IF THE BEAR LURKS, HIGH P/E STOCKS ARE THE DREADED "PHONE RINGERS"

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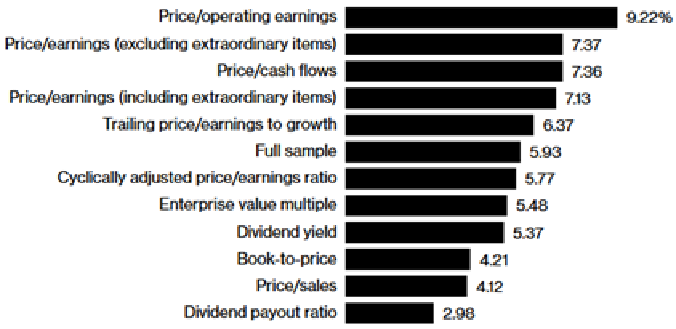
A Value investing article recently went quasi-viral.

Titled "Quants Show They're Still Human With 3,168 Versions of Value," it pointed to the price-to-earnings (P/E) ratio as the best performing value factor (figure 1).

Figure 1: Annualized Returns, Assorted Value Factors, Feb. 1988–Feb. 2017

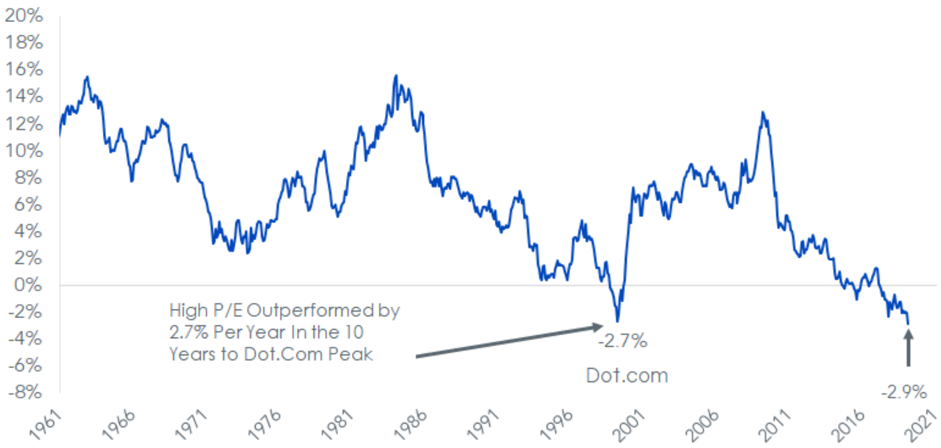


Source: "Value by Design?" by Stephan Kessler, Bernd Scherer, Jan Philipp Harries. Data shows annualized average returns based on median strategy built from each metric. Republished in "Quants Show They're Still Human With 3,168 Versions of Value" by Justina Lee of Bloomberg, 1/16/20.

For definitions of terms in the chart, please visit our glossary.

But even the best performing value factor was no contest for a market that has avoided value stocks like the Bubonic plague. Figure 2 is my favorite chart right now.

Figure 2: 10-Year Rolling Annualized Outperformance, Low P/E vs. High P/E Stocks



Source: Ken French Data Library, 7/31/1951–12/31/2019, with data through 1/31/20 using WisdomTree's attribution software on the S&P 500 for the final month. Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns.

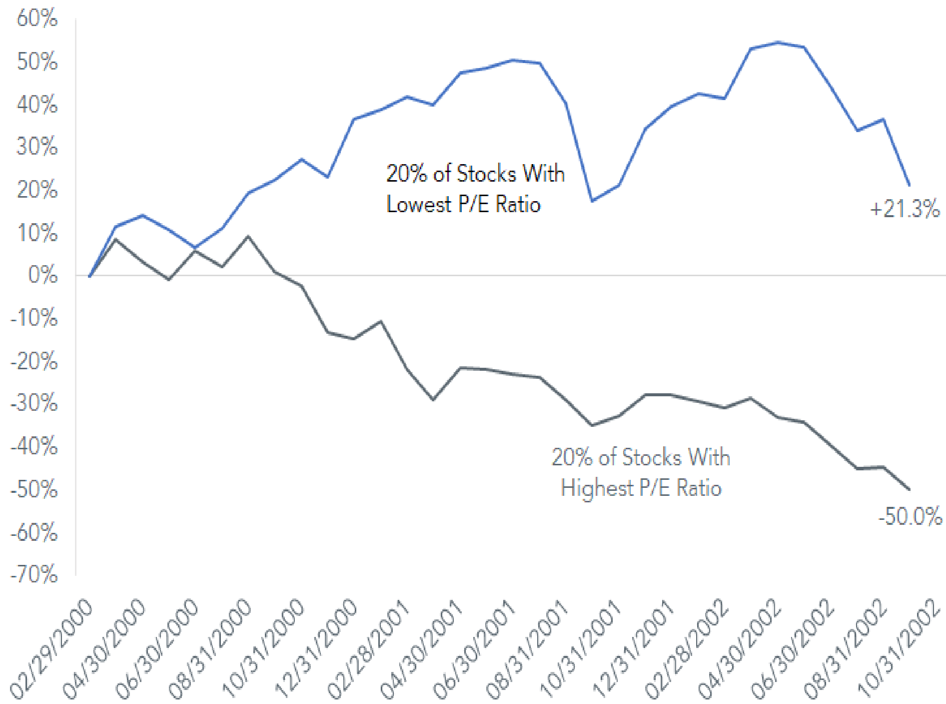
Face it: The amount by which high P/E stocks have outperformed low P/E stocks in the last 10 years exceeds the amount observed at the apex of the dot-com bubble.

I mean, seriously. Are our memories this bad? The dot.com bubble wasn't even that long ago.

This is remarkable. The 10 years after that blowup—the period ending February 2010—witnessed the quintile of stocks with the lowest P/E beating the quintile with the highest P/E by nearly **13% per year**.

That's because not everything fell in that bear markets (figure 3).

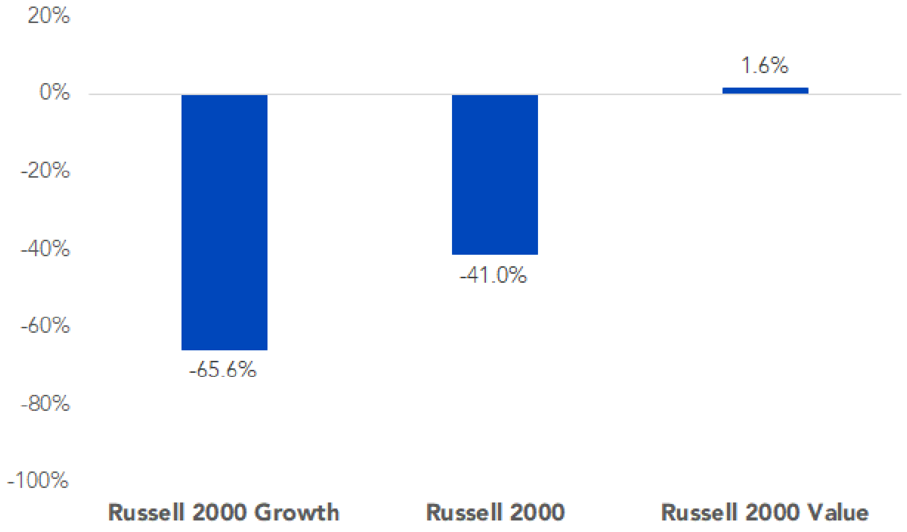
Figure 3: Cumulative Return, 2/29/00–9/30/02



Source: Ken French Database. Lowest and highest 20% of stocks by P/E. Past performance is not indicative of future results.

Here's another interesting fact from the 2000–2002 crash: In the small-cap sector, the Russell 2000 Growth Index lost two-thirds of its value in that bear market, yet the Russell 2000 Value Index of cheaper stocks went up (figure 4).

Figure 4: Cumulative Return, 2000–2002 Bear Market



Sources: Bloomberg, WisdomTree. Russell 2000 Growth & Value, respectively. Cumulative total return from the market's high to its low (3/24/00–10/09/02), as gauged by the S&P 500. Past performance is not indicative of future results. You cannot invest directly in an index.

The double whammy for money managers is when you get:

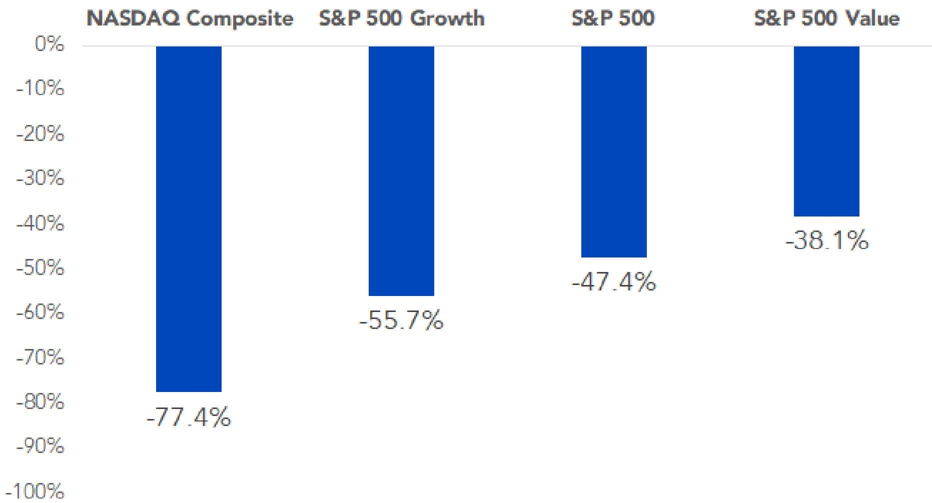
1. A bear market in your largest holding (U.S. large caps), and
2. Your stuff goes down harder than the market

Because the crash was so deep, figure 5 is the dreaded "phone ringing off the hook" chart.

Your whole day is spent trying to convince clients not to dump you for some "smarter" money manager.

The nastiest "phone ringers?" Look at the left side of figure 5.

Figure 5: Cumulative Return, 2000–2002 Bear Market

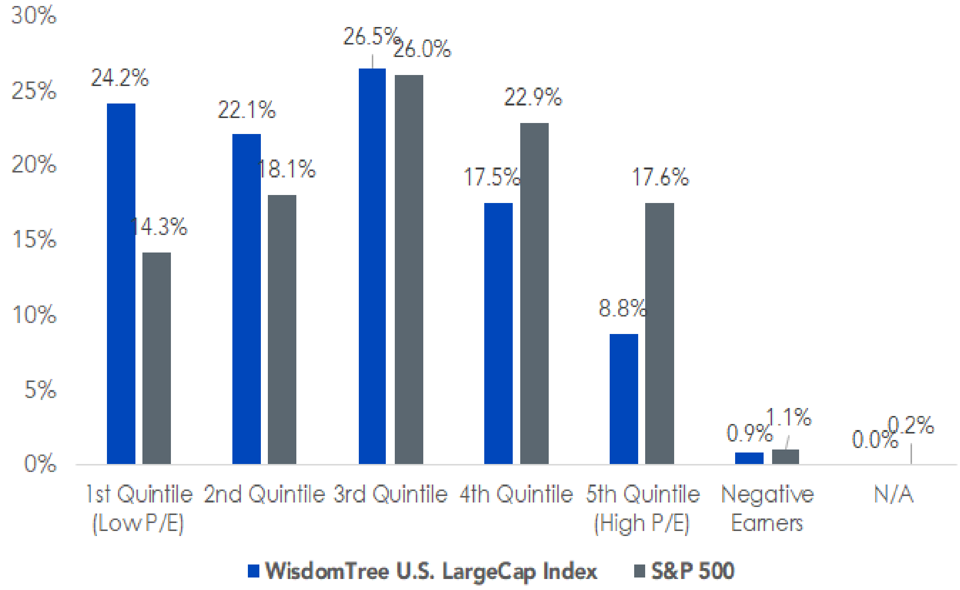


Sources: Bloomberg, WisdomTree. Cumulative total return, 3/24/00–10/9/02. Past performance is not indicative of future results. You cannot invest directly in an index.

Last year we slashed the fee to 8 basis points (bps) on the WisdomTree U.S. LargeCap Fund (EPS), our P/E-focused ETF that seeks to track the price and yield performance before fees and expenses of the WisdomTree U.S. LargeCap Index. It's "beta-lite," so we put it right there with the expense ratios of the three biggest ETFs that seek to track the S&P 500.

If the gray groups on the right in figure 6 get hurt in the next bear market, our stocks at 8 bps are a way to avoid many of them. It's about cutting down on the dreaded phone ringers.

Figure 6: Underlying Index P/E Composition



Sources: WisdomTree, Bloomberg, as of December 2019. Negative earners have no qualified P/E because earnings are not positive. Stocks characterized by "N/A" have incomplete data in Bloomberg. Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns.

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You cannot invest directly in an index.

DEFINITIONS

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

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.

Bear market : A sustained downturn in market prices, increasing the chances of negative portfolio returns.

Small caps : new or relatively young companies that typically have a market capitalization between $200 million to $2 billion.

Russell 2000 Growth Index : Measures the performance of the small-cap growth segment of the U.S. equity universe. It includes those Russell 2000 Index companies with higher price-to-book ratios and higher forecasted growth values.

Russell 2000 Value Index : measures the performance of small-cap value segment of the U.S. equity universe. It includes those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values.

Large-Capitalization (Large-Cap) : A term used by the investment community to refer to companies with a market capitalization value of more than $10 billion. Large cap is an abbreviation of the term “large market capitalization”. Market capitalization is calculated by multiplying the number of a company’s shares outstanding by its stock price per share.

Basis point : 1/100th of 1 percent.