

BUY LOW, SELL HIGH—WORDS TO LIVE BY IN A RELATIVE VALUE REBALANCE

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When we introduce people to WisdomTree, we emphasize time and again that we did extensive research on equity markets that led us to build our own Indexes—the first of which were launched more than 10 years ago. The concept—owning equity markets broadly while anchoring exposures to a metric of [fundamental](#) value—[has delivered incredible results thus far](#).

What drove this success and performance in our view?
[Rebalancing](#) back to relative value.

WisdomTree U.S. Earnings Indexes: Nearly 10 Years of Live History

Over the summer of 2016, WisdomTree's original [dividend](#) Indexes hit their 10-year anniversary. We did a great deal of analysis on the results of the dividend approach. In February 2017, WisdomTree's earnings family will hit its 10-year anniversary, and considering today's markets, there is no better time to review this methodology.

What Is the Main Concern Today in U.S. Equities? VALUATION

Look at the valuation multiples ([price-to-earnings \[P/E\] ratios](#)) of some U.S. equity Indexes generating significant attention this year:¹

- [Russell 3000 Index](#): 21.8x
- [S&P 500 Index](#): 20.3x
- [MSCI USA Minimum Volatility Index](#): 23.0x
- [Dow Jones U.S. Select Dividend Index](#): 19.9x
- [S&P MidCap 400 Index](#): 22.3x
- [S&P SmallCap 600 Index](#): 24.5x

Across the board, we see P/E multiples climb. While this does not portend an imminent or necessary collapse, it does create a hurdle for the future—specifically for the generation of future returns. It has followed throughout history that a higher valuation today means a lower total return tomorrow.

WisdomTree Earnings Indexes Had Significantly Lower P/E Ratios²

- [WisdomTree Earnings Index](#): 16.2x (25.8% below the Russell 3000 Index)
- [WisdomTree Earnings 500 Index](#): 16.1x (20.7% below the S&P 500 Index)
- [WisdomTree MidCap Earnings Index](#): 17.6x (21.1% below the S&P MidCap 400 Index)
- [WisdomTree SmallCap Earnings Index](#): 15.6x (36.3% below the S&P SmallCap 600 Index)

How WisdomTree's Earnings Approach Was Designed with Continued Focus on Valuation in Mind

For any equity index, two things can cause the P/E ratio to rise:

1. The price of the index climbs, indicating a willingness to pay more per dollar of earnings per share.
2. There are companies in the index with negative earnings, lowering the overall earnings per share for the index and causing the P/E ratio to appear higher.

How Do Stocks Gain Entry into WisdomTree's Earnings Indexes?

The answer is positive cumulative earnings over the four quarters leading up to the November 30 screening date. No profits, no inclusion. It's that simple, and it directly attacks point No. 2 shown above.

How Do Stocks Gain Big Weights in WisdomTree's Earnings Indexes?

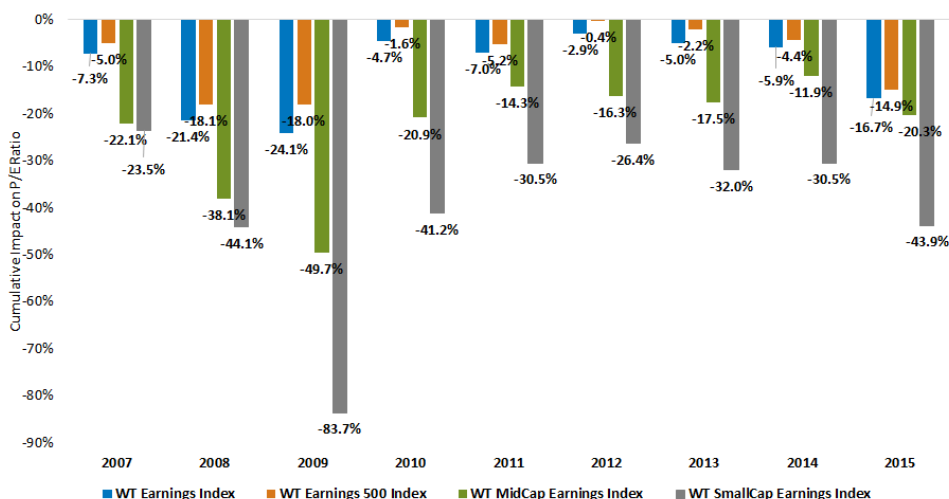
They have to generate more cumulative earnings than other constituents. Small earnings, small weight. Big profits, big weight.

How Does WisdomTree's Annual Rebalance Work?

The answer is twofold. First, companies with negative cumulative earnings are eliminated. Second, companies whose

prices have increased significantly—therefore gaining greater exposure in the Index—must grow their earnings commensurately to maintain that higher weight. Great stock performance without commensurate growth in earnings leads to weight reduction. Similarly, stocks that were underperformers but whose earnings grew significantly would tend to see greater weight, as these could be the performers of tomorrow.

WisdomTree's Rebalance Has Reduced Trailing P/E Ratios across Size Segments for 9 Years



Sources: WisdomTree, FactSet, with data indicating the change in trailing 12-month P/E ratio for the specified Indexes due to the annual rebalance occurring based on an annual screening date of November 30 of each specified year.

For definitions of terms and indexes in the chart, visit our [glossary](#).

- All four of the WisdomTree earnings Indexes saw P/E reductions at each of the nine live rebalances.
- It's interesting that the benefit was particularly strong in the small-cap and mid-cap cuts.

Does WisdomTree's Earnings Approach Work Better in Mid- and Small Caps?

This is an appropriate question if one defines "better" as a greater reduction in P/E ratio. As mentioned above, the two things that can cause an index's P/E ratio to rise are a rising price and a greater proportion of firms with negative earnings. The key is that the elimination of firms with negative earnings is most pronounced among small-cap stocks. Considering the Russell 2000 Index universe, approximately 20% of the market cap of this Index tends to have had negative earnings over the prior 12-month period. The greater than 83% drop in P/E ratio for the WisdomTree SmallCap Earnings Index in 2009 is a combined impact of 1) lowering weight to firms that had price performance that outpaced earnings growth and 2) eliminating exposure to firms with negative earnings. As a benchmark, the figure without the impact of eliminating negative earnings would have been closer to 44% to 45%, still a significant reduction in valuation. If you're looking at 2016 and, like many, are concerned with valuation, WisdomTree's earnings strategies may be a very interesting place to turn.

Unless otherwise stated, data source is Bloomberg, as of October 10, 2016.

¹The Russell 3000, S&P 500, S&P MidCap 400 and S&P SmallCap 600 Indexes are selected as representative [market capitalization-weighted](#) benchmarks for the [WisdomTree Earnings](#), [WisdomTree Earnings 500](#), [WisdomTree MidCap Earnings](#) and [WisdomTree SmallCap Earnings Indexes](#), respectively. The MSCI USA Minimum Volatility and Dow Jones U.S. Select Dividend Indexes are shown as prominent, widely followed examples of minimum-[volatility](#) and high-[dividend-yield](#) strategies. For all bullets, source is Bloomberg, as of 10/10/16.

²Source: Bloomberg, as of 10/10/16.

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](#).

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You cannot invest directly in an index.

DEFINITIONS

Fundamentals : Attributes related to a company's actual operations and production as opposed to changes in share price.

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.

Dividend : A portion of corporate profits paid out to shareholders.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

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.

Russell 3000 Index : Measures the performance of the 3,000 largest U.S. companies based on total market capitalization.

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.

MSCI USA Minimum Volatility Index : Aims to reflect the performance characteristics of a minimum variance strategy applied to the large and mid cap USA equity universe.

Dow Jones U.S. Select Dividend Index : The index is a modified market capitalization approach and weights by dividend yield. Stocks are selected for fundamental strength relative to their peers, subject to various screens such as dividend quality and liquidity.

S&P MidCap 400 Index : provides investors with a benchmark for mid-sized companies. The index covers over 7% of the U.S. equity market, and seeks to remain an accurate measure of mid-sized companies, reflecting the risk and return characteristics of the broader mid-cap universe on an on-going basis.

S&P SmallCap 600 Index : Market capitalization-weighted measure of the performance of small cap equities within the United States, with constituents required to demonstrate profitability prior to gaining initial inclusion.

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.

Volatility : A measure of the dispersion of actual returns around a particular average level.

Dividend yields : Refers to the trailing 12-month dividend yield. Dividends over the prior 12 months are added together and divided by the current share price. Higher values indicate more dividends are being generated per unit of share price.