EQUITIES: IDENTIFYING THE BEST OPPORTUNITIES ON EARNINGS YIELD BASIS

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Historically, one way to view the attractiveness of equities is to compare them to another major asset class: bonds. One model for gauging equity valuations—dubbed the "Fed Model"—compares the earnings yield (E/P ratio, or the inverse of the P/E ratio) to a long-term bond yield. There are clearly different risks associated with equities and bonds, but essentially one is judging the relative value of one security against another. In the table below, I will look at the current earnings yield, bond yield and the spread for the world's 15 largest countries by market capitalization[1] to get a sense of relative valuation. • A higher earnings yield indicates a lower valuation because investors are essentially getting more earnings per share, so countries that exhibit a higher earnings yield are more attractively priced compared to their own history. • The same can be said about countries that have a higher earnings yield to bond yield spread; these countries are currently selling at lower relative valuations compared to their own history in terms of asset classes. **Figure 1: Earnings Yields vs. Bond Yields**

Country	Historical Median (10/31/2003-10/31/2013)			Current (10/31/2013)		
	Earnings Yield	10-Yr Bond Yield	Spread	Earnings Yield	10-Yr Bond Yield	Spread
South Korea	7.63%	4.93%	2.70%	10.90%	3.39%	7.51%
Japan	4.83%	1.33%	3.50%	6.84%	0.60%	6.24%
Germany	7.12%	3.30%	3.82%	7.54%	1.67%	5.86%
Switzerland	5.87%	2.10%	3.77%	6.13%	0.93%	5.20%
United Kingdom	6.68%	4.10%	2.58%	7.46%	2.62%	4.84%
France	7.04%	3.55%	3.49%	6.88%	2.16%	4.72%
Taiwan	5.82%	1.73%	4.09%	6.39%	1.72%	4.67%
Netherlands	7.14%	3.55%	3.59%	6.38%	2.01%	4.37%
Hong Kong	8.67%	2.82%	5.85%	6.16%	1.85%	4.31%
Canada	5.71%	3.59%	2.12%	6.42%	2.42%	4.00%
United States	6.10%	3.65%	2.45%	6.30%	2.55%	3.75%
Sweden	6.54%	3.33%	3.21%	5.90%	2.27%	3.63%
Brazil	8.48%	5.87%	2.61%	7.74%	4.19%	3.56%
Australia	6.51%	5.40%	1.11%	6.48%	4.02%	2.46%
Spain	8.04%	4.24%	3.81%	6.06%	4.03%	2.03%

Sources: WisdomTree, Bloomberg (10/31/03–10/31/13). The respective MSCI country indexes were used to calculate the earnings yield for each country above, except for the United States, where the S&P 500 Index was used.

Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of indexes in the chart, please visit our Glossary. • **South Korea Had Highest Earnings Yield** – With an earnings yield over 10%, South Korea had the highest earning yield and the highest spread of all the countries listed above. It is also impressive that the current spread is almost three times larger than its own 10-year historical median spread. The equities are currently selling at lower valuations (higher earnings yield), and the bonds at higher valuations (lower yield), compared to their own history. For those looking to accentuate a focus on the earnings yield as a potential indicator of a valuation opportunity for South Korean firms, an earnings-weighted approach could be of particular interest when considering different ways to build an Index of these stocks. • **Japan Offers Attractive Spread** – After so many years of deflation and bear markets, it is not surprising that Japanese citizens' stockpiles of cash have driven government bond yields to such low levels, but I feel the sentiment is starting to change. Japanese households cannot be expected to shift into equities overnight, but as inflation expectations increase, they should start to view the much higher earnings yield offered by equities as a viable option. One possible incentive beside valuations are the newly created Nippon Individual Savings Accounts (NISA) , which allow Japanese citizens to invest up to 1 million yen per year for at least five years, free of capital gains and dividend taxes. These accounts were designed to encourage risk taking, so government bonds are not eligible for purchase in these accounts. At the end of the day, we believe that equities are attractive due to their potential earnings growth, and with the depreciation of the Japanese yen, this explosive earnings growth is particularly evident amongst exporters. • **Germany and the United Kingdom Round Out Five** – Two of the largest European economies, Germany and the United Kingdom, currently have a higher earnings yield than most of their global peers. Compared to the United States, each has an earnings yield advantage of over 1%, and their current spread is 2% and 1%, respectively, higher than the U.S. With both countries being among the top economies for the European region, it is interesting they also have some of the lowest current valuations compared to U.S. and global peers. We feel this further confirms that there is opportunity in Europe. And for those looking to maintain diversification, it is important to recognize that many German and British firms are global in nature—meaning their revenues come from all different regions of the world. **Continued Rotation Back into Equities** Since the financial crisis, global interest rates around the world have remained low, ultimately driving down bond yields. Now that growth has stabilized and expectations are beginning to increase, investors are looking for options outside of fixed income to potentially participate in this growth. Unlike fixed income, which by definition offers a fixed payment of interest over time and no growth potential, equities have the potential to see earnings or dividends grow over time. I would point investors looking for equity exposure to countries with higher earnings yields compared to their historical medians and also toward countries with high earnings yield spreads.

[1]Excluding China.

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DEFINITIONS

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.

Bond yield : Refers to the interest received from a bond and is usually expressed annually as a percentage based on its current market value.

Relative value : The relationship between a particular attribute, e.g., a dividend, and the firm’s share price compared to that of another firm.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

Market Capitalization : 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.

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.

Earnings per share : Total earnings divided by the number of shares outstanding. Measured as a percentage change as of the annual Index screening date compared to the prior 12 months. Higher values indicate greater growth orientation.

Deflation : The opposite of inflation, characterized by falling price levels.

NISA : Nippon Individual Savings Account. Nippon is the Japanese word for Japan.