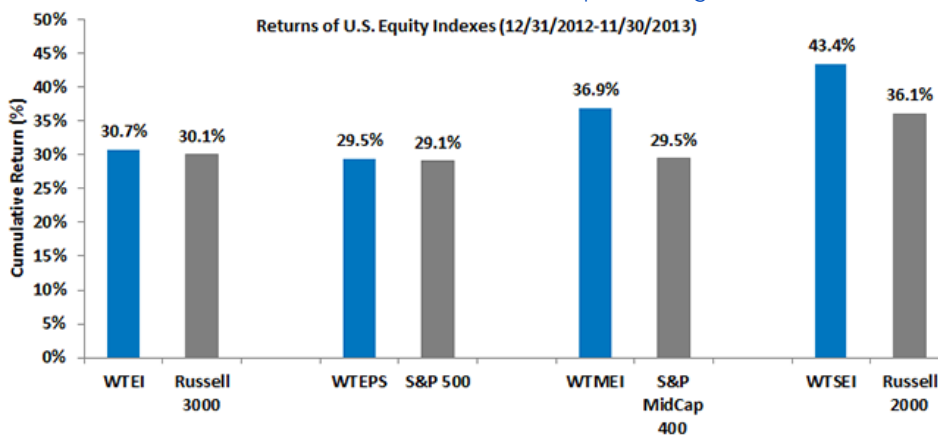


EQUITY MARKETS SETTING NEW HIGHS: WHAT IS YOUR INDEX GOING TO DO ABOUT IT?

Jeremy Schwartz — Global Head of Research
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When people consider the performance of U.S. equities¹ for much of 2013², they tend to notice that the returns have been quite impressive. At various points in time, large-³, mid-⁴ and small-cap⁵ equities have achieved record highs.⁶ At WisdomTree, we have seen similarly impressive performance in our family of U.S. Earnings Indexes, specifically the [WisdomTree Earnings Index \(WTEI\)](#), the [WisdomTree Earnings 500 Index \(WTEPS\)](#), the [WisdomTree MidCap Earnings Index \(WTMEI\)](#) and the [WisdomTree SmallCap Earnings Index \(WTSEI\)](#). **The Performance Picture**



Source: Bloomberg. Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of indexes in the chart, please go to [Glossary](#). **Behind the Scenes of Equity Market Highs** Equity prices can often be explained by one of two variables: • **Earnings Growth:** If the rate of [earnings-per-share \(EPS\)](#) growth is similar to the rate of price growth, you'll tend to see [price-to-earnings \(P/E\) ratios](#) remaining fairly constant, even in the face of potentially compelling returns. In this case, one can say that equity returns were largely being driven by earnings growth. • **Multiple Expansion:** If, on the other hand, EPS growth was slow to non-existent or even falling but prices were rising, you'll tend to see price-to-earnings (P/E) ratios rising (in other words, multiple expansion). In this case, investors may be envisioning potential future earnings growth and be willing to pay more for it today. Therefore, returns aren't being driven by current earnings growth but rather by multiple expansion. **This Year's Case Study in Multiple Expansion** 2013's rally, for the most part, was driven by multiple expansion. Below, we look at how large-cap multiple expansion compared to that of small caps, as well as how [market capitalization-weighted](#) indexes performed against [earnings-weighted](#) indexes.

Price-to-Earnings (P/E) Ratio

	12/31/2012	11/30/2013	P/E Multiple Expansion ¹	Price Change ²
WTEI	11.7x	14.3x	22.1%	28.2%
WTEPS	11.6x	14.0x	21.0%	27.0%
WTMEI	12.2x	15.5x	26.3%	35.2%
WTSEI	12.0x	16.9x	40.8%	41.8%
Russell 3000	13.3x	15.9x	20.0%	27.8%
S&P 500	12.7x	15.1x	18.6%	26.6%
S&P MidCap 400	15.4x	17.9x	15.8%	27.8%
Russell 2000	17.4x	22.6x	30.3%	34.6%

¹P/E multiple expansion: Refers to the percentage change in P/E ratio from 12/31/2012 to 11/30/2013.

²Price change: Refers to the percentage change in price of the specified index from 12/31/2012 to 11/30/2013.

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- At year-end 2012, the [S&P 500](#) was selling at 12.7x estimated earnings. Eleven months later it had increased to 15.1x estimated earnings. This multiple expansion represented a large part of the 26.6% change in the S&P 500 price levels.
- **WisdomTree Mid & Small Caps Lead the Way:** We saw earlier that WTMEI and WTSEI delivered returns greater than 35%. The notable outlier, however, in terms of multiple expansion is WTSEI—the only Index shown with multiple expansion greater than 40%.
- **Small Caps Notable for Multiple Expansion:** Whether one looks at WTSEI in the WisdomTree Earnings family or at the [Russell 2000 Index](#) among the market capitalization-weighted benchmarks, multiple expansion among small caps is notably higher than in the other size segments.
- **What Is Your Index Going to Do about It?** In an environment of rising P/E ratios, we know that stocks are necessarily becoming more expensive relative to their earnings. Market capitalization-weighted indexes will simply hold greater proportions of stocks that have increased in [market capitalization](#), in other words, they will hold more of what has increased in price. These indexes may also continue to hold stocks that have generated negative earnings over the prior 12 months. WisdomTree’s Earnings Indexes, on the other hand, do two things that market capitalization-weighted indexes do not do:
 - **Rebalance to a Concept of Relative Value:** Each year, the relationship between price performance and earnings growth is judged for each constituent. WisdomTree’s Earnings Indexes will tend to decrease weight to firms where price appreciation outpaced earnings growth and add weight to firms where earnings growth outpaced price appreciation—in essence, finding potentially underappreciated nooks and crannies of the market.
 - **Elimination of Firms with No Profits:** Each ongoing (or new) constituent of WisdomTree’s Earnings Indexes must demonstrate cumulative profitability over the prior four quarters leading up to the annual November 30 screening. Firms that cannot do so don’t make the cut, thereby helping to mitigate the upward pressure on Index P/E ratios caused by firms with negative earnings.
- **The Heart of the Matter: Indexes That Respond to Fundamentals** We all know that stocks do not tend to move in any one direction in a straight line and that past performance does not indicate future results. Therefore, after such a strong year in U.S. equities, there may be benefits to shifting weight away from some of the top-performing companies most responsible for these results and toward those that might have been underappreciated by the market despite growing their earnings. In an ongoing discussion about the benefits of “[smart beta](#)”-related indexes, we will be discussing how a key element of the smart beta family of indexes is their rules-based rebalance that we believe can help manage [valuation risks](#) in the market. ¹Refers to the Russell 3000 Index, S&P 500 Index, S&P MidCap 400 Index and Russell 2000 Index. ²Refers to the 12/31/2012 to 11/30/2013 period. ³Large-cap refers to the S&P 500 Index. ⁴Mid-cap refers to the S&P MidCap 400 Index. ⁵Small-cap refers to the Russell 2000 Index. ⁶Source: Bloomberg, as of 11/30/2013.

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You cannot invest directly in an index.

DEFINITIONS

WisdomTree Earnings Index : Fundamentally-weighted index that measures the performance of earnings-generating companies within the broad U.S. stock market.

WisdomTree Earnings 500 Index : A fundamentally weighted index that measures the performance of earnings-generating companies within the large-capitalization segment of the U.S. Stock Market. Companies in the index are incorporated and listed in the U.S and have generated positive cumulative earnings over their most recent four fiscal quarters prior to the index measurement date. The index is comprised of the 500 largest companies ranked by market capitalization in the WisdomTree Earnings Index.

WisdomTree MidCap Earnings Index : Fundamentally-weighted index that measures the performance of the top 75% of the market capitalization of the WisdomTree Earnings Index after the 500 largest companies have been removed.

WisdomTree SmallCap Earnings Index (WTSEI) : measures the performance of earnings-generating companies within the small-capitalization segment of the U.S. Stock Market. The index is comprised of the companies in the bottom 25% of the market capitalization of the WisdomTree Earnings Index after the 500 largest companies have been removed.

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.

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.

Multiple expansion : Term for a rising P/E ratio, meaning that share prices are rising faster than earnings are growing.

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-weighted : Earnings for all constituents in an index are added together, and individual constituents are subsequently weighted by their proportional contribution to that total.

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 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.

Market Capitalization : 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.

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.

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

Valuation risk : The risk of buying or over-weighting a particular stock that has appreciated significantly in price relative to its dividends, earnings or any other fundamental metric.