SMART BETA: DEBATE THE TERM BUT DON'T QUESTION THE TREND

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Many devotees of conventional index investing argue that any deviation from a market capitalization-weighted approach is not passive index investing at all, but rather a form of active management. At the same time, some traditional active managers bristle at the notion of a rules- based strategy—no matter how refined—being classified as anything other than passive. In a way, both factions are correct. For some context on the exchange-traded fund (ETF) industry's evolution, let's first review its origins. The ETF industry began in 1993 with market capitalization-weighted equity funds. The structural benefits of ETFs—transparency of holdings, intraday liquidity and tax efficiency—powered the industry's growth to roughly $1.7 trillion. Over the past two decades, investors have sought out the structural benefits of ETFs in additional asset classes and strategies such as fixed income, commodities, alternative weighting methodologies and strategy ETFs. In fact, I believe thanks to a growing investor preference for solutions in the ETF structure, the renaissance in index innovation has taken place almost exclusively in ETFs. Now let's turn to how this innovation has been labeled and perceived. As I argued in a previous blog post, classifications common in the mutual fund world don't always translate well to ETFs. Strictly speaking, the Securities and Exchange Commission classifies WisdomTree's fundamentally weighted equity ETFs as passive because they track Indexes. But these Indexes were in fact built by WisdomTree. We designed them to be different from market capitalization-weighted indexes, thus they have performed differently than their comparable market capitalization-weighted benchmarks over time. As we and other sponsors innovate in new asset classes and strategies such as dividend growth, low-volatility, currency-hedged equities and commodities, traditional notions of passive and active become less significant as investors use these new beta exposures to create sophisticated portfolios with specific characteristics and investment objectives. Whether driven by a "smart" index or a smart portfolio manager, the ETF is a flexible structure useful for delivering a wide variety of investment strategies. In 2013, U.S.-listed ETFs tracking non-market-cap weighted indexes gathered $65 billion, or nearly one-third of new net inflows.[1] And according to a new study conducted by Cogent Research, a division of Market Strategies International, more than half (53%) of institutional decision makers will increase their use of smart beta ETFs over the next three years—that's more than any other ETF category, including market-cap weighted ETFs (48%).[2] Terminology is debatable; the facts on the ground are not. [1]Source: Dodd Kittsley, "What You Need To Know About 'Strategic Beta,'" BlackRock, 1/15/14. [2]Source: Marketwired, LP, 12/11/13.

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You cannot invest directly in an index.

DEFINITIONS

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.

Passive : Indexes that take a rules-based approach with regular rebalancing schedules that are not changed due to market conditions.

Active : Funds that attempt to outperform the market by selecting securities a portfolio manager believe to be the best.

Active manager : Portfolio managers who run funds that attempt to outperform the market by selecting those securities they believe to be the best.

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

Fundamental weighting : A type of equity index in which components are chosen based on fundamental criteria as opposed to market capitalization. Fundamentally weighted indexes may be based on fundamental metrics such as revenue, dividend rates, earnings or book value.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

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.