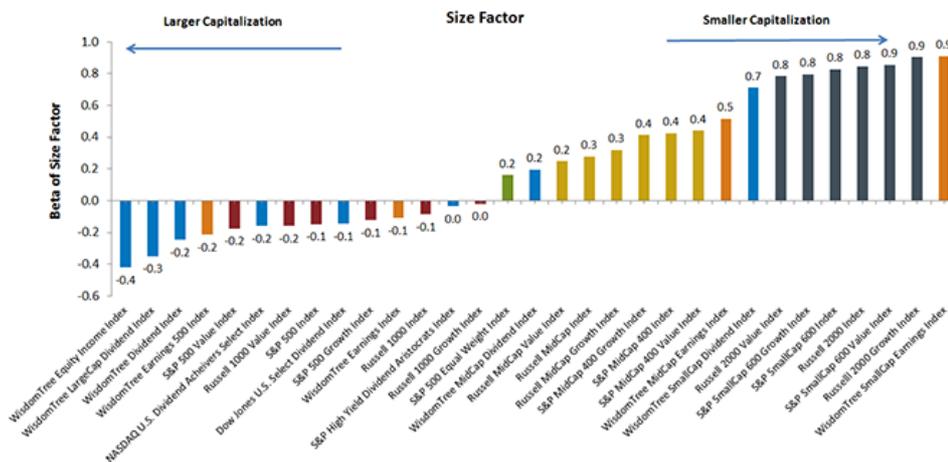


# LOOKING UNDER THE HOOD OF SMART BETA: A FOCUS ON THE SIZE FACTOR

Christopher Gannatti — Global Head of Research  
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Our research team is having many conversations on how one should view [smart beta](#) indexing strategies and what factors are driving the results. We attempted to quantify the various factors at play. My colleague explained our general approach to this analysis in a [prior blog post](#), but in general we evaluated indexes according to their exposure to various factors, from their “market” [risk](#), “size” exposure, “[value](#)” tilts and “momentum” tilts. In this post, I want to focus on the size exposures inherent to our Index approach, as one of the most common misconceptions regarding smart beta indexes is that they “incorporate a [small-cap](#) tilt” to their construction. Some do, but WisdomTree’s traditional Indexes



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. Subject to change.

Legend: Blue represents dividend focused strategies; Orange represents earnings focused strategies; Green represents equal-weighted strategies; Gray represents market-cap weighted (small caps); Yellow represents market-cap weighted strategies (mid-caps); Red represents market-cap weighted strategies (large caps);

do not.

*For definitions of indexes in the chart, please visit our [glossary](#).*

- **Equal Weighting:** We can start with the classic, intuitive example of equal-weighting the [S&P 500 Index](#) to illustrate how different weighting methodologies can influence the size factor of a particular index. We see that the S&P 500 Index registers a negative value (meaning that it’s tilting toward exposure to larger companies) whereas the [S&P 500 Equal Weight Index](#) registers a positive value (meaning that its size exposure is tilting toward smaller companies). It’s interesting that the S&P 500 Equal Weight Index has a very similar size factor to the [WisdomTree MidCap Dividend Index \(WTMDI\)](#).
- **Size Factor Takeaways:** The [WisdomTree LargeCap Dividend Index \(WTLDI\)](#) and [Equity Income Index \(WTHYE\)](#) indicated size factors more than twice that of the S&P 500 Index. When critics characterize smart beta as being a tilt to small caps, they are clearly not talking about WisdomTree’s large-cap dividend or earnings approaches, which are more [large cap](#) than the S&P 500. Part of this distinction is caused by the fact that WisdomTree *selects* stocks by [market capitalization](#) for its size-based segments, and then *weights* securities by dividends or [Earnings Streams®](#). In our opinion, that selection rule results in purer size segmentations across the spectrum.
- Interestingly, the [WisdomTree Dividend Index](#), which includes all dividend payers and has more than twice the number of securities of the S&P 500, still has a great large-cap bias and more loading to large caps than the S&P 500 (more negative size factor than the S&P 500 Index).
- **Most Small-Cap Tilted:** The [WisdomTree SmallCap Earnings Index](#) had the largest factor sensitivity to small caps of all the indexes included in the analysis. What can be done with this factor information to impact strategic investment considerations? **Take 1: Targeting Allocations to Match the Size**

**Exposure of the S&P 500 Index** One of the most widely followed equity indexes is the S&P 500. We mentioned that our Indexes have more of a large-cap bias than the S&P 500. A natural question is, what combination of indexes with our large-cap bias would produce a size exposure similar to the S&P 500? We think it's interesting to consider blending WTLDI with mid-cap options in order to bring the weighted average size exposure into alignment with that of the S&P 500 Index, and the two mid-caps we use are the [WisdomTree MidCap Earnings Index \(WTMEI\)](#) and the [WisdomTree MidCap Dividend Index \(WTMDI\)](#). **The conclusion:**

- An allocation of 77% WTLDI / 23% WTMEI achieved the same size factor as the S&P 500.
- An allocation of 64% WTLDI / 36% WTMDI achieved the same size factor as the S&P 500.

WTMDI had a bigger size factor than WTMEI and thus more was necessary to lower the overall size factor to the S&P 500's. The [WisdomTree Earnings 500 Index \(WTEPS\)](#) also has more of a large-cap bias than the S&P 500, and we analyzed what combinations targeted the S&P 500 size factor. They are:

- 91% WTEPS / 9% WTMEI
- 85% WTEPS / 15% WTMDI

As people consider ways in which to potentially outperform the S&P 500 on a risk-adjusted basis, we believe that these are examples of one approach that could be of interest. It also shows that as one looks to add in the WisdomTree large-cap options, there is a large-cap bias to construction relative to the S&P 500 that could impact desired allocations in other segments. To read our full factor analysis on our smart beta approach, click [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.

**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.

**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.

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

**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.

**S&P 500 Equal Weight Index** : Designed to track the equally weighted performance of the 500 constituents in the S&P 500 Index.

**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 LargeCap Dividend Index** : Measures the performance of the 300 largest companies in the WisdomTree Dividend Index ranked by market capitalization. Weighting is by indicated cash dividends.

**WisdomTree Equity Income Index** : Measures the performance of the 30% highest-yielding dividend-paying equities within the WisdomTree Dividend Index, weighted by indicated cash dividends.

**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.

**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.

**Earnings Stream®** : Earnings per share x the number of shares outstanding. For an index, these totals are added for all constituents.

**WisdomTree Dividend Index** : Measures the performance of dividend-paying companies incorporated in the United States that pay regular cash dividends and meet WisdomTree's eligibility requirements. Weighted by indicated cash dividends.

**WisdomTree SmallCap Earnings Index (WTSEI)** : measures the performance of earnings-generating companies within the small-capitalization segment of the U.S. Stock Market. The index is comprised of the companies in the bottom 25% of the market capitalization of the WisdomTree Earnings Index after the 500 largest companies have been removed.

**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.

**WisdomTree Earnings 500 Index** : A fundamentally weighted index that measures the performance of earnings-generating companies within the large-capitalization segment of the U.S. Stock Market. Companies in the index are

incorporated and listed in the U.S and have generated positive cumulative earnings over their most recent four fiscal quarters prior to the index measurement date. The index is comprised of the 500 largest companies ranked by market capitalization in the WisdomTree Earnings Index.