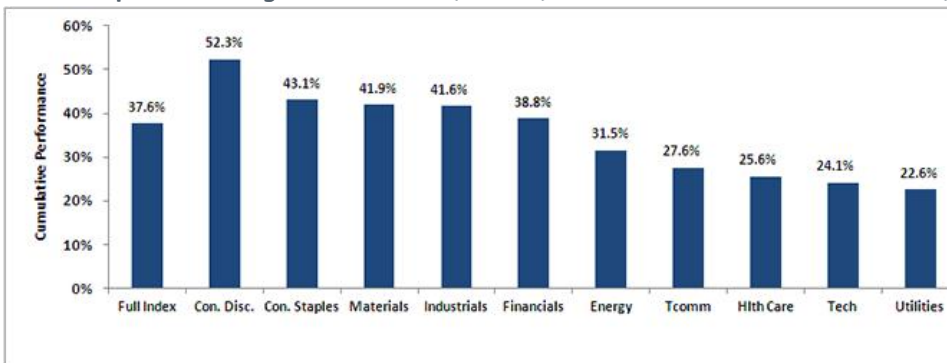


TAKING STOCK OF RELATIVE VALUATIONS WITH SMALL CAP MOVES

Christopher Gannatti – Global Head of Research
08/29/2013

U.S. equity markets have been strong thus far in 2013, and small-cap stocks particularly so. Recently, we have focused on the [WisdomTree SmallCap Earnings Index](#), with particular emphasis on strong performance—a focus that we reiterate here. When market movements reach this level, it's important to ask whether these moves are justified in each case. Are share prices moving more than their underlying [fundamentals](#)? A focus on [valuation](#) becomes increasingly important when equity markets move at such a speed. Below, we will discuss the process the WisdomTree SmallCap Earnings Index employs to manage the valuation risk inherent in gains of nearly 38% over the prior year. **WisdomTree SmallCap Earnings Index (WTSEI) Sector Performance (7/31/2012–7/31/2013)**



Source: Bloomberg. Past performance is not indicative of future results. You cannot invest directly in an index.

What we see (in this case on a sector basis) is that WTSEI delivered a nearly 38% return over the period, with strong returns spread across all 10 sectors, ranging from 22% at the low end for Utilities to over 52% at the high end for Consumer Discretionary stocks. • **Consumer Staples and [Cyclical Sectors](#) Lead:** The two Consumer sectors (Consumer Staples and Consumer Discretionary) lead the way within WTSEI over this period. Much has been made of the potential for the Federal Reserve to alter its policy due to a perceived strengthening of the U.S. economic picture. Other cyclical sectors—Materials, Industrials and Financials—also had returns of nearly 40% or more. **Are Valuations Getting Stretched?** Strong performance is well and good, but a potential issue with [market capitalization-weighted](#) indexes is that they tend to simply hold what has run up in price instead of rebalancing based on any metric of [relative value](#). In essence, there is no mechanism employed with a disciplined regularity that attempts to shift weight from what has performed strongly in the past to what may have potential to perform strongly in the future. **How WTSEI Delivers a Disciplined Rebalancing Process** Every year on November 30, WisdomTree runs a screen upon which a subsequent rebalance of WTSEI is based. The purpose of this screening and rebalancing process is simple: • Looking to trim weight from stock positions whose prices have appreciated significantly but whose fundamentals may not have increased commensurately. • Looking to add weight to stock positions whose prices have stagnated or even fallen but whose fundamentals may have actually exhibited positive growth. It is in this way that WisdomTree looks to mitigate the risk of being exposed to firms that may have enjoyed strong momentum and price increases but whose price levels may be at a relatively higher risk of being classified

as “expensive.” **Continual Focus on the *Earnings Stream***[®] Mechanically, WTSEI’s rebalancing process is based on the *Earnings Stream*, which, simply put, is derived from a firm’s earnings per share multiplied by its number of shares outstanding. This ends up being much different than the process employed by market capitalization-weighted indexes, where the weights are determined by multiplying share price with the number of shares outstanding. In essence:

- WTSEI “rewards” (with greater weights) the firms that have generated the greatest levels of earnings.
- A market capitalization-weighted index “rewards” the firms with the greatest market capitalizations, which in many cases ends up being the firms whose share prices have increased the most.

Perhaps the most interesting element of WTSEI’s rebalance is the fact that each and every year companies must demonstrate profitability to maintain their eligibility for inclusion. Put another way: firms that on the screening date cannot demonstrate a prior four quarters of cumulative positive earnings are excluded from the Index. **Conclusion** After such strong performance in U.S. small-cap stocks, we believe a focus on a disciplined rebalancing process gains significant importance. While market capitalization-weighted indexes may simply continue giving the greatest weights to the firms with the largest market caps, WTSEI focuses on fundamentals, specifically the *Earnings Stream*, to determine its constituent weights. We believe this gives WTSEI the potential to sell stocks that have become more expensive and buy stocks that have become less expensive relative to the earnings they have generated. In essence, this could be one way to manage risk after a market rally.

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 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.

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

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.

Cyclical sectors: Consumer Discretionary, Energy, Industrials, Materials, Financials and Information Technology sectors.

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.

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

Earnings Stream[®]: Earnings per share x the number of shares outstanding. For an index, these totals are added for all constituents.