HOW TO MANAGE VALUATION RISK IN U.S. EQUITIES

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05/04/2018

Over a decade ago, WisdomTree launched a family of earnings-weighted Indexes that were designed to manage valuation risk and help protect from bubbles in asset pricing.

These Indexes appealed to my mentor, Professor Jeremy Siegel, under whom I studied at Wharton. He was concerned about the technology bubble in 1999 and 2000 and wrote an op-ed in the *Wall Street Journal* titled "Big-Cap Tech Stocks Are a Sucker Bet." Siegel's column listed nine stocks with triple-digit price-to-earnings (P/E) ratios that he thought could not justify their valuations, no matter how optimistic analysts were for earnings over the following decade.

The decade after the launch of these earnings-weighted Indexes was not particularly kind to a value-tilted indexing approach.

1. Growth beat value, particularly in large caps.
2. High P/E beat low P/E.
3. Market multiples rose.

Concerns about equity markets today often focus on elevated market valuation multiples. Usually, pessimistic prognosticators start with how high the CAPE (cyclically adjusted price-to-earnings) ratios are and how that dooms us to terrible forward-looking returns.

Having an index process that systematically and strategically rebalances back to underlying *Earning Streams*—one that incorporates a strategic sell discipline when stocks have *rising* P/E *ratios* and a buy discipline when stocks have *falling P/E ratios*—is a useful way to manage valuation risk.

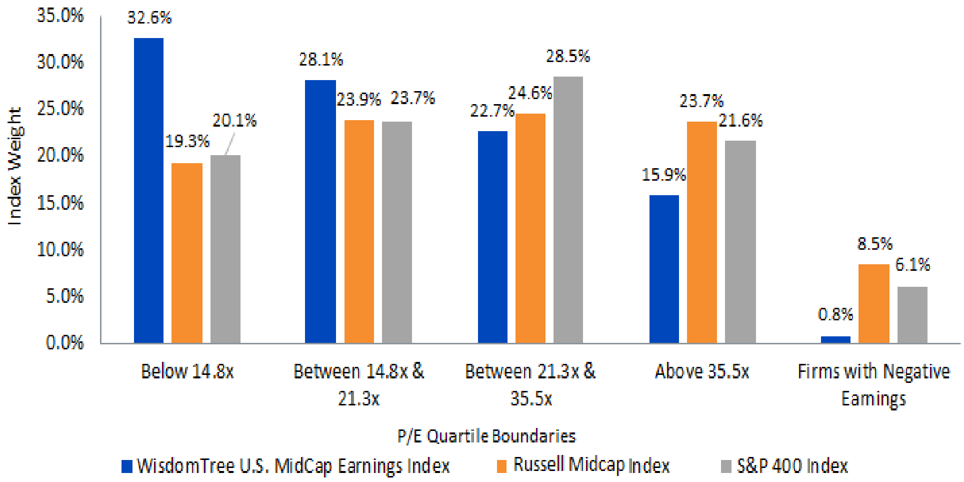
Where is this most interesting today? While large caps receive the bulk of attention, I think valuations in traditional market cap-weighted mid-cap and small-cap indexes, where more unprofitable companies also are found, are particularly worthy of focus. Below, I'll focus on the mid-cap segment and how our earnings process results in a lower P/E portfolio.

To start, it is important to point out that valuations are not universally dramatically extended across the market. When we focus on profitable companies and weight by earnings, our current P/E ratios on the mid-cap series are 14x to 15x, whether looking at trailing or forward earnings. This contrasts sharply with the S&P 500, which is well over 20x trailing and at 17x forward 12-month earnings.[1]

Looking across the market-cap indexes, the Russell Midcap Index has the highest P/E ratio, and that is because a greater percentage of its companies are unprofitable.

Index	Trailing 12-mo P/E Ratio	Avg. Since 2007	Forward 12-mo P/E Ratio	Avg. Since 2007
WisdomTree U.S. MidCap Earnings	14.13x	15.47x	15.03x	15.09x
Russell MidCap	22.84x	21.34x	18.09x	17.74x
S&P 400	22.00x	21.21x	17.87x	17.72x
S&P 500	22.18x	17.09x	16.95x	15.31x

Quantifying Tilt Toward Lower (or Higher) Price-to-Earnings (as of March 31, 2018)

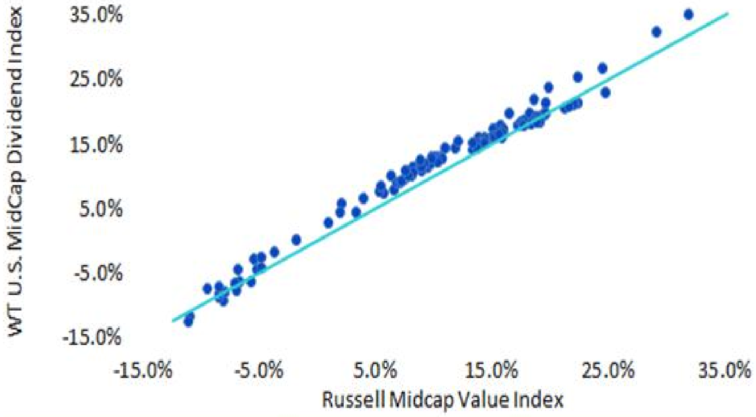


Sources: WisdomTree, FactSet, as of 3/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

The disciplined screening and rebalancing process—devoid of human emotion affecting allocations—in this earnings-weighted strategy has resulted in very consistent performance over the last 11 years this index has been live.

The consistency chart below plots the returns of the Russell Midcap Index on the x-axis and the [WisdomTree MidCap Earnings Index] on the y-axis. Approximately 80% of the rolling three-year return periods the WisdomTree Index outperformed the Russell Midcap Index, and when the Index underperformed, it was usually very close to the market return. But you do find periods where the [rolling three-year returns] were meaningfully higher.

Manager Consistency 3-Year Rolling



# Of Monthly Observations	# Outperform Benchmark	% Outperform Benchmark
112	95	85%

Index	WisdomTree Index Inception	Average Annual Total Returns			
		1-year	3-years	5-years	10-years
WisdomTree U.S. MidCap Earnings	2/1/2007	11.18%	8.11%	12.18%	12.49%
Russell Midcap		12.20%	8.01%	12.09%	10.21%

Source: WisdomTree, as of 3/31/18. Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns. WisdomTree, its affiliates and their independent providers are not liable for any informational errors, incompleteness or delays or for any actions taken in reliance on information contained herein.

As interest rates have started to creep higher in 2018, markets have started to focus on the length of this bull market and the rising valuations and collapsing earnings yields–the declining equity risk premium, or compensation one receives for taking equity risk over bonds. Lowering the P/E ratio on the equity markets utilizing the earnings-weighted process is becoming even more important, in my view. And while WidomTree's mid-cap earnings Index performed well, in a market environment where growth beat value, the decade ahead could come even more in this Index's favor.

[1]Sources: WisdomTree, FactSet, as of 3/31/18.

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You cannot invest directly in an index.

DEFINITIONS

Earnings-weighted : Earnings for all constituents in an index are added together, and individual constituents are subsequently weighted by their proportional contribution to that total.

Valuation risk : The risk of buying or over-weighting a particular stock that has appreciated significantly in price relative to its dividends, earnings or any other fundamental metric.

Bubble : when market participants drive stock prices above their "fair value" in relation to some system of stock valuation.

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.

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.

Growth : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

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.

Cyclically Adjusted Price to Earnings (CAPE) Ratio : a valuation measure of the S&P 500 Index that is adjusted for inflation and takes into account cyclical fluctuations in market earnings relative to longer term averages.

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.

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.

Mid-Cap : Characterized by exposure to the next 20% of market capitalization (after the top 70% have been removed) within the Value, Blend or Growth style zones with the majority of the fund's weight.

Small caps : new or relatively young companies that typically have a market capitalization between $200 million to $2 billion.

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.

Russell Midcap Index : The Russell Midcap Index measures the performance of the mid-cap value segment of the U.S. equity universe. It includes those Russell Midcap Index companies with lower price-to-book ratios and lower forecasted growth values.

Rolling : trading out of a security that is close to maturing and into the same or similar security with a later maturity date.

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

Bullish : a position that benefits when asset prices rise.

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.

Equity premium : the excess return that investors may receive over the risk free rate as compensation for taking on the relatively higher risk associated with equit.