
A BETTER WAY TO STRUCTURE AN ETF PORTFOLIO

Brendan Loftus — Associate, Product Solutions Strategist

01/03/2019

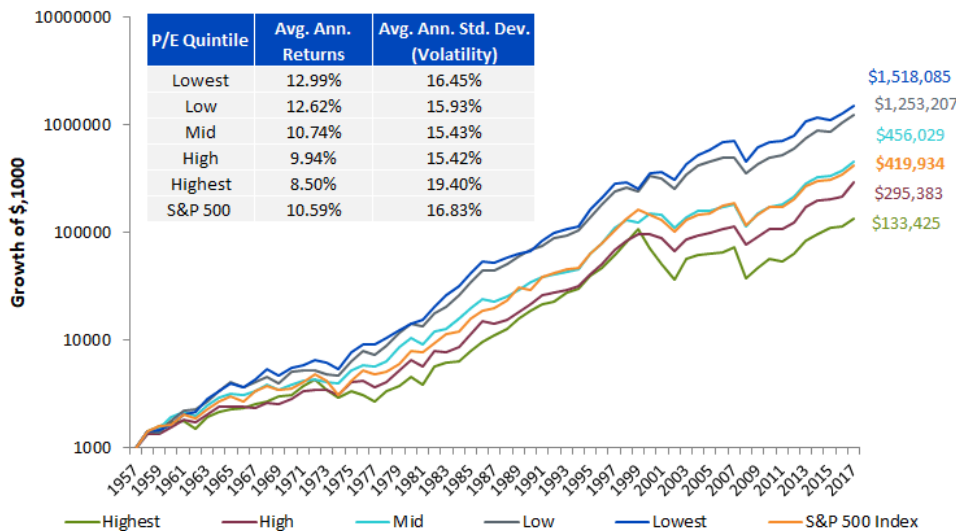
Recently, we showed how WisdomTree's new [ETF Characteristics Comparison Tool](#) can [contrast the fundamentals of WisdomTree funds with market benchmarks over time](#).

After an uptick in [volatility](#), some investors may be eager to find ways to manage [valuations](#) in today's market. Below we show how investors can use our new tool to help focus on [fundamentals](#) in 2019.

Higher Valuations Are Not the Answer

While valuations alone should never be an investing catalyst, economic research has shown that returns tend to be higher at lower [price-to-earnings \(P/E\) ratios](#) (and higher [earnings yields](#)). Professor Jeremy Siegel highlighted this point in his book, *The Future for Investors*, showing that stocks with lower P/E ratios outperformed those with higher P/E ratios over long periods of time, and with lower volatility.

Figure 1: Cumulative Growth of \$1,000 Based on Relative [P/E Quintiles](#), 12/31/1957–12/31/2017



Sources: Jeremy Siegel, *The Future of Investors* (2005), with updates to 2017. Quintile universe: S&P 500 Index, where Highest represents the highest 20th percentile of stocks in the S&P 500 and Lowest represents the lowest 20th percentile in the S&P 500. Past performance does not guarantee future results. Does not represent the performance of any investment vehicle; provided for educational/illustrative purposes only. This information should not be considered investment advice. 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. Standard deviation (volatility): measure of how widely an investment or investment strategy's returns move relative to its average returns for an observed period. A higher value implies more "risk," in that there is more of a chance the actual return observed is farther away from the average return. 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.

Given that overvaluation poses one of the greatest risks during market [bubble](#) peaks—when investors drive stock prices far beyond their intrinsic value—our research has shown that investors can mitigate risk by managing valuations by anchoring to fundamentals.

WisdomTree created a suite of indexes (and ETFs designed to track such indexes) over a decade ago to address inherent flaws in [market-capitalization weighting](#) that can concentrate investors in high-valuation stocks. Our earnings-focused indexes only invest in companies with positive core earnings over the trailing 12 months. In order to magnify the impact of earnings in the methodology, companies are then weighted by their individual contribution to the [Earnings Stream](#). As a result, companies generating the largest dollar value in earnings will receive the largest weight in the portfolio.

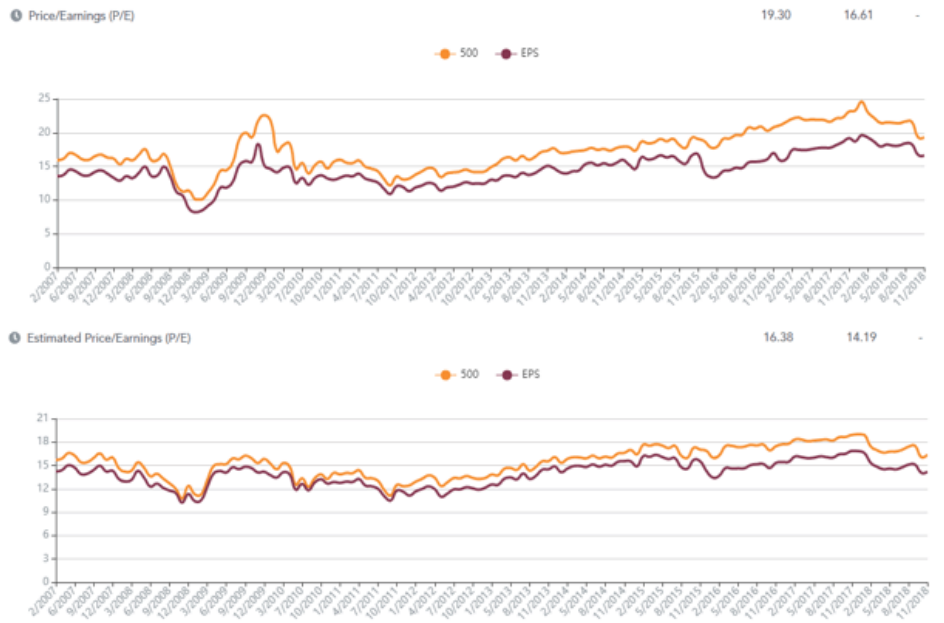
The Right Tools for the Job

The [WisdomTree U.S. Earnings 500 Fund \(EPS\)](#), which seeks to track the [WisdomTree U.S. Earnings 500 Index \(WTEPS\)](#), is an example of a fundamentally weighted strategy. EPS weights the 500 largest U.S. companies proportionately by the share of the aggregate earnings each component company has generated, rather than benchmarks such as the S&P 500 Index, which relies on market cap to determine weights in the index.

Using our ETF Characteristics Comparison Tool, we can see how the valuation story has played out vs. the S&P 500 Index over the course of EPS's history.

Figure 2 shows EPS has been trading at a considerable valuation discount to the S&P 500 on both a trailing and forward P/E basis. This makes intuitive sense since EPS increases exposure to more profitable companies among large-cap U.S. equities. In fact, since inception, EPS has tended to trade at a 18.3% average discount to the S&P 500 on a trailing basis, and a 12.1% average discount on a forward basis.

Figure 2: Historical Trailing and Forward P/Es of EPS vs. S&P 500, 2/28/07–11/30/18



Source: WisdomTree ETF Characteristics Comparison Tool. Past performance is not indicative of future results. You cannot invest directly in an index

For standardized performance of EPS, please click [here](#).

Tilting Toward Quality

In addition to managing valuations, another aspect on many investors’ radars is the notion of “quality.”

As we have written several times, [quality companies tend to perform well during the later stages of a bull market](#). By using fundamental metrics such as [return on equity \(ROE\)](#) as a proxy for quality, EPS has compared favorably to the S&P 500 in this respect as well.

Notably, the ROE gap between EPS and the S&P 500 became more pronounced during periods of distress, such as the global financial crisis from 2008 to 2009.

Figure 3: Historical ROE of EPS vs. S&P 500, 2/28/07–11/30/18



Source: WisdomTree ETF Characteristics Comparison Tool. Past performance is not indicative of future results. You cannot invest directly in an index.

Conclusion

These characteristics help illustrate the difference a [Modern Alpha](#)[™] approach can make for portfolio construction. We continue to build out our capabilities to empower investors with new tools and information. We encourage investors to continue to use this tool and take a closer look at the underlying risks in their current asset allocation.

Check out all WisdomTree investing tools [here](#).

Unless otherwise stated, data is sourced by WisdomTree, as of 11/30/18.

Important Risks Related to this Article

There are risks associated with investing, including 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 the Fund's prospectus for specific details regarding the Fund's risk profile.

For more investing insights, check out our [Economic & Market Outlook](#)

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)

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 and Brian Manby 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

Volatility : A measure of the dispersion of actual returns around a particular average level. .

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.

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

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.

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.

Quintile : One of the class of values of a variate which divides the members of and batch or sample into equal-sized subgroups of adjacent values or a probability distribution into distributions of equal probability.

Bubble : when market participants drive stock prices above their "fair value" in relation to some system of stock valuation.

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.

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over time.

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

Modern Alpha : Modern Alpha® combines the outperformance potential of active with the benefits of passive—to offer investor strategies that are built for performance.