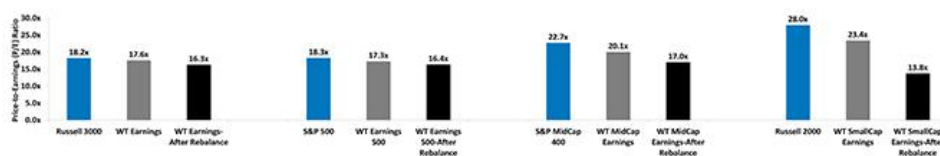


HOW REBALANCING CAN HELP IMPROVE EARNINGS QUALITY AND LOWER MULTIPLES

Jeremy Schwartz — Global Chief Investment Officer
02/09/2015

A key process driving the WisdomTree [earnings-weighted](#) Index approach is a [rebalancing process](#) that refreshes constituent weights based on changes in [Earnings Stream®](#) and relative value. In earnings-weighted indexes, changes at the rebalance are made based on each stock's [relative price appreciation](#) compared to its [relative earnings growth](#):

- Companies whose stock prices increased compared to their peers' while their earnings decreased compared to their peers' would typically see reduced weight in the WisdomTree Earnings Indexes.
- In a [market cap-weighted](#) index, the only driver of weight is the relative change in market capitalization, which is usually driven by the stock price.
- Companies whose stock prices fell while their earnings were flat or grew would typically see increased weight in the WisdomTree Earnings Indexes.
- Companies that have not been profitable on a cumulative basis over the previous four quarters are removed to ensure the continued focus on earnings-generating stocks—one element that improves the quality of the basket by removing more speculative, unprofitable ventures. Weight is also shifted to the relatively more profitable companies and those that have seen highest earnings growth. One way to gauge the impact of the rebalance process is to look at the [price-to-earnings \(P/E\) ratio](#), essentially the price of the Index divided by its [earnings per share](#) before and after the rebalance. Below we show the P/E multiples across market segments. As will be shown, the rebalance can have a large impact on a portfolio's P/E ratio. **U.S. Equity Index Estimated 12-Month P/E Ratios*** (as of 11/30/14)



Sources: WisdomTree, Standard & Poor's, Bloomberg. Past performance is not indicative of future results.

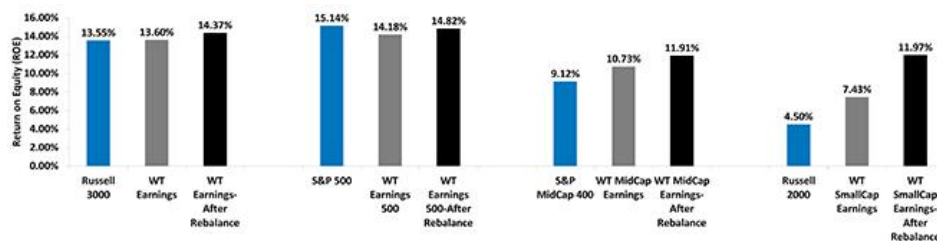
For definitions of terms and

indexes in the chart, visit our [glossary](#). • **A Lower P/E Ratio Approach:** Even prior to the 2014 rebalance, each earnings-weighted Index exhibited a lower P/E ratio than its market capitalization-weighted counterpart. After the rebalance, the P/E ratios dropped even more significantly compared to these benchmarks. This is a key benefit of the [annual rebalance process](#) that forces the discipline of reweighting to the [fundamental value](#) of the underlying constituents in the Index.

- **Multiples Contracted Anywhere between 7% and 40% across All Indexes:** The [WisdomTree SmallCap Earnings Index](#) saw multiples contract the greatest at approximately 40%. WisdomTree requires each constituent of its earnings family to demonstrate profitability. This addresses the problem seen in the [Russell 2000 Index](#) —namely, a high index-level P/E ratio that is due to index-level earnings being depressed by constituents with negative earnings—by eliminating firms that have had negative earnings over the prior 12 months. Since there are more constituents in small-cap indexes that have delivered negative earnings over the prior 12 months than there are in large-cap indexes, this effect is more pronounced within this size segment.¹

Rebalance Track Record—Consistency in Raising [Return on Equity \(ROE\)](#) Now that we have studied the impact of the rebalance on lowering P/E multiples, we will show the impact of the rebalance in helping to raise the “quality” of the earnings Indexes, measured by the ROE. **Post-Rebalance**

Raising ROE and Improving Quality



Sources: WisdomTree, Standard & Poor's, with data from 11/30/14 and 12/31/14. 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](#). This chart illustrates how the rebalance has raised the ROE across four WisdomTree Earnings Indexes. In the 2014 rebalance, for example, the ROE of the WisdomTree SmallCap Earnings Index before and after the rebalance was 7.43% and 11.97%, respectively. As the [bull market](#) in equities carries on, it becomes ever more important to pay attention to the underlying [valuations](#) and market [fundamentals](#). Above we show how the rebalance both lowered the P/E ratios of each WisdomTree Earnings Index and raised the ROE, a key metric of quality. We believe these are attractive attributes of market exposures, made even more important by the continued gains in the market we have seen in recent years. ¹Source: Bloomberg, as of 11/30/14.

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.

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

WisdomTree Earnings Index : Fundamentally-weighted index that measures the performance of earnings-generating companies within the broad U.S. stock market.

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.

Relative price : Refers to the share price of the ETF. A large demand for shares, all other things being equal, would be assumed to increase this price.

Earnings growth estimates : Bloomberg analysts' long-term earnings growth expectations, which encompass the estimated growth in operating earnings per share over the company's next full business cycle, typically three to five years.

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.

Earnings per share : Total earnings divided by the number of shares outstanding. Measured as a percentage change as of the annual Index screening date compared to the prior 12 months. Higher values indicate greater growth orientation.

Fundamental value : The value of a firm that is related to a company's actual operations and production as opposed to changes in share price.

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.

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.

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

Bullish : a position that benefits when asset prices rise.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Fundamental value : The value of a firm that is related to a company's actual operations and production as opposed to changes in share price.