

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

Jonathan Steinberg — CEO of WisdomTree

03/17/2014

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.<sup>1</sup> 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%).<sup>2</sup> Terminology is debatable; the facts on the ground are not. <sup>1</sup>Source: Dodd Kittsley, "What You Need To Know About 'Strategic Beta,'" BlackRock, 1/15/14. <sup>2</sup>Source: Marketwired, LP, 12/11/13.

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](http://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**

**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.&nbsp;.

**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.