

A FUNDAMENTAL REBALANCE CASE STUDY: THE WISDOMTREE SMALLCAP EARNINGS INDEX

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At WisdomTree, we believe strongly in relative value [rebalancing](#). The act of rebalancing constituents of an Index back to their [fundamental](#) values is important, given our belief that stocks often overshoot their underlying fundamentals. Consequently, investors run the risk of paying too much for stocks that have become expensive compared to their fair value. A disciplined strategy of reweighting allocations back to attractively valued stocks through an annual rebalance process is an important element in managing market [valuation risks](#). Typically, this results in the following:

- Companies whose share prices appreciated at a faster rate than their fundamentals would typically see a reduction in their constituent weight during the rebalancing process.
- Companies whose share prices did not appreciate or even dropped, but whose fundamentals were maintained or improved, would typically see an increase in their constituent weight during the rebalancing process.

The [WisdomTree SmallCap Earnings Index \(WTSEI\)](#) generally has a cyclical bias to its underlying holdings — both from its constituents being generally lower in average [market cap](#) than most other small-cap benchmarks and from its sector composition that tends to be more cyclical due to earnings weighting.

During periods when the market is worried about the U.S. economy and growth prospects, WTSEI tends to underperform large-cap stocks. Since July 8, when [interest rates](#) bottomed along with fears about economic growth, and later in November, small caps, and WTSEI in particular, started to meaningfully outperform the broader markets. In November alone, WTSEI outperformed the [S&P 500](#) by over 10 percentage points and was ahead in 2016 YTD by an even wider margin through November 30 (24.3% vs 9.8%).

This strong performance post-U.S. election means it's a good time to rebalance and take chips away from some of the really big winners while adding weight to the stocks at lower multiples, the underperformers. Stocks that were up more than 20 percentage points since the last rebalance saw their weight reduced by almost 15 percentage points, and stocks with negative returns saw their weight increase by almost 12 percentage points.

Change in Fundamentals

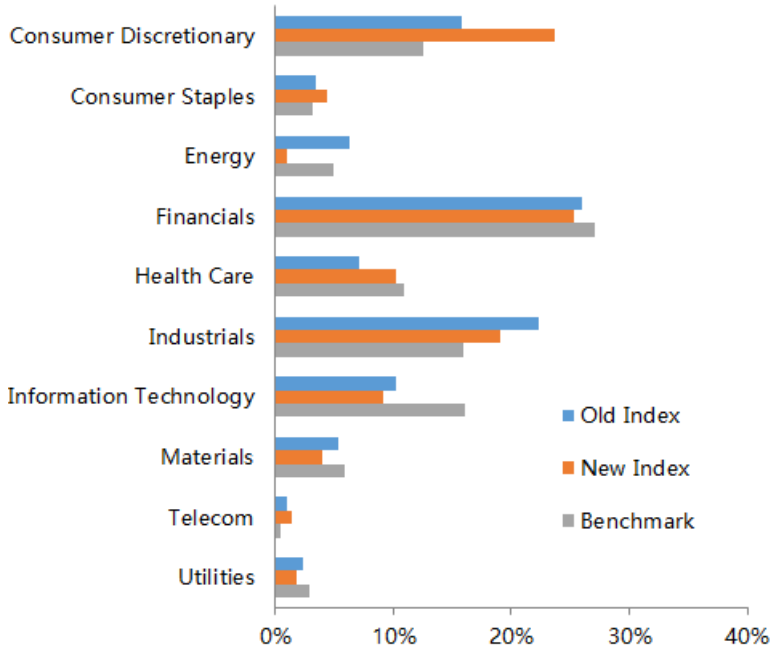
Index Statistics	New Index	Old Index	Benchmark
	WTSEI	WTSEI	MXUSCC
Dividend Yield	1.37%	1.18%	1.52%
Net Buyback Yield	1.26%	1.05%	-0.18%
Shareholder Yield	2.63%	2.22%	0.01%
P/E Ratio	12.2x	26.8x	35.0x
Estimated P/E Ratio	15.8x	19.2x	24.1x
Estimated Long Term Growth	11.28%	11.90%	10.77%
Return On Equity	13.05%	5.45%	6.55%
Return On Assets	3.57%	1.44%	1.57%

Sources: WisdomTree, MSCI, FactSet, as of 11/30/16. "WTSEI" refers to the WisdomTree SmallCap Earnings Index; "MXUSCC" refers to the MSCI USA Small Cap Index; "Old Index" refers to Index composition before the 11/30/16 rebalance; "New Index" refers to Index composition after the annual rebalance based on the 11/30/16 screening. Past performance is not indicative of future results. You cannot invest directly in an index.

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

- The [estimated price-to-earnings \(P/E\)](#) ratio is more than 8 multiple points (and over 30%) lower than that of a comparable market cap-weighted index. WTSEI also saw large increases in profitability measures like [return on equity \(ROE\)](#) and [return on assets \(ROA\)](#).

Changes In Sector Composition



Sources: WisdomTree, MSCI, FactSet, as of 11/30/16. "WTSEI" refers to the WisdomTree SmallCap Earnings Index; "MXUSSC" refers to the MSCI USA Small Cap Index; "Old Index" refers to Index composition before the 11/30/16 rebalance; "New Index" refers to Index composition after the annual rebalance based on the 11/30/16 screening.

- The Index saw large increases in the Consumer Discretionary (7.8%) and Health Care (3.1%) sectors, both primarily driven by poor relative price performance of those sectors and above-average earnings growth.
- The Index saw large decreases in the Energy (-5.2%) and Industrials (-3.3%) sectors, both driven by a decrease in earnings and strong relative price performance of those sectors.

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

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You cannot invest directly in an index.

DEFINITIONS

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.

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

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.

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.

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

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.

Estimated P/E ratios : Share price divided by estimated 12-month earnings per share. Lower numbers indicate an ability to access greater amounts of estimated 12-month earnings per dollar invested.

Return on Equity (ROE) : Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

Return on assets (ROA) : Firm profits (after accounting for all expenses) divided by the firm's total assets. Higher numbers indicate greater profits relative to the level of assets utilized to generate them.