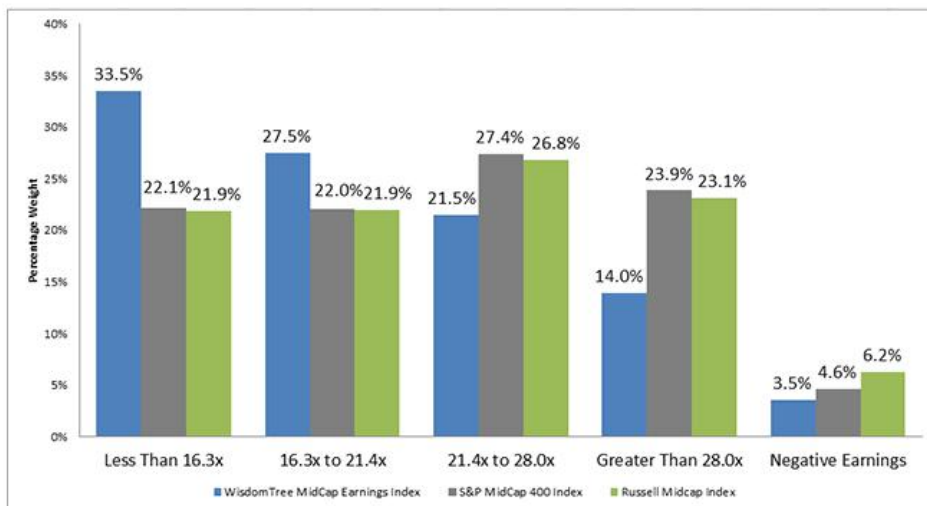


MANAGING MID CAP VALUATION RISK

Tripp Zimmerman — Director, Research
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Earlier we wrote about managing [valuation risks](#) in the domestic [small-cap](#) market by focusing on profitable companies and rebalancing back to [fundamentals](#). We thought it would be useful to expand on how screening and weighting by profitability can also help manage valuation risk in mid-caps. WisdomTree feels that weighting by [market capitalization](#), which does not weight, consider or rebalance back to any [fundamental](#) value, may not be the best approach. Instead, we believe a disciplined strategy of anchoring allocations back to a concept of [relative value](#), based on fundamentals such as [dividends](#) or earnings, can add value over time. **The Fundamental Difference** The WisdomTree Earnings Indexes seek to provide exposure to the core, profitable market but do so while maintaining sensitivity to valuation. To help achieve this, WisdomTree weights companies in the Indexes by the profits they generate, rather than their market cap, and rebalances back to profitability on an annual basis. WisdomTree's Earnings Index rebalance process typically is driven by:

-Earnings Growth: Companies increasing profits see their weight increased -Relative Performance: -Underperformers typically see their weight increased -Outperformers often see their weight decreased This process tends to shift weight to firms with lower [price-to-earnings \(P/E\) ratios](#), as illustrated in the chart below: it compares the distribution of stocks by their P/E ratios in the [WisdomTree MidCap Earnings Index](#) to that of widely followed market cap-weighted indexes. **P/E Ratio and Weight Distribution** The P/E ratio for the [WisdomTree MidCap Earnings Index](#) is approximately 16.4x, about 15% lower than the 19.4x P/E ratio of the [S&P MidCap400 Index](#) and 16% lower than the 19.7x P/E ratio of the [Russell Midcap Index](#).¹ The chart below provides a look at how the weight is distributed, to give a sense for why this lower P/E ratio is seen at the aggregate index.



Sources: WisdomTree, Bloomberg, as of 7/17/14. P/E ranges were selected using quartiles from the S&P MidCap 400 Index. You cannot invest directly in an index.

•More Weight to Lower-

Priced Stocks – The WisdomTree MidCap Earnings Index has over 60% of its weight in the two lowest-priced quartiles, which is over 16% more weight than the S&P MidCap 400 or the Russell Midcap. There is a natural tendency of earnings-weighted approaches to reduce weight to stocks whose prices have appreciated at a faster rate than their earnings, and concurrently to increase weight to stocks that have fallen in price despite exhibiting positive earnings growth.

•**Less Weight to Higher-Priced Stocks** – WisdomTree's 16% over-weight to lower-priced stocks comes from a 16% under-weight to the higher-priced segment of the mid-cap market. WisdomTree also has approximately 40% less weight to stocks that fall in the highest P/E ratio quartile than either of the market cap-weighted indexes.

•**Negative Earnings and Speculative Stocks** – Although profitability may fluctuate throughout the year, at each annual rebalance

WisdomTree requires companies to be profitable before inclusion. This requirement limits the weight to firms we feel tend to be more speculative and lower quality at zero. Neither of the market cap-weighted indexes above shares this requirement. ¹Sources: WisdomTree, Bloomberg, as of 7/17/14.

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.

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You cannot invest directly in an index.

DEFINITIONS

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.

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

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.

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

Relative value : The relationship between a particular attribute, e.g., a dividend, and the firm's share price compared to that of another firm.

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

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.

S&P MidCap 400 Index : provides investors with a benchmark for mid-sized companies. The index covers over 7% of the U.S. equity market, and seeks to remain an accurate measure of mid-sized companies, reflecting the risk and return characteristics of the broader mid-cap universe on an on-going basis.

Russell Midcap Index : The Russell Midcap Index measures the performance of the mid-cap value segment of the U.S. equity universe. It includes those Russell Midcap Index companies with lower price-to-book ratios and lower forecasted growth values.