

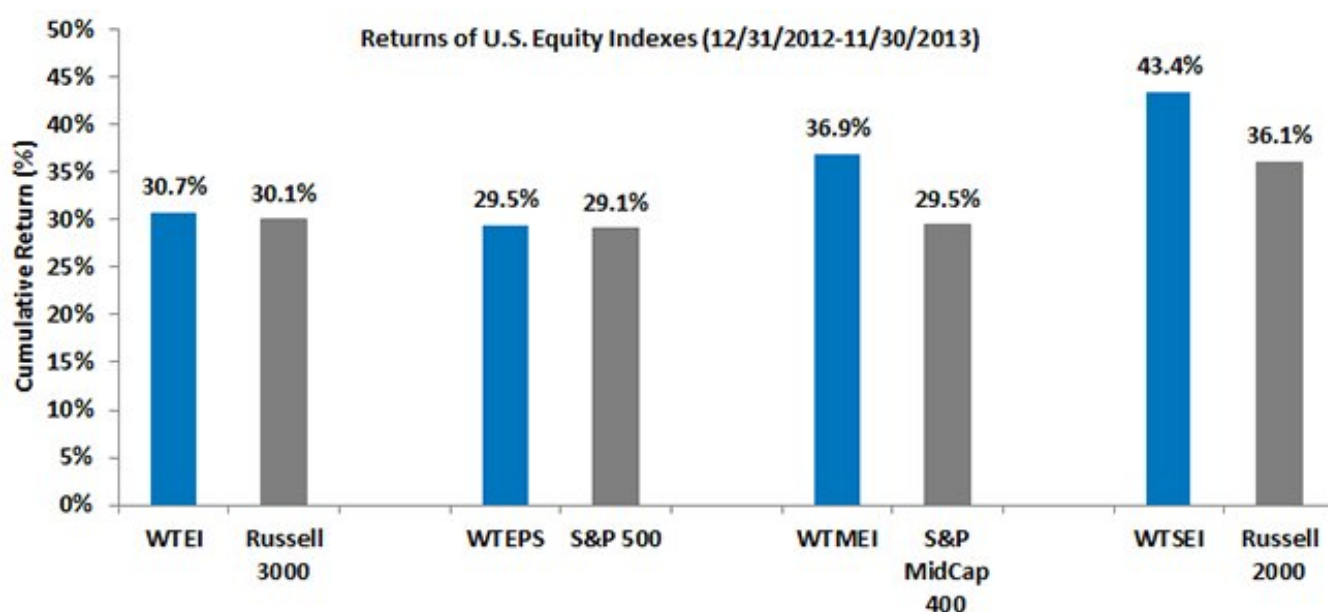
Equity Markets Setting New Highs: What Is Your Index Going to Do about It?

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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.

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](#). • 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.

Important Risks Related to this Article

Investments focusing on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility.