WisdomTree U.S. Multifactor Fund

USMF

THE HISTORY—AND FUTURE—OF SMART BETA

The first exchange-traded funds (ETFs)—and the majority of those that followed—were based on market capitalization-weighted[1] indexes. This type of weighting is based on the efficient market hypothesis, which assumes that price is always the best representative of underlying value. But time and again we have seen that markets are not always efficient and that prices can deviate from true value. And since these indexes give more weight to securities with higher prices and fail to rebalance back to relative value, they ultimately expose investors to pricing bubbles.

In 2006, WisdomTree launched its first smart beta[2] indexes and ETFs that weight underlying securities by fundamentals,[3] rather than market price, and rebalance on a regular basis. WisdomTree's methodology of weighting by dividends or earnings provides fundamental tilts to broad beta benchmarks[4] and incorporates both a quality discipline (if companies can support dividends or have an overall profit stream) as well as a valuation discipline (rebalancing annually based on the concept of relative value).

THE FACTORS OF SMART BETA

Fama, French, Siegel and many other academics have demonstrated not only that factors exist but that they drive performance. In fact, you are likely aware that over the long term, value has outperformed growth and small caps have outperformed large caps. But value and size are not the only factors that drive performance; research in the academic community has found three other key factors: quality, momentum and low volatility. And, as indicated below, these also outperformed over the long term, with low volatility achieving better risk-adjusted returns versus the market.

[1] 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.
[2] Smart beta: A term for rules-based investment strategies that don't use conventional market cap weightings.
[3] Fundamentals: Attributes related to a company's actual operations and production as opposed to changes in share price.
[4] Beta benchmark: Characterized by measuring the performance of a particular universe of equities without attempting to utilize selection and weighting to generate differences in performance relative to this universe.

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Time Period (6/30/1963 – 12/31/2018)[1]									
	Value (HML)[2]		**Size (SMB)[3]**		**Profitability/Quality (RMW)[4]**		**Momentum (MOM)[5]**		**Low Volatility (Low Vol)[8]**	
	High 30%	12.0%	Smallest 30%	11.7%	Highest 30%	11.2%	Highest 30%	13.0%	Least Volatile 30%	9.7%
	Low 30%	9.9%	Largest 30%	9.8%	Lowest 30%	7.8%	Lowest 30%	6.6%	Most Volatile 30%	7.8%
	Excess Return[6]	2.1%	Excess Return[6]	1.9%	Excess Return[6]	3.3%	Excess Return[6]	6.4%	Excess Return[6]	1.9%
	Volatility	16.6%	Volatility	21.1%	Volatility	14.9%	Volatility	16.6%	Volatility	11.7%
	Sharpe Ratio	0.44	Sharpe Ratio	0.33	Sharpe Ratio	0.44	Sharpe Ratio	0.50	Sharpe Ratio	0.43
Market[7]	U.S. Stock Market	10.0%	U.S. Stock Market	10.0%	U.S. Stock Market	10.0%	U.S. Stock Market	10.0%	U.S. Stock Market	10.0%
	Volatility	15.2%	Volatility	15.2%	Volatility	15.2%	Volatility	15.2%	Volatility	15.2%
	Sharpe Ratio	0.35	Sharpe Ratio	0.35	Sharpe Ratio	0.35	Sharpe Ratio	0.35	Sharpe Ratio	0.35

In the excess return category, the high 30% and low 30% refer to the top 30% and bottom 30%, respectively, of a portfolio of stocks as a function of how well those stocks exhibit the qualities of their respective factor category. In the case of low volatility, top and bottom 20% are being used due to data availability. By finding the difference between the top and bottom 30%, shown as excess return in the table, the premiums of concentrating on a certain factor's qualities can be observed.

[1] Time period: Selected due to the data availability of the quality factor from the Kenneth French Data Library.

[2] Value (HML): Measured as the ratio of book value of equity to market value of the equity of a firm, with higher values indicating a lower market price relative to this fundamental factor. Portfolio shown here is a large-cap portfolio.

[3] Size (SMB): Measured as the market value of equity, with smaller values indicating smaller market capitalization companies and larger values indicating larger market capitalization companies.

[4] Profitability (RMW), often referred to as quality: Measures aspects of operating profitability. Portfolio shown here is a large-cap portfolio.

[5] Momentum (MOM): Means of measuring resilience of positive trends in share price behavior, with stronger resilience in exhibiting positive trends leading to higher momentum. Portfolio shown here is a large-cap portfolio.

[6] Excess return: References the additional return generated by investing in securities with certain attractive fundamental factors (value, size, profitability, momentum and low volatility) versus portfolios investing in securities with weak exposures to those same factors. Portfolios used here are large-cap portfolios except for size.

[7] Market : Refers to a market capitalization-weighted measure of the returns of all firms captured by the Center for Research in Security Prices and listed on the New York Stock Exchange, American Stock Exchange or NASDAQ. Volatility and Sharpe ratio here are calculated on the returns of this measure.

[8] Low volatility (Low Vol): References securities with low variance. Portfolio shown here is a large-cap portfolio.

Source: Kenneth French Data Library

Past performance is not indicative of future results.

WisdomTree's original smart beta offerings, by their very nature, provide exposure to several of these factors, with the exception of momentum. Weighting by dividends or earnings[5] provides access to value, quality and—in the case of dividends—low beta (low volatility), while our small- and mid-cap offerings provide access to size, as well. In recent years, they have also exhibited fairly low levels of tracking error compared with traditional cap-weighted benchmarks.

As the existence and benefits of factors become more accepted, multifactor strategies are the next logical step in smart beta.
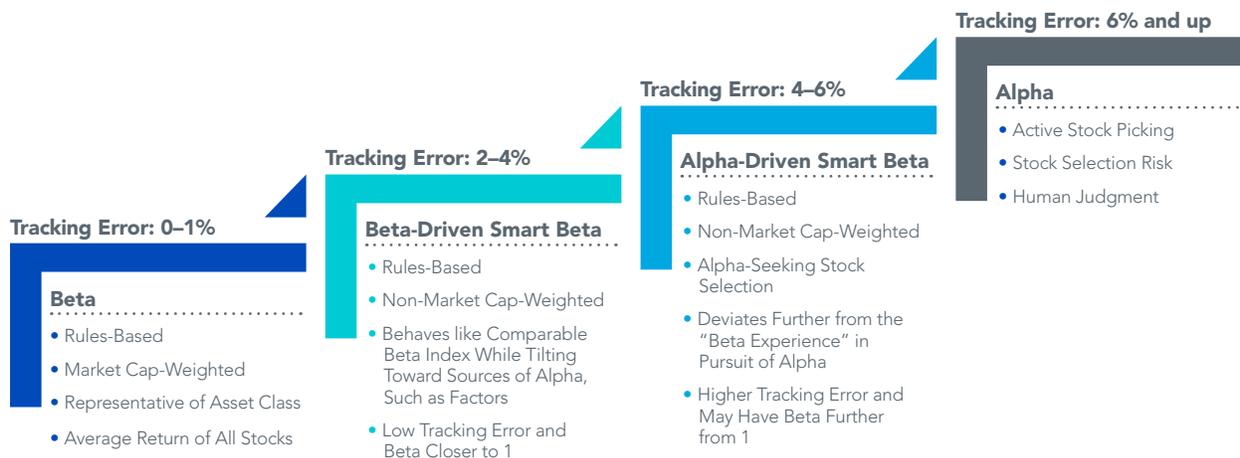
REACHING BEYOND BETA TO FIND ALPHA

Many investment managers describe the asset management spectrum as ranging from passive on one end of the continuum to active on the other. Because "smart beta" and factor strategies combine elements of passive and active, such strategies usually exist in the middle of this continuum. They have a similar goal as active managers—to try to outperform the market—but typically try to do so through a rules-based approach that can be codified into a stock index.

[5] Dividend or earnings weighted: Constituent securities represented within an index in proportion to their contribution to the dividend stream or earnings stream, respectively.

Another way to visualize this continuum is to consider how much potential tracking error one is willing to tolerate in the quest for alpha.

THE ASSET MANAGEMENT SPECTRUM (FROM A "TRACKING ERROR" PERSPECTIVE)

Tracking Error: 6% and up

Alpha
- Active Stock Picking
- Stock Selection Risk
- Human Judgment

Tracking Error: 4–6%

Alpha-Driven Smart Beta
- Rules-Based
- Non-Market Cap-Weighted
- Alpha-Seeking Stock Selection
- Deviates Further from the "Beta Experience" in Pursuit of Alpha
- Higher Tracking Error and May Have Beta Further from 1

Tracking Error: 2–4%

Beta-Driven Smart Beta
- Rules-Based
- Non-Market Cap-Weighted
- Behaves like Comparable Beta Index While Tilting Toward Sources of Alpha, Such as Factors
- Low Tracking Error and Beta Closer to 1

Tracking Error: 0–1%

Beta
- Rules-Based
- Market Cap-Weighted
- Representative of Asset Class
- Average Return of All Stocks

A NEW BREED OF ACTIVE?

Many of today's investors love the benefits of ETFs, but they still want the even higher alpha[6] potential of active management, only without the higher fees and risks that tend to go hand in hand with it. We believe multifactor smart beta strategies can provide this higher alpha potential they are looking for, with the low fees[7] of ETFs, and potentially with lower risks—if they are built with the right discipline.

Multifactor and active approaches exist, but they are not all created equal. More active approaches naturally include more risks and more tracking error—you cannot, after all, generate more alpha without some more risk. However, at WisdomTree, we believe it is possible—and critical—to balance the risks that come with more active mandates, including the following:

+ **Factor imbalance:** Consider that some factors can become meaningfully out of favor for a long stretch of time. For instance, in the 10+ years since WisdomTree launched its original fundamentally-weighted Index family, value indexes have lagged growth indexes by roughly 300 basis points[8] per year. While this does not necessarily mean a strategy tilted to value cannot outperform, one that is only tilted to value would have had a meaningful headwind over this period.

[6] Alpha: Measure of risk-adjusted performance that compares how the constituents move relative to a benchmark.
[7] Ordinary brokerage commissions apply.
[8] Basis point: 1/100th of 1%.

+ **Sector bets:** Factor tilts can sometimes make a strategy meaningfully over- or under-weight in certain sectors. Minimum volatility and high-dividend indexes, for example, are inherently over-weight in bond proxy sectors like Utilities. These sector bets may help or hurt over given market cycles, potentially causing the performance of a strategy to have more to do with its sector exposures than its factor exposures.

+ **Stock selection:** In a strategy designed to add alpha, one must take meaningful stock selection risk. We believe factor diversification can improve the merits of stock selection.

Our more "active" methodology is uniquely designed to combine factors that we believe provide diversified multifactor alpha generation while minimizing the risks described above.

A UNIQUE, MULTIFACTOR APPROACH

The WisdomTree U.S. Multifactor Index is designed to target factors consistent with many "smart beta" approaches. It is the first to use WisdomTree's innovative method of combining factors to maximize the potential for higher absolute and risk-adjusted returns. Highlights of the process include:

+ **Multiple Factors:** A unique blend of fundamental and technical factors is used to create a proprietary stock selection and weighting model:
  - **WisdomTree's fundamental factor screens: value and quality**
  - **WisdomTree technical factor screens: momentum and low correlation**

+ **Active Selection:** WisdomTree starts with the 800 largest market capitalization stocks in listed in the United States. From this universe, we select the top 200 stocks with the highest combined factor score (we look for stocks that access multiple factors because we want securities that can perform in different market environments).

+ **Risk and Return Weighting:** In addition to the factor score, WisdomTree considers a stock's volatility level when assigning weight (it accounts for half the weighting)—incorporating the important concept of risk-adjusted return as a key driver of its Index weighting.

+ **Sector Neutrality:** To add value in the diversified factor selection model, WisdomTree wanted to minimize the risk of diluting our alpha signals with mismatched sector weights relative to the market. Consequently, weights are adjusted to remove any sector tilts relative to the market cap universe.

WISDOMTREE®

Quarterly Rebalance
Start with Top 800 Stocks by Market Cap

Assign Each Stock
a Composite Multifactor Score

Select Top 200 Stocks with the
Highest Multifactor Score

Assign Each Stock a Volatility Score (Trailing 12-Month Volatility)
Rewarding Less Volatile Stocks

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

INTRODUCING THE WISDOMTREE U.S. MULTIFACTOR FUND

The next step in the smart beta evolution

The WisdomTree U.S. Multifactor Fund seeks to track the WisdomTree U.S. Multifactor Index. It is designed to provide higher alpha potential with lower volatility and all the benefits of an ETF. This unique fund offers:

+ Access to numerous smart beta factors

+ Alpha potential across different market environments

+ Sector neutrality and lower volatility than some active and multifactor approaches

+ The potential for enhanced risk-adjusted returns

+ All the benefits of the ETF structure—and more

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USMF Quick Facts	
Ticker	**USMF**
Exchange	**NASDAQ**
Expense Ratio	**0.28%**
Structure	**Open-end ETF**
Exposure	**U.S. Stocks with Multifactor Exposure**
Rebalancing	**The portfolio is rebalanced on a quarterly basis**

At WisdomTree, we do things differently. We build our ETFs with proprietary methodologies, smart structures and uncommon access to provide investors with the potential for income, performance, diversification and more.

For more information about USMF, contact your WisdomTree representative or visit WisdomTree.com.