WisdomTree

SMART BETA

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In the past two decades, exchange-traded funds (ETFs) have exploded onto the investment scene. New ETFs are coming to market all the time. And although ETFs still represent a much smaller piece of the investment pie than mutual funds overall, they are growing rapidly. And they are growing at the expense of mutual funds.

And many experts, including top-rated financial advisors, believe that ETFs may displace mutual funds within the next 10 to 15 years.[1]

Their numerous benefits—including easy diversification, low cost[2], tax efficiency and the convenience of stock trading flexibility—have helped this newer type of investment to flourish. And there are many other drivers that will likely help this industry continue to grow over the coming years. Of course, diversification does not eliminate the risk of experiencing investment losses.

One of these drivers is the continued growth and acceptance of what has come to be known as "smart beta" ETFs. What is smart beta? Before we get into this, let's briefly review a bit of ETF—and finance theory—history.

BETA

BETA[3] AND THE "EFFICIENT MARKET"

The very first ETFs—and the majority of those that followed—were based on market capitalization-weighted indexes. You may be wondering why. Consider that the measurement of the volatility[4] of an investment compared to the market is known as "beta." These ETFs mirror these indexes in an effort to help provide investors with a portfolio that seeks to deliver the same risk, and moves in the same way, as the market; thus the term "beta" has become synonymous with broad market representation.

But if you want to understand why these indexes are market capitalization weighted, we need to go a bit further. Market capitalization-weighted indexes, the bulk of indexes in existence today, weight individual components by their stock market capitalization (price per share times shares outstanding).

This approach is supported by what is known as the Efficient Market Hypothesis, a widely accepted theory that claims the market price of any security is always the best unbiased estimate of a firm's true underlying value (i.e., its "fundamental value") and that no other information that can be easily obtained will give a better estimate of the stock's fundamental value.

Taken a step further, this theory implies that capitalization-weighted indexes deliver the highest expected returns given any level of risk and the lowest possible risk for any given return—making them "mean variance efficient," which would mean that they offer the optimal risk/return ratio regardless of an investor's risk tolerance. So, if the Efficient Market Hypothesis holds, any portfolio that does not weight individual stocks by market capitalization will not be mean-variance efficient and therefore will not offer these desirable risk/return characteristics.

But what if markets are not always efficient?

FOR PROFESSIONAL AND SOPHISTICATED INVESTORS ONLY

[1] Source: John Spence, "Can ETFs Ever Top Mutual Fund Assets?" ETF Trends, 11/27/12.

[2] Ordinary brokerage commissions apply.

[3] Beta: Measure of the volatility of an index or investment relative to a benchmark. A reading of 1.00 indicates that the investment has moved in lockstep with the benchmark; a reading of -1.00 indicates that the investment has moved in the exact opposite direction of the benchmark.wwwwwwww

[4] Volatility: A measure of the dispersion of actual returns around a particular average level.

Who is WISDOMTREE?

WisdomTree launched its first ETFs in the United States in June of 2006 and in Europe in October of 2014. Globally, WisdomTree is currently the eighth largest ETP provider with strategies spanning asset classes and countries around the world. A smart beta innovator, WisdomTree pioneered the concepts of fundamentally weighted indexes and active ETFs—and is currently an industry leader in both categories.

WisdomTree is listed on the NASDAQ Global Market under the ticker: **WETF**.

THE NOISY MARKET HYPOTHESIS

While the Efficient Market Hypothesis has had tremendous influence in the finance profession, it is just one of several theories that seek to explain broad movements in stock prices. As with all theories, it is subject to challenge. There is persuasive evidence that markets are not always efficient and that stock prices can deviate from their fundamental values for many reasons. WisdomTree believes that stock price movements are better explained by a different hypothesis—the Noisy Market Hypothesis—a term coined by Professor Jeremy Siegel, Senior Investment Strategy Advisor to WisdomTree and Russell E. Palmer Professor of Finance at The Wharton School of the University of Pennsylvania.

Conventional wisdom has long recognized that prices of speculative assets, such as equities, experience periods of irrational bubbles and frenzies—as evidenced by the Information Technology sector in the United States during the late 1990s—that can cause their prices to deviate widely from their fair value. Consider that, if traders such as momentum traders[5] speculate on the basis of past price movements or are motivated by "noise" such as rumors or incomplete or inaccurate information, the prices of individual stocks will not always be efficient. Furthermore, investors and institutions often buy or sell shares for reasons unrelated to the valuation of the firm, sometimes for liquidity, fiduciary, tax—or even emotional—reasons. Consequently, the prices realized on these trades are often not representative of the best, unbiased estimate of the fundamental value of the shares.

Performance is now bearing out the idea that market capitalization weighting may not be the best method of indexing. According to Cass Consulting, a research-led consultancy service provided by Cass Business School, returns of traditional, market capitalization-weighted indexes lagged various fundamentally weighted—or smart beta—indexes by as much as 2% per year from 1969–2011.[6] So, although the majority of ETF assets in the market today track cap-weighted indexes, it may not be surprising that alternative methods are growing in popularity.

SMART BETA DEFINED

Now that we've discussed beta and market theory, let's take a look at "smart beta." Some define smart beta as simply any type of index that is not market capitalization weighted. In our opinion, the smart beta approaches that are attracting the greatest attention in the world of equity indexing today are as follows:

+ **FUNDAMENTALLY WEIGHTED INDEXES:** Components are selected to provide broad exposure to an equity market based on market capitalization, but companies are weighted by a fundamental factor such as aggregate dividends or earnings.
+ **EQUAL WEIGHT INDEXES:** Components are often selected from established indexes like the S&P 500[7], but are equally weighted so that all components have identical weights when rebalanced.
+ **FACTOR-BASED INDEXES:** Components are selected based on one or more fundamental factors and are weighted based on one or more fundamental factors. Factor-based Indexes can also be modified equal weighted, where stocks are first divided into tiers based on certain factors, and then equal weighted within the tiers.
+ **LOW VOLATILITY INDEXES:** Components are selected because they have exhibited lower volatility than the overall stock market and/or are weighted based on their historic volatility.

ETFs tracking such rules-based, passive indexes have attracted tens of billions of dollars in assets in recent years, helping to legitimize the category of smart beta as a viable alternative to traditional cap-weighted indexes.

So, put simply, the difference between beta and smart beta may be the idea that smart beta seeks to provide an exposure with the potential to outperform the market—or generate better risk-adjusted returns than the market—rather than merely measure the performance of all investable stocks in an equity market.

THE INTRODUCTION OF SMART BETA

Though many investors may only now be hearing about smart beta indexes and ETFs, they have been around for some time. In fact, WisdomTree was an early pioneer in this category, inventing the concept of dividend weighting equity markets. And in the U.S. in 2006, we launched one of the first families of alternatively weighted ETFs, calling them "fundamentally weighted." We weighted these first ETFs by dividends because we believe these fundamentals offer a more objective measure of a company's health, value and profitability than stock price alone. Today, WisdomTree offers investors smart beta ETFs in all major equity markets around the world.

For our dividend ETFs, we use proprietary weighting methodologies designed to magnify the effect fundamentals—such as dividends have on risk and return characteristics.

WHEN IT COMES TO IDENTIFYING SMART BETA, WE THINK INVESTORS SHOULD LOOK FOR:

01 A rules-based, repeatable methodology that offers broad, representative exposure to an asset class

02 Alternative weighting methods that allow for ample investment capacity

03 High correlations to established benchmarks

04 A proven track record on a total return and risk-adjusted basis

05 Regular rebalancing back to a measure of relative value

CONCLUSION

Investment managers and investors alike are always looking for better ways to invest. Indexing can be highly efficient, and ETFs have a number of benefits that make them a wise way to invest and have led to their quick adoption and impressive industry growth.

If you can accept that price may not always be the best indicator of value—as history has shown time and again—you can appreciate the potential value of smart beta indexes such as WisdomTree's, which rebalance and weight equity markets based on income.

We believe smart beta approaches like ours may help advisors and investors to:

+ Enhance portfolio returns
+ Reduce portfolio risk
+ Increase dividend income
+ Benefit from more complete diversification
+ And much more

At WisdomTree, we do things differently. Our ETFs are built with proprietary methodologies, smart structures or uncommon access to provide investors with the potential for income, performance, diversification and more. **For more information on WisdomTree ETFs, visit www.wisdomtree.com.**

Investment can fall as well as rise and is not guaranteed – you may get back less than you pay in.

[5] Momentum traders: Individuals whose buy and sell decisions are influenced more heavily by recent price performance than any other factors; they typically buy after upward movements and sell after downward moves.

[6] Andrew Clare, et. al. "An Evaluation of Alternative Equity Indices Part 2: Fundamental Weighting Schemes." Cass Business School. March 2013.

[7] S&P 500 Index: A 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.

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