

# AMONG GIANTS

TINY UPSTART MONEY MANAGER WISDOMTREE HAS GONE FROM ZERO TO MORE THAN \$2 BILLION IN ASSETS IN UNDER ONE YEAR. THIS YOUNG INDEXING COMPANY MANAGED TO CREATE A LINE OF FUNDAMENTALLY WEIGHTED PORTFOLIOS TO COMPETE WITH ETF HEAVYWEIGHTS. BUT THE CONCEPT HAS YET TO BE TESTED IN REAL TIME.

**BY KEVIN BURKE**

**PHOTOGRAPH BY DIRK EUSTERBROCK**

On the evening of June 15, 2006, the New York Stock Exchange was the site of a party for WisdomTree Investments, an ETF maker that, on the following day, was set to issue 20 ETFs representing \$200 million in assets. The 250 or so guests—from *Wall Street Journal* reporters to Wall Street executives and WisdomTree employees—mingled on the trading floor, among the specialists' trading posts, sipping cocktails and munching on *hors d'oeuvres*; party goers climbed into the balcony to have photos of themselves banging the famous gavel. They were having a fine time. After

all, the floor of the NYSE is a remarkable place to party.

Of course, probably nobody at the celebration was having as much fun as WisdomTree's CEO, Jonathan Steinberg. You see, WisdomTree's mere existence (let alone success) defied the odds. Like many entrepreneurial efforts, Steinberg suffered lean times. Steinberg nursed and pushed his vision of an ETF company into fruition, despite a three-year period in which his company (then called Index Development Partners) generated no revenue. (A deal he had signed—with Nuveen—to launch an index of fast-growing companies fell apart; the index was later abandoned.)

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"I was down to about \$500," Steinberg recalled that June evening, probably exaggerating the hardship he had endured. He bulged his eyes, and clutched his heart for dramatic effect. He smiled broadly. Yup, the smile seemed to say that was then. But that night, Steinberg was partying on the floor of the NYSE, hobnobbing with the likes of Michael Steinhardt, Jeremy Siegel and Steinberg's glamorous wife, Maria "Money Honey" Bartiromo.

### The Weight

Since last June, WisdomTree has launched 36 ETFs and amassed more than \$2.8 billion in assets. Of course, it helps to have the legendary Michael Steinhardt as the principal financial backer, and Wharton Professor Jeremy Siegel brings intellectual credibility to the research. Indeed, WisdomTree has established itself as a credible money manager and a challenger (albeit a tiny one now, with just 0.6 percent market share) to the big three ETF manufacturers (Barclays Global Investors, State Street Global Advisors and The Vanguard Group) and even other "fundamental" indexers (such as Rydex and PowerShares). But, as investors pour into fundamental indexes, it begs the question: Is an "index" based on earnings and dividends going to work in real time? Will WisdomTree's line of dividend- and earnings-based exchange-traded funds revolutionize the indexing world, proving—once and for all—that fundamental factors of value are the true measures of a company's fiscal health rather than its stock price? Or will advisors and their investors turn tail the minute growth comes back?

Let's take a step back. Unlike ETF titans Barclays, State Street and Vanguard, WisdomTree uses fundamentals to weight indexes as opposed to the traditional market-cap weighted method. Steinberg argues that picking stocks for indices by ranking weightings according to dividends will produce higher returns (with less risk) than standard, capitalization-weighted indices.

Steinberg argues that cap-weighted indices are vulnerable to pricing anomalies that lead to overweighting overvalued stocks and underweighting undervalued ones. WisdomTree's back-tested models have shown that compared to cap-weighted indexes, the fundamentally weighted indexes achieved higher returns with lower volatility. Siegel joined the company because his own research found similar results—that, over time, stocks with the highest yields (dividends) and low P/Es (strong earnings) did best. Earth shattering? Not really; it's called value investing, and many have been extolling the virtues of investing by dividend yields for years. Dividends fell out of favor in the 1990s, but they remain a good objective measure of a company's value, since it's real cash being paid to shareholders. In other words, like other value devotees, WisdomTree rejects the premise that a stock's price is the best measure of fair value. (WisdomTree is taking a page out of the playbook of Robert Arnott, chairman of investment management firm Research Affiliates,

who is regarded by some as "the godfather" of fundamental indexing and is seeking to patent the idea.) The idea behind so-called "fundamentally" weighted ETFs, then, is to exploit the inherent flaws in cap weighting.

"Everything iShares is doing in equities, we're offering a fundamentally better alternative," Steinberg says. You've got to love his attitude: WisdomTree is dwarfed by iShares, which has \$254 billion in assets.

WisdomTree claims that its lineup of funds offers access to market segments that you cannot get anywhere else. For example, WisdomTree has the only international small-cap ETF and the only pure non-U.S. sector ETFs. Its WisdomTree Total Earnings ETF enables investors to own the market at a lower P/E ratio than the Russell 3000 or the S&P 1500, he says. WisdomTree is also offering six ETFs weighted on the earnings of domestic stocks.

While its methodology runs counter to that of the bigger players, WisdomTree is emulating them in other ways: by hiring their people. WisdomTree hired Bruce Lavine, who had been Barclays' CFO and director of product development, and former Barclays' counsel Richard Morris, now WisdomTree's deputy general counsel. WisdomTree has also raided Barclays' sales force, recruiting a handful of its 20 wholesalers from the San Francisco-based fund giant. Mimicking Barclays in its

### WISDOMTREE SNAPSHOT

**Name:** WisdomTree Asset Management

**Location:** New York

**Specialty:** Dividends- and Earnings-Focused ETFs

**No. of Funds:** 36

**No. of Employees:** 40

**2006 AUM:** \$1.7 billion

**2006 Earnings:** \$19.3 million loss

**Recent Share Price:** \$7.05 up from \$3.70 last March

**Market Cap:** \$792 million

approach to selling funds through financial advisors makes sense because most funds tend to be "sold" by FAs anyway. But WisdomTree has a way to go before beating Barclays, which is No. 1 in ETFs (seven out of every \$10 invested in ETFs goes to iShares).

WisdomTree says it has relationships with all five major wirehouse firms, the major regional broker/dealers and independent b/d bigs, such as LPL Financial Services. The firm would not disclose the exact number of relationships, offering instead that about 7,500 firms and 35,000 financial advisors are registered to its Web site. ETFs are distributed through ALPS Distributors and 20 internal wholesalers. Its funds have been licensed to Seattle-based registered investment advisor Parametric Associates, which will use them in its separate account business. The firm is also making a play

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for the retirement business, having inked an agreement with a Web-based 401(k) platform provider.

Wielding the academic star power of Siegel, the famed Wharton finance professor (also the firm’s spokesman, advisor and 2 percent stakeholder), coupled with the deep pockets of Steinhardt (with a 34.2 percent stake), the company is raking in assets. Much of its early success can be attributed, in part, to an aggressive marketing campaign complete with TV commercials, print ads and public appearances by Siegel to get the word out on fundamental indexing. Former SEC Chairman Arthur Levitt, who joined WisdomTree’s board of directors in August 2006, also said publicly that WisdomTree is “a well-reasoned strategy packaged in an investor friendly structure.” Other board members include former Merrill Lynch COO Frank Salerno and James Robinson IV, co-founder of private equity firm RRE Ventures. Robinson has a 19.5 percent stake in the firm.

### Stepping In It

That lineup of Wall Street luminaries reminds one of the 1927 Yankees’ Murderer’s Row. Their participation is all the more interesting given the path “Jono,” as Steinberg is called, took to get there. The (distant) antecedent company was Individual Investor Group, publishers of *Individual Investor* magazine that had, at its peak in the mid-1990s, half-a-million paid subscribers; IIG also launched *Ticker* magazine, a competitor to this magazine, as well as a couple of investing newsletters. Steinberg built the company, which was eventually publicly traded, by transforming a penny-stock tip sheet he purchased in 1988. Having won *The Wall Street Journal*’s dartboard stockpicking contest six times in the late 1980s and early 1990s, he also launched a hedge fund, also called WisdomTree, that imploded in 1996 after Steinberg made an outsized bet on a meat-and-fish distribution company that was morphing itself into a provider of supposedly cutting-edge data switching devices.

### WISDOMTREE OWNERSHIP BREAKDOWN

|                    |       |
|--------------------|-------|
| Michael Steinhardt | 34.2% |
| RRE Ventures       | 19.5% |
| AIG                | 10%   |
| Atlantic Pacific   | 4%    |
| Jonathan Steinberg | 3.8%  |
| Jeremy Siegel      | 2%    |

In July 2001, Steinberg closed the *Individual Investor* and laid off 90 percent of the staff due to a precipitous decline in advertising revenue and lower newsstand sales. He sold the subscriber list to *Kiplinger’s* to help fund a new venture based on building stock indices called Index Development Partners. Money was tight, and, like his father Saul Steinberg, the corporate raider, Steinberg and his company were the occasional subjects of unflattering articles that to family and friends seemed particularly *ad hominem*.

But Steinberg kept at it, working with his longtime research director, Luciano Siracusano, to build strategy (or rules-based) ETFs. Meanwhile, he kept hitting the pavement, looking for financing. But his grueling search for a lead investor lasted three years and included many weepy and sleepless nights. “It was a very difficult and very dark period,” Steinberg says. After knocking on a lot of doors (including offering to build a “brokerage” index for *Registered Rep.*), finally, in late 2003, he was introduced by “a mutual acquaintance” to legendary hedge fund investor Steinhardt. Steinberg spent six or seven months “working on him,” trying to convince him that his research on fundamentally weighted indexes was a winning strategy. It was an uphill fight and it took countless meetings and phone conversations to sell him on the concept. But Steinhardt was drawn to the discount cost structure. “I was attracted to WisdomTree’s low-fee<sup>1</sup>, transparent ETFs, which can serve the vast majority of investors,” said Steinhardt via email. “And, WisdomTree’s commitment to develop products designed to generate alpha<sup>2</sup> is very much in line with my own investment philosophy.”

Steinhardt finally agreed to back him under one condition: that another individual be brought on board to vet the intellectual property. The defining moment came when Siegel, who had been conducting his own research on the importance of yields in returns and low P/E ratios, agreed the methodology was sound and that he would endorse it and come aboard as a consultant. Why? “I had become disenchanted with market-cap weighting during the tech bubble,” Siegel says. “My years of research have shown that value-tilted portfolios outperformed growth in the long run. And I saw how important dividends were to superior returns when selecting stocks. I would only put my name on a low-cost product.”

Steinberg couldn’t have found a better backer. “It was a perfect serendipitous moment where what we showed him was the commercialization of research he was doing separately,” Steinberg says.

### The Critics

Fundamental indexes are criticized for having a value bias, for being too expensive, for not being indexes at all, but rather active management, among other reasons. Efficient

<sup>1</sup>Ordinary brokerage fees apply.

<sup>2</sup>Alpha is a measure of risk-adjusted returns relative to a benchmark. A higher number indicates higher risk-adjusted returns relative to the benchmark.

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market purists still think trying to outsmart Mr. Market is a fool's errand, since value doesn't always beat growth. What will your clients say when a long, 1990s-like growth cycle returns? Best to just “buy” the market—and its occasional craziness—and go home, they argue.

Financial advisors considering these new-age ETFs may want to do their homework before jumping on the bandwagon. “I caution advisors to know what they're getting,” says Paul Mazzilli, director of ETF research at Morgan Stanley. “If somebody wants a core holding, value approach with decent dividend yields—which are tax efficient these days—WisdomTree is attractive and, in some

cases, less volatile. If you want beta<sup>3</sup> and growth, that's not part of the equation.”

Some may argue that the real-world jury is still out on WisdomTree and the other fundamental ETFs on the market. Bill Keifer, a Wachovia rep who builds model portfolios primarily with ETFs, says it's really not that black and white. He says that cap-weighting and fundamental-weighting strategies both share space on his shelf. He blends the two strategies into eight different model portfolios ranked according to risk profile. Keifer says, “The more things you have that behave differently at different times the better. There are periods when each will outperform the other.” ●

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<sup>3</sup>Beta is a measure of volatility relative to a benchmark. A lower beta indicates lower volatility relative to the benchmark.

The performance of WisdomTree Indexes is based on a back test, i.e. calculations of how an index might have performed in the past had it existed. Hypothetical back-tested performance has inherent limitations and is not indicative of future performance. Additional information regarding the WisdomTree Indexes is available at [www.wisdomtreeindexes.com](http://www.wisdomtreeindexes.com).

WisdomTree Investments, Inc. has patent applications pending on the methodology and operation of its Indexes.

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