

The Fundamental Difference for U.S. Large Caps

Published June 18, 2015

Tripp Zimmerman, CFA

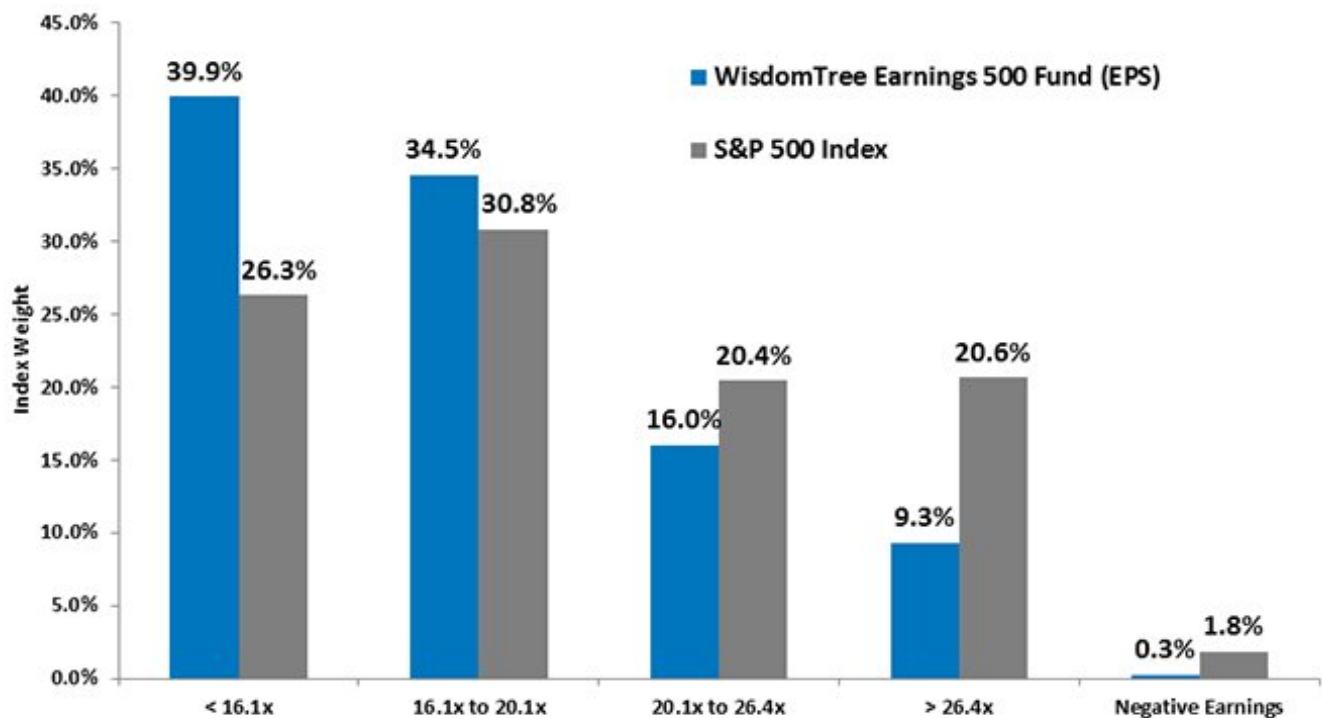
Director, Research

On May 21, 2015, the [S&P 500 Index](#) closed at a record high. Since the March 2009 lows, the index has appreciated by over 210% on a price basis and, as a result, the [price-to-earnings \(P/E\) ratio](#) has expanded from 11x to 18.8x1. Now, six years into this bull market, many market participants are concerned about both the price appreciation and multiple expansion, actively debating whether the markets are ripe for a pullback. If you are also concerned about valuations, then we think you should look to fundamentally weighted investment options, which tend to be more sensitive to valuations. WisdomTree feels that weighting by market capitalization, which does not weight, consider or rebalance back to any fundamental value, renders an investment most susceptible to bubbles. We believe that a disciplined strategy of anchoring allocations back to a concept of relative value, based on fundamentals such as dividends or earnings, can protect against valuation risks. **The Fundamental Difference** The [WisdomTree Earnings 500 Index \(WTEPS\)](#) seeks to provide exposure to the 500 largest profitable U.S. companies but to do so while maintaining sensitivity to valuation. To help achieve this, the Index weights companies by the profits they generate, rather than their market cap, and rebalances back to profitability on an annual basis. WisdomTree's rebalance process typically is driven by:

- Earnings Growth: Companies increasing profits see their weight increased
- Relative Performance:

- Underperformers typically see their weight increased
- Outperformers often see their weight decreased

P/E Ratio Weight Distribution The annual Index rebalance process tends to shift weight to firms with the lowest P/E ratios and away from firms with the highest P/E ratios. The chart below helps visualize the distribution of stocks by their P/E ratios for the [WisdomTree Earnings 500 Fund \(EPS\)](#), which seeks to track WTEPS before fees and expenses, against the S&P 500 Index, one of the most widely followed market cap-weighted indexes. **P/E Distribution**



Sources: WisdomTree, Bloomberg, as of 5/21/15. P/E ranges were selected using quartiles from the S&P 500 Index. Subject to change.

• **More Weight to Lower-Priced Stocks** – The WisdomTree Earnings 500 Fund has almost 75% of its weight in the two lowest-priced quartiles, which is over 17% more weight than the S&P 500 Index. There is a natural tendency of earnings-weighted approaches to reduce weight to stocks whose prices have appreciated at a faster rate than their earnings, and concurrently to increase weight to stocks that have fallen in price despite exhibiting positive earnings growth.

• **Less Weight to Higher-Priced Stocks** – WisdomTree's 17% over-weight to lower-priced stocks comes from a 17% under-weight to the higher-priced segment of the market. EPS also has less than half the weight of the S&P 500 to stocks that fall in the highest P/E ratio quartile.

• **Negative Earnings and Speculative Stocks** – Although profitability may fluctuate throughout the year, at each annual rebalance WisdomTree requires companies to be profitable before inclusion. This requirement limits the weight to firms we feel tend to be more speculative and of lower quality to zero. Although the weight to unprofitable firms is currently low for the S&P 500 Index as well, the index does not screen for profitability on an annual basis, so that number could potentially rise in times of market stress. 1Source: Bloomberg, 3/9/09–5/21/15.

Important Risks Related to this Article

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.