

THE POWER OF FUNDAMENTALS AMONG SMALL CAPS

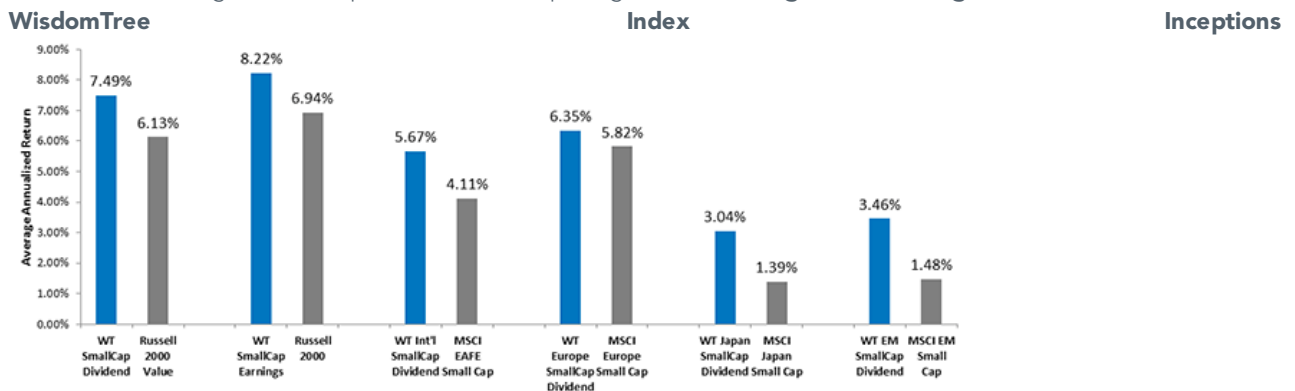
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We continue to see proliferation of the term “[smart beta](#),” which in its simplest terms indicates an index construction that does not weight constituents by [market capitalization](#) but incorporates some type of rules-based [rebalancing](#) process. We believe that smart beta fits between traditional market capitalization-weighted approaches and [active management](#), by offering some of the best attributes of each. A wide array of smart beta indexes are starting to have live performance histories greater than five years, and we evaluated the [WisdomTree Indexes](#) focused on [small-cap](#) equity markets with at least that much history. Previously we discussed how [these strategies compared against active managers](#), but below we will compare them to market capitalization-weighted indexes. **Are Markets Always Efficient?** The [Efficient Market Hypothesis](#) posits that the market price of any security reflects the most accurate possible estimate of the firm’s fundamental value—there are no “bubbles,” or periods when stocks may be bid up in price due to excitement or euphoria. We believe that this isn’t always the case, and therefore we believe that markets are not always efficient, and the default weighting shouldn’t always be based on market cap. WisdomTree believes that screening and weighting equity markets based on [fundamentals](#) such as [dividends](#) or earnings can help produce higher total and [risk-adjusted returns](#) over a complete market cycle. **The Annual Rebalance** One of the most important elements of a fundamental index is the annual rebalance process, where the index screens the eligible universe and then weights those securities based on their fundamentals. In essence, the process takes a detailed look at the relationship between the underlying fundamentals and price performance. **WisdomTree’s Dividend Index rebalance process typically is driven by:**

- **Dividend Growth:** Companies increasing dividends see their weight increased.
- **Relative Performance:**

- Underperformers typically see their weight increased.
- Outperformers often see their weight decreased.

In the charts below, we compare the absolute and [risk-adjusted](#) performance for various [WisdomTree SmallCap Dividend Indexes](#) against a comparative market cap-weighted index. **Figure 1a: Average Annual Performance since Inceptions**



Sources: WisdomTree, Bloomberg, as of 6/30/15. Performance for each index pair is since the respective WisdomTree Index inception.

Figure 1b: Standardized

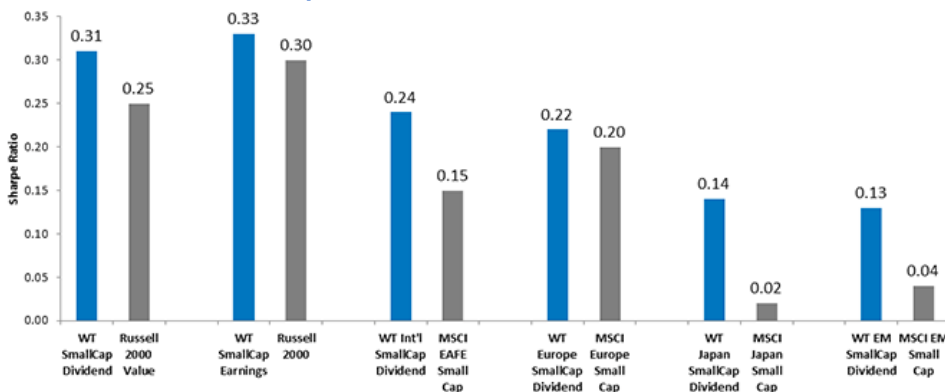
Index	WisdomTree Index Inception Date	Average Annual Returns as of 6/30/2015			
		1-Yr.	3-Yr.	5-Yr.	Since WT Index Inception
WT SmallCap Dividend Index	6/1/2006	3.55%	16.83%	16.28%	7.49%
Russell 2000 Index		6.49%	17.81%	17.08%	7.74%
Russell 2000 Value Index		0.78%	15.50%	14.81%	6.13%
WT SmallCap Earnings Index	2/1/2007	3.54%	18.02%	17.40%	8.22%
Russell 2000 Index		6.49%	17.81%	17.08%	6.94%
WT Int'l SmallCap Dividend Index	6/1/2006	-3.11%	15.37%	12.33%	5.67%
MSCI EAFE Small Cap Index		-0.77%	15.69%	12.40%	4.11%
WT Europe SmallCap Dividend Index	6/1/2006	-1.73%	24.65%	17.04%	6.35%
MSCI Europe Small Cap Index		-1.92%	20.04%	15.19%	5.82%
WT Japan SmallCap Dividend Index	6/1/2006	6.93%	12.59%	10.31%	3.04%
MSCI Japan Small Cap Index		7.08%	13.61%	10.49%	1.39%
WT EM SmallCap Dividend Index	8/1/2007	-4.89%	4.83%	5.85%	3.46%
MSCI EM Small Cap Index		0.34%	7.98%	5.04%	1.48%

Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns.

Index Performance

WisdomTree Indexes Displayed Higher Absolute Returns: WisdomTree believes that the more inefficient the market, the greater the potential for fundamentally weighted indexes to outperform market capitalization-weighted indexes. Therefore, it has come as no surprise to us that, since their inception, WisdomTree’s fundamentally weighted Indexes have produced some of the greatest outperformance compared to their cap-weighted peers in the small-capitalization size segments. In arguably one of the most inefficient small-cap markets, the emerging markets, the [WisdomTree Emerging Markets SmallCap Dividend Index](#) outperformed by approximately 2% per annum. **Figure 2: Risk-Adjusted**

Performance (Sharpe Ratio) since WisdomTree Index Inceptions



Sources: WisdomTree, Bloomberg, Zephyr StyleADVISOR, as of 6/30/15. Performance for each index pair is since the respective WisdomTree Index inception. Past performance is not indicative of future results. You cannot invest directly in an index.

• WisdomTree Indexes

Displayed Higher Risk-Adjusted Returns: We find it impressive that in every instance above, across many regional markets, all of the WisdomTree Indexes also outperformed on a risk-adjusted basis compared to their market cap-weighted peer indexes since their inception. Inefficient markets are typically those where there is less analyst coverage and where stock prices may tend to exhibit greater fluctuations in price (i.e., higher [volatility](#)), compared to the true underlying value of the firm. Therefore, we believe fundamentals become even more important and help control for [valuation risks](#).

Important Risks Related to this Article

Dividends are not guaranteed, and a company’s future ability to pay dividends may be limited. A company currently paying dividends may cease paying dividends at any time.

Investments focusing on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development.

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

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You cannot invest directly in an index.

DEFINITIONS

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

Market Capitalization : 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.

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.

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

Small caps : new or relatively young companies that typically have a market capitalization between \$200 million to \$2 billion.

Efficient Market Hypothesis : Current share prices correctly reflect all available information about publicly traded firms and continually incorporate the emergence of new information on a nearly instantaneous basis; there are no bubbles, and firms are neither expensive nor inexpensive.

Fundamentals : Attributes related to a company's actual operations and production as opposed to changes in share price.

Dividend : A portion of corporate profits paid out to shareholders.

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.

Dividend growth : The growth in trailing 12-month dividends for the specified universe.

Risk : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

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.

Volatility : A measure of the dispersion of actual returns around a particular average level. nbsp;.

Valuation risk : The risk of buying or over-weighting a particular stock that has appreciated significantly in price relative to its dividends, earnings or any other fundamental metric.