

# REBALANCING OUR CORE EQUITY STRATEGIES FOR 2022

Alejandro Saltiel — Head of Indexes, U.S.

12/23/2021

WisdomTree is a pioneer in fundamentally weighting strategies. We seek to manage risks like [valuation](#) and profitability that are inherent with market cap-weighted strategies.

In 2007, [WisdomTree launched its domestic core equity](#) family of Funds, seeking to give investors broad exposure to the different size cuts of the U.S. market by selecting profitable companies and weighting them by their earnings.

With annual rebalancing, the [WisdomTree U.S. LargeCap Fund \(EPS\)](#), the [WisdomTree U.S. MidCap Fund \(EZM\)](#) and the [WisdomTree U.S. SmallCap Fund \(EES\)](#) seek to maintain lower valuations than the broad market and help ensure investors are not overpaying as markets rise.

Last year, we added a layer seeking to reduce the risk of these strategies by limiting exposure to companies our CRS model flags as having higher-than-average earnings risk, along with actively constraining sector and individual security biases, reducing active risk versus the market. The constraints included:

- Sector constraints: In addition to our existing 25% sector cap, we introduced +/- 5% active sector constraints. This means sector weights are limited to within 5% of the sector exposure of a market cap-weighted version of our core equity Indexes.
- Individual security constraints: Relative to the market cap-weighted version of our core equity Indexes, the weight of an eligible company will be equal to or between 0.33 times and 3 times its market cap weight.

This year we announced the creation of the WisdomTree Core Equity Index Committee, which will oversee the rebalance of the underlying WisdomTree Indexes these Funds seeks to track the price and yield performance of, before fees and expenses. The Index Committee will ensure the earnings measure used as input in the annual reconstitution properly reflects a company's recurring profitability, an area our team has done extensive research on throughout the year.

## Improving Measure of Earnings

One of the focus areas of the Index Committee is a topic that has received increased academic coverage over the past few years: how traditional accounting measures often fail to reflect the structure of modern businesses.

Technology and health care companies, among others, invest significantly in **intangible assets** such as products, patents and other competitive advantages created through research and development (R&D) activities.

Since 1974, the Financial Accounting Standards Board (FASB) has required that companies must expense R&D, deducting it in their income statements in the fiscal year the expense is incurred. Businesses that spend on **tangible assets**, such as vehicles and factories, are allowed to capitalize these expenses and depreciate/amortize them throughout the life of the asset—basically, spreading out the expense across many reporting periods.

The argument behind this is that tangible assets have a value that can be easily assessed, whereas intangible assets are more difficult (or impossible) to value. In a conservative approach by the FASB, intangible assets are not assigned a value on the balance sheet, unlike tangible assets.

All else equal, this distinction results in higher earnings for asset-heavy businesses operating in the Industrials, Materials and Energy sectors and lower measures for asset-light businesses in the Information Technology and Health Care sectors. This can have important implications in terms of eligibility and weighting for the WisdomTree domestic core equity Funds.

Although less than 3.5% of the companies eligible for each [basket](#) were affected by this adjustment, we believe the Index Committee adjustments provide a better, more diversified family of Indexes and enhanced exposures.

## Rebalance Results

WisdomTree rebalanced its domestic core equity Funds after the close on December 14. As a result of their annual reconstitution, these Funds are trading at significant discounts to their broad-based benchmarks.

As intended, the combination of earnings weighting along with the previously mentioned risk-reduction layer results in higher-quality characteristics, with aggregate [return on equity \(ROE\)](#) above the broad-based cap-weighted benchmarks.

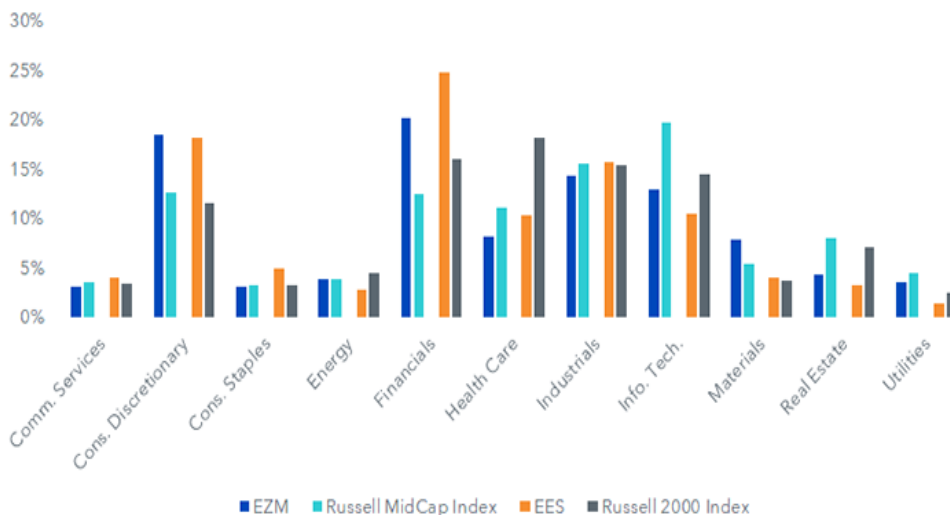
Forward Price-to-Earnings Ratio					
EPS	17.4x	EZM	11.6x	EES	10.6x
S&P 500 Index	21.2x	S&P MidCap 400 Index	17.2x	S&P SmallCap 600 Index	16.2x
Russell 1000 Index	21.7x	Russell MidCap Index	21.8x	Russell 2000 Index	29.1x
Russell 1000 Value Index	15.8x	Russell MidCap Value Index	17.1x	Russell 2000 Value Index	19.7x
Return on Equity (ROE)					
EPS	18.6%	EZM	19.0%	EES	17.3%
S&P 500 Index	18.2%	S&P MidCap 400 Index	13.5%	S&P SmallCap 600 Index	10.7%
Russell 1000 Index	17.3%	Russell MidCap Index	12.5%	Russell 2000 Index	7.4%
Russell 1000 Value Index	13.4%	Russell MidCap Value Index	12.0%	Russell 2000 Value Index	7.7%

Sources: WisdomTree, FactSet. Data for WisdomTree U.S. core equity Funds as of 12/15/21. Data for benchmarks as of 11/30/21. You cannot invest directly in an index. Favorable metrics do not guarantee favorable fund performance. Forward P/E = Share price divided by compilation of analyst estimates for earnings-per-share over the coming 12-month period. These are estimates that may be subject to revision or prove to be incorrect over time.

### Outlook for 2022

Following 2020, a year in which overvalued, unprofitable stocks experienced strong returns, 2021 has seen the market focus on profitability and valuations. Through December 9, 2021, [EZM](#) and [EES](#) are outperforming their broad cap-weighted benchmarks, the [Russell MidCap](#) and [Russell 2000 indexes](#), by more than 7% and 17% year-to-date, respectively. During this same period, [EPS](#) has managed to track closely to the [S&P 500](#), lagging by less than 150 [basis points](#)<sup>1</sup>.

Going into 2022, and due to their earnings focus, [EZM](#) and [EES](#) remain overweight in cyclical sectors compared to their broad benchmarks. We like this positioning heading into the middle stages of the economic recovery



Sources: WisdomTree, FactSet. Data for WisdomTree U.S. core equity Funds as of 12/15/21. Data for benchmarks as of 11/30/21. Data subject to change.

Meanwhile, [EPS's](#) sector biases are contained except for its slight overweight allocation to the Financials sector and underweight allocation to the Information Technology sector, seeking to provide investors with a core exposure at constrained valuations and increased quality.



Sources: WisdomTree, FactSet. Data for WisdomTree U.S. core equity Funds as of 12/15/21. Data for benchmarks as of 11/30/21. Data subject to change.

### Exclusions on High Earnings Risk

The rebalance process for the domestic core equity Funds includes a [risk screen](#) to remove companies with high earnings risk from the eligible universe. There were 46 companies excluded because of this additional composite risk score.

Looking at the chart below, we see that the excluded companies had significantly higher trailing [P/E ratios](#) at 59 times earnings and substantially lower standard quality metrics like ROE and [ROA](#).

	Number of Securities	Dividend Yield	Net Buyback Yield	Price-to-Earnings (P/E) Ratio	Return on Assets (ROA)	Return on Equity (ROE)
<b>Eligible Universe</b>	2,057	1.2	1.22	24.1	3.96	17.92
<b>High Earnings Risk</b>	46	0.64	0.63	57.87	1.1	4.17

Source: WisdomTree, FactSet as of 11/30/2021. Eligible universe are securities eligible for inclusion into the Domestic Core Equity funds after earnings and liquidity constraints. This applies to the funds EZM, EPS, and EES. The "Eligible Universe" and "High Earnings Risk" baskets in the chart above are weighted by their Market Capitalization.

<sup>1</sup> Sources: WisdomTree, FactSet. Data 12/31/20–12/09/21. All performance information referenced in terms of Fund NAV. Past performance is not indicative of future results.

#### Important Risks Related to this Article

There are risks associated with investing, including the possible loss of principal. Funds focusing their investments on certain sectors increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Please read each Fund’s prospectus for specific details regarding the Fund’s risk profile.

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.

#### Related Funds

- + [WisdomTree U.S. SmallCap Fund](#)
- + [WisdomTree U.S. LargeCap Fund](#)
- + [WisdomTree U.S. MidCap Fund](#)

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.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages ([www.msci.com](http://www.msci.com))

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Kara Marciscano, Jianing Wu, Brian Manby and Scott Welch are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

## DEFINITIONS

**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.

**Baskets** : The composition of an ETF in terms one creation/redemption unit.

**Return on Equity (ROE)** : Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

**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.

**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.

**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.

**Basis point** : 1/100th of 1 percent.

**Risk screen** : A process of filtering, or removing, companies that are eligible for an investment process based on certain risk parameters.

**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.

**Return on assets (ROA)** : Firm profits (after accounting for all expenses) divided by the firm's total assets. Higher numbers indicate greater profits relative to the level of assets utilized to generate them.