

THE THREE ‘RS’ OF EQUITIES: RISK, REWARD AND THE ROLE IN A PORTFOLIO

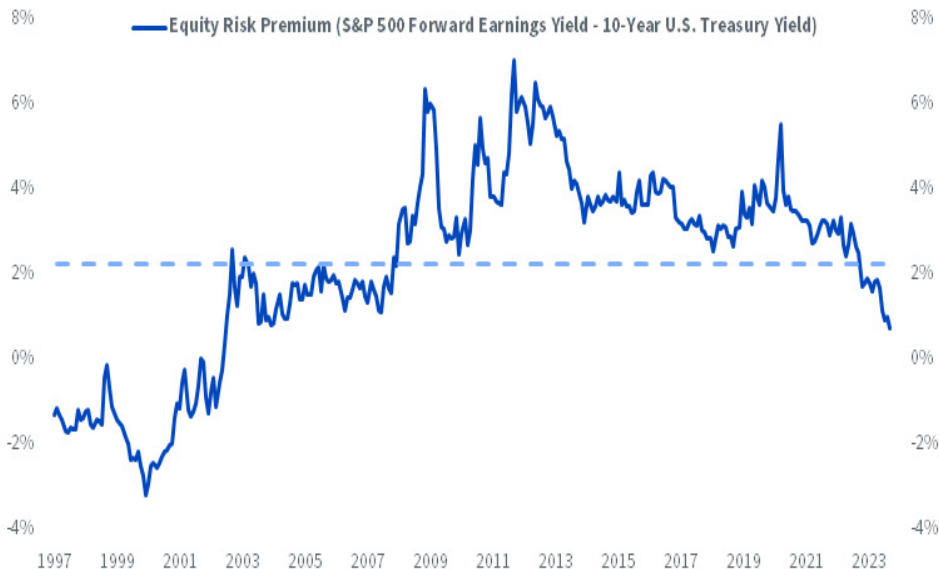
Jeremy Schwartz – Global Chief Investment Officer, Brian Manby – Associate, Investment Strategy
10/03/2023

Markets have been fascinated by [equity risk premiums](#) recently.

Not long ago, interest rates were near 0%, [Treasury yields](#) offered less than 1%, [inflation](#) was benign and there was little discussion about whether the earnings yield on equities offered appropriate compensation for their inherent risks. Risk premiums simply did not matter in a yield-scarce environment when the TINA (“there is no alternative”) narrative dominated markets. And TINA existed for good reason, as equities offered very attractive compensation relative to bonds of all durations.

But just a few years later, market conditions have reversed. Both [interest rates](#) and Treasury yields ratcheted upward with pernicious inflation, prompting renewed discussion about equity risk premiums in a new environment with abundant opportunity for yield. More importantly, investors wonder what current risk premiums portend for equity markets.

Nominal Equity Risk Premium at it Lowest Level since 2004



Newly Positive Real Yields at Post-GFC Highs



Sources: WisdomTree, Bloomberg, ICE, as of 8/31/23. You cannot invest directly in an Index. Subject to change.

There is no doubt that prevailing equity market [valuations](#) are lofty, with the nominal equity risk premium below its historical average and at its lowest since 2004. Meanwhile, [real yields](#) on [Treasury bonds](#) have not been this high since the [global financial crisis \(GFC\)](#).

So, if investors can receive roughly 2% real yields risk-free in the bond market, does that mean equities are overvalued and poised for downside?

Are Today's Yields Sustainable?

We don't deny that bonds look more attractive than they have in a long time. But just because something looks appealing relative to its own history doesn't preclude ownership of other assets.

At a steady, 2% real yield, it would take 36 years to double an investment while maintaining purchasing power, according to the infamous Rule of 72 theory. Even if such a time horizon is acceptable for an investor, we question whether a 2% real yield will be a reliable, real return for the next four decades.

Since [Treasury Inflation-Protected Securities \(TIPS\)](#) were introduced in 1997, long-term real rates in the U.S. remained in a structural decline. Several determinants have contributed to their secular downtrend with most derived from demographic and economic forces rather than solely monetary influences. Professor Jeremy Siegel does an excellent job outlining these effects in chapter eight of the sixth edition of *Stocks for the Long Run*, so I will not reiterate them here, but the historical path of real rates appears capped by these forces.

Real yields peaked over 4% during the tech bubble and slid for two decades thereafter, even breaching negative territory. Although there were a few, brief periods of rising rate respite, real yields resumed their downtrend shortly after these catalysts faded.

Given the structural headwinds supporting declining rates, we question whether real yields of 2% (or more) are sustainable for long-term investment.

Think Stocks... for the Long Run!

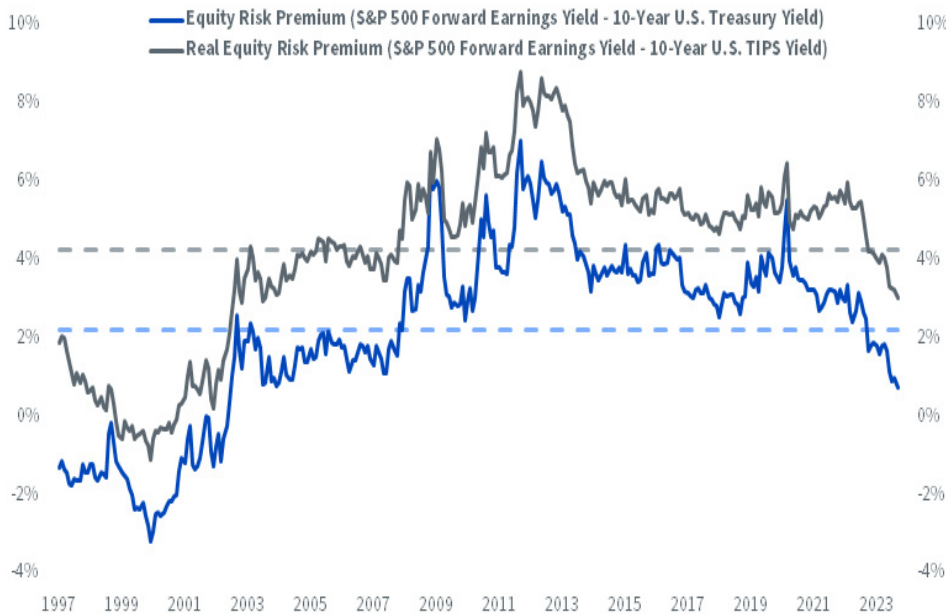
Earlier this year, we urged investors to [reconsider nominal gauges of equity risk premiums](#) in an effort to discourage rejecting stocks merely because of a narrowing spread between their earnings yield and that of the nominal 10-Year U.S. Treasury yield.

Stocks are real assets, whose returns have *exceeded* inflation over the long term, and whose risk premiums should therefore be judged against *real* risk-free yields rather than nominal ones. In inflationary environments, companies pass along higher input costs to consumers via higher prices, and the long-term evidence indicates that dividends and

earnings have outpaced inflation over the long run.

Today's equity risk premium using real yields is still below its long-term average but provides nearly 1.4% of additional compensation over TIPS and 2.2% over the nominal gauge.

Real Equity Premiums Provide Better Risk Compensation



Sources: WisdomTree, Bloomberg, ICE, as of 8/31/23. You cannot invest directly in an Index. Subject to change.

The [S&P 500](#) is currently priced at 19 times next year's earnings, resulting in a 5.1% forward earnings yield. Using the Rule of 72 with that forward yield, an investment would double and maintain purchasing power in about 14 years, over two decades earlier than the 36-year horizon using today's real bond yields.

The current 3% equity risk premium is also consistent with the long-term 3% average premium of equities over bonds from over 200 years of data in Professor Siegel's *Stocks for the Long Run*. Though both bonds and stocks are expensive according to their 200-year history, their long-term equity risk premiums are preserved because their implied forward returns are reduced by similar magnitudes.

We don't believe the real equity risk premium is prohibitive, especially when you consider the concentration of 2023's equity sector leadership. Stretched technology and consumer discretionary valuations continue to support the S&P 500 while lowering the forward earnings yield for the headline index. Meanwhile, eight of the 11 sectors feature earnings yields either in line with or *higher* than the headline number, representing nearly 60% of the index.

S&P 500 Index

Sector	Est. Price to Earnings	Est. Earnings Yield	Weight
Headline Index	18.9x	5.3%	100.0%
Communication Services	16.8x	6.0%	8.8%
Consumer Discretionary	24.7x	4.0%	10.6%
Consumer Staples	19.2x	5.2%	6.6%
Energy	12.2x	8.2%	4.7%
Financials	13.8x	7.2%	12.9%
Health Care	17.3x	5.8%	13.5%
Industrials	18.3x	5.5%	8.3%
Information Technology	25.4x	3.9%	27.2%
Materials	18.0x	5.6%	2.4%
Real Estate	33.9x	3.0%	2.4%
Utilities	16.2x	6.2%	2.5%

Sources: WisdomTree, FactSet, as of 8/31/23. You cannot invest directly in an Index. Subject to change.

Conclusion

As long-term investments in real assets, equities deserve comparison to real risk premiums. By these measures, we’re not convinced that U.S. equities are overbought to the extent that they prohibit ownership or exhibit insufficient risk compensation.

We agree that bonds and real interest rates are attractive relative to their own history and may warrant renewed attention for a portfolio, but support for them does not, and should not, create opposition for equities.

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.

Related Blogs

+ [The Most Important Charts for 2023](#)

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.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an “as is” basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the “MSCI Parties”) expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only. You cannot invest directly in an index.

DEFINITIONS

Equity risk premium: Refers to an excess return that investing in the stock market provides over a risk-free rate.

Treasury yield: The return on investment, expressed as a percentage, on the debt obligations of the U.S. government.

Inflation: Characterized by rising price levels.

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

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.

Real yield: the annual interest rate that an investor demands for holding a bond to maturity including the impact of inflation.

Treasury bond: A government bond issued by the U.S. Treasury.

The Global Financial Crisis: Refers to the period of extreme stress in global financial markets and banking systems between mid 2007 and early 2009.

Treasury Inflation-Protected Securities (TIPS): Bonds issued by the U.S. government. TIPS provide protection against inflation. The principal of a TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index. When a TIPS matures, you are paid the adjusted principal or original principal, whichever is greater.

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.