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# THE WISDOMTREE EARNINGS 500: T-REXING MONEY MANAGEMENT'S ACCIDENT OF HISTORY

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## EPS: The Answer to Our Industry's Secret "Oops"

The [WisdomTree Earnings 500 ETF \(EPS\)](#) was launched February 23, 2007, with a clearly defined thought process: tracking an Index weighted by a [fundamental](#) factor such as earnings could be the way to go.

What was the impetus for the [S&P 500 Index's market capitalization-weighted](#) design—which gives the largest companies the highest weights—when it took its current form in 1957?<sup>1</sup> Was the index created in response to rigorous academic study or was it, troublingly, an accident? You decide.

## Malkiel's Citations: Confirming the Accident of History

The [efficient market hypothesis \(EMH\)](#), a beaten-down concept that says that all known information is already baked into asset prices, came along *after* the birth of the S&P 500. Say what?

The simpleton index had to be naive, because there were no computers, no WisdomTree-style fundamental equity screens in 1957. Some guy probably needed to do a calculation based on his own slogging through hundreds of paper-based annual reports, then sit down with a pen and paper to work out the arithmetic. Now, trillions of dollars of real money tracks that index.

Think about this: In 2003, legendary professor Burton Malkiel, author of the 1973 classic *A Random Walk Down Wall Street*, penned "The Efficient Market Hypothesis and Its Critics<sup>2</sup>." The 47-page research paper cited 57 classic studies for and against the EMH. The only pre-1957 reference was to anti-EMH Graham & Dodd, the founding fathers of deep value investing.

The S&P 500's legend as a deeply thought-out index is an illusion, an accident, and today it stands as *the* benchmark almost solely because it was the first index of its kind.

## Jeremy Siegel & Ken French vs. S&P's Summer Intern

Consider work by Wharton Professor Jeremy Siegel, who concluded that the 20% of stocks

with the lowest [price-to-earnings \(P/E\) ratio](#) returned 12.9% per year from 1957 to 2016, generating [alpha](#) of 249 [basis points \(bps\)](#) per annum over the S&P.<sup>3</sup>

And this:

We navigated through Kenneth French’s data library<sup>4</sup> to analyze performance since 1957. Like Siegel’s study, French breaks the market<sup>5</sup> into five [quintiles](#) based on [earnings yield](#). Companies with negative earnings are excluded and the research encompasses all NYSE, AMEX and NASDAQ stocks for which French has data.

The highest earnings-to-price quintile (the least expensive, synonymous with the lowest P/E ratio quintile) returned 15.13% annually for 59 years, *463 bps more than the total market* (see below). It did this with only a slightly higher [standard deviation](#) (16.54% vs. 15.06%).

### Long-Term Performance, Portfolios Formed Using Earnings-to-Price Ratio December 31, 1957 to December 31, 2016

	Quintile	Return (%)	Std Dev. (%)	Beta	Sharpe Ratio	Information Ratio	Tracking Error (%)	Correlation
Least Expensive ↑ ↓ Most Expensive	Highest	15.13%	16.54%	0.81	0.67	0.60	7.75%	0.88
	High	13.81%	14.61%	0.94	0.65	0.54	6.15%	0.91
	Mid	11.37%	14.54%	0.97	0.51	0.16	5.38%	0.93
	Low	10.35%	14.70%	0.97	0.44	-0.03	4.87%	0.95
	Lowest	8.66%	17.26%	0.83	0.31	-0.34	5.37%	0.95
	Total Market	10.50%	15.06%	1.00	0.44	0.00	0.00%	1.00

Sources: Kenneth French Data Library, WisdomTree, as of 12/31/2016. Beta, information ratio, tracking error and correlation require a benchmark for their calculation, which in this case is the total market (bottom row). Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of terms in the chart, visit our [glossary](#).

One dollar invested in the total market would have grown to \$361, while the highest earnings-to-price quintile would have multiplied more than 4,000-fold.

Meanwhile, the S&P 500 is still here, maybe courtesy of a class of '57 interns.

### A New Benchmark

We believe the WisdomTree Earnings 500 Index, with its more than 10-year track record, is the “new S&P 500,” because its [Earnings Stream](#) methodology taps into concepts that make the Siegel and French studies compelling.

Rather than going the S&P 500 route and blindly buying stocks because they have large market capitalizations and could be expensive, companies are instead weighted by their earnings. If all companies together earn \$1 trillion and one of them earns \$30 billion, it is 3% of the Index-logical.

Rationally, this creates a tilt to lower P/E ratios and thus the [value factor](#).

### The WisdomTree Earnings 500 through the Years

Despite the [S&P 500 Growth Index](#) outperforming the [S&P 500 Value Index](#) by 337 bps from February 23, 2007, to March 31, 2017 (the life of EPS, the WisdomTree Earnings 500 Fund), our ETF actually managed to come within 13 bps of the S&P 500 Index during that time horizon despite the considerable value factor headwind.

This is fascinating because EPS is designed to track the price and yield performance before fees and expenses of the [WisdomTree Earnings 500 Index](#), an Index that naturally tilts toward low P/E stocks, and yet EPS returned 162 bps more per year than the S&P 500 Value Index since its launch in 2007.

**Average Annual Returns of EPS**

Fund/Index Name	Fund Information			Total Return NAV (%)							Total Return Mkt (%)						
	Ticker	Exp. Ratio	Fund Inception Date	QTD	YTD	1 Yr	3 Yr	5 Yr	10 Yr	Since Fund Inception	QTD	YTD	1 Yr	3 Yr	5 Yr	10 Yr	Since Fund Inception
WisdomTree Earnings 500 Fund	EPS	0.28%	2/23/2007	5.90%	5.90%	19.31%	9.74%	12.72%	7.35%	7.09%	5.84%	5.84%	19.35%	9.72%	12.72%	7.34%	7.09%
WisdomTree Earnings 500 Index				5.99%	5.99%	19.69%	10.03%	13.04%	7.66%	7.40%	5.99%	5.99%	19.69%	10.03%	13.04%	7.66%	7.40%
S&P 500 Value Index				3.29%	3.29%	18.66%	8.87%	12.64%	5.69%	5.47%	3.29%	3.29%	18.66%	8.87%	12.64%	5.69%	5.47%
S&P 500 Index				6.06%	6.06%	17.17%	10.36%	13.28%	7.50%	7.22%	6.06%	6.06%	17.17%	10.36%	13.28%	7.50%	7.22%
S&P 500 Growth Index				8.53%	8.53%	15.40%	11.52%	13.76%	9.18%	8.84%	8.53%	8.53%	15.40%	11.52%	13.76%	9.18%	8.84%

Sources: WisdomTree, Bloomberg, Zephyr StyleADVISOR, as of 3/31/2017.

Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Performance data for the most recent month-end is available at [www.wisdomtree.com](http://www.wisdomtree.com).

WisdomTree shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Total returns are calculated using the daily 4:00 p.m. EST net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times.

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.

**Newman!**

Remember the *Jurassic Park* scene with Seinfeld's "Newman" sitting in the car, freaking out when the cup of water starts shaking? You can feel the T-Rex.

A lot of vested interests depend on blind allegiance to the S&P 500 Index, but the clock is ticking on that historical accident. WisdomTree has a live 10-year track record on a large-cap core Index that outperformed the S&P 500 Index—and we believe in its potential to be here in year 15 and year 20 and so on. What happens if the value factor comes into favor?

At one of these anniversaries the WisdomTree Earnings 500 Index may not be "smart" beta anymore; it may just be beta. New beta. We think it's time to replace what we see as our industry's accident of history.

In 2007 WisdomTree was a baby T-Rex cracking out of its shell. Now, the adult T-Rex is peering through the windshield. Newman, run for the hills!

<sup>1</sup>The S&P 500 Index began its live calculation March 4, 1957.

<sup>2</sup>Burton Malkiel, "The Efficient Market Hypothesis and Its Critics," *Journal of Economic Perspectives* (17(1):59-82), February 2003.

<sup>3</sup>Source: Wharton Professor Jeremy Siegel, Senior Strategy Advisor to WisdomTree, *The Future For Investors*, originally published in 2005; updated in 2016.

<sup>4</sup>[http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/Data\\_Library/det\\_port\\_form\\_ep.html](http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/Data_Library/det_port_form_ep.html)

<sup>5</sup>The "market" refers to all publicly listed U.S. equities with available pricing and necessary fundamental data.

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You cannot invest directly in an index.

## DEFINITIONS

**Fundamentals**: Attributes related to a company's actual operations and production as opposed to changes in share price.

**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.

**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.

**Efficient Market Hypothesis**: Current share prices correctly reflect all available information about publicly traded firms and continually incorporate the emergence of new information on a nearly instantaneous basis; there are no bubbles, and firms are neither expensive nor inexpensive.

**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.

**Alpha**: Can be discussed as both risk-adjusted excess return relative to a specific benchmark, or absolute excess return relative to a benchmark. It is sometimes more generally referred to as excess returns in general.

**Basis point**: 1/100th of 1 percent.

**Quintile**: One of the class of values of a variate which divides the members of and batch or sample into equal-sized subgroups of adjacent values or a probability distribution into distributions of equal probability.

**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.

**Standard deviation**: measure of how widely an investment or investment strategy's returns move relative to its average returns for an observed period. A higher value implies more "risk", in that there is more of a chance the actual return observed is farther away from the average return.

**Earnings Stream**<sup>®</sup>: Earnings per share x the number of shares outstanding. For an index, these totals are added for all constituents.

**Value Factor**: 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 time.

**S&P 500 Growth Index**: A market capitalization-weighted benchmark designed to measure the growth segment of the S&P 500 Index.

**S&P 500 Value Index**: A market capitalization-weighted benchmark designed to measure the value segment of the S&P 500 Index.

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