WISDOMTREE'S EARNINGS-WEIGHTED INDEXES TURN 10: HOW DID WE DO?

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While many investors evaluate investment managers based on how they've performed over the prior three- or five-year periods, 10-year numbers often provide an important lens through which to examine an investment strategy. That's because most economic cycles and bull markets run out of steam within a decade, and thus 10-year records show how strategies have performed over full market cycles.

In February, WisdomTree's core earnings-weighted Indexes hit their 10-year anniversary. How did we do? WisdomTree's smart beta Indexes beat beta. In each and every case, WisdomTree's core earnings-weighted Indexes beat their comparable cap-weighted peers over the past decade. This performance was consistent with what we saw in our research: the more inefficient the market, the greater the opportunity to generate excess returns with a fundamentally weighted approach. The WisdomTree SmallCap Earnings Index, for example, outperformed the Russell 2000 Index by more than 150 basis points (bps) annualized over the past 10 years.

		Average Annual Total Return as of 1/31/2017			
Index	WT Inception	1-Year	3-Year	5-Year	10-Year
WisdomTree Earnings	2/1/2007	24.15%	10.61%	13.87%	7.45%
Russell 3000		21.73%	10.28%	13.97%	7.07%
WisdomTree Earnings 500	2/1/2007	22.93%	10.73%	13.78%	7.15%
S&P 500		20.04%	10.85%	14.09%	6.99%
WisdomTree MidCap Earnings	2/1/2007	29.43%	9.25%	14.35%	9.65%
S&P MidCap 400		30.17%	10.43%	14.24%	8.95%
WisdomTree SmallCap Earnings	2/1/2007	39.43%	8.81%	13.62%	8.49%
Russell 2000		33.53%	7.89%	13.00%	6.93%

Sources: WisdomTree, Zephyr StyleADVISOR, Bloomberg, as of 1/31/2017

For definitions of terms and indexes in the charts, visit our glossary.

	10-Year Summary Statistics						
Index	Std Dev	Beta	Alpha	Sharpe Ratio	Tracking Error	Information Ratio	Correlation
WisdomTree Earnings	15.53%	0.98	0.49%	0.44	1.9%	0.20	0.99
Russell 3000	15.82%	1.00	0.00%	0.40	0.0%	0.00	1.00
WisdomTree Earnings 500	15.09%	0.98	0.26%	0.43	1.7%	0.10	0.99
S&P 500	15.28%	1.00	0.00%	0.41	0.0%	0.00	1.00
WisdomTree MidCap Earnings	19.14%	1.04	0.44%	0.47	3.9%	0.18	0.98
S&P MidCap 400	18.06%	1.00	0.00%	0.46	0.0%	0.00	1.00
WisdomTree SmallCap Earnings	22.08%	1.06	1.36%	0.35	6.1%	0.26	0.96
Russell 2000	20.14%	1.00	0.00%	0.31	0.0%	0.00	1.00

Sources: WisdomTree, Zephyr StyleADVISOR, Bloomberg, as of 1/31/2017. Std Dev = Standard Deviation
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.

It's important to note that these excess returns were not generated by taking on excessive risk. In each and every case, the WisdomTree earnings-weighted Indexes generated higher risk-adjusted returns as measured by a higher Sharpe ratio. They also demonstrated very high correlations to the established cap-weighted benchmarks.

Rationale for Earnings-Weighted ETFs

I am often asked how to use earnings-weighted exchange-traded funds (ETFs) in a broader allocation, and why WisdomTree believes such excess returns may persist into the future.

WisdomTree's core earnings-weighted ETFs can be used in the core of a U.S. equity allocation. They provide exposure to the four broad size segments of the U.S. market. The initial universe is all companies incorporated in the U.S. with market capitalizations of at least $100 million that have generated profits in the prior year. That's typically around 2,000 companies, with an aggregate market capitalization that is larger than that of the S&P 500 Index and about 90% of the Russell 3000 Index.

Because WisdomTree only includes profitable companies at the annual rebalance in December, we are able to assign constituent weights based on the total amount of earnings a company has generated in the prior year, rather than its market value. This typically reduces the price-to-earnings (P/E) ratio of the earnings-weighted Index relative to its cap-weighted peer—in effect giving investors who buy its tracking ETF a way to "own the market" at a more reasonable price. That reduction in P/E ratio has occurred for each of the WisdomTree Indexes highlighted above at each annual rebalance for the last 10 years.

This selection and weighting methodology allows WisdomTree to replenish exposure to the smart beta factors of value and quality each year. And selecting by market cap for the size-segmented Indexes allows us to minimize "size bets" in the large and broad market Indexes, while maximizing the size bet in the mid- and small-cap Indexes.

The earnings-weighted ETFs share much in common, philosophically, with our dividend-weighted ETFs. But there are three important differences.

First, Morningstar categorizes the core dividend-weighted ETFs we launched more than a decade ago in the Value Category. Our four core earnings-weighted ETFs are categorized as Blend.

Second, the earnings-weighted ETFs typically have less exposure to the real estate investment trust (REIT) and Utilities sectors, so different sector exposures mean that earnings-weighted ETFs perform differently from dividend-weighted ETFs during different phases of the economic cycle. For example, the WisdomTree Midcap Earnings Fund (EZM) and the WisdomTree SmallCap Earnings Fund (EES) have, on average, outperformed the S&P 500 over the past decade during periods when interest rates rose in the U.S.

Third, for investors looking to maximize the capital appreciation portion of the total return, as opposed to the dividend income portion, WisdomTree's earnings-weighted ETFs offer an excellent complement to our dividend-weighted ETFs.

Conclusion

The WisdomTree earnings-weighted ETFs that track core earnings Indexes approach the standardized 10-year track record in March. For investors looking to migrate assets from the mutual fund structure into the ETF structure, we believe they represent an excellent choice for those in search of low-fee alpha.

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You cannot invest directly in an index.

DEFINITIONS

Bullish : a position that benefits when asset prices rise.

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

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.

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.

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.

Basis point : 1/100th of 1 percent.

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.

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

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

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.

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.

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 tim.

Dividend weighted : Constituent securities represented within the Index in proportion to their contribution to the dividend stream of the Index.

Real estate investment trust (REIT) : Investment structure containing a basket of different exposures to real estate, be it directly in properties or in mortgages. Returns predominantly relate to changes in property values and income from rental payments.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

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.