WisdomTree Japan Multifactor Fund

JAMF

THE CASE FOR THE WISDOMTREE JAPAN MULTIFACTOR FUND (JAMF)

WisdomTree aspires to be at the forefront of innovation when it comes to marrying the benefits of the ETF structure with the goals associated with active[1] managers, such as outperforming market capitalization-weighted[2] indexes over the long run.

In 2017, WisdomTree launched a domestic multifactor strategy to target factors well researched in academic literature. We believe our bottom-up method for combining factors helps maximize the potential for higher absolute and risk-adjusted returns[3] in a unique fashion.

WisdomTree is expanding this strategy and providing investors with greater access to its multifactor approach with an active ETF specifically tailored to the Japanese equity market: the WisdomTree Japan Multifactor Fund.

GOING BEYOND BETA FOR ALPHA

The very first ETFs—and the majority of those that followed—were based on market cap-weighted indexes. Broad market indexing and ETFs have gained a large and growing share of the asset management market due to investors' desire to lower the costs of investing. In addition, study after study has found it difficult for traditional active managers to overcome the higher fees they often charge.

In 2006, believing in a passive, low-cost approach, WisdomTree launched a suite of fundamentally weighted[4] Indexes and ETFs designed to address a central drawback of market cap-weighted indexing: that traditional cap weighting does not incorporate any sense of rebalancing back to relative value,[5] and thus becomes unduly exposed to major asset-pricing bubbles.

1 Active: Funds that attempt to outperform the market by selecting securities a portfolio manager believes to be the best.
2 Market capitalization weighting: Market cap = share price x number of shares outstanding. Firms with the highest values receive the highest weights.
3 Risk-adjusted returns: Returns measured in relation to their own variability. High returns with a high level of risk indicate a lower probability that actual returns were close to average returns. High returns with a low level of risk would be more desirable, as they indicate a higher probability that actual returns were close to average returns.
4 Fundamental weighting: A type of equity index in which components are chosen based on fundamental criteria such as revenue, dividend rates, earnings or book value, as opposed to market capitalization.
5 Relative value: The relationship between a particular attribute (e.g., a dividend) and the firm's share price compared to that of another firm.

Alongside the consistent drive toward index investing, there has also been a growing adoption of factor-based portfolio strategies. Academic research has focused on the value,[6] quality,[7] low volatility,[8] momentum[9] and size[10] factors.

WisdomTree's original factor ETFs from 2006 provided exposure to all of these well-regarded factors, with the exception of momentum. Factor analysis illustrates that our small-cap dividend ETF, the WisdomTree U.S. SmallCap Dividend Fund (DES), has provided exposure to small caps[11] (size), value, quality and low beta[12] (low volatility) factors. These original WisdomTree factor ETFs were designed to be broad-based, scalable solutions with low levels of tracking error[13] compared to more traditional market cap-weighted benchmarks.

While WisdomTree believes that broad beta benchmarks—both market capitalization weighted and fundamentally weighted—should continue to gain share at the expense of costly active management, we also think there is a place for reasonably priced investment strategies that are seeking higher alpha,[14] with relatively low fees compared to traditional active management.

A NEW BREED OF ACTIVE?

Vanguard, which is considered a most formidable competitor in the drive toward low-cost indexing, also believes in active management, with offerings that date back to its founding in 1975. The primary variable that stacks the odds in Vanguard's favor—in addition to finding the right managers with the patience to stick with their strategies—is the low costs of its funds. Vanguard's long-term track record in actively managed funds (a 2017 Vanguard study shows that its active funds beat more than 95% of the competition over the previous 10 years) also suggests it is possible for active managers to hit the top of their categories with the right mix of investment strategy, discipline and cost structure.[15]

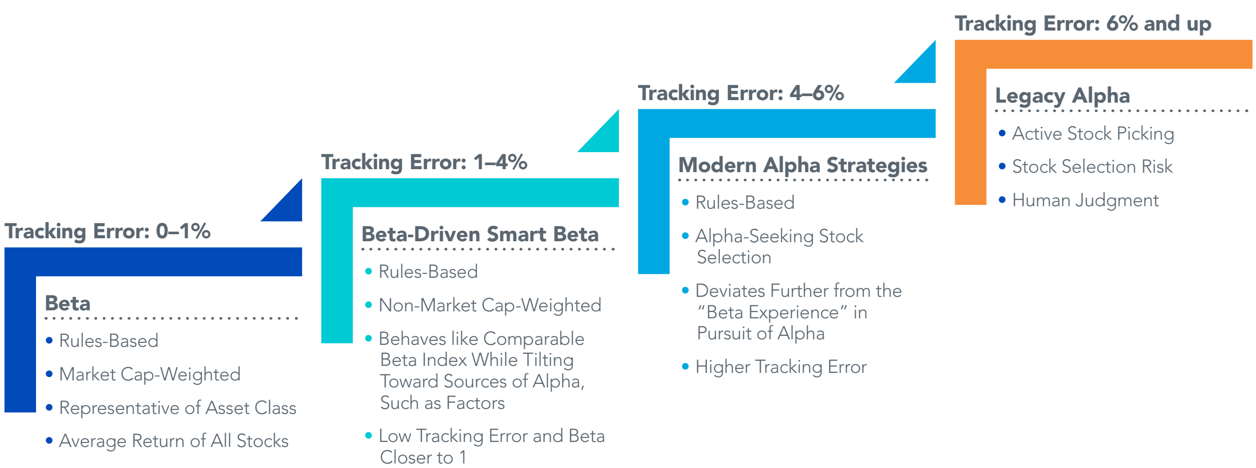
If an investor is searching for alpha, using a low-tracking-error strategy will limit the value added over the market that can be achieved. An investor clearly has to be willing to suffer through periods of underperformance in higher alpha, higher active share[16]-oriented investment strategies. The general maxim of investing holds true here: The less "active risk," the less potential for active reward.

[6] Value: Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the future performance of these fundamentals. Also, value factor, which associates these stock characteristics with excess returns versus the market over time.
[7] Quality: Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets and operating profitability. Also, quality factor, which associates these stock characteristics with excess returns versus the market over time.
[8] Low volatility: Characterized by lower standard deviation of price over time. Also, low volatility factor, which associates lower-volatility stocks with better risk-adjusted returns versus the market over time.
[9] Momentum: Characterized by assets with recent price increase trends over time. Also, momentum factor, which associates these stock characteristics with excess return versus the market over time.
[10] Size: Characterized by smaller companies rather than larger companies by market capitalization. Also, size factor, which associates smaller market cap stocks with excess returns versus the market over time.
[11] Small caps: New or relatively young companies that typically have a market cap of $200 million to $2 billion.
[12] 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.
[13] Tracking error: Can be discussed as both the standard deviation of excess return relative to a specific benchmark, or absolute excess return relative to a specific benchmark.
[14] Alpha: A risk-adjusted measure of the so-called excess return on an investment. It is a common measure for assessing an active manager's performance, as it measures the return in excess of a benchmark index or "risk-free" investment.
[15] "The keys to active management success," The Vanguard Group, Inc., 5/23/17.
[16] Active share: The percentage of stock holdings in a manager's portfolio that differs from the benchmark index.

SEGMENT THE HYBRID FACTOR APPROACH: HIGH AND LOW ALPHA/TRACKING ERROR STRATEGIES

Many investment managers discuss the asset management spectrum as ranging from passive on one end to active on the other. Smart beta and factor strategies, being a hybrid of both, usually lie in the middle, with a goal of outperforming the market like active strategies but achieved with a rules-based approach like passive investing.

WisdomTree believes it is important to consider a further refinement of this passive-to-active spectrum—how much tracking error one is willing to tolerate in the quest for alpha?



Tracking error numbers are meant to serve as a guideline and are not exact measurements.

MODERN ALPHA™ STRATEGIES

In the quest to build higher tracking error and more active strategies, WisdomTree believes it is important to balance the risks that come with more active mandates. These risks include:

+ **Balance of factors:** Are you over-weight certain factors that become meaningfully out of favor for a long stretch of time? For instance, WisdomTree believes in the long-run efficacy of the value factor, yet in the past decade, value indexes have lagged growth indexes in nearly every market globally, with Japan as one of the only notable exceptions. A strategy that just tilts to value, therefore, has had a meaningful headwind over this period.
+ **Sector bets:** Are you meaningfully under-weight or over-weight certain sectors that are a result of your factor tilts? For instance, minimum-volatility and high-dividend indexes have an inherent over-weight to bond proxy sectors, such as Utilities and Real Estate.

+ **Balance benefits of diversified factor approach:** In a strategy designed to add alpha, an investor must take on meaningful stock selection risk. Employing factor diversification to improve the merits of stock selection signals was a key element shaping WisdomTree's thinking on a more active methodology.
+ **Currency management overlay:** WisdomTree has worked with Record Currency Management to use its currency research and signals to dynamically hedge currency exposures in international equity strategies. In international investing, currencies can contribute a significant proportion of overall returns and volatility, making exposure to currency an important factor driving international results.

UNIQUE, MULTIFACTOR ACTIVE ETFs

WisdomTree's multifactor strategies take significant tilts away from pure market cap weighting with more concentrated stock selection rules and a flatter factor and risk-based weighting methodology more akin to equal weighting. In addition, there is an active overlay from the purely model-based output.

The active overlay: WisdomTree's quantitative team seeks to apply risk analysis of our raw factor model. When certain factor bets creep into the model portfolio and make the balance of risks tilt too much in one factor's direction, we can adjust the portfolio to be more balanced across our factors.

Our research shows there are times when a pure indexing approach can lead to unbalanced factor exposures or sector concentration risk resulting from extreme sector weights—even when indexes are designed to equally weight a diverse set of factors.

Innovations in our active approach include:

+ Unique blending of fundamental and technical[17] factors to create a proprietary stock selection and weighting model.
    - **WisdomTree's fundamental factor screens: value and quality**
    - **WisdomTree's technical factor screens: momentum and correlation**

Including value, quality and momentum as factors in a portfolio has been common across competitor multifactor approaches. The low correlation factor may not be one people are as familiar with, but we have witnessed other quantitative managers publish on this factor recently as well. This low correlation factor is related to low volatility and the low beta phenomenon.

[17] Technical indicators: Technical indicators attempt to predict the future price levels, or simply the general price direction, of a security by looking at past patterns.

The metrics we evaluate to create a factor score for each company are listed below. The specific metrics will be common to many similar approaches, but we believe our more active formula for how we apply these factor tilts helps set us apart from other publicly disclosed index methodologies.

Value Factor

+ Sales-to-Price, Book-to-Price, Earnings-to-Price, Estimated Earnings-to-Price, EBITDA-to-Enterprise Value, Operating Cash Flow-to-Price

Quality Factor

+ Static observations and trends of Return on Equity, Return on Assets, Gross Profits over Assets, Cash Flow over Assets

Momentum Factor

+ Risk-adjusted total returns over historical periods (6 and 12 months)

Low Correlation Factor

+ Incorporates diversification potential of stocks that are less correlated to the market

Fundamental Factors   Technical Factors

FACTOR PERFORMANCE ATTRIBUTION

The factor attribution of the MSCI Japan IMI Index can be used to show how WisdomTree's factor definitions have performed over time. Every company in these benchmarks is given a numerical factor score for each of the fundamental factors (value and quality) and technical factors (low correlation and momentum). Once scored, constituents are ranked and assigned to one of three portfolios—Good, OK or Bad—created by dividing each benchmark universe into thirds.

The chart below provides information on the historical trends of individual factor portfolios in Japan. For example, we can see that the portfolio of top value scores (Good) in the MSCI Japan IMI Index tends to outperform the portfolio of worst value scores (Bad) whether on an absolute or risk-adjusted basis.

While any of these factors tend to perform well during different time periods, we think that a portfolio of constituents with above-average exposure to each one of these factors can provide a more consistent risk and return profile.

Summary Statistics 1/1/02–2/28/19							
	Avg. Ann. Return	Std Dev	Beta	Sharpe Ratio	Tracking Error	Information Ratio	Correlation
MSCI Japan IMI Value Factor (Good)	9.13%	15.81%	1.01	0.50	3.50%	1.07	0.98
MSCI Japan IMI Value Factor (Ok)	3.96%	15.40%	0.99	0.17	2.93%	-0.49	0.98
MSCI Japan IMI Value Factor (Bad)	3.99%	14.75%	0.93	0.18	3.97%	-0.35	0.97
MSCI Japan IMI Quality Factor (Good)	5.52%	15.67%	0.99	0.27	3.99%	0.03	0.97
MSCI Japan IMI Quality Factor (Ok)	5.86%	15.55%	1.00	0.29	3.26%	0.14	0.98
MSCI Japan IMI Quality Factor (Bad)	5.56%	15.04%	0.94	0.28	4.46%	0.04	0.96
MSCI Japan IMI Momentum Factor (Good)	4.65%	12.56%	0.69	0.27	8.38%	-0.09	0.84
MSCI Japan IMI Momentum Factor (Ok)	5.23%	16.17%	1.03	0.24	3.73%	-0.04	0.97
MSCI Japan IMI Momentum Factor (Bad)	6.55%	19.68%	1.21	0.27	7.46%	0.16	0.94
MSCI Japan IMI Low Correlation Factor (Good)	7.10%	13.67%	0.78	0.43	7.62%	0.22	0.87
MSCI Japan IMI Low Correlation Factor (Ok)	5.26%	16.56%	1.06	0.24	3.55%	-0.04	0.98
MSCI Japan IMI Low Correlation Factor (Bad)	4.15%	18.00%	1.10	0.16	6.83%	-0.18	0.93
MSCI Japan IMI	5.39%	15.25%	1.00	0.27	0.00%	0.00	1.00

Sources: WisdomTree, Zephyr StyleADVISOR, FactSet. Past performance is not indicative of future results. You cannot invest directly in an index. **Sharpe ratio:** Measure of risk-adjusted return. Higher values indicate greater return per unit of risk, specifically standard deviation, which is viewed as being desirable. **Standard deviation:** A 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. **Information ratio:** A risk-adjusted return measure calculated by taking the excess return against the benchmark and dividing by the tracking error.

SCREENING FOR OUR ETFs

To create the portfolio, the following discipline is applied:

+ **Active selection:** WisdomTree's stock selection starts with a broad, total market cap Japanese stock universe. From this universe, WisdomTree selects the top 200 stocks with the highest combined factor score. Taking one-fourth of the starting universe—from a stock selection standpoint—is a fairly "active" cut of the universe. We did not find value or additional consistent alpha by going deeper with more precise stock selection rules, such as selecting 100 stocks instead of 200.
+ **Risk and return weighting:** WisdomTree uses not just a factor score—a stock's alpha signal—as part of the weighting process, but also a stock's volatility[18] level. This incorporates a concept of risk-adjusted return as a key driver of weights in our portfolios.
+ **Sector neutrality:** One of the key potential risks WisdomTree identified in factor investment strategies is how many such strategies wind up with large sector bets compared to the market. These bets may help or hurt over given market cycles. WisdomTree, in looking to add stock selection value through a diversified factor selection model, wanted to minimize the risk of diluting our alpha signals as a result of mismatched sector weights relative to the market. Yet we also found that our factor models have some implicit signaling in terms of sector tilts, and so we constrained deviation on a sector basis away from the pure market index.

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

The initial stock screening process can be summarized with this flow diagram:

Quarterly Rebalance
Start with a Broad Total Market Cap Universe

Assign Each Stock
a Composite Multifactor Score

Select Top 200 Stocks with the
Highest Multifactor Score

Assign Each Stock a Volatility Score
Rewarding Less Volatile Stocks

Final Profolio
½ Weight Multifactor Score (Alpha Signal)
½ Weight Volatility Score
Sector Neutrality Adjustments to Remove Sector Tilts versus Market Cap Universe

THE CURRENCY FACTOR: A DYNAMIC AND MORE ACTIVE APPROACH

WisdomTree also believes a factor that impacts international markets is currency risk,[19] and many investors want to leave it to their active managers to make such hedging decisions for them.

Among the index investment strategies that WisdomTree has in the marketplace today, we offer three currency approaches: unhedged, fully hedged[20] and dynamically hedged.[21]

In the WisdomTree Japan Multifactor Fund, we offer an investment approach that takes currency risk management as one of the factors we are actively seeking to manage. There will be times the Fund will have currency risk, and other times more of the currencies will be hedged. All those decisions are grounded by research and a factor model.

Hedge ratios are set on a monthly basis. For any individual currency, hedge ratios can be set between 0% and 100%, based on the results of three signals:

+ **Carry (interest rate differentials):** Signal operates at the short- to medium-term horizon
+ **Value (purchasing power parity):** Signal operates over the medium- to long-term horizon
+ **Momentum (10- and 240-day moving average):** Signal operates at the short- to medium-term horizon

[19] Currency risk: The risk that an investment will decline in value due to a change in foreign exchange rates.
[20] Hedge: Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.
[21] Dynamic hedge: Strategy in which a currency hedge can be varied (as opposed to targeting a constant level) and change over the course of time.

INTRODUCING WISDOMTREE JAPAN MULTIFACTOR

The next step in the Modern Alpha evolution

WisdomTree's systematic approach to multifactor investing is designed to provide higher alpha potential with lower volatility and all the benefits of an ETF. This multifactor approach offers:

+ Access to numerous smart beta factors
+ Alpha potential across different market environments
+ Sector neutrality and seeking lower volatility than some active and multifactor approaches
+ The potential for enhanced risk-adjusted returns
+ All the benefits of the ETF structure—and more

WisdomTree Japan Multifactor Fund Quick Facts	
Ticker	JAMF
Exchange	NYSE
Expense Ratio (Gross)	48 bps
Expense Ratio (Net)	43 bps, contractually waived through October 31, 2019
Structure	Open-end ETF
Exposure	Japanese equities with dynamic currency overlay
Equity Rebalancing	Quarterly
Currency Hedge Rebalancing	Monthly

Investors should carefully consider the investment objectives, risks, charges and expenses of the Fund before investing. To obtain a prospectus containing this and other important information, please call 866.909.9473 or visit WisdomTree.com to view or download a prospectus. Investors should read the prospectus carefully before investing.

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Diversification does not eliminate the risk of experiencing investment losses.

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MSCI Japan IMI Index: A free float adjusted market cap-weighted index composed of companies representative of the market structure of Japan, covering the large-cap, mid-cap and small-cap segments of the capitalization spectrum.

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