

# DO WISDOMTREE U.S. EARNINGS INDEXES "WORK"?

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We've been writing a lot lately about the connection between [factor risk premiums](#) and any potential to achieve [modern alpha](#). One of the best things about WisdomTree is a long track record from which to evaluate any measure of success in this area.

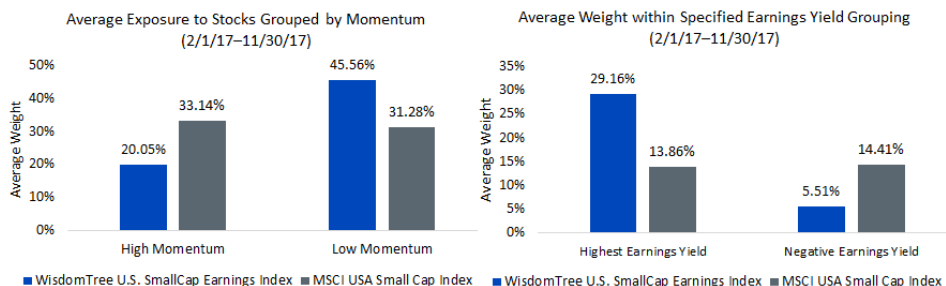
## A [Value](#) Tilt with an "Anti-Momentum" Bias

Over time, it has become clear that WisdomTree's equity approaches offer greater contrasts to [market capitalization-weighted](#) benchmarks in less efficient areas of the market. With that in mind, we focus on comparing the [WisdomTree U.S. SmallCap Earnings Index](#) with the [MSCI USA Small Cap Index](#). Our annual rebalance—which happens the last trading day of November each year—has tended to do two things very consistently:

1. **Raise [Earnings Yields](#) (Lower [Price-to-Earnings \(P/E\) Ratios](#)):** When adjusting exposure to give firms with the greatest earnings the largest weights, as well as eliminating exposure to firms with negative earnings, the natural consequence is lowering valuations based on measures of earnings.
2. **Break the Link between a Rising Share Price and Increasing Weight (Anti-Momentum):** Market Capitalization = Price per Share x Number of Shares Outstanding. It's clear, therefore, how a rising price leads to a rising market capitalization—in other words, greater weight within a market capitalization-weighted index. A way to see this—take Facebook, Amazon, Netflix and Google (the FANG stocks), which had a combined weight of 5.61% in the [S&P 500 Index](#) as of December 31, 2016. Year-to-date (YTD) through December 7, 2017, these stocks had delivered a weighted average performance of about 46% (compared with the full S&P 500 Index at 20.72%), and their combined weight had grown to 7.05%.<sup>1</sup>

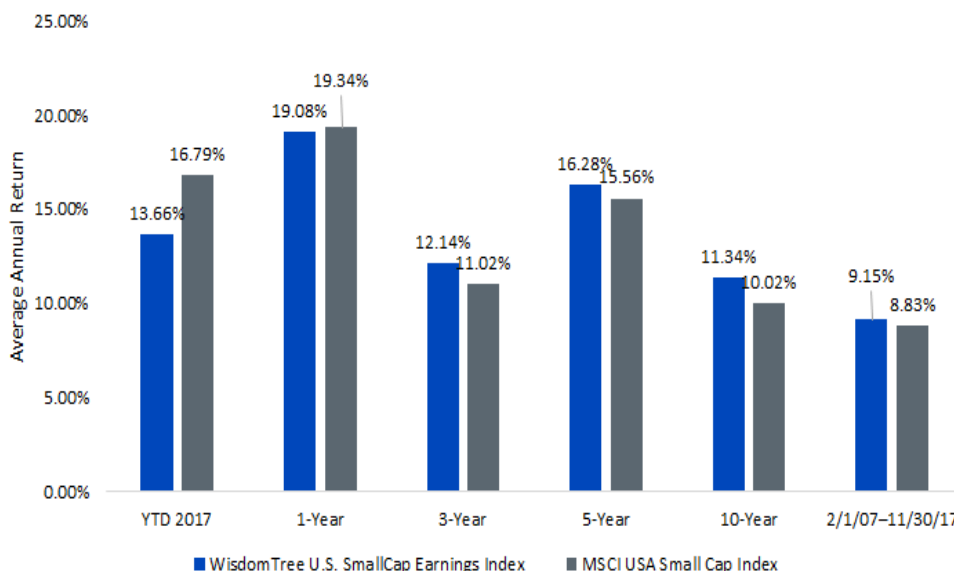
A market capitalization-weighted approach will add weight to stocks that are outperforming and therefore increasing their market capitalization relative to the rest of the index, and this is one of the biggest contrasts that exists between market capitalization weighting and fundamentally focused [rebalancing](#).

## A Track Record of Raising Earnings Yields and Anti-Momentum Exposure



Sources: WisdomTree, FactSet, with data measured over the full live calculation of the WisdomTree U.S. SmallCap Earnings Index. Highest Earnings Yield refers to the highest quintile of stocks grouped by earnings yield. Negative Earnings Yield refers to stocks with negative earnings over the 12-month period, with earnings per share not calculated on the basis of core earnings, upon which the WisdomTree U.S. SmallCap Earnings Index is based. High Momentum stocks and Low Momentum stocks are ranked in the top and bottom third, respectively, on a measure of 6-month and 12-month returns divided by standard deviation. You cannot invest directly in an index.

## An Impressive Long-Term Track Record with Near-Term Underperformance



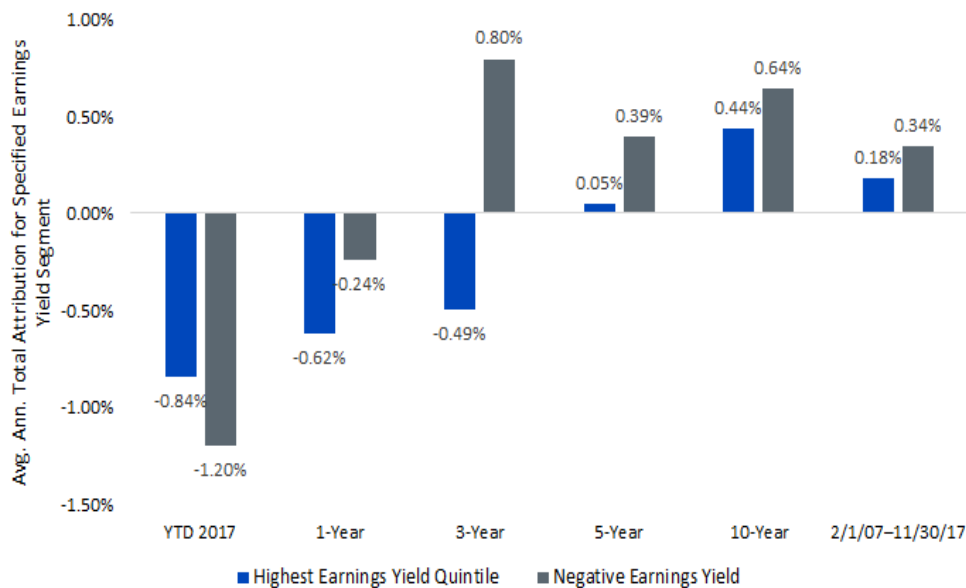
Sources: WisdomTree, Bloomberg, with data for the period 2/1/07–11/30/17. You cannot invest directly in an index.

The total returns of a given equity index tend to be the first thing that investors can easily see and study. When comparing the WisdomTree U.S. SmallCap Earnings Index against the MSCI USA Small Cap Index benchmark, we see the following:

- On the three-year horizons and longer, as of November 30, 2017, the WisdomTree Index outperformed the MSCI index.
- On the one-year and YTD horizons, the MSCI index outperformed the WisdomTree Index.

We set out to use unique attribution studies, based on grouping stocks by earnings yield and momentum, with the goal of explaining both the outperformance and underperformance of the WisdomTree U.S. SmallCap Earnings Index.

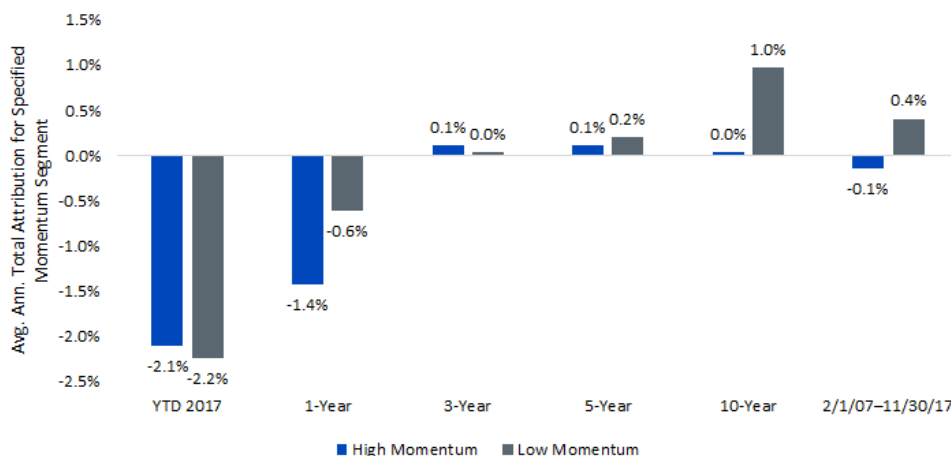
## Earnings Yield-Based Attribution



Sources: WisdomTree, FactSet, with data measured over the full live calculation of the WisdomTree U.S. SmallCap Earnings Index. Highest Earnings Yield refers to the highest quintile of stocks grouped by earnings yield. Negative Earnings Yield refers to stocks with negative earnings over the period 12-month period, with earnings per share not calculated on the basis of core earnings, upon which the WisdomTree U.S. SmallCap Earnings Index is based. You cannot invest directly in an index.

- It would be nice if the lowest P/E or highest earnings yield stocks always outperformed, but the fact is they do not. We can see from the chart that the combined impact of stock selection and allocation toward the highest earnings yield quintile helped relative performance of the WisdomTree strategy over the since inception, 10-year and 5-year periods, but not during the YTD, 1-year, and 3-year periods.
- The other critical point is how the WisdomTree methodology tilts away from more speculative stocks that have generated negative earnings—but it's true that sometimes these stocks outperform. Over the YTD and 1-year periods—periods where we know that the WisdomTree U.S. SmallCap Earnings Index underperformed the MSCI USA Small Cap Index—we can see that the combined allocation toward and selection within this grouping led to negative relative performance.

## Momentum-Based Attribution



Sources: WisdomTree, FactSet. High Momentum stocks and Low Momentum stocks are ranked in the top and bottom third, respectively, on a measure of 6-month and 12-month returns divided by standard deviation. You cannot invest directly in an index.

- The combined impact of stock selection within and weighting of the lowest-momentum stocks delivered its greatest relative benefit over the 10-year period. Positioning related to this grouping detracted over the YTD and 1-year periods.
- Over the 1-year period, as well as in the 2017 YTD period, where we know that stocks with strong momentum have done well, we see that the combined effects of selection within and weighting of the High and Low Momentum groupings hurt the WisdomTree strategy relative to the MSCI strategy.

### How This Knowledge Can Help with Manager Selection and Portfolio Construction

While some people may have an initial reaction of “so what?” we think that this represents a very important foundational understanding of how the WisdomTree U.S. SmallCap Earnings Index works. It can also tell us that if one were to have a complementary exposure to a high-momentum, small-cap approach, the two strategies working in tandem may lead to a lower risk of underperformance and being out of favor. Analysis like this can really be used to thinking in a broader context about how different strategies that are attempting to generate modern alpha may complement one another.

<sup>1</sup>Source: Bloomberg.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

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.

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You cannot invest directly in an index.

## DEFINITIONS

**Factor** : Attributes that based on its fundamentals or share price behavior, are associated with higher return.

**Risk premium** : Equity investments are not risk free, but it is thought that investors buy stocks because the returns they expect are high enough to allow them to take the risk.

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

**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 vs the market over time.

**Momentum** : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

**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.

**MSCI USA Small Caps Index** : a small-cap US equity index aiming to capture the performance of the securities within this size segment.

**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.

**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.

**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.

**Rebalance** : An index is created by applying a certain set of selection and weighting rules at a certain frequency. WisdomTree rebalances, or re-applies its rules based selection and weighting process on an annual basis.