Valuations, Bubbles and the Stories We Tell Ourselves—Part 2

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Key Takeaways

- Historically, higher market valuations have been linked to lower future returns, reinforcing the importance of price discipline even in high-growth environments.
- With U.S. large-cap growth stocks surging, investors should be mindful of overly optimistic expectations that could lead to corrections if earnings growth fails to keep pace.
- Income-generating strategies like the WisdomTree PutWrite Strategy Fund (PUTW) and WisdomTree U.S. High Dividend Fund (DHS) may provide alternative opportunities in an environment where future equity returns are uncertain.

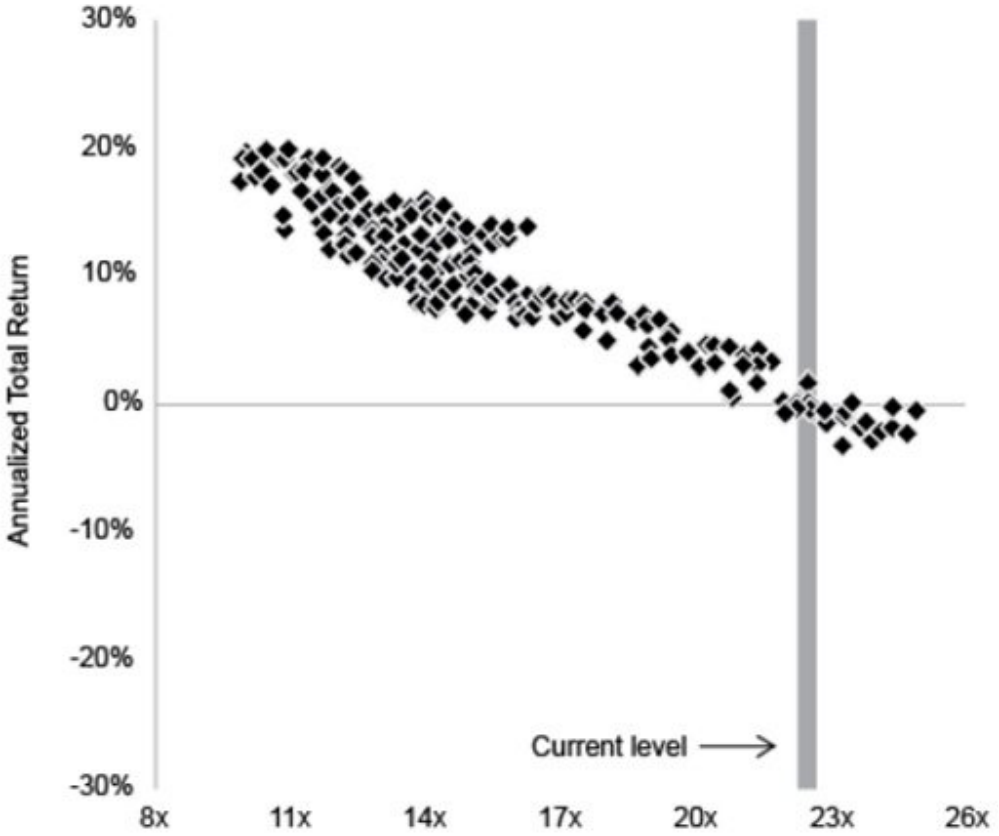
We recently wrote about how investing is a curious mix of logic and emotion and that few topics capture this tension as vividly as market valuations. They evoke awe during periods of booming optimism and despair when pessimism grips the crowd. From the tech boom of the late 1990s to the dominance of today's AI-driven narratives, markets rarely follow a script. As Howard Marks eloquently puts it, bubbles aren't just about numbers—they're about the stories we tell ourselves.[1]

High valuations, like those seen in the late 1990s or during the Nifty Fifty era, often presage significant corrections. But the market's tendency to overshoot—both up and down—creates opportunities for those with patience and discipline.

Howard Marks included a graph in a recent article from J.P. Morgan Asset Management, shown here as figure 1.[2] There is a square for each month from 1988 through late 2014, meaning there are 324 monthly observations. Each square represents the forward P/E ratio on the S&P 500 Index and then the annualized return over the following 10 years. It's a clear depiction of all that we've said so far: the starting valuation has had a clear relationship to the subsequent return experienced.

- Higher valuations have been associated with lower forward-looking returns.
- Lower valuations have been associated with higher forward-looking returns.

Figure 1: S&P 500 Forward P/E Ratios and Subsequent 10-Year Returns



Source: J.P. Morgan Asset Management, from Howard Marks, "On Bubble Watch," *Oaktree Capital*, 1/7/25. **Past performance is not indicative of future returns. You cannot invest directly in an index.**

The clear takeaway is that higher starting valuations have been associated with lower forward-looking returns.

Navigating High-Valuation Markets

The question isn't whether we're in a bubble—it's how to navigate the current environment. As Howard Marks says, "It's not what you buy; it's what you pay." Even great companies can become poor investments if bought at inflated prices.

So, what should investors do?

At WisdomTree, we think that if there might be a scarcity of forward-looking returns, income generation could be at a premium.

- The WisdomTree PutWrite Strategy Fund (PUTW) sells put options. Specifically, PUTW seeks to track the price and yield performance, before fees and expenses, of the Volos US Large Cap Target 2.5% PutWrite Index. The index methodology specifies selling options every two weeks, not every month. Instead of holding an underlying basket of equities, the strategy is holding a basket of short-term, U.S. Treasury securities.

- WisdomTree U.S. High Dividend Fund (DHS): DHS is designed to track the total return performance, before fees and expenses, of the WisdomTree U.S. High Dividend Index. This strategy focuses on relatively higher-yielding dividend payers rather than quality measures of earnings growth. Since we are talking about generating income it could be worthwhile to consider PUTW's performance experience against that of a strategy focused on higher-yielding dividend payers.
- WisdomTree U.S. Quality Growth Fund (QGRW): QGRW is designed to track the total return performance, before fees and expenses, of the WisdomTree U.S. Quality Growth Index. This strategy focuses on higher-quality companies with strong earnings growth measures, and notably does not require constituents to pay dividends.

We can benchmark these against the S&P 500 Index, mentioned in figure 1.

Figure 2: Standardized Returns

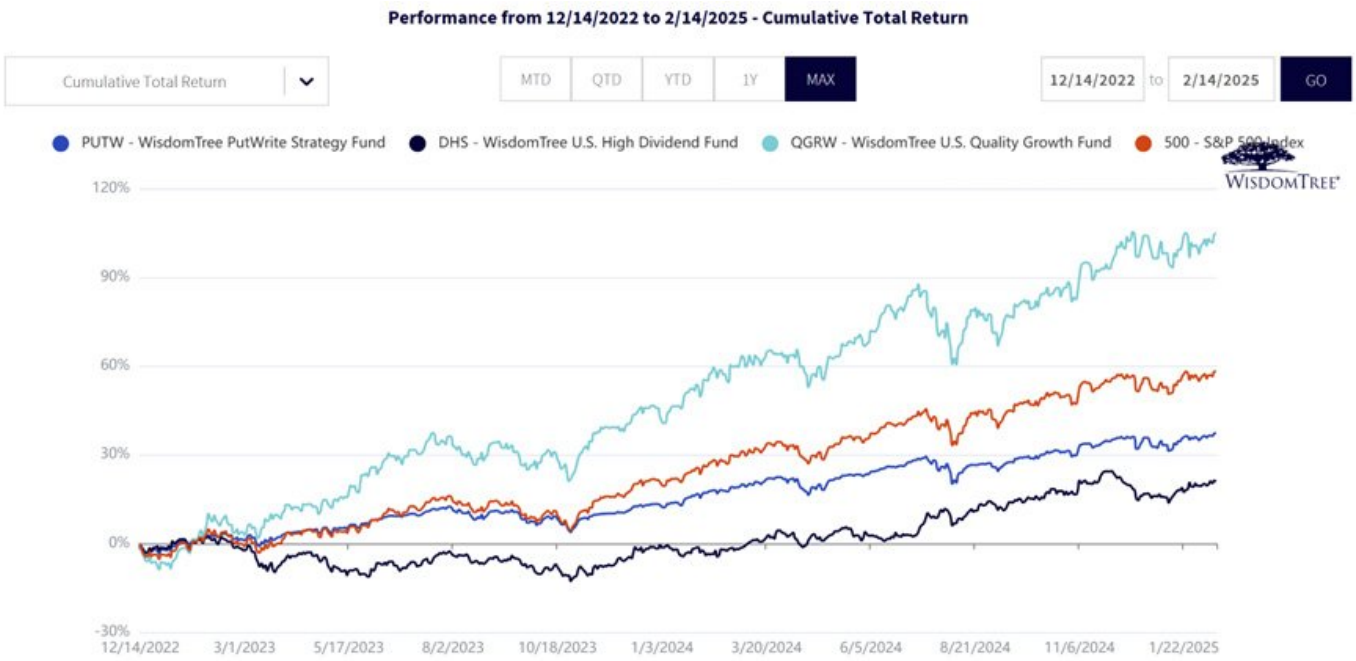
Fund/Index Name	Fund Ticker Symbol	Fund Inception Date	Fund Expense Ratio	SEC 30-Day Yield	1-Year	3-Year	5-Year	10-Year	Since Fund Inception
WisdomTree PutWrite Strategy Fund (NAV)	PUTW	2/24/16	0.44%	4.46%	17.02%	6.70%	8.40%	N/A	7.75%
WisdomTree PutWrite Strategy Fund (MP)	PUTW	2/24/16	0.44%	4.46%	16.88%	6.66%	8.40%	N/A	7.72%
WisdomTree U.S. High Dividend Fund (NAV)	DHS	6/16/06	0.38%	3.71%	17.98%	8.30%	8.08%	8.17%	7.38%
WisdomTree U.S. High Dividend Fund (MP)	DHS	6/16/06	0.38%	3.71%	17.99%	8.29%	8.11%	8.16%	7.37%
WisdomTree U.S. Quality Growth Fund (NAV)	QGRW	12/15/22	0.28%	0.18%	34.81%	N/A	N/A	N/A	39.11%
WisdomTree U.S. Quality Growth Fund (MP)	QGRW	12/15/22	0.28%	0.18%	34.87%	N/A	N/A	N/A	39.14%
S&P 500 Index					25.02%	8.94%	14.53%	13.10%	N/A

Source: WisdomTree, specifically data from the Fund Comparison Tool in the PATH suite of tools, accessed 2/16/25, with returns as of 12/31/24. SEC 30-Day Yield as of 12/31/24. NAV denotes total return performance at net asset value. MP denotes market price performance. Prior to 10/24/22, the WisdomTree PutWrite Strategy Fund was named the WisdomTree CBOE S&P 500 PutWrite Strategy Fund. **Past performance is not indicative of future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. For the most recent month-end and standardized performance and to download the respective Fund prospectuses, click the relevant ticker: PUTW, DHS and QGRW.**

OpenAI released ChatGPT on November 30, 2022. While it was trickier to know at the time, in hindsight, this software release kicked off a massive run in large market capitalization growth equities in the U.S. As ChatGPT was capturing the world's collective attention, WisdomTree launched QGRW on December 15, 2022, which explains the starting point of figure 3. During this massive run in U.S. large-cap growth stocks:

- QGRW dramatically outperformed.
- We have seen many, many headlines about the exposure of the so-called Magnificent 7[3] stocks within the S&P 500 Index at a level of around 30%. It is not surprising that this benchmark also rallied significantly over this period.
- PUTW versus DHS is a very important comparison to take account of as well. Many investors may be thinking about income-generating strategies. One approach, higher-yielding dividend-paying stocks, is represented by DHS. Another, selling options, is represented by PUTW. In a massive large-cap equity growth rally, neither of these strategies would be expected to outperform the S&P 500 Index. DHS is taking a lot of stock selection risk against the S&P 500 Index—basically avoiding the Magnificent 7. PUTW writes put options against an S&P 500 Index underlying, so the risk does not come down to stock selection but rather the simple mechanics of how selling put options is not designed to keep up with a trending upward market.

Figure 3: Performance since the Launch of QGRW



Source: WisdomTree, specifically data from the Fund Comparison Tool in the PATH suite of tools, accessed 2/16/25. NAV denotes total return performance at net asset value. Prior to 10/24/22, the WisdomTree PutWrite Strategy Fund was named the WisdomTree CBOE S&P 500 PutWrite Strategy Fund. The chart begins on 12/14/22, which essentially means that the opening price on QGRW's 12/15/22 inception date is captured. **Past performance is not indicative of future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. For the most recent month-end and standardized performance and to download the respective Fund prospectuses, click the relevant ticker: PUTW, DHS, and QGRW.**

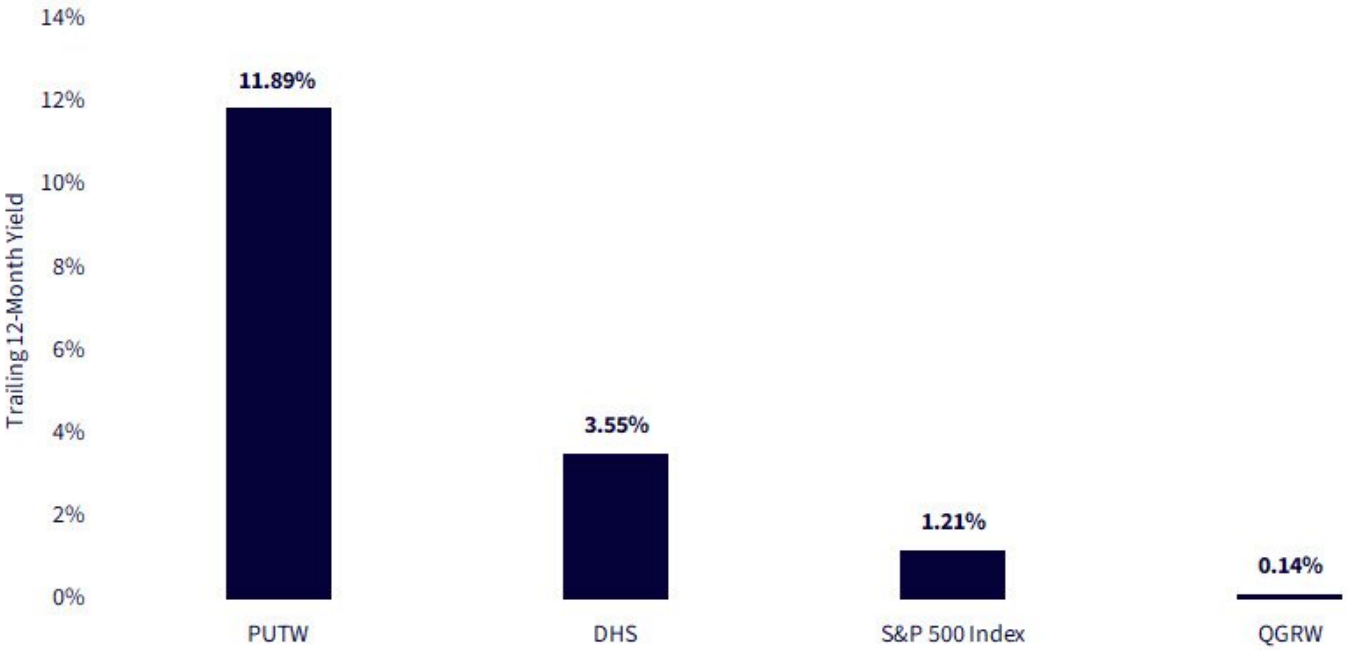
Figure 1 discussed the relationship using the S&P 500 Index seeing that lower forward P/E ratios have been historically associated with stronger forward-looking 10-year returns.

In our view, this isn't telling us that the returns in growth are over—it's not that simple. It's telling us that stocks in the growth segment of U.S. equities are at greater risk of a particularly rosy set of circumstances being priced in. If those expectations are not met, a correction could be catalyzed.

One of the stories being told in figure 1 is that the price level of the S&P 500 Index has been appreciating faster than the earnings have been growing—which accounts for the higher P/E ratio. It could also indicate that the price level has been appreciating faster than dividends have been growing, accounting for a lowering of the dividend yield.

In figure 4, we look at the different distribution yields of PUTW, DHS and QGRW, with the S&P 500 Index dividend yield shown as a point of reference. It's clear that PUTW stands out, so it's important for us to look into this further.

Figure 4: Distribution Yields, as of February 14, 2025



Source: WisdomTree, specifically data from the Fund Comparison Tool in the PATH suite of tools, accessed 2/14/25. **Past performance is not indicative of future results.**

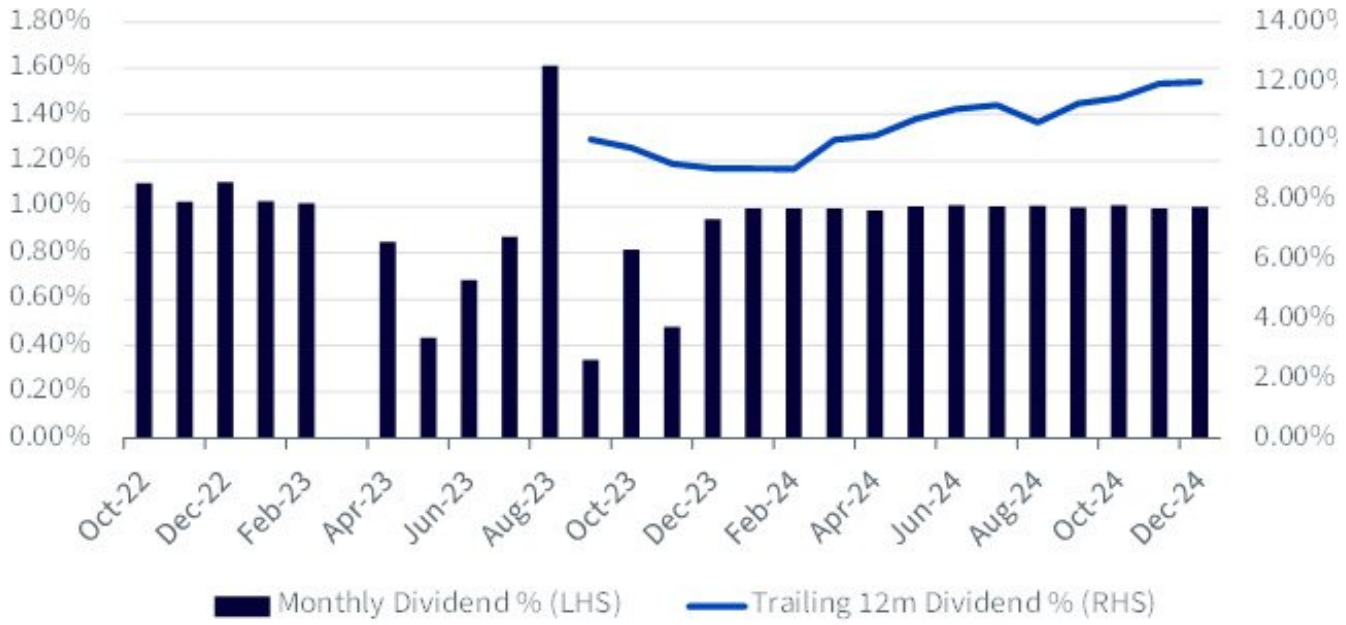
With PUTW's high distribution yield, it's important to understand this figure's inherent risk. The following quote comes from PUTW's prospectus: "The Fund is managed in a way that seeks, under normal circumstances, to provide monthly distributions at a relatively stable level."

It makes sense to test how relatively stable these distributions have been over the period for which the current strategy has been in place, which began on October 24, 2022.

- 2023 did show a more volatile distribution history, particularly from March 2023 to November 2023.

- From December 2023, onwards, the distribution has been much closer to a 1 % level. There is no guarantee that the distribution will always be 1%, but it is a good illustration using data to establish from the actual record how stable it has been.

Figure 5: PUTW's Distribution History under its Current Methodology



Source: WisdomTree. Prior to 10/24/22, the WisdomTree PutWrite Strategy Fund was named the WisdomTree CBOE S&P 500 PutWrite Strategy Fund, which accounts for the time period shown in figure 5. **Past performance is not indicative of future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. For PUTW's most recent month-end and standardized performance, click here.**

Conclusion

Market valuations are a mirror of human psychology, reflecting both our hopes and fears. Today's market, driven by AI enthusiasm and the dominance of the Magnificent Seven, is a testament to the power of storytelling in investing. But as history has shown, the best narratives don't always yield the best returns.

Investing isn't about certainty—it's about probabilities. It's about balancing optimism about the future with realism about its price. Many people we speak to don't know if the market is more likely to trend upwards or downwards. If returns are simply more volatile and the compound annual growth rates are lower than they have been for the period since about 2020, we believe that income generating strategies, like PUTW and DHS, may be better positioned.

[1] Source: Howard Marks, "On Bubble Watch," *Oaktree Capital*, 1/7/25.

[2] Source: Marks, 2025.

[3] The Magnificent 7 refers to Alphabet, Amazon.com, Apple, Microsoft, Meta Platforms, Nvidia and Tesla.

Important Risks Related to this Article

There are risks associated with investing, including the possible loss of principal. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

PUTW: The Fund will invest in derivatives, including S&P 500 Index put options ("SPX Puts"). Derivative investments can be volatile, and these investments may be less liquid than securities, and more sensitive to the effects of varied economic conditions. The value of the SPX Puts in which the Fund invests is partly based on the volatility used by market participants to price such options (i.e., implied volatility). The options values are partly based on the volatility used by dealers to price such options, so increases in the implied volatility of such options will cause the value of such options to increase, which will result in a corresponding increase in the liabilities of the Fund and a decrease in the Fund's NAV. Options may be subject to volatile swings in price influenced by changes in the value of the underlying instrument. The potential return to the Fund is limited to the amount of option premiums it receives; however, the Fund can potentially lose up to the entire strike price of each option it sells. Due to the investment strategy of the Fund, it may make higher capital gain distributions than other ETFs.

DHS: 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. Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time.

QGRW: Growth stocks, as a group, may be out of favor with the market and underperform value stocks or the overall equity market. Growth stocks are generally more sensitive to market movements than other types of stocks. The Fund is non-diversified, as a result, changes in the market value of a single security could cause greater fluctuations in the value of Fund shares than would occur in a diversified fund. The Fund invests in the securities included in, or representative of, its Index regardless of their investment merit. The Fund does not attempt to outperform its Index or take defensive positions in declining markets and the Index may not perform as intended.