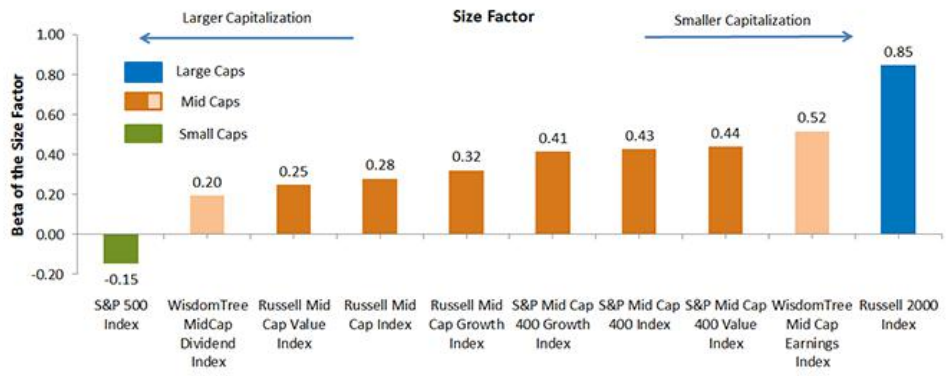
CONSIDERATIONS FOR THE "FORGOTTEN SIZE SEGMENT": MID CAPS

Jeremy Schwartz — Global Chief Investment Officer
05/01/2014

While many allocate specifically to large caps and/or small caps, mid-caps tend to be something of a forgotten size segment. Our research team conducted an under-the-hood analysis of smart beta indexes to detail their underlying factor exposure and explain factor return drivers in performance comparisons. The relative tilt of a portfolio or index to small-cap stocks and value stocks can have a large impact on performance,[1] and one of the interesting takeaways from our factor analysis was just how different the size indexes and exposure factors were for the various mid-cap indexes. In this blog post, I will first show the size factor analysis across mid-cap indexes and then provide a framework that can serve as a strategic baseline for considering how much of a portfolio could be allocated to mid-caps. **The Mid-Cap Size Factor Spectrum: WisdomTree at "Book-Ends"**



Sources: WisdomTree, Bloomberg, Zephyr StyleADVISOR, Kenneth French Data Library. Period 2/1/2007–12/31/2013 due to full history of live performance for WisdomTree Earnings Indexes. You cannot invest directly in an index. Subject to change.

For definitions of indexes in the chart, please visit our glossary. • **Fundamentally-Weighted "Book-Ends":** It's interesting that the WisdomTree MidCap Dividend Index (WTMDI) is the largest mid-cap Index shown, whereas the WisdomTree MidCap Earnings Index (WTMEI) is the smallest. Size factors of 0.20 to 0.52 represent a wide variation in size exposure, in our opinion, and therefore very different potential risk and return characteristics. Even within the market capitalization-weighted peers, the S&P MidCap 400 Index's small-cap tilt was more than 50% greater with its size loading factor of 0.43, compared to 0.28 for the Russell Midcap Index. • **"Book-Ends" Offer a Size Exposure that Is Materially Different from the Large and Small Caps:** While the S&P 500 (large cap) and the Russell 2000 (small cap) have size factors at opposite ends of the spectrum (at -0.15 and 0.85, respectively), the mid-cap indexes occupy a notably different niche, with factors that range from 0.2 to 0.52. This suggests that mid-caps potentially offer a different return experience than their large- and small-cap peers. • **Blends Worth Considering:** Based on these figures, a blend of approximately 75% WTMDI and 25% WTMEI would match the size factor of the Russell Midcap Index, whereas a blend of approximately 72% WTMEI and 28% WTMDI would match the size factor of the S&P MidCap 400 Index. These are very different portfolios, which helps us emphasize that benchmark selection is very important when considering mid-cap equities in the U.S. Having discussed the unique ways of accessing mid-caps and how different the size factor exposure can be across index families, let's turn to the larger question of how much of a total portfolio should be allocated to mid-caps. One framework to answer this question begins with the Russell 3000 Index as of December 31, 2013, and cuts the exposure as follows. Approximate weights: • Large caps: Over $10 billion in market capitalization (78.4% weight) • Mid-caps: Between $2 billion and $10

billion in market capitalization (16.4% weight) • Small caps: Below $2 billion in market capitalization (5.2% weight) We ran a factor analysis that combines this portfolio allocation to WisdomTree Large-, Mid- and SmallCap Indexes in the same proportions as large, mid- and small caps appear in the Russell 3000 Index. The resulting factor exposures are listed in the table below. **Building Exposure to the Market Capitalization Size Spectrum**

Regression Period (Feb. 2007 - Dec. 2013)	Market Factor	Size Factor	Value Factor	Momentum Factor	Average Annual Return
78.4% WTEPS / 16.4% WTMEI / 5.2% WTSEI	0.97	-0.04	0.03	-0.08	7.3%
78.4% WTLDI / 16.4% WTMDI / 5.2% WTSDI	0.89	-0.20	0.34	-0.05	5.7%
Russell 3000 Index	1.01	-0.01	0.01	0.00	6.3%
Russell 3000 Value Index	0.98	-0.09	0.31	-0.01	4.5%
Russell 3000 Growth Index	1.04	0.05	-0.28	0.01	8.0%

Sources: WisdomTree, Bloomberg, Zephyr StyleADVISOR, Kenneth French Data Library. Period 2/1/2007–12/31/2013 due to full history of live performance for WisdomTree Earnings Indexes. Past performance is not indicative of future results. You cannot invest directly in an index.

Market Factor: This factor is meant to denote exposure to the market's "risk premium"—a figure that is calculated by looking at the equity market's return minus the risk-free rate. Size Factor: This factor is meant to denote exposure to different market capitalization size segments. More positive values indicate exposure to the smaller capitalization size segments. Value Factor: The differentiation between "value" or "growth" exposure. More positive figure indicates a greater sensitivity to the value style. Momentum Factor: Propensity of an investment strategy to capture different trends exhibited by the market. More positive values indicate a greater propensity to this factor.

• **Dividend Blend:** Simply put, the major attributes of the dividend blend, compared to the Russell 3000 Index, are 1) lower beta, 2) exposure to larger companies, and 3) a greater tilt toward the value style that is largely similar to the Russell 3000 Value Index. • **Earnings Blend:** The major attributes of the earnings blend, compared the Russell 3000 Index, are 1) slightly lower beta, 2) very similar size, and 3) very similar "core" allocation with a value factor similar to the Russell 3000 Index (core). The crucial point is that all of this was accomplished with nearly 100 basis points of incremental average annual performance.

Conclusion In our research on smart beta, we used a factor model analysis to describe the exposure inherent in WisdomTree's Index methodology. We believe a critical part of evaluating the smart beta approach is taking a look under the hood of the strategies. We hope this research and blog series helped frame why and how WisdomTree's U.S. Index family achieved the results it did over the real-time period analyzed. [1]Source: Eugene F. Fama and Kenneth R. French, "Size, Value, and Momentum in International Stock Returns," 6/21/11.

Important Risks Related to this Article

Investments focusing on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Dividends are not guaranteed and a company's future abilities to pay dividends may be limited. A company currently paying dividends may cease paying dividends at any time. The Dow Jones U.S. Select Dividend Index is calculated, distributed and marketed by Dow Jones Indexes, a licensed trademark of CME Group Index Services LLC, and has been licensed for use.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our Economic & Market Outlook

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Large-Capitalization (Large-Cap) : A term used by the investment community to refer to companies with a market capitalization value of more than $10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

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

Mid-Cap : Characterized by exposure to the next 20% of market capitalization (after the top 70% have been removed) within the Value, Blend or Growth style zones with the majority of the fund's weight.

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

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 tim.

WisdomTree MidCap Dividend Index : A fundamentally weighted index that measures the performance of the mid-capitalization segment of the U.S. dividend-paying market. The Index comprises the companies that constitute the top 75% of the market capitalization of the WisdomTree Dividend Index after the 300 largest companies have been removed. The index is dividend weighted annually to reflect the proportionate share of the aggregate cash dividends each component company is projected to pay in the coming year, based on the most recently declared dividend per share.

WisdomTree MidCap Earnings Index : Fundamentally-weighted index that measures the performance of the top 75% of the market capitalization of the WisdomTree Earnings Index after the 500 largest companies have been removed.

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.

S&P MidCap 400 Index : provides investors with a benchmark for mid-sized companies. The index covers over 7% of the U.S. equity market, and seeks to remain an accurate measure of mid-sized companies, reflecting the risk and return characteristics of the broader mid-cap universe on an on-going basis.

Russell Midcap Index : The Russell Midcap Index measures the performance of the mid-cap value segment of the U.S. equity universe. It includes those Russell Midcap Index companies with lower price-to-book ratios and lower forecasted growth values.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Russell 2000 Index : Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

Russell 3000 Index : Measures the performance of the 3,000 largest U.S. companies based on total market capitalization.

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.

Russell 3000 Value Index : Measures the performance of the Russell 3000 Index constituents with value characteristics.

Basis point : 1/100th of 1 percent.