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ECHOES OF DOT-COM: HIGH P/E[1] STOCKS LOOK VULNERABLE

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Old investing hands may know this adage: "Stock markets take the escalator up and the elevator down." It means bull markets have historically taken years to develop, but bear markets can come fast and furious. Here is a question: Is there an adage for 2020, where stocks took the elevator down *and* up?

Suddenly, the excesses in the U.S. stock market that were wrung out in February and March are right back with us. Maybe the current economic depression will morph into a V-shaped economic recovery. But even in that scenario, it is hard to argue that the S&P 500 is cheap at 21.4x trailing earnings and 24.6x earnings[2] for the next 12 months.

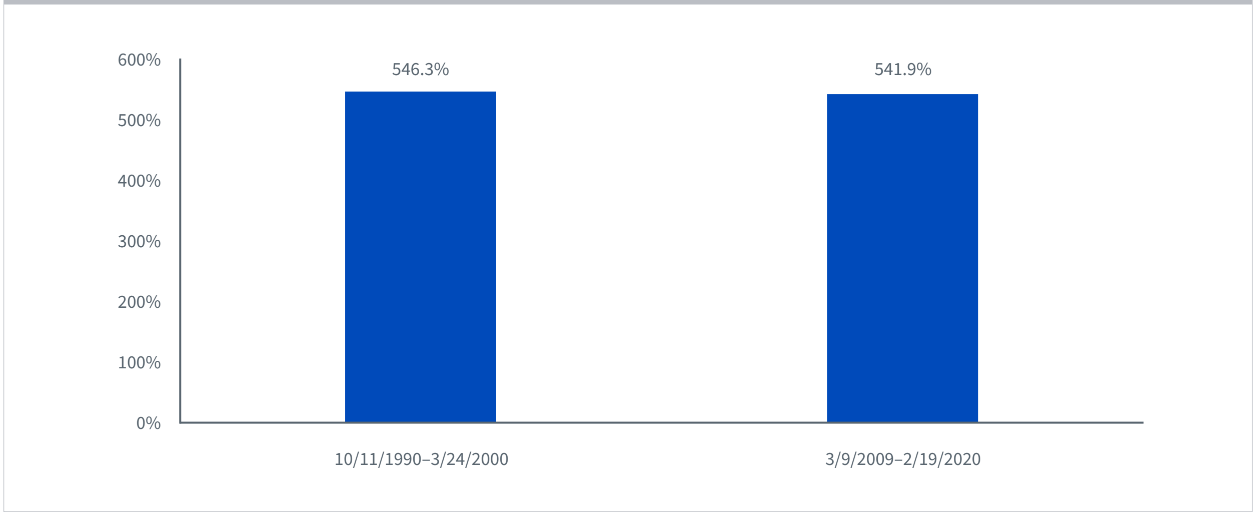
The oft-cited Bob Farrell, the former head of research at Merrill Lynch who was famous for his 10 investment "rules," often asserted:

"(Market) excesses in one direction will lead to an opposite excess in the other direction." Let's assess.

One place to start is to look at the scale of the bull market that started in March 2009 and ended on February 19, 2020. It exceeded the 1990–2000 run in duration and just missed it in total returns (Figure 1). Considering that the 1990s mania is often ranked as being possibly more egregious than the Dutch tulip bulb and South Sea bubbles, this market ***is showing considerable excesses.***

[1] 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. A higher number indicates that a company's stock is overvalued.
[2] Trailing earnings: The amount of profit that a company produces during the prior fiscal year.

Figure 1: S&P 500 Bull Market Total Returns to Pre-COVID-19 Crash High

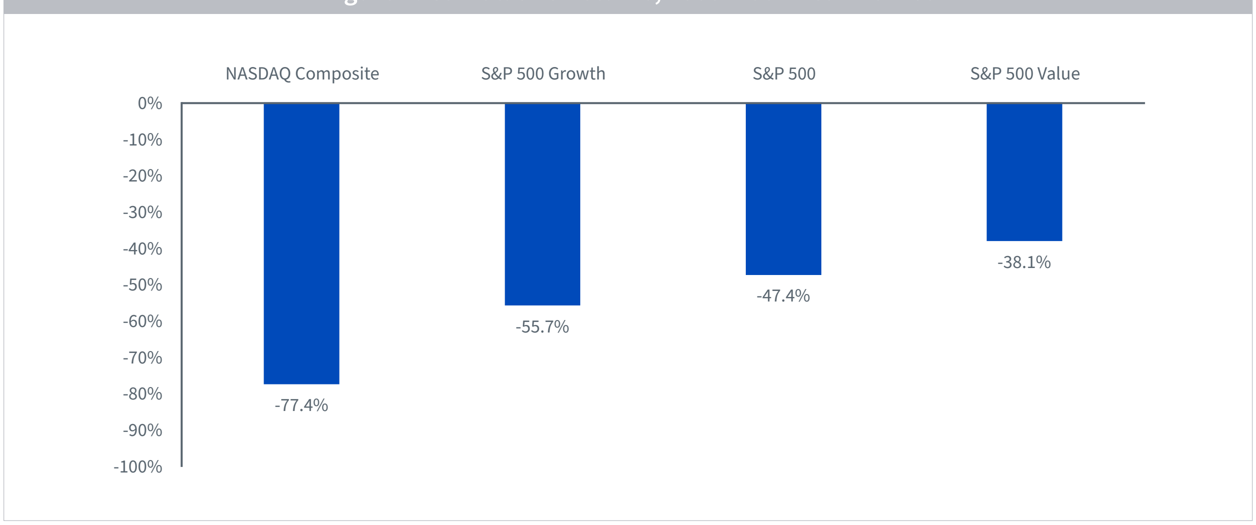


Sources: WisdomTree, Bloomberg. You cannot invest directly in an index. Past performance is not indicative of future results.

A corollary to Farrell's maxim is the notion that the stocks that lead bull markets are often the laggards in bear markets.

Although that was not the case in the February–March panic, when expensive tech stocks declined less than the market, it may be wise to pay heed to the lesson of the 2000–2002 crash. The king of the 1990s—the NASDAQ Composite—was the king of pain in the crash. The tech-heavy NASDAQ Composite went down more than three-quarters in that plunge (Figure 2).

Figure 2: Cumulative Returns, 2000–2002 Bear Market



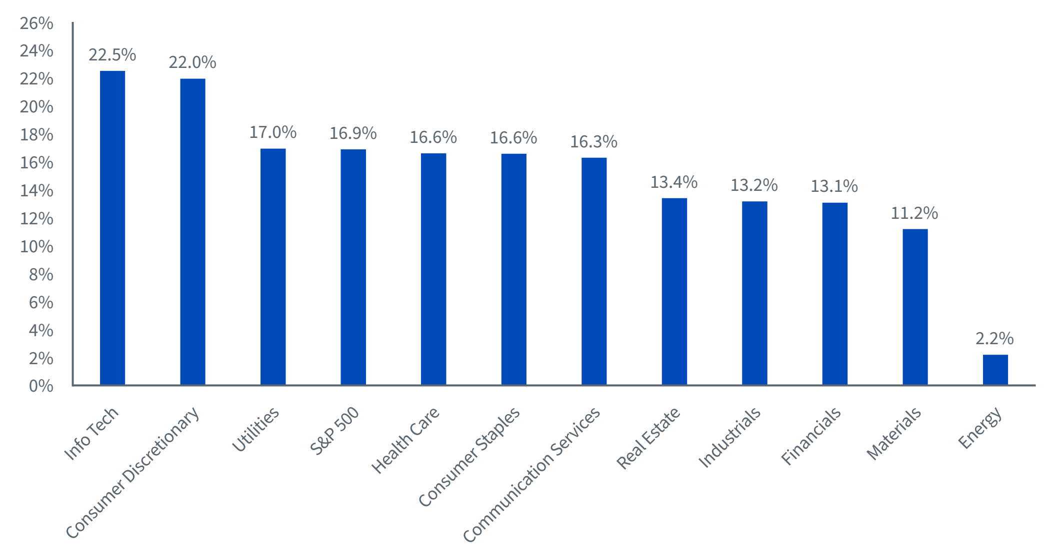
Sources: Bloomberg, WisdomTree. Cumulative total returns from the market's high to its low (3/24/00–10/9/02), as gauged by the S&P 500. You cannot invest directly in an index. Past performance is not indicative of future results.

Figure 3 paints a thousand pictures, especially in context. Tech, the quintessential growth[3] stock sector, has returned 22.5% in the more than 11 years since the global financial crisis low on March 6, 2009, inclusive of the COVID-19 crash.

On the other extreme is down-and-out Energy, which has returned 2.2% in that time. That gap—20.3 percentage points annually—is so large that it now exceeds the 16.2 percentage point performance gap between those two sectors from September 11, 1989 (the start of S&P's sector performance data) to the era's bull market peak on March 24, 2000.

Again, this is a performance gap that exceeds the amount witnessed in that mania of manias: the 1990s.

Figure 3: S&P 500 Sector Returns (3/6/09–5/31/20)



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

WHEN LAGGARDS BECOME LEADERS

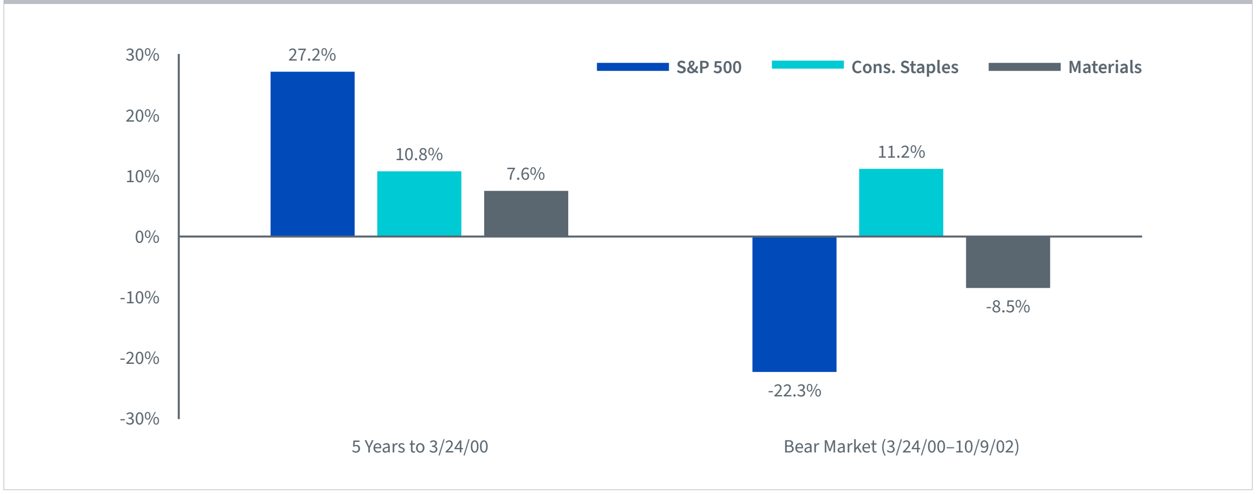
Figure 4 identifies the two sectors that participated the least in the last five years of the 1990s bull market. That environment, notorious for the "TMT" contingent of Tech, Media and Telecom domination, famously left Consumer Staples and Basic Materials behind.

Then the S&P crashed.

[3] Growth: Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

Falling from 1,527 to 776 in the approximately 31 months to October 2002, the S&P 500's losses were so deep that some people were burned for life. In contrast, Basic Materials declined at an 8.5% annual rate in those 31 months, a considerable savings amid the S&P's 22.3% annualized losses. Owners of Consumer Staples actually turned a profit, and a robust one at that. The sector acted as if there was no bear market, posting an 11.2% annual return.

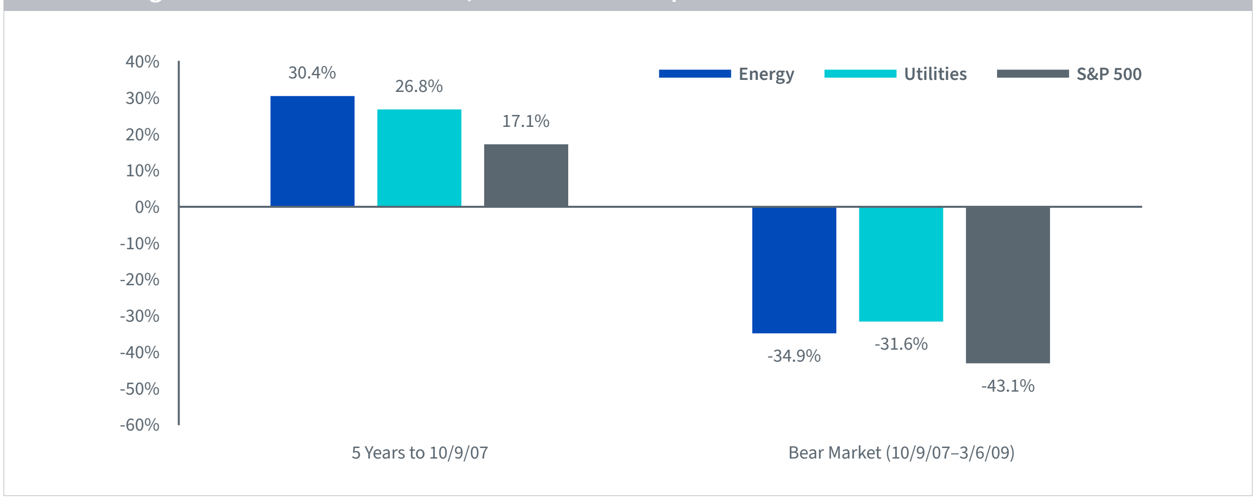
Figure 4: Annual Performance, Two Worst Sectors in the 1990s Bull Market



Sources: Bloomberg, WisdomTree, 3/24/1995–10/9/2002. You cannot invest directly in an index. Past performance is not indicative of future results.

But the stock market gods never make it easy. In the subsequent bull market, the one that ended with the global financial crisis, the two sectors that performed best in the five years to the stock market's October 9, 2007 peak were Energy and Utilities. They actually held up better than the S&P 500 when the bear market came (Figure 5).

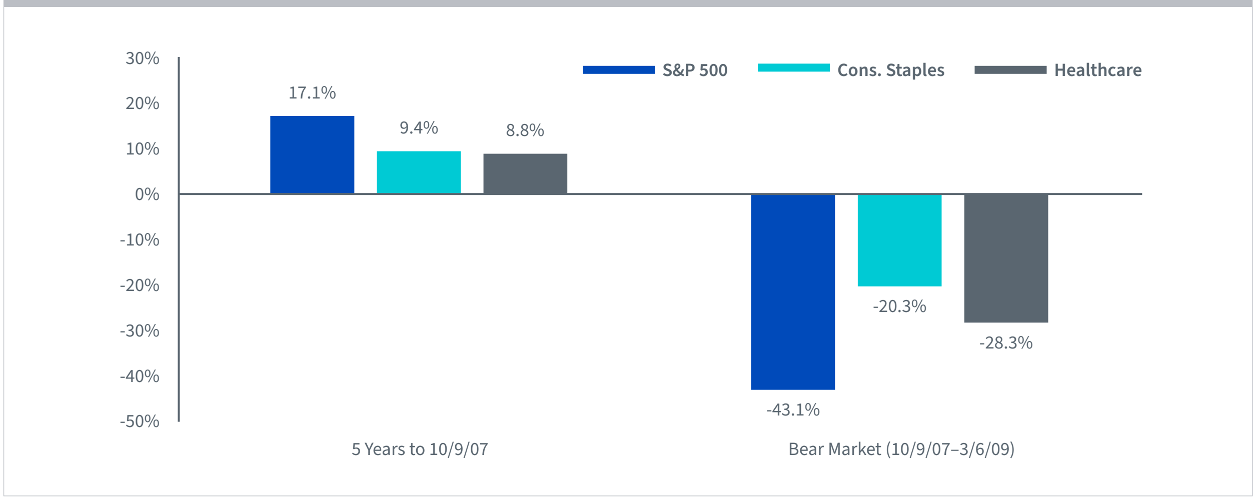
Figure 5: Annual Performance, Sectors That Outperformed in the 2002–2007 Bull Market



Sources: Bloomberg, WisdomTree, 10/9/02–3/6/09. You cannot invest directly in and index. Past performance is not indicative of future results.

The good news is that, like the 1990s bubble years, the two sectors that were most unloved in the 2002–2007 bull market—Consumer Staples and Health Care—outperformed when stocks crashed in the global financial crisis (Figure 6).

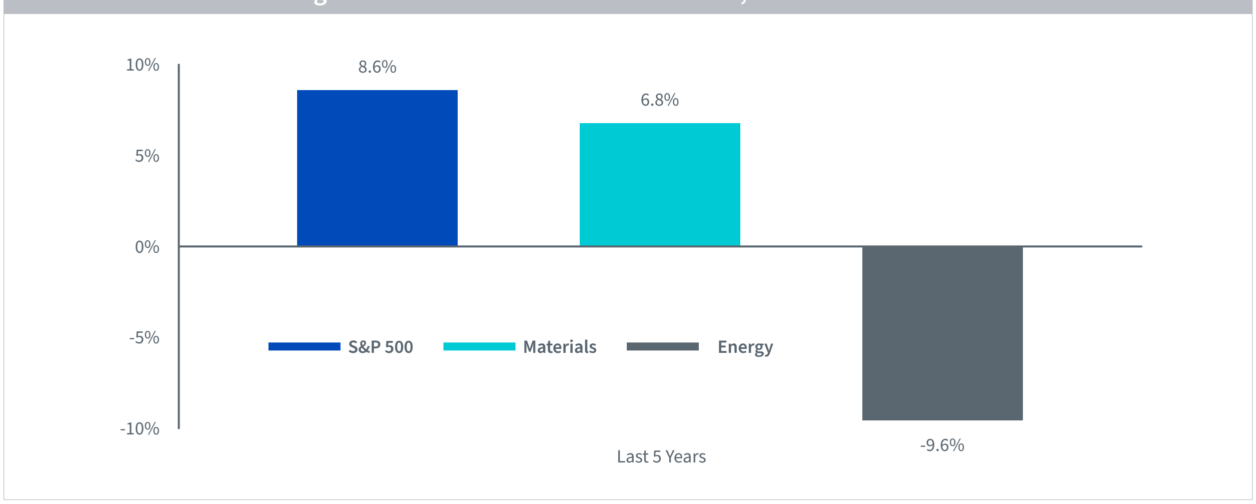
Figure 6: Annual Performance, Two Worst Sectors in the 2002–2007 Bull Market



Sources: Bloomberg, WisdomTree, 10/9/02–3/6/09. You cannot invest directly in an index. Past performance is not indicative of future results.

Over the last five years, Basic Materials struggled while Energy companies were left for dead (Figure 7), even as stocks returned nearly 9% per year. At this point, the combined market value of the Energy and Basic Materials sectors is lower than that of Microsoft alone.

Figure 7: Five-Year Annual Performance, Two Worst Sectors

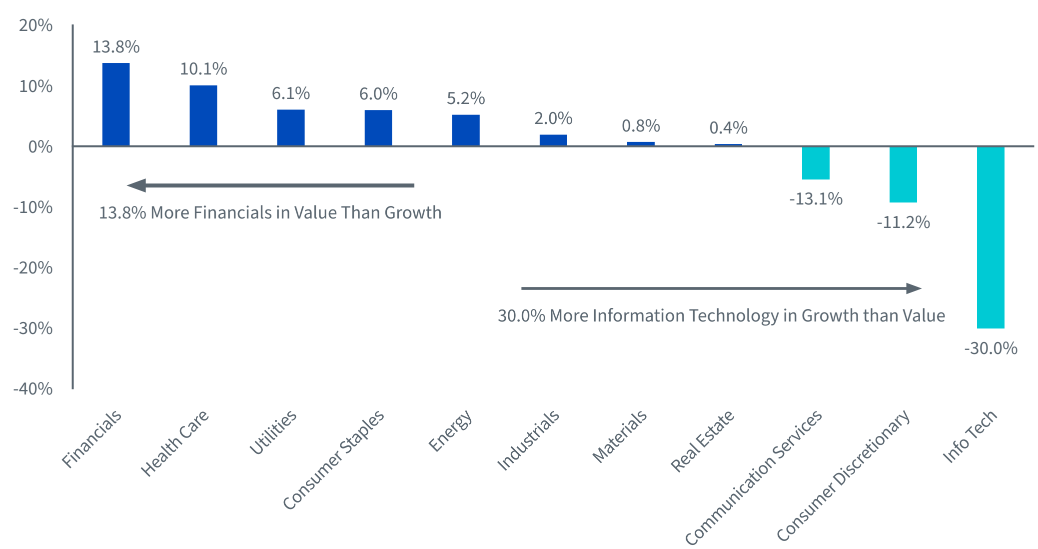


Sources: Bloomberg, WisdomTree, 5/31/15–5/31/20. You cannot invest directly in an index. Past performance is not indicative of future results.

Figure 8 shows the amount that sectors are over-weighted and under-weighted in the S&P 500 Value and S&P 500 Growth Indexes. For example, the Financials sector comprises 18.5% of the Value Index but just 4.7% of Growth, so it has nearly 14% more representation in the former than the latter. The other extreme is Technology, which has a 30% higher weighting in the S&P 500 Growth Index than in the S&P 500 Value.

Homing in on our two unloved sectors, Energy has 5.2% more weight in the Value Index, while Materials' weight is tiny in both. Combining the two, there is 6% more exposure for the unloved sectors in the S&P 500 Value Index.

Figure 8: S&P 500 Value Over-Weight (Under-Weight) vs. S&P 500 Growth



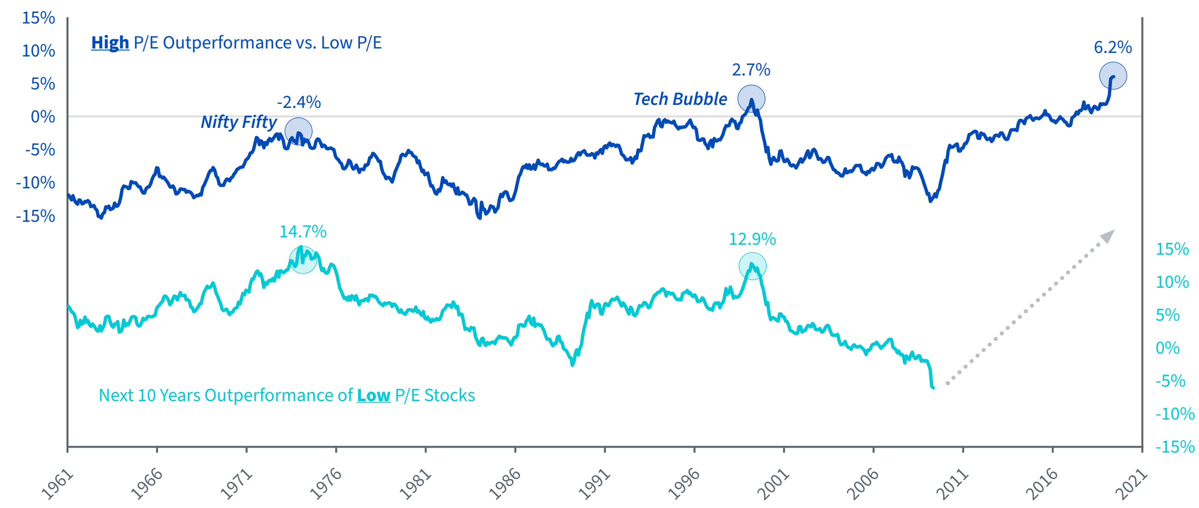
Sources: Bloomberg, WisdomTree, as of 5/31/20. You cannot invest directly in an index.

BEYOND THE SECTORS: THE P/E QUESTION

Figure 9 shows how much the one-fifth of the stock market with the highest price/earnings ratio outperformed/underperformed the one-fifth of stocks with the lowest P/E ratios over 10-year windows. In the decade to May 31, 2020, the high P/E stocks returned 6.2% more per year, exceeding any other time in history dating to the Eisenhower administration.

The last time the differential between high P/E and low P/E stocks was nearly this stretched was in the 10 years ending with the peak of the dot-com bubble. The subsequent 10 years—February 2000 through February 2010—witnessed the low P/E cohort beat the high P/E group by 12.9% per year. Fascinatingly, that outcome is not an outlier; when low P/E was "on" in prior generations, its outperformance was often handsome.

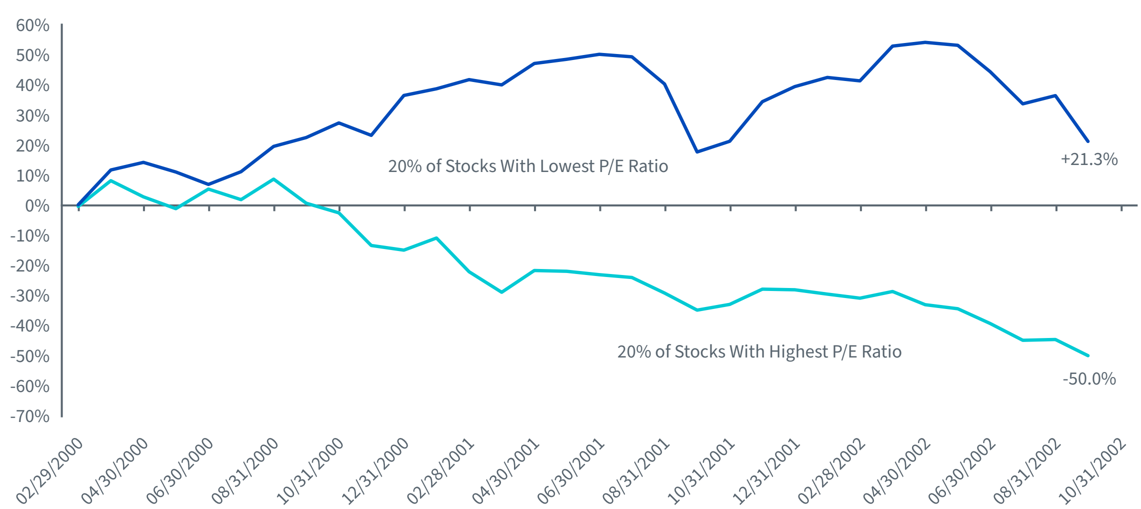
Figure 9: 10-Year Annualized Performance, Low P/E vs. High P/E Stocks



Source: Ken French CRSP Database, 7/31/1951–5/31/2020, updated to 1/31/20 with WisdomTree's attribution software on the S&P 500 for the final month. Past performance is not indicative of future results. High P/E stocks are often considered to be "growth" stocks, while low P/E stocks are "value." Depending on market sentiment, one or the other may be in favor.

Figure 10 shows how a large chunk of the alph[4] in low P/E was generated after the bubble was pricked in the dot-com crash. While many investors in NASDAQ stocks got burned, owners of low P/E stocks turned a profit.

Figure 10: Cumulative Return, 2/29/00–9/30/02



Sources: Ken French Database and Ken French CRSP Database. Past performance is not indicative of future results.

[4] Alpha: Can be discussed as either risk-adjusted excess returns relative to a specific benchmark or absolute excess returns relative to a benchmark. It is sometimes referred to as excess returns in general.

VALUE FOR THE 2020S

It has been so long since value[5] investing has witnessed a protracted period of outperformance that some investors may have forgotten that history has witnessed many multi-year windows of value stock dominance over growth stocks (Figure 11).

Figure 11: High P/E Growth Stocks vs. Low P/E Value Stocks				
Returns by Decade				
Era	20% of Stock Market With Highest P/E	20% of Stock Market With Lowest P/E	S&P 500	Winner
1950s	15.8%	27.0%	18.3%	Low P/E
1960s	6.8%	15.0%	7.8%	Low P/E
1970s	2.4%	12.0%	5.9%	Low P/E
1980s	12.3%	19.1%	17.5%	Low P/E
1990s	18.7%	17.2%	18.2%	High P/E
2000s	-2.5%	9.4%	-1.0%	Low P/E
2010s	13.9%	11.6%	13.0%	High P/E
2020s	?	?	?	?
Total	**9.3%**	**15.6%**	**11.0%**	**Low P/E**

Source: Ken French CRSP Database, 6/30/1951–12/31/2019. The 1950s had the beginning of data (6/30/1951); the 2010s end on 12/31/2019. You cannot invest directly in an index. Past performance is not indicative of future results.

If value investing is to make a comeback, Figure 12 is a guide for WisdomTree Funds on the growth-value spectrum.

The Funds are:

DGRW: WisdomTree U.S. Quality Dividend Growth Fund

EPS: WisdomTree U.S. LargeCap Fund

DLN: WisdomTree U.S. LargeCap Dividend Fund

QSY: WisdomTree U.S. Quality Shareholder Yield Fund

DHS: WisdomTree U.S. High Dividend Fund

DTN: WisdomTree U.S. Dividend ex-Financials Fund

[5] 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 versus the market over time.

Figure 12: Attribution to S&P 500 Growth and S&P 500 Value Indexes

Source: Bloomberg. Five-year weekly attribution to the S&P 500 Growth and S&P 500 Value Indexes, 1/31/15–1/31/20. You cannot invest directly in an index. Past performance is not indicative of future results. Growth: Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals. 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 versus the market over time. Core Funds: Represent large-cap companies. These are corporations that represent the greatest net worth on the stock market and can be depended on for returns in the coming years. Because of their security, large-cap companies have stocks with high values, which cost more to invest in than risky companies. Beta (β): A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

For readers looking to tap into Energy and Basic Materials, **DTN** has a large holding in the two (about 17%). For context, the combined weight of those sectors in the S&P 500 is 5.5%. That Fund and **DHS** are two of our "deeper" Value Funds.

For readers looking to capitalize on the low P/E versus high P/E setup, the ETF that most taps into this philosophy is **EPS**. We slashed its expense ratio to 8 bps[6] in Q1 2019 to go after S&P 500 tracker funds. Here is a decision tree for investors who may be inclined to own a market capitalization-weighted ETF:

Path A: Track one of the three largest S&P 500 ETFs offered by our competitors at expense ratios of 3 bps, 4 bps or 9.5 bps and own a large proportion of invested capital in high P/E stocks; or

Path B: Own WisdomTree's 500 stocks via EPS at an expense ratio of 8 bps, cutting down exposure to high P/E companies.

Remember Bob Farrell's rule:

> Excesses in one direction will lead to an opposite excess in the other direction.

Where are the excesses? High P/E stocks. Consider avoiding them.

[6] Basis point(s) (bps): 1/100th of 1 percent.

Unless otherwise stated, all data is sourced through May 31, 2020. Fund holdings are subject to change.

Investors should carefully consider the investment objectives, risks, charges and expenses of the Funds before investing. To obtain a prospectus containing this and other important information, please call 866.909.9473, or visit WisdomTree.com to view or download a prospectus. Investors should read the prospectus carefully before investing.

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. While QSY is actively managed, the Fund's investment process is expected to be heavily dependent on quantitative models, and the models may not perform as intended. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

Investments in value stocks present the risk that a stock may decline in value or never reach the value the advisor believes is its full market value. Value stocks are considered riskier than growth stocks because of the skeptical attitude the market has toward them. In addition, the Fund's value investment style may go out of favor with investors during certain parts of the market cycle, which may negatively affect the Fund's performance.

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. **S&P 500 Growth Index:** A market capitalization-weighted benchmark designed to measure the growth segment of the S&P 500 Index. **S&P 500 Value Index:** A market capitalization-weighted benchmark designed to measure the value segment of the S&P 500 Index. **NASDAQ Composite Index:** A market capitalization-weighted index of more than 3,300 common equities listed on the NASDAQ stock exchange.

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