare the [net buyback yield](#) of the [WisdomTree Earnings Index](#) to a [market cap-weighted](#) peer universe. Below we look at how the net buyback yield changes when you screen and weight U.S. equity markets by firms' profitability instead of market cap.



Sources: WisdomTree, FactSet, 2/28/07–3/31/16. Start date was chosen because it is first month-end after inception date for the WisdomTree Earnings Index (2/01/07). "Broad Market Cap Universe" refers to the 3,000 largest US listed and US domiciled securities by market cap, weighted by market cap and reconstituted monthly. Net buyback yield does not measure dividends or investment returns from stocks; and is not intended to represent the past or future performance of any particular index or investment product. Historical results do not guarantee future results.

The WisdomTree Earnings Index consistently had a higher net buyback ratio than did a market cap-weighted universe consisting of the 3,000 largest securities by market cap. The WisdomTree Earnings Index averaged a net buyback yield of 2.2% over the period, compared to just 1.1% for the market cap peer universe. We believe that having an annual profitability screen for inclusion in the WisdomTree Earnings Index helps avoid speculative and unprofitable smaller-capitalization firms that have a tendency to raise capital by periodically issuing new shares. The earnings-weighted approach that tilts weight to more profitable firms can also be a reason the weighted average net buyback yield is higher. The chart below looks at the net buyback yield on a universe of the lowest [price-to-earnings \(P/E\) ratio](#) stocks within the 3,000 largest stocks by market cap and contrasts that with the net buyback yield on the highest P/E ratio stocks. **Net Buyback Yield by P/E Ratio**



Sources: WisdomTree, FactSet, 3/31/01–3/31/16. Period chosen based on data availability. "Broad Market Cap Universe" refers to the 3,000 largest US listed and US domiciled securities by market cap, weighted by market cap and reconstituted monthly. "High-Priced Stocks" refers to the 50% highest-priced stocks from a P/E perspective from the broad market cap universe. "Low-Priced Stocks" refers to the 50% lowest-priced stocks from a P/E perspective from the broad market cap universe. Net buyback yield does not measure dividends or investment returns from stocks; and is not intended to represent the past or future performance of any particular index or investment product. Historical results do not guarantee future results.

If corporate America responds well to incentives, the higher-priced basket would issue more shares (given that their stocks are high priced and issuing more of them would be an effective way to raise growth capital) and the lower-priced basket would issue fewer shares or actually buy back shares to reduce their shares outstanding and thus power their earnings-per-share growth. What we see in the data is the higher-priced universe buys back fewer share, and instead issues more shares (having more companies with negative net buyback yields). **Why Earnings Weight** Going back to the WisdomTree Earnings Index in the first chart—weighting by [Earnings Stream](#) is essentially tilting weight from a market cap-weighted scheme to over-weight those companies with below average P/E ratios and to under-weight those companies with high P/E ratios. The *Earnings Stream* can be defined as [earnings per share](#) times [shares outstanding](#) or market cap x [earnings yield](#) (which is equivalent to 1/P/E ratio). Tilting weight to the higher-earnings-yield stocks by earnings weighting thus is one effective way to tilt the net buyback yield balance in one’s favor. Companies reducing shares outstanding are essentially locking in earnings-per-share growth by reducing their share count, while companies that are issuing more shares are creating a higher hurdle to overcome to achieve earnings-per-share growth. There is a philosophical debate about the motivations for all the buybacks we are seeing today as well as fears that companies are failing to reinvest for future growth (or that they just see no growth opportunities, hence all the dividends and buybacks). One thing is clear to us from the data: the lower-priced stocks issue fewer shares, and the more expensive stocks issue more shares (and have lower net buyback yields). This can be especially true in the small-cap space, as we will discuss in a future blog post. The consistently greater-than 2% net buyback yields seen on the WisdomTree Earnings Index over the last five years, combined with 2% [dividend yields](#) on this basket today, provides critical valuation support and also helps explain why we think the earnings-weighted approach can add value over time.

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

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

Dividend : A portion of corporate profits paid out to shareholders.

Risk-adjusted returns : Returns measured in relation to their own variability. High returns with a high level of risk indicate a lower probability that actual returns were close to average returns. High returns with a low level of risk would be more desirable, as they indicate a higher probability that actual returns were close to average returns.

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.

Net Buyback Yield : A company's net share buyback is the difference between the capital raised by issuing new shares and the money the company spent on buying back any outstanding shares. A positive net share buyback means that more was spent on buying back existing shares than received from issuing new shares. Net buyback yield is the amount of a company's net buybacks divided by its market capitalization. Please note that net buyback yield does not represent a dividend paid by the company.

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 Stream@ : Earnings per share x the number of shares outstanding. For an index, these totals are added for all constituents.

Earnings per share : Total earnings divided by the number of shares outstanding. Measured as a percentage change as of the annual Index screening date compared to the prior 12 months. Higher values indicate greater growth orientation.

Shares outstanding : all the shares of a corporation or financial asset that have been authorized, issued and purchased by investors.

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.

Dividend yields : Refers to the trailing 12-month dividend yield. Dividends over the prior 12 months are added together and divided by the current share price. Higher values indicate more dividends are being generated per unit of share price.