# 50 SHADES OF VALUE: PART I

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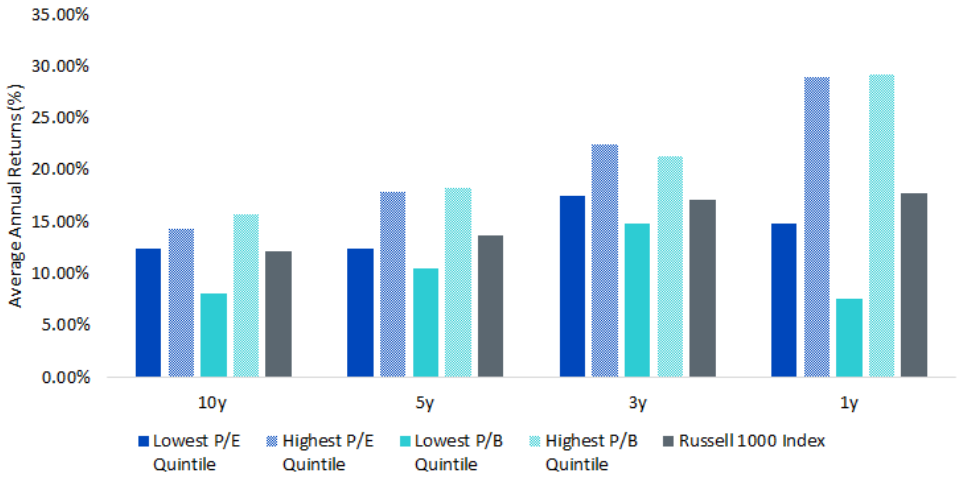
The premise of value investing is simple—less-expensive companies tend to outperform more-expensive companies in the long term. Its first proponents can be traced back to the 1930s, beginning with the iconic value investor Benjamin Graham. Value was first referred to in terms of "factors" in Eugene Fama and Kenneth French's renowned 1993 academic paper.[1] In their paper, value was defined using a company's current book value. Since then, practitioners in the industry have adapted and created their own definitions of value in their attempts to beat the market. Below, we contrast different measures of value to help explain drivers of returns across U.S. equities.

Common ways used to identify value include price-to-book (P/B), price-to-earnings (P/E), dividend yield and EV/EBITDA metrics. The definition of value used in an investment strategy matters because it drives material differences in a value portfolio's sector and fundamental characteristics. The definition also matters because it can affect how sensitive a strategy is to interest rates, which empirical research has proven is a significant driver for the value factor. At WisdomTree, we implicitly tilt our Indexes toward value by fundamentally weighting constituents using their dividends or earnings in an approach we pioneered more than 11 years ago.

## Performance of Value Over the Past Decade

### Russell 1000 Index




Sources: WisdomTree, FactSet. Ten-year period: 9/30/08–9/30/18; five-year period: 9/30/13–9/30/18; three-year period: 9/30/15–9/30/18; one-year period: 9/30/17–9/30/18. Past performance is not indicative of future results. You cannot invest directly in an index.

In the chart above, we show the annualized return for the broad-based Russell 1000 Index over several time periods in the gray bars, along with the performance of its

constituents in its lowest and highest P/E or P/B quintiles. There is a generalized sense in the investment community that value as a factor has lagged the market over the last 10 years. So, it is no surprise that the most expensive stocks ( highest P/E or P/B quintiles, which are shown in the textured bars) have outperformed the cheapest companies (those that are in the lowest P/E or P/B quintiles). What is worth pointing out is how the return of the lowest P/E quintile in dark blue has kept up or outperformed the Russell 1000 in every period, while the lowest P/B quintile in teal has significantly trailed. In our view, the devil is in the details when it comes to defining value.

## WisdomTree's Original Value Approach

In 2007, WisdomTree launched its U.S. earnings-weighted Index family. Once a year, the U.S. earnings-weighted Indexes are reconstituted by weighting companies with positive earnings by their proportionate share of total aggregate earnings. Companies with greater earnings generally have larger weights in the Index. This methodology results in our U.S. earnings family having a significant weight in the lowest P/E quintile, or cheaply valued stocks, in the investment universe.

Below, we compare the portfolio characteristics of the implicitly tilted WisdomTree U.S. Earnings 500 Index (WTEPS) with the explicitly tilted Russell 1000 Value Index. The Russell 1000 Value Index is built by over-weighting companies that have a lower P/B ratio within their respective universe. This results in the index being significantly over-weight in the Financials and Energy sectors, which tend to have a lower P/B, and under-weight in the Information Technology sector, which has a higher P/B. At the portfolio level, the result of over-weighting these companies rather than weighting by earnings can be seen in a higher P/E ratio along with lower profitability metrics.

| Portfolio Characteristics | | | | | | |
|---|---|---|---|---|---|---|
| Index | Dividend Yield (%) | Price to Earnings | Price to Book | Price To Sales | Return On Assets | Return On Equity |
| WT U.S. Earnings 500 | 2.04 | 17.44 | 2.90 | 1.69 | 2.99 | 15.88 |
| Russell 1000 Value | 2.41 | 19.12 | 2.00 | 1.62 | 2.05 | 9.95 |

Sources: WisdomTree, FactSet. For the period 9/30/15–9/30/18. Characteristics shown are median values using monthly data. Past performance is not indicative of future results. You cannot invest directly in an index.

As would be expected, sector tilts stemming from different methodologies have a significant impact on performance. Over the last three years, WTEPS has outperformed the Russell 1000 Value Index by 3.18% annually. Most of the outperformance comes from WTEPS being over-weight in the high P/B sectors such as Information Technology, Industrials and Consumer Staples, while being under-weight in Financials did not create a significant drag in performance.

| WisdomTree U.S. Earnings 500 Index (WTEPS) vs. Russell 1000 Value Index (09/30/15–09/30/18) Sector Attribution | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Sector | Attribution Components | | | | Average Category Weights | | | Category Performance | |
| | Allocation | Stock Selection | Interaction | Total Attribution | WT Index Weight | Benchmark Weight | +/- Wgt | WT Index Return | Benchmark Return |
| Information Technology | 1.13% | 0.27% | 0.52% | 1.91% | 21.44% | 9.62% | 11.82% | 26.08% | 22.60% |
| Industrials | -0.01% | 0.45% | 0.07% | 0.51% | 10.49% | 9.35% | 1.13% | 19.77% | 14.42% |
| Consumer Staples | -0.03% | 0.21% | 0.01% | 0.19% | 9.17% | 7.90% | 1.27% | 8.78% | 6.15% |
| Real Estate | 0.21% | -0.07% | 0.04% | 0.17% | 1.84% | 4.77% | -2.93% | 5.91% | 7.20% |
| Energy | 0.19% | 0.10% | -0.13% | 0.16% | 3.91% | 11.96% | -8.06% | 12.92% | 11.62% |
| Utilities | 0.12% | -0.02% | 0.01% | 0.11% | 3.13% | 6.32% | -3.20% | 10.17% | 10.58% |
| Telecommunication Services | 0.03% | 0.06% | 0.01% | 0.10% | 2.95% | 3.24% | -0.29% | 9.24% | 7.17% |
| Consumer Discretionary | -0.29% | 0.20% | 0.16% | 0.08% | 11.79% | 5.74% | 6.05% | 11.50% | 8.44% |
| Health Care | 0.07% | -0.02% | -0.02% | 0.03% | 12.69% | 12.88% | -0.19% | 14.47% | 15.04% |
| Materials | 0.08% | -0.05% | -0.01% | 0.01% | 2.62% | 2.60% | 0.02% | 16.33% | 18.40% |
| Financials | -0.14% | 0.05% | -0.02% | -0.11% | 19.98% | 25.61% | -5.62% | 16.25% | 16.22% |
| **Total** | **1.36%** | **1.18%** | **0.65%** | **3.18%** | | | | **16.73%** | **13.55%** |

Sources: WisdomTree, FactSet. Past performance is not indicative of future results. You cannot invest directly in an index.

## Conclusion

Modern-day value investors have two main arguments why this investment style works: behavioral biases and risk premium. Most investors romantically focus on stocks with a narrative about the future as opposed to those that are undervalued and have experienced a fall in their price, which makes cheap stocks cheaper than they should be. Value stocks should also compensate investors for higher levels of risk given their attractive valuations. There are many shades of value, and investors should be aware of the consequences of using different definitions.

[1]Eugene F. Fama and Kenneth R. French, "Common Risk Factors in the Returns on Stocks and Bonds," Journal of Financial Economics, volume 33, issue 1, February 1993, pages 3–56.

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## DEFINITIONS

**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 tim.

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

**Book Value** : refers to the net asset value of a company determined by subtracting liabilities and intangible assets from Total assets.

**Price-to-book ratio** : Share price divided by book value per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

**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.

**Dividend yield** : A financial ratio that shows how much a company pays out in dividends each year relative to its share price.

**Earnings before interest, taxes, depreciation, and amortization (EBITDA)** : The net income of a company with interest, taxes, depreciation, and amortization added back to it.

**Interest rates** : The rate at which interest is paid by a borrower for the use of money.

**Russell 1000 Index** : A measure of the performance of the 1,000 largest companies by market capitalization in the Russell 3000 Index.

**Russell 1000 Value Index** : A measure of the large-cap value segment of the U.S. equity universe, selecting from the Russell 1000 Index.

**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.