

# HOW WE TAP INTO THREE KEY SMART BETA FACTORS WITH EZM AND EES

Luciano Siracusano — Chief Investment Strategist, Christopher Carrano — Quantitative Research Analyst

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Sometimes numbers are worth a thousand words.

For example, these percentages: 99% and 92%. In school, a score of 90% or better on an exam is equated with excellence.

In asset management, these percentages make it easy to compare how a particular fund has performed against competitor funds in a defined category over a specific time frame. In the case of the [WisdomTree MidCap Earnings Fund \(EZM\)](#), 99% corresponds to the percentage of funds in its peer group that EZM outperformed over nearly 10 years, according to Morningstar; 92% is the corresponding figure for the percentage of mutual funds and exchange-traded funds (ETFs) that the [WisdomTree SmallCap Earnings Fund \(EES\)](#) outperformed in its peer group over nearly 10 years.

How is that possible? How can an index fund, an ETF, beat the vast majority of [active](#) and [passive](#) competitors in its category? Aren't index funds supposed to be average?

Well, if it's a WisdomTree ETF tracking a WisdomTree Index, it's not uncommon to see above-average results.

As we can see from the table below, after fees, expenses and transaction costs, EES and EZM outperformed both the core and [value](#) cuts of major [capitalization-weighted](#) indexes since their respective inceptions back in 2007. And if an ETF can beat the major benchmarks over time, the odds are high that it will also beat the vast majority of [active managers](#).

Fund/Index	Fund Information		Average Annual Total Returns as of 12/31/2016					Percent of Peers Beaten In Respective Morningstar Category as of 12/31/2016								
	Ticker	WT Fund Inception	NAV Return			Market Price Return		Morningstar Category	Since Fund Inception							
			Expense Ratio	1-year	3-year	5-year	Since Fund Inception		1-year	3-year	5-year					
WisdomTree MidCap Earnings Fund	EZM	2/23/2007	0.38%	19.71%	7.38%	15.38%	9.06%	19.69%	7.36%	15.33%	9.06%	MidCap Blend	85%	64%	90%	99%
WisdomTree MidCap Earnings Index				20.07%	7.67%	15.68%	9.29%	20.07%	7.67%	15.68%	9.29%					
Russell MidCap Value Index				20.00%	9.45%	15.70%	7.03%	20.00%	9.45%	15.70%	7.03%					
S&P MidCap 400 Index				20.74%	9.04%	15.33%	8.44%	20.74%	9.04%	15.33%	8.44%					
WisdomTree SmallCap Earnings Fund	EES	2/23/2007	0.38%	29.96%	7.26%	15.07%	8.32%	29.94%	7.28%	15.60%	8.30%	SmallCap Blend	97%	66%	83%	92%
WisdomTree SmallCap Earnings Index				30.17%	7.45%	15.87%	8.49%	30.17%	7.45%	15.87%	8.49%					
Russell 2000 Value Index				31.74%	8.31%	15.07%	5.92%	31.74%	8.31%	15.07%	5.92%					
Russell 2000 Index				21.31%	6.74%	14.46%	6.63%	21.31%	6.74%	14.46%	6.63%					

Sources: WisdomTree, Morningstar. Number of peers in each category: Mid-Cap Blend- 429 (1yr), 373 (3yr), 335 (5yr), 222 (Since Inception). Small Blend- 753 (1yr), 631 (3yr), 539 (5yr), 369 (Since Inception). Since-inception peer group comparisons are based on the closest month-end from an intramonth inception date. 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](#).

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.

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The truth is, in many instances, index funds over time have generated above-average returns compared to active managers, after accounting for fees, expenses and transaction costs. That realization has contributed to a great migration in assets that has been occurring over the past several years—out of equity mutual funds and into equity ETFs.

## How WisdomTree Taps into Multiple Factors

How do we explain WisdomTree's success in generating returns that have beaten active and passive competition for nearly a decade? Let's start by examining some ways the [earnings-weighted](#) Indexes that EZM and EES seek to track tap into the value, [quality](#) and size factors that have been associated with excess returns compared to the broader market over time.

- **Value:** The [WisdomTree MidCap Earnings](#) and [WisdomTree SmallCap Earnings](#) Indexes tap into the value factor through their earnings-weighted methodology and annual [rebalancing](#) process. Each December, the indexes rebalance to include only profitable companies and then weight those companies based on the profits they generated in the prior year. This selection and weighting process typically lowers the aggregate [price-to-earnings \(P/E\) ratio](#), a measure of value, relative to comparable market cap-weighted indexes.

- **Quality:** We also find that weighting profitable companies by earnings tends to tilt our Indexes toward stocks with higher measures of [return on equity \(ROE\)](#) and [return on assets \(ROA\)](#), commonly used measures of the quality (or profitability) factor.

- **Size:** Providing purer exposure to the mid- and small-cap segments of the market can also help improve returns over time. As of December 31, 2016, the WisdomTree MidCap Earnings Index held 95% of its weight in stocks between the \$2 billion and \$10 billion market cap range, while the WisdomTree SmallCap Earnings Index held 100% of its weight in stocks with market values below \$2 billion. These percentages, along with the weighted average market capitalizations of these two WisdomTree Indexes, show just how efficiently they capture targeted size factor exposure.

[Learn more about how our fundamentally weighted Indexes exist and perform in the smart beta universe.](#)

WisdomTree Replenishes These [Smart Beta](#) Factor Exposures at the Annual Rebalance

In the two tables below, we show summary statistics for the Indexes that EZM and EES track: the WisdomTree MidCap Earnings Index and the WisdomTree SmallCap Earnings Index, respectively. Note that in each and every case, at the annual rebalance going back to 2007, WisdomTree was able to lower the P/E ratio of each Index, while raising aggregate return on equity and return on assets compared to where they were before the rebalance.

WisdomTree MidCap Earnings Index					WisdomTree SmallCap Earnings Index				
	P/E Ratio	Return On Equity (%)	Return On Assets (%)	Weighted Average Mkt Cap (\$)		P/E Ratio	Return On Equity (%)	Return On Assets (%)	Weighted Average Mkt Cap (\$)
12/21/2007	16.75	11.97	3.23	3,061,374,371	12/21/2007	16.86	10.01	2.20	699,130,736
12/24/2007	13.29	15.02	3.71	2,714,807,871	12/24/2007	13.27	11.78	2.64	644,068,902
12/19/2008	12.23	8.17	1.76	1,884,312,739	12/19/2008	13.50	5.13	1.02	533,337,892
12/22/2008	7.04	15.91	5.42	1,493,284,747	12/22/2008	6.80	12.34	3.74	395,508,055
12/18/2009	31.41	5.32	1.78	2,651,561,979	12/18/2009	75.12	0.47	0.20	789,701,255
12/21/2009	15.40	11.47	3.50	1,796,119,903	12/21/2009	11.22	15.58	3.41	486,965,962
12/17/2010	16.38	12.14	3.70	2,328,237,427	12/17/2010	22.84	7.18	1.58	693,350,029
12/20/2010	12.34	14.68	4.41	2,600,849,210	12/20/2010	12.61	13.09	3.30	670,784,322
12/16/2011	12.86	12.56	3.76	2,625,566,421	12/16/2011	13.37	10.48	2.74	734,566,195
12/19/2011	10.74	14.27	4.15	2,480,379,777	12/19/2011	8.99	14.50	3.58	626,868,298
12/21/2012	13.94	12.67	3.60	3,242,846,466	12/21/2012	14.96	9.70	2.40	824,130,416
12/24/2012	11.45	14.59	3.79	2,866,564,777	12/24/2012	10.65	13.03	3.06	707,091,209
12/20/2013	19.36	11.10	2.89	4,158,960,988	12/20/2013	21.62	9.38	2.20	1,107,713,276
12/23/2013	15.73	14.44	3.54	3,817,660,550	12/23/2013	14.58	12.50	3.13	1,005,349,633
12/19/2014	17.76	12.71	3.08	4,625,783,492	12/19/2014	19.34	9.30	2.21	1,099,130,925
12/22/2014	15.64	13.23	3.35	4,151,048,114	12/22/2014	13.25	12.60	3.16	1,063,252,520
12/18/2015	16.29	11.86	2.90	4,133,340,613	12/18/2015	18.26	8.52	1.84	1,087,565,916
12/21/2015	13.62	15.20	3.45	3,649,048,198	12/21/2015	11.29	12.60	3.31	934,034,155
12/16/2016	19.63	11.74	2.65	4,524,628,555	12/16/2016	28.58	5.64	1.48	1,336,215,653
12/19/2016	16.84	14.00	3.40	3,929,033,560	12/19/2016	12.99	13.23	3.57	1,076,115,999

Sources: WisdomTree FactSet, as of 12/19/16. Past performance is not indicative of future results. You cannot invest directly in an index.

By rebalancing, each Index increased its exposure to proxies for value and quality 100% of the time. Ninety-nine percent of the time, these Indexes increased their exposure to all three return premiums, including size. In other words, both Indexes not only provide exposure to these three smart beta factors in a passive rules-based structure, they have also successfully refreshed and increased these exposures, once per year, via WisdomTree’s annual rebalance process.

**Conclusion: Explore the Core**

Because EZM and EES track broad, representative Indexes, they can be used by investors seeking to generate passive [alpha](#) in the core of their portfolios. Since their respective inceptions in February 2007, EZM has beaten 99% of the funds in its peer group; EES has outperformed 92%. Having beaten both [beta benchmarks](#) and the vast majority of active managers over the past decade, these two WisdomTree ETFs rank among WisdomTree’s most compelling “smart beta” offerings.

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You cannot invest directly in an index.

**DEFINITIONS**

**Active** : Funds that attempt to outperform the market by selecting securities a portfolio manager believe to be the best.

**Passive exchange-traded funds** : Exchange-traded funds that track the performance of an index.

**Value** : 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.

**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.

**Active manager** : Portfolio managers who run funds that attempt to outperform the market by selecting those securities they believe to be the best.

**Earnings-weighted** : Earnings for all constituents in an index are added together, and individual constituents are subsequently weighted by their proportional contribution to that total.

**Quality** : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over time.

**Rebalance** : An index is created by applying a certain set of selection and weighting rules at a certain frequency. WisdomTree rebalances, or re-applies its rules based selection and weighting process on an annual basis.

**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.

**Return on Equity (ROE)** : Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

**Return on assets (ROA)** : Firm profits (after accounting for all expenses) divided by the firm's total assets. Higher numbers indicate greater profits relative to the level of assets utilized to generate them.

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

**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.

**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.