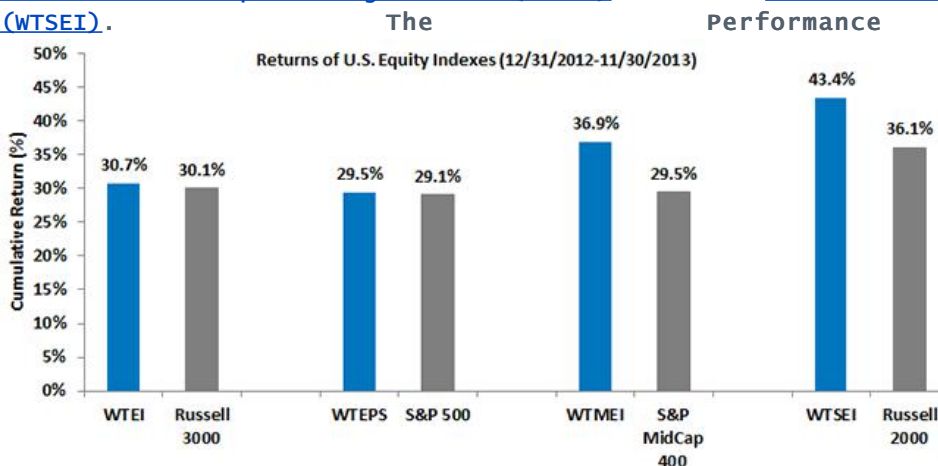


# EQUITY MARKETS SETTING NEW HIGHS: WHAT IS YOUR INDEX GOING TO DO ABOUT IT?

Jeremy Schwartz – Global Chief Investment Officer  
12/26/2013

When people consider the performance of U.S. equities<sup>1</sup> for much of 2013<sup>2</sup>, they tend to notice that the returns have been quite impressive. At various points in time, large-<sup>3</sup>, mid-<sup>4</sup> and small-cap<sup>5</sup> equities have achieved record highs.<sup>6</sup> At WisdomTree, we have seen similarly impressive performance in our family of U.S. Earnings Indexes, specifically the [WisdomTree Earnings Index \(WTEI\)](#), the [WisdomTree Earnings 500 Index \(WTEPS\)](#), the [WisdomTree MidCap Earnings Index \(WTMEI\)](#) and the [WisdomTree SmallCap Earnings Index \(WTSEI\)](#).



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

*For definitions of indexes in the chart, please go to [Glossary](#).* Behind the Scenes of Equity Market Highs Equity prices can often be explained by one of two variables: • **Earnings Growth:** If the rate of [earnings-per-share \(EPS\)](#) growth is similar to the rate of price growth, you'll tend to see [price-to-earnings \(P/E\) ratios](#) remaining fairly constant, even in the face of potentially compelling returns. In this case, one can say that equity returns were largely being driven by earnings growth. • **Multiple Expansion:** If, on the other hand, EPS growth was slow to non-existent or even falling but prices were rising, you'll tend to see price-to-earnings (P/E) ratios rising (in other words, multiple expansion). In this case, investors may be envisioning potential future earnings growth and be willing to pay more for it today. Therefore, returns aren't being driven by current earnings growth but rather by multiple expansion. **This Year's Case Study in Multiple Expansion** 2013's rally, for the most part, was driven by multiple expansion. Below, we look at how large-cap multiple expansion compared to that of small caps, as well as how [market capitalization-weighted](#) indexes performed against [earnings-weighted](#) indexes.

## Price-to-Earnings (P/E) Ratio

	12/31/2012	11/30/2013	P/E Multiple Expansion <sup>1</sup>	Price Change <sup>2</sup>
WTEI	11.7x	14.3x	22.1%	28.2%
WTEPS	11.6x	14.0x	21.0%	27.0%
WTMEI	12.2x	15.5x	26.3%	35.2%
WTSEI	12.0x	16.9x	40.8%	41.8%
Russell 3000	13.3x	15.9x	20.0%	27.8%
S&P 500	12.7x	15.1x	18.6%	26.6%
S&P MidCap 400	15.4x	17.9x	15.8%	27.8%
Russell 2000	17.4x	22.6x	30.3%	34.6%

<sup>1</sup>P/E multiple expansion: Refers to the percentage change in P/E ratio from 12/31/2012 to 11/30/2013.

<sup>2</sup>Price change: Refers to the percentage change in price of the specified index from 12/31/2012 to 11/30/2013.

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

*For definitions of indexes in*

*the chart, please go to [Glossary](#).* • At year-end 2012, the [S&P 500](#) was selling at 12.7x estimated earnings. Eleven months later it had increased to 15.1x estimated earnings. This multiple expansion represented a large part of the 26.6% change in the S&P 500 price levels. • **WisdomTree Mid & Small Caps Lead the Way:** We saw earlier that WTMEI and WTSEI delivered returns greater than 35%. The notable outlier, however, in terms of multiple expansion is WTSEI—the only Index shown with multiple expansion greater than 40%. • **Small Caps Notable for Multiple Expansion:** Whether one looks at WTSEI in the WisdomTree Earnings family or at the [Russell 2000 Index](#) among the market capitalization-weighted benchmarks, multiple expansion among small caps is notably higher than in the other size segments. **What Is Your Index Going to Do about It?** In an environment of rising P/E ratios, we know that stocks are necessarily becoming more expensive relative to their earnings. Market capitalization-weighted indexes will simply hold greater proportions of stocks that have increased in [market capitalization](#), in other words, they will hold more of what has increased in price. These indexes may also continue to hold stocks that have generated negative earnings over the prior 12 months. WisdomTree's Earnings Indexes, on the other hand, do two things that market capitalization-weighted indexes do not do: • **Rebalance to a Concept of Relative Value:** Each year, the relationship between price performance and earnings growth is judged for each constituent. WisdomTree's Earnings Indexes will tend to decrease weight to firms where price appreciation outpaced earnings growth and add weight to firms where earnings growth outpaced price appreciation—in essence, finding potentially underappreciated nooks and crannies of the market. • **Elimination of Firms with No Profits:** Each ongoing (or new) constituent of WisdomTree's Earnings Indexes must demonstrate cumulative profitability over the prior four quarters leading up to the annual November 30 screening. Firms that cannot do so don't make the cut, thereby helping to mitigate the upward pressure on Index P/E ratios caused by firms with negative earnings. **The Heart of the Matter: Indexes That Respond to Fundamentals** We all know that stocks do not tend to move in any one direction in a straight line and that past performance does not indicate future results. Therefore, after such a strong year in U.S. equities, there may be benefits to shifting weight away from some of the top-performing companies most responsible for these results and toward those that might have been underappreciated by the market despite growing their earnings. In an ongoing discussion about the benefits of "[smart beta](#)"-related indexes, we will be discussing how a key element of the smart beta family of indexes is their rules-based rebalance that we believe can help manage [valuation risks](#) in the market. <sup>1</sup>Refers to the Russell 3000 Index, S&P 500 Index, S&P MidCap 400 Index and Russell 2000 Index. <sup>2</sup>Refers to the 12/31/2012 to 11/30/2013 period. <sup>3</sup>Large-cap refers to the S&P 500 Index. <sup>4</sup>Mid-cap refers to the S&P MidCap 400 Index. <sup>5</sup>Small-cap refers to the Russell 2000 Index. <sup>6</sup>Source: Bloomberg, as of 11/30/2013.

**Important Risks Related to this Article**

Investments focusing on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility.

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.

For more investing insights, check out our [Economic & Market Outlook](#)

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](http://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

**WisdomTree Earnings Index**: Fundamentally-weighted index that measures the performance of earnings-generating companies within the broad U.S. stock market.

**WisdomTree Earnings 500 Index**: A fundamentally weighted index that measures the performance of earnings-generating companies within the large-capitalization segment of the U.S. Stock Market. Companies in the index are incorporated and listed in the U.S and have generated positive cumulative earnings over their most recent four fiscal quarters prior to the index measurement date. The index is comprised of the 500 largest companies ranked by market capitalization in the WisdomTree Earnings Index.

**WisdomTree MidCap Earnings Index**: Fundamentally-weighted index that measures the performance of the top 75% of the market capitalization of the WisdomTree Earnings Index after the 500 largest companies have been removed.

**WisdomTree SmallCap Earnings Index (WTSEI)**: measures the performance of earnings-generating companies within the small-capitalization segment of the U.S. Stock Market. The index is comprised of the companies in the bottom 25% of the market capitalization of the WisdomTree Earnings Index after the 500 largest companies have been removed.

**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.

**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.

**Multiple expansion**: Term for a rising P/E ratio, meaning that share prices are rising faster than earnings are growing.

**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.

**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.

**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 2000 Index**: Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

**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.

**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.

**Smart Beta**: A term for rules-based investment strategies that don't use conventional market-cap weightings.

**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.