GROWTH STOCKS ARE LESS EXPENSIVE THAN TRADITIONAL MEASURES IMPLY

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This year's sharp rise in U.S. equities has many questioning whether prices have overshot fundamentals.

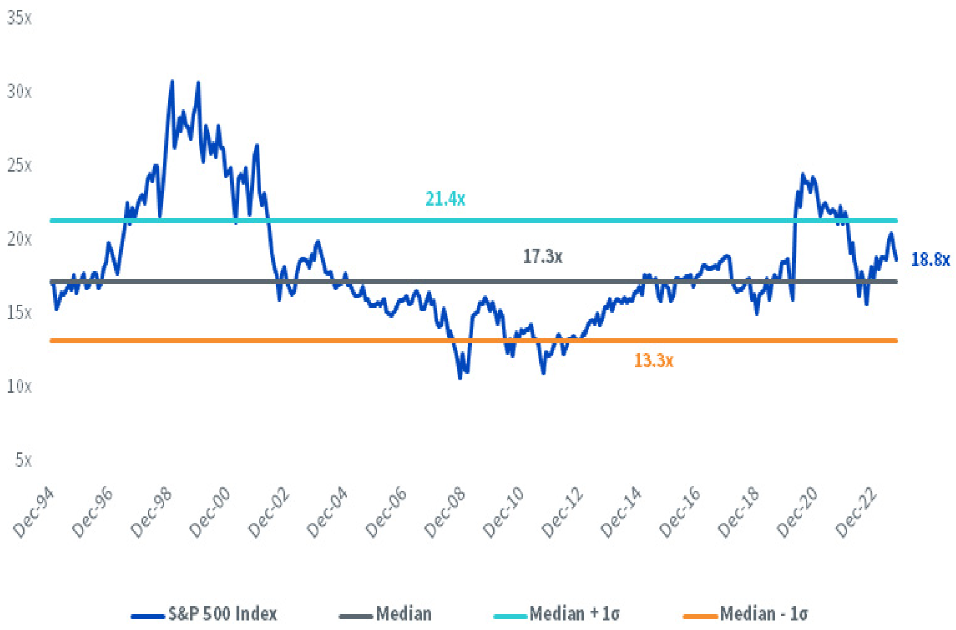
The concern is amplified for mega-cap growth stocks.

Apart from the case of Nvidia, whose earnings have soared, the biggest impact of artificial intelligence (AI) on earnings growth will be felt in the years to come, leaving investors with highly uncertain guesses as to the magnitude of the technology's benefit. All the while, these companies are investing heavily in R&D to reap future rewards in sales and earnings.

The S&P 500 Index's forward price-to-earnings (P/E) multiple of 18.8 times is 8% greater than the historical median valuation of 17.3 times, and in the 68th percentile relative to history.

Though high, valuations are clearly not at extremes and well off the highs from recent years.

S&P 500 Index Forward P/E Ratio, as of 9/29/23



Sources: WisdomTree, FactSet, S&P, 12/31/1994–9/29/2023 . You cannot invest directly in an index.

Over the last several years, stock prices handily outpaced earnings growth, leading to P/E multiple expansion in the S&P 500.

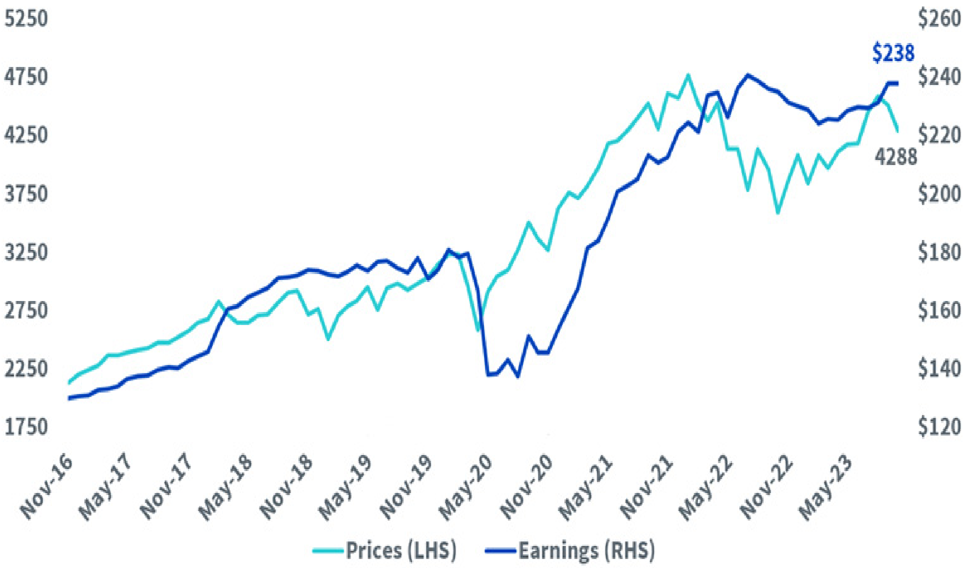
In the last year, S&P 500 prices have recovered nearly 20% with earnings only slightly higher.

Earnings and Price Growth, as of 9/29/23

	1-Year	3-Year	5-Year	Since 11/30/15
Price Return	19.6%	8.8%	9.2%	10.5%
Earnings Growth	1.1%	16.3%	6.8%	8.6%

Sources: WisdomTree, FactSet, S&P, 11/30/15–9/29/23. Earnings growth based on forward 12-month Index aggregated earnings per share. You cannot invest directly in an Index.

S&P 500 Index Price Level & Forward 12M Earnings per Share, as of 9/29/23



Sources: WisdomTree, FactSet, S&P, 11/30/15–9/29/23. Earnings growth based on forward 12-month Index aggregated earnings per share. You cannot invest directly in an Index.

Missing Intangible Assets

As the industrial age gave way to the information age in recent decades, intangible assets that are difficult to assign values to—brands, supply-chain management, well-trained sales staff, superior technology, research and development expenditures—have taken up the bulk of a company's capital expenditures and asset values.

Few, if any, updates have been made to [Generally Accepted Accounting Principles (GAAP)] to keep up with this new reality.

Internally generated intangible assets are largely missing on financial statements, causing book equity values (which equals assets less liabilities) to be understated.

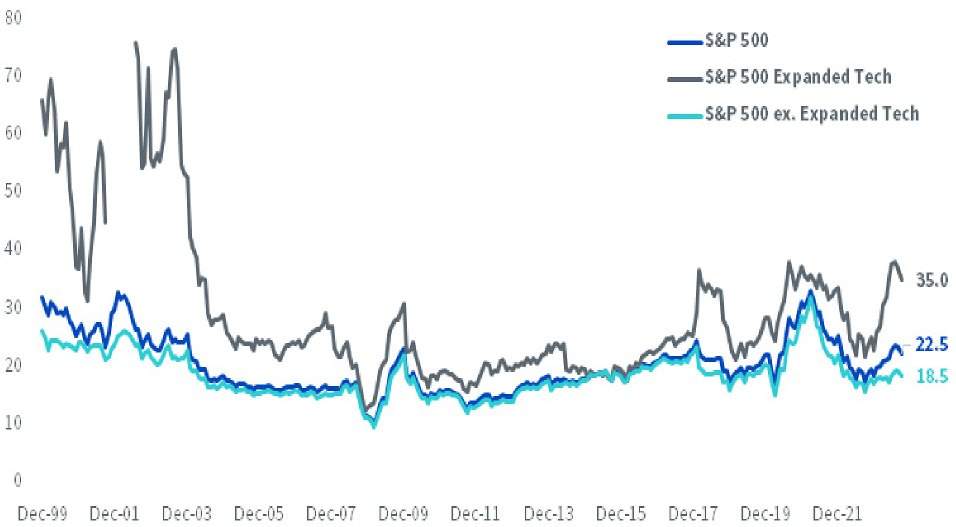
And because investments related to intangible assets (like research and development) are to be immediately expensed rather than capitalized, companies are building large intangible assets when investing aggressively in R&D and understating true earnings relative to companies who depreciate physical assets over future years.

The companies penalized the most by this accounting treatment of R&D-type intangible assets are the high-growth tech companies.

Updating Valuations for Intangibles

In the below chart we see the S&P 500 Expanded Tech[1] valuation of 35 times is significantly higher—a 56% premium—than the S&P 500 valuation of 22.5 times.

Price-to-Earnings



	S&P 500	S&P 500 Tech+	S&P 500 ex. Tech
Current	22.5	35.0	18.5
Historical Median	19.0	24.5	18.0
% Premium/(Discount) vs. Historical Median	18%	43%	2%
% Premium/(Discount) vs. S&P 500		56%	(18%)

Sources: WisdomTree, FactSet, S&P, 12/31/1999–9/29/2023. You cannot invest directly in an index.

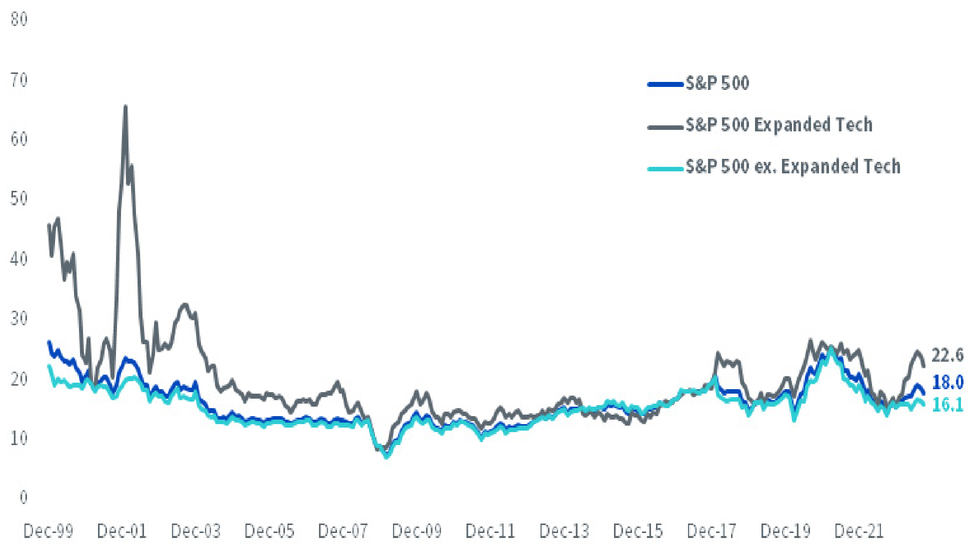
If we adjust earnings to account for the investments in intangible assets, we see a meaningfully different picture.

Using a revised intangible adjusted P/E, the S&P 500 Tech+ Index valuation is only 25% greater than the S&P 500—down from the nearly 60% premium in traditional P/E ratios.

Unlike the previous chart that showed the Tech+ basket having significantly higher multiples over the period following the global financial crisis, the below chart shows much less dispersion in valuations. Only in the last few months have the Tech+ valuations materially diverged from the S&P 500.

The S&P 500 P/E itself also drops 20% from 22.5 times to 18.0 times, showing the market is less expensive than traditional measures imply. The historical median discount looking at the S&P 500 P/E on the intangible adjusted measure versus the regular P/E has been 18%.

Intangible Adjusted Price-to-Earnings



	S&P 500	S&P 500 Tech+	S&P 500 ex. Tech
Current	18.0	22.6	16.1
Historical Median	15.6	17.7	15.5
% Premium / (Discount) vs. Historical Median	16%	28%	3%
% Premium / (Discount) vs. S&P 500		25%	(11%)

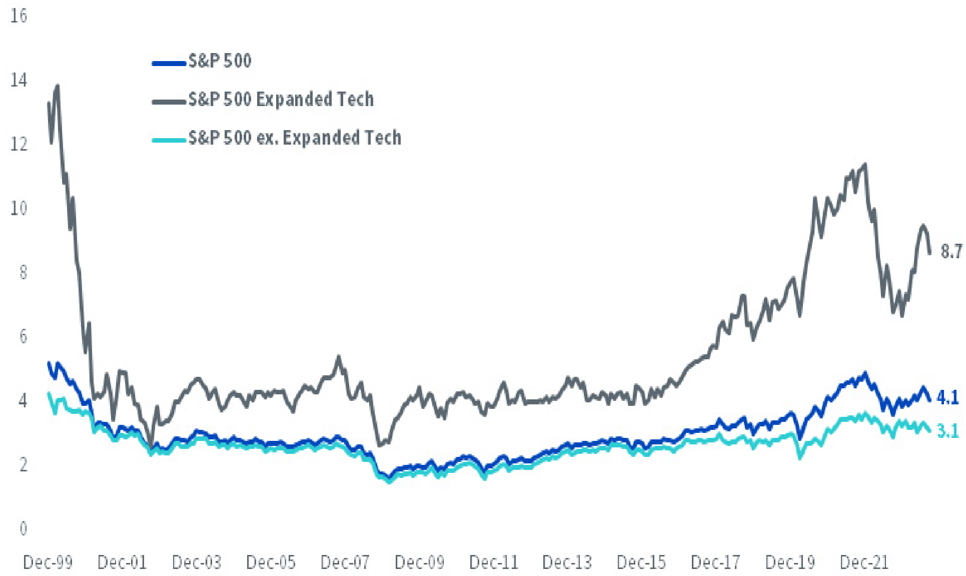
Sources: WisdomTree, FactSet, S&P, 12/31/1999–9/29/2023. You cannot invest directly in an index.

The impact of using the standard price-to-book (P/B) versus intangibles adjusted P/B is an even greater contrast.

The 8.7 times P/B ratio of the S&P 500 Expanded Tech is a 111% premium to the P/B ratio of the S&P 500.

But using an intangible adjusted P/B, the Tech+ valuation drops in half—like the P/E ratio—to just 49% greater than the S&P 500.

Price-to-Book



	S&P 500	S&P 500 Tech+	S&P 500 ex. Tech
Current	4.1	8.7	3.1
Historical Median	2.9	4.4	2.7
% Premium / (Discount) vs. Historical Median	45%	98%	18%
% Premium / (Discount) vs. S&P 500		111%	(24%)

Sources: WisdomTree, FactSet, S&P, 12/31/1999–9/29/2023. You cannot invest directly in an index.

Intangible Adjusted Price-to-Book

Both the regular return on equity (ROE) and the intangible adjusted ROE show that the profitability of the S&P 500 Tech+ is far greater than the S&P 500, perhaps justifying these higher valuations we see on the index.

Return on Equity

Intangible Adjusted Return on Equity

What It All Means

It can be easy to argue that enthusiasm for a hot theme like AI is causing investors to chase returns and bid up the price of growth stocks without regard for fundamentals.

In this post, we consider that the alternative—being too myopically focused on valuation ratios that rely on outdated accounting principles—may cause some investors to overstate the valuations for the market as a whole, and tech stocks in particular.

After adjusting earnings, common equity and assets for investments in intangible assets, we still see the S&P 500 Expanded Tech basket as having premium valuations multiples, but significantly less than what we saw with the unadjusted metrics.

The key concern for investors is the ability of the S&P 500 Expanded Tech basket to maintain its premium earnings growth going forward as it has done repeatedly over the last 10 to 15 years.

Annualized Weighted Average Trailing Earnings Growth

[1] Expanded Tech includes the Information Technology sector, Interactive Home Entertainment subindustry, Interactive Media & Services subindustry, Amazon, E-Bay, Etsy and Netflix. Ex-Tech excludes the Expanded Tech companies.

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DEFINITIONS

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.

Artificial intelligence : machine analysis and decision-making.

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.

Multiple : A multiple measures some aspect of a company's financial well-being, determined by dividing one metric by another metric.

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.

Generally Accepted Accounting Principles (GAAP) : Principles of accounting utilized in the U.S. that deal with different aspects and assumptions that are deemed acceptable in calculating the earnings of a firm.

S&P North American Expanded Technology Sector Index : The S&P North American Expanded Technology Sector Index is designed to measure securities from the S&P North American Technology Sector Index and the supplementary stock Netflix, Inc. (NASD: NFLX).

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.