
WISDOMTREE'S NEW U.S. MULTIFACTOR INDEX: THE QUEST FOR ALPHA

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Before introducing [WisdomTree's new U.S. Multifactor Index](#), we think it is important to discuss why factor investing, after decades of academic research and support, is increasingly resonating with investors.

The Great Migration

The very first exchange-traded funds (ETFs)—and most of those that followed—were based on [market capitalization-weighted](#) indexes. Broad market indexing and ETFs have gained a large and growing share of the asset management marketplace due to investors' desire to lower the costs of investing. In addition, most studies conclude that it's difficult for traditional [active managers](#) to overcome the higher fees they charge.¹

A Better Way to Index

Over 10 years ago, WisdomTree pioneered an income-tilted indexing strategy designed to provide broad [beta](#) exposure with [alpha](#) potential. WisdomTree recognized the value of marrying the benefits of the ETF structure, which can help bring tax efficiency, to an investment process that is built on [rebalancing](#) based on relative [value](#), a departure from traditional market cap-weighted indexes.

As WisdomTree and other index providers proved the appeal of alternatively weighted indexes, more interest has developed around factor investing generally.

In recent years, traditional index providers have created stock indexes that tap into the specific factors that academic research suggests help explain higher returns or higher risk-adjusted returns over long holding periods: [value](#), [size](#), [quality](#), [momentum](#) and [low volatility](#).

In the original WisdomTree Indexes, launched in 2006 and 2007, we provided exposure to several of these well-regarded factors, apart from momentum, in a holistic way, while providing broad exposure to the various size segments of U.S. equity market. Factor analysis, for example, illustrates that our [small-cap dividend](#) ETF provided exposure to small caps (size), value, quality and low beta (low [volatility](#)) over the past decade.

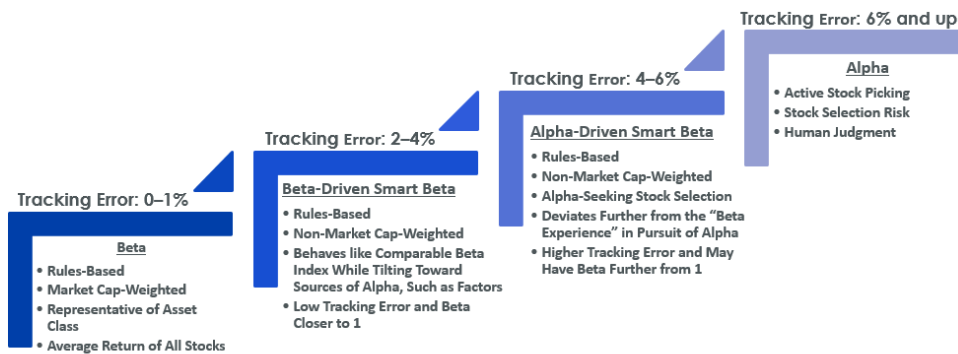
The original WisdomTree ETFs were created to be broad-based, scalable solutions in categories deemed hard for managers to add value, such as U.S. [large caps](#). In recent years, many have also exhibited fairly low levels of [tracking error versus traditional market capitalization-weighted benchmarks](#).

A New Breed of Active and Alpha Strategies

Many investment managers describe the asset management spectrum as ranging from [passive](#) on one end of the continuum to [active](#) on the other. Because “[smart beta](#)” and factor strategies combine elements of passive and active, such strategies usually exist in the middle of this continuum. They have a similar goal as active managers—to try to outperform the market—but typically try to do so through a rules-based approach that can be codified into a stock index.

Another way to visualize this continuum is to consider how much potential tracking error one is willing to tolerate in the quest for alpha.

Segmenting the Hybrid “Factor Approach”: High and Low Alpha/Tracking Error Strategies



Source: WisdomTree.

A Low Tracking Error Example of a Beta-Driven Smart Beta Approach

For some context, consider the [WisdomTree Earnings Index](#), which weights companies once a year based on the aggregate earnings they’ve generated in the prior year. This Index had tracking error relative to the [Russell 3000 Index](#) of less than 2% over the past 10 years—a period in which the WisdomTree Earnings Index outperformed the Russell 3000 Index by 30 [basis points \(bps\)](#) per year.

Index	Smart Beta Approach	10 Year Summary Statistics as of 5/31/2017						
		Return (%)	Std Dev (%)	Beta	Sharpe Ratio	Tracking Error (%)	Information Ratio	Correlation
WisdomTree Earnings	Beta Driven	7.26	15.48	0.98	0.43	1.93	0.15	0.99
Russell 3000		6.96	15.77	1.00	0.41	0.00	0.00	1.00

Source: WisdomTree, Zephyr StyleADVISOR as of 5/31/17. 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.

WisdomTree’s Approach to Multifactor Indexing

While we believe that such fundamentally weighted indexes still hold out the potential to beat comparable cap-weighted indexes for the next 10 years, WisdomTree concedes that it may be possible to generate greater excess return over time by taking on greater active risk and concentrating index holdings in stocks that have greater exposure to the factors that have historically been associated with excess return. For investors interested in more active strategies, WisdomTree believes it is important to balance the risks that come with more active mandates. Some of these risks include:

- **Balance of Factors:** Are you over-weight in certain factors that become meaningfully out of favor for a long stretch of time? For instance, WisdomTree believes in the long-run efficacy of the value factor. Yet in the 10 years since WisdomTree launched its original fundamentally weighted Index families, value indexes lagged growth indexes by roughly 300 bps per year. A strategy that just tilts to value, therefore, faced a meaningful headwind over this period.
- **Sector Bets:** Are you meaningfully under-weight or over-weight in certain sectors that are a result of your factor tilts? For instance, minimum volatility and high-dividend indexes are inherently over-weight in bond proxy sectors, such as Utilities.
- **Balance Benefits of Diversified Factor Approach:** In a strategy that seeks to add alpha, one must take meaningful stock selection risk. We believe employing factor diversification improves the merits of stock selection and is a key element in shaping WisdomTree's thinking on a more "active" index methodology.

We designed the WisdomTree U.S. Multifactor Index to target factors consistent with many "smart beta" approaches. But we believe our method of combining factors to maximize the potential for higher absolute and risk-adjusted returns is unique.

In our next post, we will outline the process of the new WisdomTree U.S. Multifactor Index in greater detail, including the introduction of the [WisdomTree U.S. Multifactor Fund \(USMF\)](#).

¹SPIVA Scorecard.

Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. Investing in a Fund exposed to particular sectors increases the vulnerability to any single economic, political or regulatory development. This may result in greater share price volatility. Due to the investment strategy of the Fund, it may make higher capital gain distributions than other ETFs. Please read the Fund's prospectus for specific details regarding the Fund's risk profile. Neither WisdomTree Investments, Inc. nor its affiliates, nor Foreside Fund Services, LLC., or its affiliates provide tax advice. All references to tax matters or information provided on this site are for illustrative purposes only and should not be considered tax advice and cannot be used for the purpose of avoiding tax penalties. Investors seeking tax advice should consult an independent tax advisor. Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time.

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You cannot invest directly in an index.

DEFINITIONS

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.

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

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.

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.

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.

Value Factor : 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.

Size : Characterized by smaller companies rather than larger companies by market capitalization. This term is also related to the Size Factor, which associates smaller market-cap stocks with excess returns vs the market over time.

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.

Momentum Factor : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

Low Volatility : Characterized by lower standard deviation of price over time. This term is also associated with the Low Volatility Factor, which associates lower volatility stocks with better risk-adjusted 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.

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

100% Passively Hedged Approach : Strategy designed to have the full currency exposure hedged, regardless of any changes in market conditions.

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.

Tracking Error : Can be discussed as both the standard deviation of excess return relative to a specific benchmark, or absolute excess return relative to a specific benchmark.

Passive : Indexes that take a rules-based approach with regular rebalancing schedules that are not changed due to

market conditions.

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

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

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

Basis point : 1/100th of 1 percent.